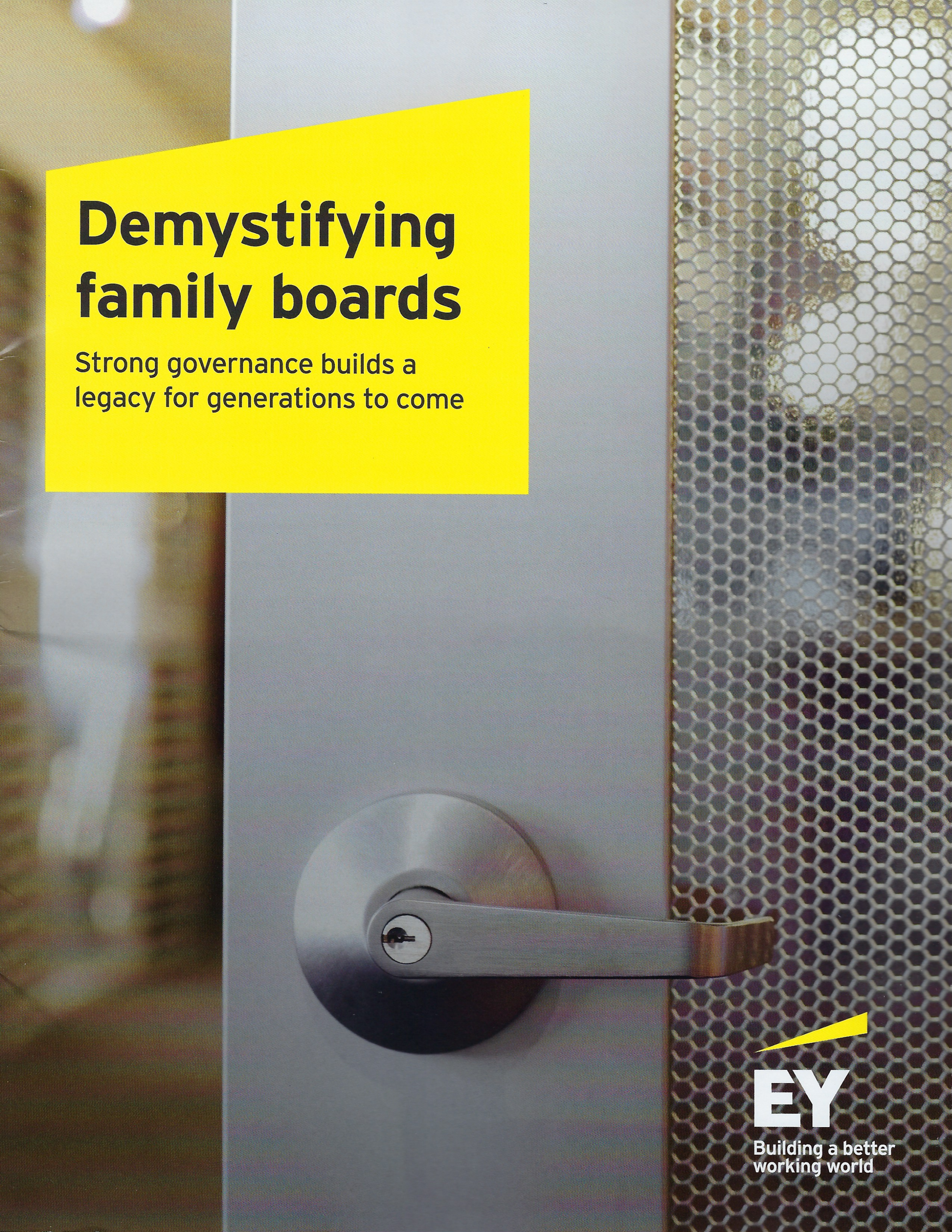
Demystifying family boards

Strong governance builds a legacy for generations to come



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Governing bodies

You started this business 20 years ago, thrived at times, battled through recessions and setbacks, and today it is larger and more successful than you dreamed. You are looking for the next stage of growth, and you would like to get your heirs involved in leadership (after all, you passed most of the ownership to them, but not control). What are your governance options, and how would they work?

Alternatively, you are the next generation. Your parents passed away, you share ownership with your siblings, and you don't always agree on the direction for the business. You don't want to sell the business, but you would like to have more peace and agreement among the owners. What can you do?

Maybe you are a family member or a trusted advisor who has been asked to serve on the board of a family business. What does that mean? What is your role and responsibility as a board member? How can you make sure this business continues to grow and thrive for the next generation?

Many variations of these scenarios are commonly found in family businesses throughout the country. Families need to decide on the right governing body for the size and stage of their business, as well as help their members understand their role to best help the business.

Here are a few of the key questions to consider:

- *How should business and family governance change as the business matures and the family grows?*
- *When is it time to separate business governance from family governance?*
- *What is the purpose of a board of directors?*
- *What are the responsibilities of a board member?*
- *Who should be on the board?*

Case study 1

The second generation (G2) was running the business, and the board was composed of all G2 siblings. Meetings often ended with arguments, raised voices and harsh language. Having a non-family business executive attend meetings helped for a while, but family cohesion was eroding. In order to position them for long-term success, they restructured the family board of directors, adding two outside members, and created a separate family council. The result has been significantly improved family unity, more professional business board meetings, and improved focus and growth of the business.

Governing bodies in a family business

A **family assembly** or family forum is the group of all family members. Sometimes participation requires a minimum age and may exclude in-laws. This group approves major policies and procedures, as well as changes to the family charter, and it elects members to the family council.

A **family council** governs family issues. This group typically has five to nine members who serve staggered terms and act as a link between the family and the business board of directors. They lead the creation of the family charter and oversee any edits, support family succession planning and education, and assist in resolving family conflicts.

A **shareholders council** is the group of owners of the business. It excludes spouses and family members who do not own shares. This council may be charged with proposing board of directors members.

A **family board of directors** blends business and family governance. It usually is the business board of directors, but when the family does not have a separate family council, it handles family topics as well. They are typically found earlier in the business life cycle and generally consist only of family members.

A **business board of directors** is the governing body of the business, separate from the family council. Most often, this body includes non-family members and is focused on defining the business strategy, overseeing its operations and advising the leadership team.

An **advisory board of directors** functions similarly to a regular board, but its members do not have voting rights. They are sometimes used as a transition step from a family board to a business board by adding non-family members in an advisory capacity.

Case study 2

The first generation (G1) believed in a strong, independent board, and the founder was the only family member on the board. After his death, his son took over the company but didn't see the value in the board, so he allowed it to wither. The result was a slow erosion in business growth, profits and vision. This could have been prevented with a stronger focus on succession planning, perhaps by having G2 participate in board meetings to understand how a functioning board works.

Evolution of governance in a family business

Not every business follows the same process, but there is a common pattern. Governance evolves from less formal to more formal, and from a blend of business and family decisions to clearly separating such decisions. Such an evolution often looks something like the graphic below.

If your business is a corporation (C- or S-), you are required to have a board of directors. Sarbanes-Oxley and other laws specify board requirements (e.g., majority of independent directors) for companies listed on US stock exchanges, but there are few requirements for non-listed companies. If your business is an LLC or partnership, using a board is not legally required but can be critical for maintaining and growing the business.

By the time it is obvious to a family that they need to move to the next stage of governance, they probably waited too long. Generally, the reasons for forming a board of directors are the following:

- The founding generation wants to prepare the next generation to be owners.
- There is conflict or disagreements among family owners, and they want outsiders to facilitate agreement.
- Leadership wants strategic thoughts and ideas from other experts.
- The business wants to borrow money, and bankers are more agreeable if there is a formal board of directors.
- Because the board of directors has a formal decision-making process, the risk of family members (owners) bringing litigation is reduced.

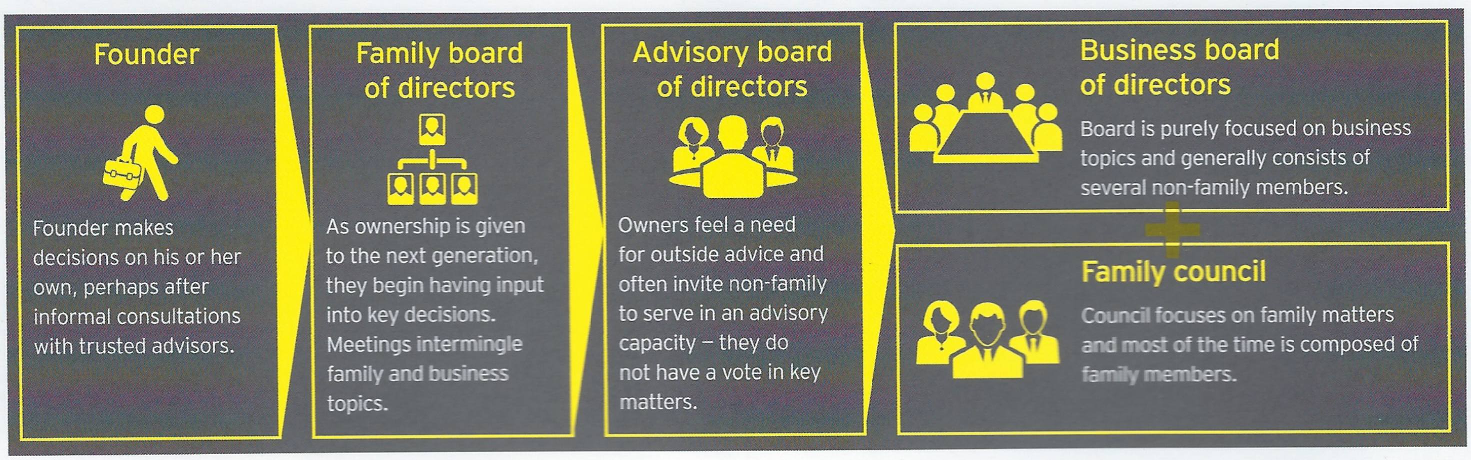
When to transition between governance structures

While the aforementioned points are the most common reasons for forming a board, there often are more specific causes for moving between each of the governance structures.

Founder

Some founders recognize the value of a board immediately, while others take some prodding. Frequently, this happens as the second generation (G2) becomes adults. They have become owners in the business (through estate planning techniques), and the founder wants to prepare them for leading the business. All too often, this transition doesn't happen until the founder passes away and the next generation shares ownership.

Evolution of governance in a family business



Advisory board of directors

Disagreements are frequent among family board members or family executives, and they want an outsider to mediate decisions or help change unhealthy behaviors. In other cases, business growth or industry changes are leading them into new territories, or perhaps growth has stagnated and they want experienced advisors who can help them through the transition.

Business board of directors

The number of family members has grown, particularly those not involved in the business, and family discussions in board meetings become a distraction from business demands. Also, it becomes difficult to attract high-quality outside board candidates when the board also provides family governance.

Family council

With the transition to a business board of directors, the family wants to establish a separate group to govern the family. Many families often initially ask a family member from the business to lead the council, but that person quite often doesn't have the time or interest to lead it. Generally, the point of the family council is to encourage more family members to participate in family governance, providing different perspectives and representing more interests, while allowing the business board to focus on the business, potentially leading to greater growth.

Purpose of a board of directors

As you consider where your family and business reside in the evolution of governance, it is important to consider the purpose of having a board of directors. A board of directors is a strategic body, created to serve the interests of owners, customers and management.

Some key purposes include:

- Assist with strategy and business development
- Serve as the voice of shareholders
- Advise management (or act as a sounding board)
- Suggest ideas for improving the business
- Identify and manage risk
- Review and understand financials
- Plan for succession
- Balance the needs of shareholders, customers, management and employees

While most people understand what a business board of directors is, not everyone grasps the meaning of a family board of directors. Sometimes, a family uses the term "family board" instead of a "family council." For our purposes, we consider a family council to be the family representatives leading or governing family topics. A family board of directors, on the other hand, is primarily the governing body over the business, serving double-duty to also oversee family topics.

Such family boards of directors are common when the business is the primary unifying element of the family and there is little wealth outside the business. Over time, most of these families choose to separate family governance responsibilities into a family council, allowing the board of directors to focus on the business.

The purposes listed above are true for either type of board. However, a family board of directors typically also has responsibilities that may later be handed to the family council, such as creating the family vision and charter, defining family compensation and employment policies, preparing the next generations, and building and maintaining family cohesion and unity.

Case study 3

As the family grew and matured, the older generation wanted to take additional steps to prepare the younger generation for business leadership. They created shadow board positions, allowing select younger family members to observe board meetings. They emphasized that the family members were required to be silent at these meetings. They were there to listen and learn; their questions were handled in mentoring sessions outside the board meetings.

However, one common question remains unanswered: "I started this company and I make the decisions. I don't need any help with that, so why should I form a board of directors?"

It is possible that you may not need a board of directors to run the business today (although one might argue that a board of directors can help you identify and get around your own blind spots), but what do you envision for the business after you retire? If you want it to stay in the family, a board of directors can help groom family members to run or lead the business, and it also can smooth the transition during one of the highest risk points in the life cycle of a business – following the founder's passing. Implementing and leading such governance during your life significantly increases the likelihood of the business staying in the family for generations to come.

Responsibilities of board members

Serving on a board is an honorable role, but it carries great responsibilities. Here are some typical responsibilities:

- Attend and participate in board meetings
- Stay informed about the business's vision, values and key initiatives, as board members should embrace and live the values of the company
- Understand the direction of the company, consider future strategic alternatives and advise on the long-term strategy
- Plan for succession at key roles within the business and the board
- Be available to key executives to coach them and serve as a sounding board
- Be willing to respectfully challenge ideas of management and other board members
- Safeguard the interests of shareholders
- Identify, consider and manage risks to the business and its owners

Who should be on the board?

Identifying board candidates is hard. Criteria for serving on the board of directors are different from those on the family council. While representing shareholders is key, directors also need to bring experience, credibility and teamwork. Here are some of the key criteria for board participation.

Familial relationship

If family members own most or all of the company, then they need representation on the board. EY's survey of the top 25 world's largest family businesses in each of the 21 top global markets found that while 90% of those businesses have a board, nearly 50% are exclusively family members. Families often separate voting shares from common shares, and board participation is often limited to those with voting shares. However, the director may be a representative of several family members or a branch of the family, including in some instances a non-family member serving as the representative on behalf of family owners.

Sometimes family qualifications are specified in family or business governance documents (e.g., business bylaws, family charter or perhaps trust documents), while other times they require the current board to approve candidates (giving the board the opportunity to reject a candidate because of inexperience, potential harm to camaraderie on the board or other reasons), and sometimes there is no guidance, leaving the decision to the family. Key criteria involve blood relation (can spouses serve, and if so, must they have been married for a minimum number of years?), age, work/life experience and prerequisites (e.g., some families require the family member to shadow the existing board for a year prior to being allowed to serve).

If the family member works for the company, is serving on the board still allowed? Some families specify this is permissible only if the person serves in an executive role. They don't want a family member to participate in strategic company discussions that the person's manager is not privy to.

Experience

When looking for board members, families often want someone with experience in at least one of the industries in which they operate. Often, this is someone who is retired from their own business or a competitor, or perhaps someone who served as a consultant in the industry. If they are considering acquiring other businesses (or perhaps selling the business), they might want someone with investment banking or mergers and acquisitions experience.

Industry contacts

Some board members are selected based on their access to potential customers or service providers.

Board dynamics

The board needs to work as a team. Some conflict is healthy, helping the board evaluate options and select the best solutions. However, excessive conflict, or the wrong type, creates an unhealthy board that can hinder the business's goals. Prospective candidates should be evaluated for how they fit with existing members.

Values

Candidates should understand and share the key values of the business and the family.

Personal traits

We see boards with older board members intentionally seek out candidates from a younger generation. Other boards specify upper age limits, forcing retirement. Is the existing board all (or mostly) of the same gender? Perhaps it could benefit from a different perspective.

Time

Serving on a board requires minimum commitments of time for participating in board meetings, reviewing financials and other materials, and attending other meetings and events. The person needs to be willing to dedicate the required amount of time.

Geography

Depending on the business, you may want someone in your same locale. Some families have no issue with flying someone across the country for meetings, while others want someone who better understands their local needs and is available for impromptu meetings.

Non-family members

Not every business requires outside board members, but in most cases, we recommend they should. Non-family members can be the key to reducing conflict. Many families find that when the board is entirely composed of family, there is fighting, name-calling and other unprofessional behavior. Introducing a non-family member often elevates the meetings, making them more productive.

In addition, outsiders can keep the CEO/president from burning out by serving as a sounding board for ideas or becoming a buffer to family critiques. They often bring a new perspective to the board due to their varied backgrounds, perhaps identifying opportunities or challenges that the family doesn't see.

Lastly, non-family members on the board may enhance the image of the business in the view of potential customers, suppliers or banks, making it easier to obtain financing or win contracts.

Finding board candidates

To find the right person, you might consider engaging a search firm. It is important to ensure that the candidates have enough experience to bring value to the board, as well as enough confidence to ask tough questions and offer critiques, even if they are contrary to what a family member has stated. Here are some tips for finding the right candidates for a board:

1. Think long term. Find directors who can help you get the business to where you aspire, rather than where you are today.
2. Formalize the board job description. This should include what type of commitment they need to make, what their role will be and how they should conduct themselves.
3. Communication. Be prepared to communicate with board members. They need to understand what is happening in the business and the family, including what changes are coming up, and they need to know what you expect from them.
4. Diversity. You want board members who each bring something different to the table, whether that is experience, industry contacts, specialty areas or thought process.
5. Team unity. While you want diverse backgrounds, you also want a board that can effectively work together.

Conclusion

Strong governance of the family and the business gives a family the best opportunity to build a positive legacy for generations to come. Families need a long-term perspective. We encourage you to be proactive and strategic in developing your governing body to better position your family and business for continued success across generations.

Case study 4

G1 formed a family board early in the life of the business. As the founder aged, he restructured the board to include two outside directors. At the same time, he formed a family council to handle family communication, education and build unity. These changes positioned the family and the business to better plan for succession and to thrive long after he passes.

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Contact us

Let us help you navigate the paths to continued success. For each family and each family business, we want to help you explore entrepreneurial thinking across generations. For more information about EY's Family Business and Family Office Advisory Services, please contact:

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