
The Family Business Center of Loyola Guidelines for Family Business Boards of Directors

Joseph Astrachan, Ph.D.

Andrew Keyt

Suzanne Lane

Kristi McMillan



FAMILY
BUSINESS
CENTER

Market Model

Setting

- Prevalent in U.K., U.S.
- More reliance on public markets
- High ownership liquidity
- Shareholders are anonymous investors, not managers
- Widely-dispersed shareholders
- Shareholders only have financial connections to the company

Elements of Governance

- High level of disclosure
- Focus on short-term strategy
- Independent board members
- Shareholders view company as one of many assets held
- Ownership and management are separate and at arm's length

Control Model

Setting

- Prevalent in Continental Europe, Asia, Latin America
- More reliance on private capital
- Illiquid ownership
- Concentrated shareholder base often overshadows minority shareholders
- Shareholders view company as more than an asset and as interested in financial and non-financial returns.

Elements of Governance

- Secretive
- Focus on long-term strategy
- Shareholders with control rights in excess of cash flow rights
- Shareholders have connections to the company other than financial (i.e., managers, board members, family)
- Insider board members
- Ownership and management overlap significantly

The recent meltdown of companies such as Enron, WorldCom, and Global Crossing generated worldwide media attention on the need to improve corporate governance. Sarbanes-Oxley and proposals from around the globe are trying to address board practices that have allowed massive corporate failure. While perhaps valuable for large public companies, many of these recommendations may be harmful to family-owned businesses.

Many “best practices” may well be at odds with the fundamental nature of most family companies and could harm family unity.

Popular corporate governance practices come from a *market model* of corporate governance, which is relevant for companies with a widely dispersed shareholder base. On the other hand, typical family businesses exhibit characteristics of a *control model* of corporate governance, which involves companies with concentrated shareholders.

Many of the current “best-practices” are generalized laundry lists, rather than specific actions that lead to identifiable results. And although some issues discussed in family and non-family business literature, such as the significance of independent boards, are important, fixating on such issues overshadows the issue at the heart of corporate governance problems today: accountability. Corporate governance guidelines for family firms must focus on the need for boards to have the competencies to be held accountable and to hold others accountable for their actions. Family business boards need to be *competency-based boards*.

Below we describe *The Family Business Center of Loyola's Guidelines for Family Business Boards of Directors** that will lead to greater board accountability and, in turn, positive identifiable results in board and company performance.

1. Family-Owned Boards Must Have the Competencies, Processes and Structure in Place To Be Held Accountable

Criteria for Director Selection

While business competencies and diversity of skills and background are important, they are not sufficient. The most critical qualification is having the ability to hold the company accountable and the discipline to not interfere in company operations. The board of the typical family firm should have competencies, such as communication, open dissent, understanding of business, and collaboration with management, to ensure strategic guidance of the company, effectively monitor management, and be held accountable to the company and its shareholders.

Many best practices underemphasize the issue at the heart of today's corporate governance crisis: accountability.

Size

Although smaller boards may be more manageable, a larger board can lead to greater accountability as long as individual board members have the necessary competencies to render good judgment, allow their judgments to be evaluated, and, in turn, be held accountable. In addition, an important ingredient that enables the success of larger boards is having a high level of tolerated, open dissent. The most effective board for the typical family firm consists of seven to twelve people, depending on the gaps in competency levels that are revealed at the board's collective or individual level.

Independent Outsiders

Many recommendations insist upon minimizing the use of insiders and including a significant proportion of independent outsiders. However, outsiders can be easily swayed by compensation, perks, recognition, and business dealings; additionally, outside independent board configurations have not been associated with firm performance. In order to promote objectivity and accountability, a director's ability to fulfill the task of accountability as well as render an opinion unfettered by extraneous influences or considerations, such as differential personal, financial or other gain, is more important than whether or not the individual works inside the business or portrays an appearance of independence.

*This is a summary version of a longer paper. To obtain a copy of the complete article, please contact the Family Business Center of Loyola University Chicago at FBC@luc.edu or 312.915.6490.

Frequency of Board Meetings

The reason to hold board meetings is to provide a forum to conduct regular and purposeful communication and to resolve conflict. In order for this to occur, the board of a typical family business should meet anywhere between three to six times per year. This amount allows for accountability and helps keep communication open between board and management, and between board and shareholders. When extraordinary events occur within the business and more accountability is needed, more frequent meetings may be needed.

Content and Process of Board Meetings

The content of board meetings should include all key matters brought forth by senior executives and a review of past activities so that accountability can be practiced; additionally, the process boards use to make decisions is best achieved by simple majority vote. While many recommendations for family firms suggest that board members should make consensus decisions, such decision making enables the most powerful board member to sway others by stature rather than a decision's merits. While some may find voting initially difficult, as long as all directors stand behind decisions, it allows for quicker and less contested decision making.

Board Member Selection

Most corporate governance experts hold that a nominating committee should be formed to manage the board selection process. The nominating committee also has the important role of building unity among the board, often by eliciting opinions from all board members, sharing ideas on board needs and criteria, and building agreement on proposed nominees based on all

the directors' input. The nominating committee should be formed with board and non-board members to insure greater accountability and to aid in building shareholder unity; this committee's role, in turn, is to be accountable for running the board selection process.

Board Commitment

Many experts believe that a board's role is reactive, indicating that a moderate level of commitment is adequate. However, boards of family businesses should be actively participating in their respective businesses. Accountability requires more than nominal participation. One caution is that an overactive board may undermine the authority of management. To achieve commitment and effective service, it may be wise to limit active participation to no more than three boards.

Board Term and Turnover

Companies that have term limits typically have them for internal political reasons; it is loosely, at best, related to ensuring accountability. A tenure system that promotes accountability is a minimum term limit of approximately three years and an extensive review process after that three-year period. Along with this tenure system, there must be a process for evaluating the progress of the director, as well as clear criteria for "keep/let go" decision making.

Board Evaluation Process

Although evaluating aggregate board performance is necessary, it is not sufficient. To promote accountability, board members must be evaluated individually. A high performance board must be able to distinguish good contributions from poor and, above all, ensure

that all directors act to hold themselves and the company accountable.

Leadership: Role of Chairman and CEO

The issue of whether or not the Chairman and CEO roles should be combined is controversial. The roles of Chairman and CEO should only be combined when a single person can do the two jobs effectively. Although the role of the Chairman may be to counsel the CEO, it is not to direct the CEO. Therefore, combining the role of the CEO with the additional responsibilities of Chairman presents a limited number of conflict of interest issues. Additionally, the board should annually evaluate the CEO using the opinions of individual directors and managers. This should be discussed privately with the CEO.

As long as the successor is able to initiate change and assert his/her leadership, and sufficient knowledge transfer occurred from old leadership to new, then a former CEO can remain on the board as Chairman, taking care not to undermine the authority of the new leader. It is advisable for separate committees to monitor the situation and act to remedy any problems if the former CEO undermines the new one.

Board Compensation

Many corporate governance experts advocate compensating board members according to market norms. However, family businesses often provide owning family members nonfinancial returns. Instead of the market rate, directors should be paid for their time commensurate to that of the CEO. A simple heuristic is to divide the CEO's annual pay by 250 working days and then pay each board member the resulting amount per day for each day spent on board

matters. This communicates that the board is as important as the CEO.

2. Boards Must Be Accountable to Shareholders

Shareholder Influence on Board Composition

Control model companies, particularly family firms, must ensure adequate board composition, but not to the detriment of minority shareholders.

One important way to influence board composition while not alienating minority shareholders is through cumulative voting. Cumulative voting, which allows shareholders to accumulate their vote for a single candidate, is an important mechanism to ensure accountability; however, it is generally invoked after a family breakdown or poor corporate performance. To guard against this, an effective nominating committee that works in concert with the board review process helps insure the protection and promotion of all interests.

Another way to influence board composition is via shareholder agreements. Shareholder agreements can highlight issues such as how the board or the Chairman will be selected, succession planning issues, estate planning issues, and dispute resolution mechanisms.

Communication Between Shareholders and the Board

Particularly in family businesses, communication between the board and family shareholders is crucial. The board must understand the needs, vision, and goals of the family shareholders whom it represents, and shareholders need reassurance that the board is attending to those needs. The

board should communicate basic strategic plans, values, and industry and supplier information to shareholders, as well as conduct surveys, questionnaires, and meetings with shareholders. As for shareholders, regular letters to the board, family meetings, family councils, and other meetings with the board are all mechanisms that enhance communication and promote accountability.

Shareholders Involvement in Strategic Decision-Making

Unlike many market model companies whose shareholders leave decision-making to the board and management, appropriate involvement by shareholders of family firms should entail establishing the values, vision, and goals of the business, as well as being a “partner” in strategy. This means helping management and the board understand owner goals as a basis for developing business strategy, and embracing and supporting the strategy that is proposed by management and endorsed by the board. This form of involvement in strategic decision making allows shareholders, the board, and management to become united in their support of the company.

3. Family-Owned Boards Must Hold Management Accountable For Their Actions

Monitoring Strategic Execution

Boards should effectively monitor management by critiquing and, when satisfied, approving the strategic plans of management. Management

should continually be held accountable for fully executing board-approved plans. The board must periodically “check in” with executives in the short-term to ensure that plans are executed and results are benchmarked against long-term indicators, such as marketshare, profit margins, and Economic Value Added. By continuing this monitoring function, board members can help identify obstacles and figure ways to overcome them when performance falls short. Management should be rewarded when plans are achieved or exceeded and penalized when they are not met.

Executive Compensation

Even though privately-held family businesses are not obligated to announce executive remuneration, family businesses must create an atmosphere of trust and transparency among family members. Information concerning compensation should be easily available to family member shareholders and reviewed annually by the board in order to preserve an atmosphere of accountability.

Boards should tie compensation to the organization’s mission, annual business performance, long-term financial results, and performance of nonfinancial measures. Family businesses are well-advised to develop their own compensation philosophy and, in turn, a written compensation policy to help assure that the family’s value system and vision are consistent with the way the business operates.

Conclusion

The path to achieving effective corporate governance in family firms is through enhanced accountability. A competency-based board is best suited to achieve accountability in the typical family business, where the shareholders are concentrated in the family and often active in the business (Quadrant 1 of Figure 1 below). However, as family businesses move away from the typical control model, as shareholder activism diminishes and the number of shareholders increases, family businesses migrate toward a market model (Quadrant 4), and ways to assure accountability may shift.

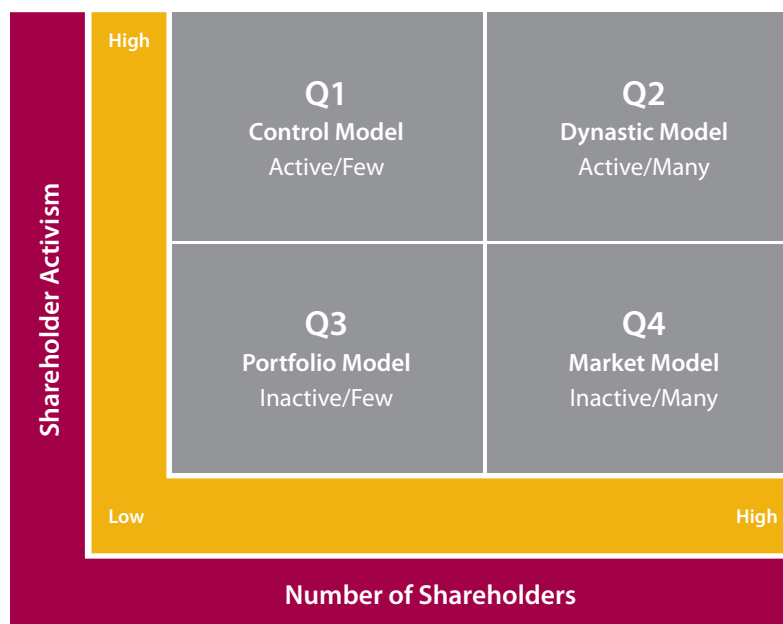
Additionally, when members of the family firm become less active in business management (a shift from Quadrant 1 to 3), but family shareholders retain their ownership stakes, family shareholders become passive investors and view the family business as another investment in their portfolio. Once these “portfolio model”

shareholders become disinterested, they may sell shares and may be prone to litigation to do so.

Another scenario occurs when family members remain active in management or the board, but as the business moves through generations, the family expands and becomes less unified. This type of “dynastic model” of governance (Quadrant 2) is unstable and the lack of unity can create a desire for the sale of shares.

One can see from this brief exploration that there is no one single model for corporate governance that can account for the many differing configurations of family, shareholders, and business conditions. The guidelines outlined here are those best suited to the typical family company. With careful analysis and consideration of family, ownership, and business characteristics, these guidelines can be tailored to meet most family business situations.

Fig. 1: The Four Quadrants of Family Firm Governance





LOYOLA
UNIVERSITY CHICAGO
FAMILY
BUSINESS
CENTER



820 North Michigan Avenue, Chicago, IL 60611 • 312.915.6490 • LUC.edu/fbc