Family Business Boards: The Arbiter of Fairness

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Family businesses have an undeserved reputation for being emotional hotspots of instability where owners' demands threaten to overwhelm the business. Headlines revealing destructive fights among prominent business families often fuel a cynicism that families are, at best, a transient vehicle for ownership, lasting only until decaying relationships lead to an inevitable cataclysm.

In our experience, however, family-led or -controlled businesses can be counted among the most successful, enduring enterprises because of the nimbleness of their relatively small ownership group, their conservative financial policies and the resilience of the family in times of hardship. Their patient, committed owners can be a huge asset in comparison to public companies saddled with short-term demands from largely anonymous shareholders.

Of course, not all family businesses are Cinderella stories – and the dividing line between the princes and paupers is not a matter of fate. Families who succeed build the structures needed for survival, particularly during times of conflict, which are inevitable. The key difference between a family business that thrives and one that implodes is the presence of a comprehensive governance system – with the board of directors in the center operating as the "arbiter of fairness."

A comprehensive governance system creates clear separation between the roles and responsibilities of the owners, board, management and family members. While that may sound straightforward, it can be tricky to get right. There is no one-size-fits-all approach to governance.

When working with family members who own a business together, we have found it helpful to use an analogy of a "four-room model" as a framework to clarify the often-muddled roles of family participation in the family business.[1] The model creates separate forums for the different types of conversations and decisions belonging to each of the four rooms: the owner room, the board room, the management room and the family room.

Each room requires its own governance. For the owner room, it may be a regular owner council or shareholder meeting where owners' business expectations are developed. For the board room, it is the board's deliberations on business issues. There must be clear boundaries between the appropriate dialogue and decision-making processes from one room to the next. Especially in family businesses where one person may play multiple roles, it is important to know what perspective he or she is coming from during different conversations.

Many mature family business boards consist of a mixture of family and independent directors. The independent directors modulate the family dynamics and referee decisions regarding the business. Unlike family directors, who may move between rooms, independent directors operate in just one: the board room. Bringing sound judgment and impartiality to bear, they monitor the business's performance. They are the arbiters of fairness. Additionally, strong independent directors can, and should, redirect conversations that are out of bounds for the board room to the appropriate room.

How Boards Operate as the Arbiter of Fairness

A well-structured board of directors can serve as a "shock absorber" between divergent interests in ownership and management, acting as an honest broker between competing visions. It can provide a disciplined forum for healthy debate and sound decision-making. All potential points of conflict in the family business system – between majority and minority owners, executive managers and "outside" stakeholders, and the senior and rising generations – benefit from the understanding that the board is acting to achieve the stated objectives of the owners as a whole, rather than implementing any single agenda.

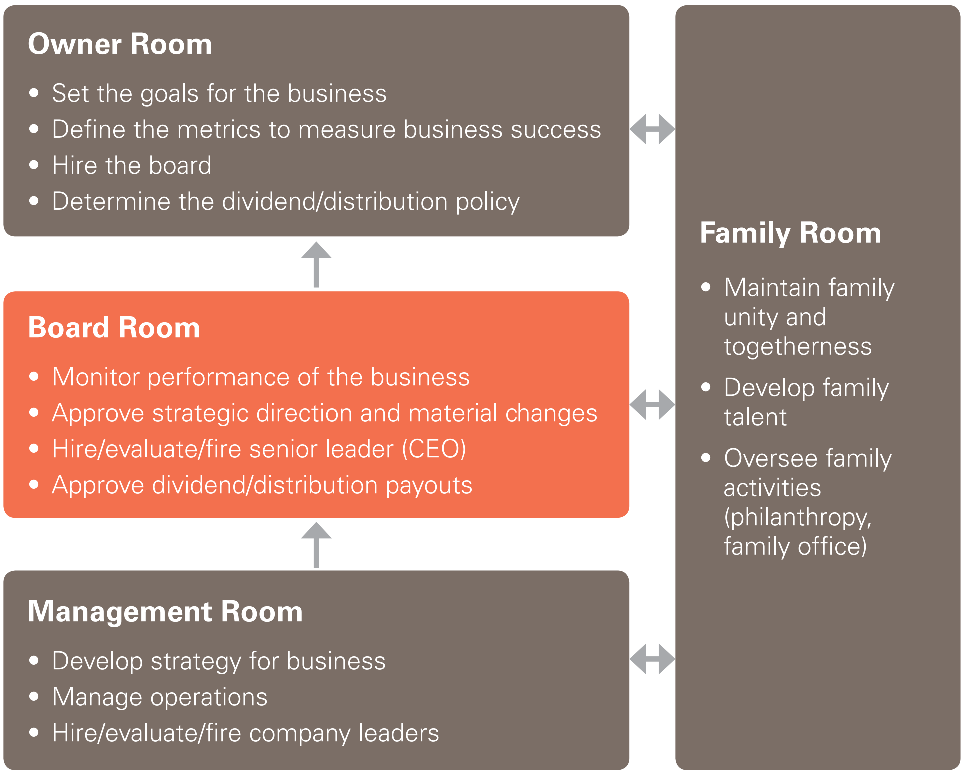
The board is, as a matter of law and commitment, charged with balancing all of those interests and the ultimate success of the business. If properly run, the board can be the arbiter of fairness in business decisions, giving all the divergent interests some assurance they were considered and their views respected, even when their agenda was not adopted.

To do so, the board needs to exercise its authority with prudence and to fulfill the twin duties of loyalty and care on behalf of the owners *as a whole*. Because it is privately owned and doesn't have to report quarterly results, the ownership group in a family-owned business can be stable and patient. At the same time, these family ties can bind uncomfortably, importing into business decisions family and owner dynamics and irritants that belong in the family room or owner room – not the board room.

The independent board should be thoughtful and intentional in decision-making for the business. It should ask tough questions and insist on healthy debate. It needs to go beyond reaching decisions solely on executive recommendations or owner demands – the "rubber stamp board" trap – and ensure that they are made the right way, through dialogue, analysis and in accordance with established policies. One of the greatest gifts an effective board can give owners is the benefit of its doubt. If a topic requires more analysis, the board must make sure it gets done *before* making a decision. It should also document the various aspects of the debate and investigation so that its logic can be disseminated and clearly understood.

Boards that set up these processes early on and adhere to them will continue to gain owners' trust. They will avoid uncomfortable questions and comments, such as, "Why did the business need to buy a box at the Super Bowl for the executive team to bring guests?" Or, "My cousin is paid how much?!" Or, "No dividends again while we build this Taj Mahal of an office building!"

THE FOUR-ROOM MODEL



How to Establish a Board to Be an Arbiter of Fairness

We recommend the following six commandments for owners to abide by when establishing an independent board in their family enterprise:

- **Position the board as an essential piece in the family owners' comprehensive governance system.** Clarify the board's role, decision-making rights and communication responsibilities in the overall system vis-à-vis the four-room model.

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- **Provide a mandate to the board.** Owners must set the agenda. The independent board cannot effectively serve owners' interests if owners do not make their objectives, risk tolerance and vision clear. Absent this clarity, the board becomes one more place where the family owners' proxy battles play out.

- **Commit to a "no crony" zone.** The director perceived as "in someone's pocket" is a director who will never be able to bear the weight of the arbiter of fairness role. Misperceptions are hard to dislodge, so directors and owners must start with positive ones. One of the owners' biggest duties is to compose the board, and when doing so, they must ensure the candidate identification and selection process is robust.

- **Respect directors' time and value.** Experienced, independent directors bring incredible value to the family enterprise, both as subject matter experts and as shock absorbers between the business, family and owners. Owners should ensure that their directors spend enough time getting to know key executives, delving into substantive issues, debating pros and cons and guiding the business with the owners' best interests in mind. Spending time with executives other than the CEO can lead to deep insights and surprisingly nuanced views of tough issues. Directors shouldn't intrude into the management room, but they should be comfortable there. Owners must also empower directors – for example, encourage them to take the time to really get to know the business or allow space for healthy debates – and compensate them for the value they bring.

- **Staff committees with care.** Committee assignments are critical aspects of board service. They are the key to imposing discipline on private businesses that may not be accustomed to oversight. The finance committee should be able to quiz the external auditors, the compensation committee needs to establish policies based on benchmark data, and a governance committee can be vital for ongoing board improvement. In addition, owners need to hire and allocate board resources to match business challenges.

- **Process is key.** Structured and disciplined board debate and documentation builds the assurance for the family ownership group that decisions are thoughtful and balanced. The rigor the board applies to performing its job well will be reflected in the responsiveness and thoroughness of the work done by management and the trust of the owners.

The Board Is Not a Silver Bullet

It's not enough to set up an effective board and assume it will run well indefinitely. Owners must continually check the temperature of the board and evaluate it at least annually to see if it is fulfilling its mandate and communicating well with the shareholders and executive team. Risk is inherent in business. A good board does not ensure any decision will succeed, just that the risk was analyzed and the bet made with prudence. A great board does this and continually evolves and communicates with all major constituencies.

Performance challenges happen. Manifesting sound judgment and making sure that all owners are informed of what is going on is critical for success. A board will only succeed as the arbiter of fairness if there is active dialogue between it and the business family owners it represents.

Brown Brothers Harriman and BanyanGlobal family business advisors are dedicated to working closely with family enterprise owners to ensure their legacy is renewed across generations. BanyanGlobal has a multidisciplinary team of advisors that works with leading family enterprises around the world to establish the structures and strategies they need to successfully transition from one generation to the next.

[1] The four-room analogy was developed by our colleagues at BanyanGlobal. For more information on the "four-room model," please refer to "Making Better Decisions in Your Family Business" in the *Harvard Business Review*. To view the article on the web, visit *Harvard Business Review*: https://hbr.org/2015/09/making-better-decisions-in-your-family-business.

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