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Using Independent Outside Directors to Supplement/Complement Family Directors in Family Owned Business Enterprises

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For decades, studies have shown that family-controlled businesses have consistently outperformed management-controlled firms and, on a worldwide basis, that outperformance has run between 6.65% and 16% annually in terms of return on equity. A study of board of director composition in family-controlled businesses in the S&P 500 found that where "independent" directors balanced the influence of founding families on the board, companies performed better and created greater shareholder value[1]. These same studies also indicated that businesses, in which founding family ownership remained dominant (with relatively few independent directors serving on the board), performed significantly worse than non-family involved businesses. This research supports findings that effective governance occurs when there is, in existence, an active, caring oversight by shareholders and significant influence by "independent" directors. A distinction should be made between the "ownership" of a family business and the "management/operation" of a family business; in circumstances in which the owners do not possess the skills, insight or initiative to manage or operate a family business, the business may be better served if non-family members manage/operate the business with only oversight by the owners.

Board of Director Functions and Responsibilities

Although the day-to-day management of any business generally is conducted by the officers and executive management team hired by the board of directors of the business, the primary responsibilities of a board of directors of a family-controlled business include the following:

(1) Monitoring and reviewing the financial condition of the business;

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[1] The studies are cited in a Family Governance White Paper entitled "Family Governance: How Leading Families Manage the Challenges of Wealth" produced by Ernesto J. Poza and others on behalf of Credit Suisse.

(2) Developing and implementing strategic planning initiatives;

(3) Ensuring the ethical management of the business and, with the assistance of the outside accountants/auditors, the application of adequate internal controls;

(4) Reviewing the performance of, and the holding of the CEO, President, and upper management, accountable for attaining established objective performance criteria, and projected shareholder returns;

(5) Promoting and preserving the ownership family's focus and long-term commitment to the business; and

(6) Mitigating, and possibly mediating, conflicts and potential conflicts among shareholders and family branches of the business to maintain family harmony for the benefit of the business, its shareholders and employees, many of whom may be family members.

<u>Practical Applications</u>

In appropriate circumstances, family-owned businesses can be enhanced by including "independent" outside directors to complement family directors. Our firm has recommended independent outside directors in many situations including, for example, the following situations:

(1) For a family business, owned 100% by a CEO, who desired to create a board consisting of three independent outside directors (including the CEO's attorney, financial advisor, and CPA) to serve as directors with the Company's CFO and COO in the event of the CEO's death or disability with the objective of: (a) stabilizing the Company's business on the loss of its CEO/founder; (b) monitoring the Company's financial status while the board interviewed and selected the Company's replacement CEO; (c) reviewing the adequacy of existing upper management; and (d) determining and evaluating alternative exit strategies for the business.

(2) For a family-owned business seeking to diversify its business activities into new business lines, independent directors with knowledge and experience in these new business areas were retained to add wisdom and insight to the business.

(3) When a CEO of a second generation family business desired to test drive a board of directors which included trusted long-term family advisors to serve as independent outside directors along with the CEO's two third-generation sons for the purpose of monitoring the collaboration and performance of the two sons in operating the family's business as the CEO contemplated stepping away from the day-to-day management of the business.

(4) Where four sons of a retiring business owner were not sufficiently aligned in their vision for the business, a fifth son who was a successful

attorney practicing business law was brought in as a fifth director to keep his brothers focused and on track.

(5) To establish a holding company for a CEO's surviving spouse to serve as a successor CEO to operate and maintain multiple lines of business and investment real estate managed in part by members of different family branches in order to produce shareholder value for the ultimate inheritance by children and grandchildren of each family branch, many of whom worked in the family businesses.

(6) Assisting the CEO and majority owner of a professional sports franchise to develop an exit strategy during life, or upon death, to maximize value for his family and to fund significant charitable objectives.

Implementation

Utilization of "independent" outside directors can take place: (a) during the life of the patriarch or matriarch of the family-owned business where the board is established as an advisory board, or an active board with voting members, so that the family can evaluate how the board can best serve the needs of the family business and ascertain the best processes and procedures as guidelines for the board to follow to accomplish the family's business objectives, or (b) in the event of the family patriarch's or matriarch's unexpected death or disability, as a mechanism to sustain the business while the board evaluates the alternatives available to the family to retain or transfer the family business. The "independent" outside directors must be adequately compensated to remain engaged, participate in regularly scheduled meetings, and be provided directors' and officers' insurance so that they can challenge the board openly and honestly without reservation or concern for frivolous suits brought by malcontent family members.

Lifetime Documents

If the board is implemented during life, the owners of the family business can establish the board of directors and retain the right to remove and replace board members. In the event of the owners' disability or incapacity, the owners should execute special business powers of attorney that, upon the disability or incapacity of the owners, name the members of the board of directors to serve as agents of the owners and set forth processes and procedures for board governance.

Death of Owner(s) of Family Business

Upon the death of the controlling owner of a family business, the family business can be placed into a Segregated Business Trust created under the business owner's Will (or pursuant to a Revocable Lifetime Trust that becomes irrevocable on death) so that the businesses of the family owner can be operated by a permanent board of directors either serving as Trustees of the Segregated Business Trust or as directors appointed by the Trustees of the Segregated Business Trust. Non-business assets of the deceased family business owner can be left directly to family members or placed in other Family Trusts for the owner's legatees/beneficiaries with Trustees who may include family members, advisors, and other individuals or institutional Trustees. In the case of the sale of the family business or businesses, the sales proceeds can be distributed into the Family Trusts to be managed by family Trustees or institutional Trustees and the Segregated Business Trusts can be terminated.

Conclusion

Although there are a myriad of strategies that can be employed to sustain and perpetuate family businesses, families who own and operate family businesses should give careful consideration to a Business Succession Plan (whether implemented upon death, disability, or voluntary retirement) and consider whether independent outside directors should be utilized to assume or enhance the chances of sustaining and maximizing the value of the family business for the benefit of shareholders and employees and to implement a successful exit strategy for the family business when the time is right. Creating and implementing a Business Succession Plan and the utilization of a board of directors (with or without "independent" outside directors) should be done with the collaboration of all of the family's trusted advisors including the family's tax advisors, lawyers, CPAs and financial advisors.

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