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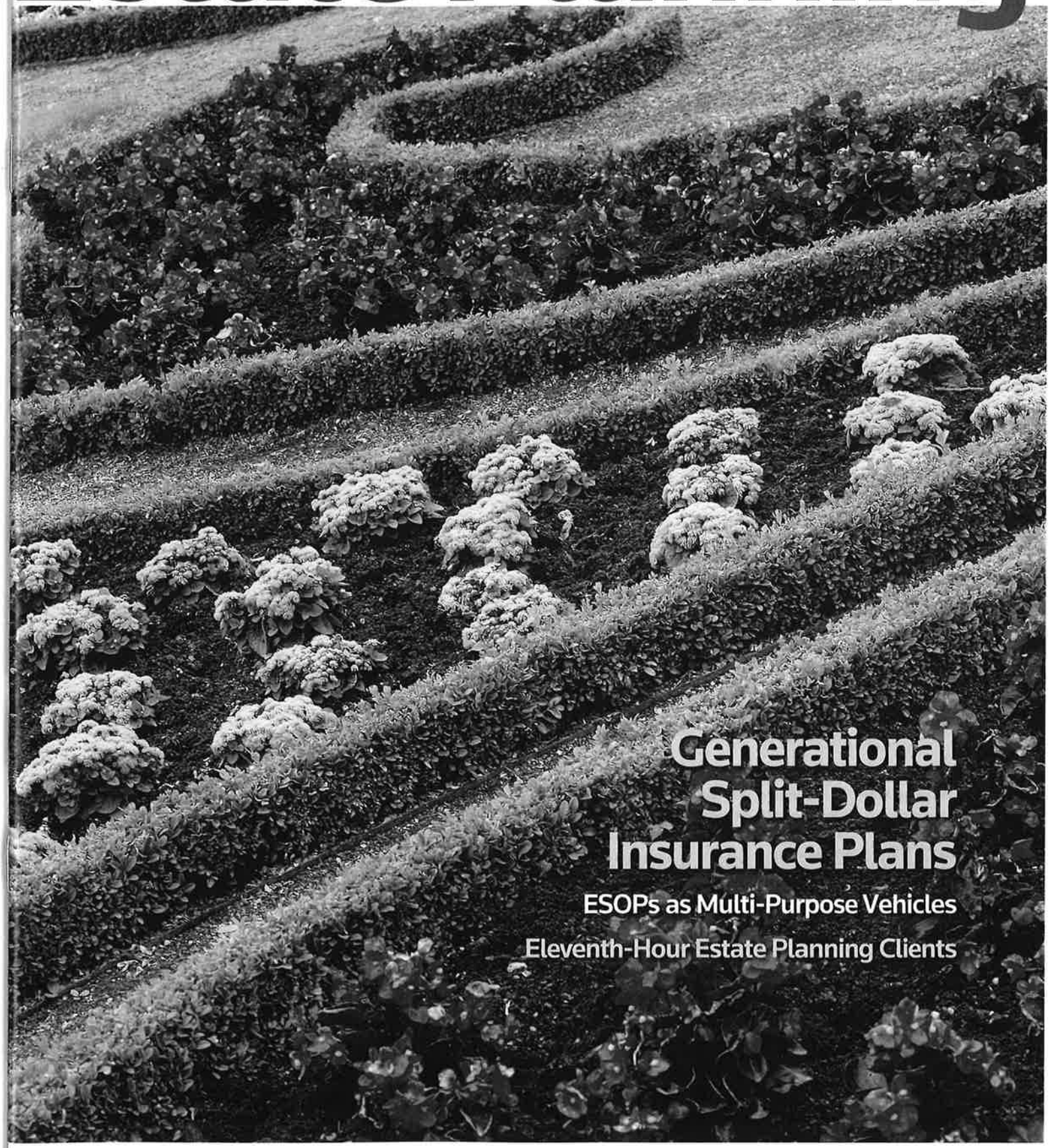

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# Game Plan for Using Outside Directors in Family Business

When a family-owned business client would benefit from outside directors, identify the steps and timeline for a successful arrangement.

BRUCE WERNER

Private and family-owned businesses are interesting clients. As these businesses evolve, their needs change in a well-known pattern. In their early years, they focus on survival; then comes an emphasis on growth, and as they mature, the worry about continuity sets in. The first generation owners are likely strong-willed entrepreneurs; the second generation is more diverse in their skills and motivation. They each have a unique personality.

Non-public businesses tend to be challenged by a lack of capital or a lack of talent. If they are able to overcome these issues, they grow and prosper. For the most part, if the bank is happy and the business pays its taxes, the owners can do as they please. This independence usually provides great satisfaction to the owners and is often a driving motivation for why they work as hard as they do. They tend to eschew consultants and outsiders if they can avoid them. Who else knows their business as well as they do?

But as the business grows and gets more complex, the owners may start to sense their own limitations. They may seek perspective or want to hear how others have dealt with their pressing issues. When this happens, leaders tend to look outside for help. After all, who can the owner or CEO talk to safely regarding existential issues? His or her job is to anticipate the future and plan for it.

The primary benefits for a private company in engaging outside directors is to deal with the existential issues the owners are not able to successfully resolve themselves. After all, even the best entrepreneurs have limitations. In this regard, outside directors can provide the following key benefits:

1. *Perspective*—provide a different point of view.
2. *Experience*—share domain expertise.
3. *Relationships*—introduce important counterparties.
4. *Compensation*—assist with compensation plans.
5. *Succession planning*—assure executive continuity.
6. *Oversight*—protect minority investors and stakeholders.
7. *Conflict resolution*—private intervention.

Experience suggests that owners start to seek help when they deal with decisions where they may hold conflicting thoughts. This is likely because they bear up to three sets of responsibilities: as owners, board members, and management. These are different roles, with distinct

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duties and priorities. In private and family businesses, the same people frequently hold these same three roles. If each role requires an individual to wear a hat, how does one know which hat to wear when? What should someone do when the answers conflict? A quick summary of board roles and responsibilities is shown in Exhibit 1.

To get a better understanding of how roles may conflict for individuals, consider using a Venn diagram to visually demonstrate the conflicts. To do this, draw three circles on a piece of paper, such that all three circles overlap in one area, while each pair of circles also overlaps. Next, label one circle each for Owner, Board, and Management. Then write the names of individuals in each circle according to their position. This should identify how many hats each person is wearing. This is the first step to identify who should be making decisions for different issues.

The more conflict there is, the more likely the client should consider outside directors. If an advisor believes he or she should recommend that a client bring in outside directors, how should the process proceed?

**EXHIBIT 1**
**Board Roles and Responsibilities**

| Group | Frequency | Key Issues and Mandate |
|---|---|---|
| *Ownership* | *Annual* | What business are we in?<br>Who represents my interests?<br>How is the business funded?<br>What results do I expect? |
| *Board* | *Quarterly* | Elected by the owners<br>Hire & fire management<br>Approves budgets<br>Major strategy decisions<br>Oversight & accountability |
| Management | Daily | Report to the board<br>Runs the business |

### Where to start

Even if the need for outside directors is compelling, inertia is a powerful force. Just because there is a clear and substantial need does not mean it will be met. The best way to overcome inertia is with education.

*Understand the marketplace.* As with many products and services, there is a market for individuals who serve as professional directors. In addition to the directors, there are consultants, search firms, and trade associations that support directors. This is a highly fragmented marketplace, with diverse offerings and price points.

Each of these market participants positions itself for commercial success, has a target client profile, promotes its competitive advantage, and has a pricing model. Exhibit 2 presents some guidelines deduced from observation. Understanding the marketplace puts an individual in a position to ask critical questions. These questions need to be asked of, and answered by the controlling ownership parties. Venture capital or private equity portfolio companies are in a different marketplace than what is described here.

### Define the board's mandate

For clients considering their initial board, it may be best to start by writing a board charter. A board charter is different from an entity's by-laws or operating agreement. The charter explains the reason the board exists, what it is expected to accomplish, and how it should function. A typical charter would cover these topics:

- Purpose and scope.
- Structure (e.g., number of seats, term of office, committees, and nominating processes).
- Meeting schedules and time commitments.
- Director qualifications.
- Director duties and responsibilities.
- Compensation, expenses, indemnifications, and insurance.
- Board and director performance evaluations.

Public company boards are driven by regulatory and exchange requirements. Private companies may craft their board charters more specifically to their needs. Boards of family-owned companies are often driven by the soft issues that test a family's interpersonal relationships. Succession planning, compensation, and individual performance are usually high priorities for discussion. Financial acumen and accountability tend to follow in priority.

Whether the board is advisory or fiduciary, the directors should recognize that they likely still bear liability. Owners should be aware of risks they are asking an outsider to accept. Family-owned business-

**EXHIBIT 2**
**Board Industry Market View: Typical Scenarios**

| Company Revenue | Fiduciary or Advisory | Style | Recruiting Method | Talent Sourcing | Compensation | Committee Work | Time Commitment* |
|---|---|---|---|---|---|---|---|
| < $20M | Advisory | Informal | Networking | Friends, family | Gratis or day-rate | No | A few days per year |
| $20M – $50M | Advisory | Semi-formal | Mix | Friends, consultants | Gratis or day-rate | Unlikely | 4 – 6 days per year |
| $50M – $150M | Both | Mix | Mix | Consultants, recruiters | Annual rate with expenses $20,000 – $50,000 per year | Mix | 4 – 10 days per year |
| $150M – $500M | Fiduciary | Formal | Traditional | Consultants, recruiters | Annual rate with expenses $25,000 – $75,000 per year | Yes | 8 – 16 days per year |
| | | | | | | | * Depends on committees |

*Notes*:
[1] For private and family-owned businesses.
[2] Excludes start-ups, venture capital, and private equity backed entities.

es tend to be looking for advice, and may feel more comfortable with strangers not having a legal vote on key issues. Some family businesses start with a board of advisors and later evaluate if they should transition to a fiduciary board over time.

Some private companies take the opposite view. They demand fiduciary responsibility so that the outsiders have "skin in the game" to hold their attention. As an example, a 95-year-old family business formed a fiduciary board because the next generation wanted to own the business, but not run the business. Members of the next generation were active professionals living in distant parts of the country. The current leadership understood that they needed outside fiduciaries to hold future professional managers accountable to the family. Significant wealth was involved, and the current leaders did not want to leave it to chance that their heirs could handle that responsibility without assistance. This is essentially the same reason public companies have outside directors.

When considering the size of the board and committees, the analysis needs to go deeper. Consider these questions:

- What are the performance deliverables and how is success measured?
- What skills, experiences, and relationships does the board need to perform well? Most new boards are designed with each seat slotted to a specific skill set. Common slots include specific expertise in marketing, sales, e-commerce, finance, and industry or regulatory expertise. Especially when succession is an issue, some boards will have a seat slotted for a director with expertise in family succession.

The on-boarding process requires forethought. Good practices include site visits, key employee interviews, financial reviews, and corporate history and culture tutorials. Seeing the company's product in use is a high priority.

It is important to consider if the client needs facilitation in this process. If so, who is best suited to help? A large body of knowledge is available to help with planning a new board. Also, an active consulting industry caters to this need. The National Association of Corporate Directors is the trade association that focuses on public company boards and has an extensive library to draw upon. The Private Directors Association services only private and family-owned businesses, and may be a better resource for non-public companies.

Once the planning is done and the client has committed to proceed, a communications plan needs to be considered to address these concerns:

- Are all owners involved in the decision to proceed? If not, when do they find out?
- What about spouses of family executives?
- When and how are key employees involved?

The interview process attracts the attention of management and employees: Who are these strangers and what are they doing here? How will it affect my job? The nature and timing of communications should be planned in advance, because the owners will want to manage the message and minimize gossipy chatter.

### Consider the cost/benefit analysis

Because bringing in outside directors is a sensitive topic for some clients, it is worthwhile to understand the costs and benefits before making a recommendation. The typical concerns are (1) money, (2) time, (3) interpersonal dynamics, and (4) interference with the business and ownership.

What does this mean to a business looking to bring in three outside directors? Common practice is to hire a consultant to facilitate this process. The cost to hire a consultant, form the board, and operate it for one year, assuming four on-site meetings plus travel, may be $100,000 to $250,000 depending on a variety of assumptions. Those costs will get attention. Then compare this cost with the benefits of having a high-performing board rather than current business operations. Relevant factors include the following:

- Does the client have a succession plan?
- Are the business owners able to resolve conflict successfully?
- Does their compensation system drive performance?
- Do they have a culture of accountability?

**Experience suggests that owners start to seek help when they deal with decisions where they may hold conflicting thoughts.**

If the answer to any of those questions is "no," what is the cost of those consequences? Is the client likely to fix those issues without outside intervention? While managing this expense is easier at a larger company, smaller companies can find ways to initiate a board with less expense.

The time commitment to recruit and run an effective board is also significant. Assume the consultant will solicit resumes, run phone interviews, and bring forward ten finalists for three seats. Each finalist is likely to have a one-hour phone interview with an owner, maybe five finalists have a full-day on-site interview, and then there may be a one-hour call with three or four of the finalists. The next step is to have internal meetings to evaluate and select candidates.

This summarizes the time spent facing candidates. To get a sense of the total time required, use the consultant's rule of thumb—double the time facing the client to get the total work time required.

This quickly starts to look like an additional three to six weeks of effort to get the board seated. The board work itself could be one to three weeks of work, spread over a year. The chairperson will devote more effort to managing offline discussions, in addition to preparing for and running the meetings.

Lastly, and most importantly, how does introducing outsiders change the interpersonal dynamics of the owners and key executives? How does this impact how they do their jobs today? How well will they work together? The purpose of bringing in outside directors is to effect substantial change on existential issues. This is where an understanding of the client's personality and business culture is critical.

There is the risk of perceived winners and losers. Some owners and executives will want advocates to help their cause; others may feel threatened. If the outsiders do their job, they will quickly identify sensitive issues and force them to be constructively addressed. One common reason for an outside board is to help hold the insiders accountable, for their own benefit.

Knowing the clients' personalities is central to a cost/benefit analysis. They should be fully committed to the process before starting. Clients are more likely to accept the time commitment and expense when they realize they need a solution and have no other way to deal with the issue.

### Getting commitment and creating momentum

Owners and executives already have full-time jobs and busy lives, and this can be viewed as just "one more thing to do." So the fact they may agree with the need to take action does not mean it will happen.

Working through the cost/benefit analysis with the client is likely the major decision-making step in the process. Owners may accept the results intellectually, but until they demonstrate action, they have

not fully committed to creating and seating an effective board.

Starting a board should be seen as a one- to three-year effort. Like any investment, money and effort are expended in the beginning, but time is needed for the investment to mature and return both principal and profit. New boards need time to become effective. New board members need to build relationships between themselves, owners, and management. If they work together only four-plus days per year, not much time is available to build good working relationships. By design, boards grapple with existential issues, which should not be snap decisions. Some decisions will take years to bear fruit. If the board is dealing with cultural change, it may take even longer to know if the right decision was made.

The recruiting process will likely take three to six months, if well managed. Once candidates are committed, the on-boarding process should be short and intense, to get them up to speed. Good directors are bright, articulate, questioning, and eager to absorb new information. They accept the position to have an impact, and that requires them to be knowledgeable and empowered.

Thus, a client who is interested in starting a board should expect to spend six to 12 months of effort before holding the first formal board meeting. This reinforces the logic that the client needs to be committed to the endeavor before starting.

**One common reason for an outside board is to help hold the insiders accountable, for their own benefit.**

As with all talent, director and board performance management are required once the board is seated. What if a wrong person was chosen, or circumstances change after the board is seated? Several tools are available to help with both director and board performance. A healthy board has a collegial environment, where difficult or divisive issues can be discussed candidly. Performance is no different. As with most investments, they need to be attended to for best results.

## Conclusion

Determining whether to recommend that a client form a board with outside directors is not a simple matter. In assessing what is in the client's best interests, the attorney needs to take a broad view to understand the implications.

There is a marketplace for outside directors, as well as an active market for the various support services that the industry uses. Knowing the basics of the industry, and how the service providers operate, is an important step in assessing the impact outside directors may have on a client.

Companies start and maintain boards with independent directors to deal with their most important issues. Boards need to be effective because they are expensive, consume substantial executive time, and affect the most sensitive matters. Choosing to avoid outside directors is one way to bury difficult or unpleasant topics, but the issues do not go away.

Achieving a high performing board with outside directors in a private company is not a simple matter. It is likely the result of a thoughtful needs assessment, a carefully crafted board mandate, meticulous recruiting and on boarding, and an unrelenting focus on director and board performance. This is a well-traveled path. Like most other subjects in business, good results depend on exemplary planning, in addition to careful execution. ■