Family Office Review
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Family Business Boards Can Easily Become Toxic

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Family businesses and family offices require an effective board of directors from a fiduciary and governance perspective similar to other public and privately held businesses. In addition, many family enterprise management teams are limited by the number of executives, independence, objectivity, and breadth of experience so the board of directors or board of advisors (non-fiduciary board) is critical to helping the family enterprise succeed.

Any board's eventual effectiveness depends upon group dynamics. This can be challenging for many family businesses and even fateful, if one director becomes toxic from various behaviors that undermine management or the board. As will be shown, an individual director's ability to successfully work within a group becomes critical to the performance of the entire board. That is not to say a director must be compliant or go along with so-called "group think." It also doesn't mean that a director can't voice a strong minority position or concern. Directors should be independent, respectful, and critical thinkers, but not confrontational, abusive, or petty.

Positive Group Dynamics

Since positive group dynamics are essential to board effectiveness, directors' "soft" interpersonal and communication skills, not just technical or business expertise, should be carefully considered in electing directors or advisors.

Having served on twenty-five boards, of which fourteen were corporate boards and several family business boards, I have observed numerous examples of one director significantly de-railing the effectiveness of a board. In certain instances, as discussed in the following case studies, one director caused so much disruption that key board fiduciary duties and directives got side-lined over less relevant pet-peeve issues or biases raised by a dysfunctional director.

Case Study #1 - The "Founder Knows Best" Director

This fiduciary board was established by the founder and 95% owner of a first generation financial services family business. The company had a successful thirty-year track record partially due to the tenacity of its founder/CEO, despite being grossly undercapitalized. As business conditions tightened and profits were declining during the Great Recession of 2008, the board directed the CEO and CFO to raise more capital to support the asset base of the firm. All outside directors voted for an equity capital raised; the founder/CEO wanted to raise more subordinated debt. To placate the board, the CEO tried to raise equity capital but insisted upon unrealistic valuations for the stock, and not unexpectedly failed in all instances to close a transaction. He was more concerned about dilution than bringing in equity capital. The board was concerned about survival! In the end, equity was not raised due to the CEO ignoring the advice of his outside board and the company folded due to lack of capital when the business took another turn for the worse. This example of the "founder knows best" director that did not listen to his independent board resulted in the founder losing his company and all of the equity he had built up over 30 years.

Case Study #2 - The "Family Branch Protector" Director

This board represented the shareholders of a third and fourth-generation family owned real estate business. The board was composed of five family members of whom one was president and one was vice president. There were no independent non-family directors, a fatal flaw by all of us involved in family business consulting. The five directors came from three family "branches". The primary goal was to grow the family business for the next generation and maintain family harmony and relationships. However, with a lack of outside and independent directors, it became very difficult for the family board to hold the family management team accountable. While intentions were initially good, under this lack of independent board oversight and management accountability, results continued to decline over a period of years. During this decline, the board chair changed from representing all shareholders to protecting the poor performance of his brother, the President. As this developed, the other board members became disgruntled and moved towards representing their family branch's interests, at times to the detriment of the family business. Family dynamics quickly eroded and the environment became political and devisive. Unfortunately, the business continued to decline and ironically family relationships suffered among the extended family. In the end, the family business had poor performance, dissatisfied shareholders, unhappy executives of which one left the business, and strained family relationships. Instead of preserving a successful family business for the next generation, the business was positioned for sale.

Case Study #3 - The "Conflicted" Director

This board represented the shareholders of a third-generation family manufacturing business. The board was composed of several family members most of whom worked for the company and three outside and independent non-family directors. Initially, the board was very high functioning and professionally run. The three outside directors helped create the formality/structure for professional board meetings. The board had annual strategy retreats with senior executives and was focused on the right issues. The business was growing by double digits in both its top and bottom lines. The management team was expanding with non-family executives, who helped drive further growth.

A major problem arose when one of the outside directors lost his job and was trying to start up various business ventures. This director ("conflicted director") wanted the family business to be the major investor in his various projects. This put the CEO in the awkward position of needing to evaluate business deals proposed by one of his independent directors. In the end, the CEO, with other board members' concurrence, rejected all of the investments in the conflicted director's proposed businesses. The CEO had to ask him not to present any more proposals for investment. This created tension and anger with this director, who then used his position on the board and relationships with various other family members to undermine the CEO. It quickly became personal. Even though the business results continued to exceed expectations, turmoil and unrest in the boardroom eventually became noticed by the senior executives. The other two outside directors would not intervene to address the internal family issues or the conflicted director's cancerous role in the board room. The problematic family/board member dynamics that had been triggered by one disgruntled and conflicted director led this 3rd generation family business to be sold in order to pacify various family stakeholders.

Case Study #4 - The "Policeman/Witch-hunt" Director

This board represented the owners of a real estate company where an outside property management firm was engaged. The mission of the board was typical - oversee management's effectiveness and approve basic business policies, operating and capital expenditure budgets, property improvement plans, and risk assessments. The directors were functioning very effectively and working well with management. However after two years, one board member was replaced with a new director. The new director had lots of knowledge related to real estate development and management and on paper appeared to be a great addition to the board. He was hard working, energetic, and quite smart about the business. He became a strong and active director who initially won the appreciation of his fellow directors and management. However, after a year, this director began to show several toxic traits that changed the entire dynamics of the board and its relationship with the management team.

He became excessively skeptical and distrusting of management and changed from a supportive director to one primarily focused on "catching" management In this "policeman's" role, the director became adversarial and disruptive both in and out of board meetings. He took it upon himself to take initiatives directly with management and with outside business suppliers that were not discussed or approved by the board. He constantly challenged management and regularly confused the role of director with that of management. He lost objectivity and made accusations that in the end could not be substantiated. He became deemed a "loose cannon" and created havoc everywhere. Relationships deteriorated significantly in his interactions with his fellow directors and management.

As a result, the board became dysfunctional, one of the key directors resigned, and issues that required board attention were circumvented due to the crises this lone director was creating. Property owners became dissatisfied as they heard directly from this rogue director about various issues that either turned out not to be true or not of any significance. In essence, the basic governance process of the board was hijacked by this director's actions. In the end, this director was forced off the board. He wrote a mea culpa letter to the board, the owners, and the management company and resigned in disgrace. Unfortunately for the owners, two years were lost in addressing key issues and a significant amount of funds were expended on legal fees and other non-productive activities created by this director.

Case Study #5 - The "Lackadaisical" Directors

This four-member board governed and oversaw a start-up technology company. After losing one director for personal reasons, the board dropped to three directors, two outsiders, and the founder/CEO. For years, the board was unofficially controlled by the CEO/founder due to a hands-off board. As one might expect, the board under this situation represented the CEO's interest which often did not represent the shareholders' interests. The board finally added another director and was re-composed with three outsiders and the founder/CEO. Unfortunately, the outside directors still never took initiative to challenge the strong-willed CEO, who was a great promoter but never delivered his projected results and proved to be a very poor businessman. The company continued to lose money and impair its capital base. The three outside directors became more complacent over time. They were afraid to challenge the technically proficient CEO since there was minimal back-up to replace him. In essence, the board became a rubber stamp and hostage to the CEO's thinking. As a result, the CEO became even more non-responsive to the board. Recently, the CEO put the company into Chapter 7 bankruptcy when its external financings were pulled. The ultimate irony is that the board learned about the bankruptcy after the fact and two hours prior to the CEO emailing the shareholders that the business had been shut down. The investors lost their entire investment, several customers lost prepaid service contracts, and the CEO lost most of his personal assets and damaged his reputation. In essence, this company ran without an effective independent board and ended up a disaster for all involved.

"Toxic" Director Characteristics

Toxic directors can come from any part of the board -- the CEO, founders/owners, and inside or external board members. It only takes one "toxic" director to impact a board's effectiveness. Each case study demonstrates the failure of boards to function effectively. None of the reasons for poor board performance were due to incompetence of the board members but rather from the softer issues of how directors functioned in a group. Careful evaluation of these issues must be included in any assessment of prospective new board members for your family business.

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