# FAMILY OFFICE REVIEW

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*Family Matters*

# *Governance for Family & Family Enterprise Success*

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If you own a family enterprise, there is an 85% to 90% chance that it will not make it to the third generation. Disappointing, but even worse, some family businesses result in lawsuits among family members that can destroy the business, cause financial ruin of family members and spoil multigenerational family relationships. To avoid these situations, your family enterprise must develop proper organizational structures and governance policies and practices.

## Governance Challenges

In non-family owned businesses, shareholders elect board members to represent them and oversee management and the overall affairs of the business. Business decisions are either defined in a Shareholder Operating Agreement or are delegated to the Board. Family issues do not exist.

Meanwhile, family enterprises have all of the issues associated with non-family owned businesses in addition to a myriad of personal, financial, and emotional issues. All of these issues must be addressed to allow any family enterprise to succeed.

Family stakeholders are not independent investors and the typical boundaries between shareholders, directors, managers, and family members are often disregarded and not respected. This results in overlapping and confusing organizational structures with family members having multiple and intertwined business and family roles.

In addition, family members' personal objectives often conflict with business needs. In my experience working with many family business clients, objectivity and independence are at times replaced by personal emotions and a desire to protect family members. Results are often not well-measured or worse, poor results are quietly excused in order to maintain good family relationships. For example, jobs may be provided based upon birthrights, age, and representation among various family legs and not upon business need or individual capabilities. Business investment and strategic decisions can be influenced by family personal needs that may not be in the best interests of the shareholders. At times, even recruiting, motivating, and retaining top non-family managers can become challenging due to family dynamics.

Problems are exacerbated as family member needs change over time based upon age, risk tolerance, individual holdings, marital status, income levels, life style needs and a desire to diversify holdings into other investments.

If not properly addressed, all of these challenges can lead to damaged family relationships and unhealthy family business dynamics.

## Creating a Governance Strategy

The first step toward implementing a strategy for the family enterprise is recognizing the individual needs of each family stakeholder and realizing these needs often differ from the needs of the business. A good starting point is having a series of family meetings to establish core values and guiding principles for governing the affairs of the family as it relates to the family enterprise.

During the initial family meetings, we typically start with a family mission statement and an agreement on the family's core values and goals. Then we ask them to define the purpose of the family enterprise and the reason for its existence. For example, "Why has the business not been sold? What role does the business play in the family? Is the business to be run for the 'family' or to maximize shareholders' returns? What are individual shareholder needs and desires from the business?" To properly address these issues, you need full participation from both passive and active family stakeholders in the business.

After these and other fundamental issues have been agreed upon by the family, two organizations should be created that separate family issues from business management issues - the Family Council and the Board of Directors.

**Creating A Family Council**

The Family Council is responsible for representing and addressing the "family" issues associated with the family enterprise. The Council should have representation from all family member constituents. In addition, member performance should be evaluated annually to maintain a high functioning Council.

The first steps in creating a Family Council are structural and should be developed with input at family meetings of active and passive family business stakeholders. Issues to consider include:

- How many members will serve on the Family Council?
- How are members elected or appointed?
- Are there term limits or other restrictions (e.g. only so many members from a specific branch of the family)?
- Are there minimum requirements to be a member (e.g. age, education, business experience, family representation, current shareholder, current executive of company, etc.)?
- What are the reporting and communication requirements to the extended family and the Board of Directors?
- What are the guidelines for compensation, meeting frequency and leadership?
- How often will family meetings occur? Who will be invited to family meetings?

Family Council meetings should be professionally run similar to a board of directors with regular formal meetings at least annually and perhaps quarterly depending upon circumstances. It should have strict attendance requirements and meeting materials should be sent out in advance of all meetings. Key agenda items to consider may include:

- Developing an annual business plan detailing expected accomplishments, funding requirements, status tracking capabilities, responsibility assignments, etc. so performance can be measured.
- Establishing and measuring performance on shareholder financial goals as it relates to risk, long term investment returns, cash distributions, wealth management and diversification objectives.
- Developing the details of a Shareholder Agreement such as:

  o Who can own stock or membership interests?
  o Options for selling or transferring your ownership including company and family members' rights of first refusal.
  o Size of and criteria for electing the Board of Directors (i.e. number of family members; number of outside independent directors, compensation, etc.)
  o Guidelines for approving major transactions such as sale of assets or cash distributions to shareholders, etc.
  o Agreement upon valuation methodology of stock/ownership interests.
  o Minority shareholder rights.

  

- Determining hiring, professional development/educational plans, succession plans, and termination guidelines for family member employment or membership on board or family council.
- Handling "problem" family members or facilitating conflict resolution among the family.
- Providing family feedback to the CEO or Board members.

**Creating A Board of Directors**

The second structure, the company Board of Directors is composed of members elected by the shareholders or selected based upon the terms outlined in a shareholder agreement. The board's mission is to focus on the business and its shareholders as a whole and not on family member nuisances.

Family business boards are not informal family meetings. They need to be professionally run. We strongly recommend having some non-family "independent" directors on the board. Non-family directors will help insure a level of professionalism, mutual respect, objectivity, and formality for your family business board meetings. These independent directors can either be fiduciary directors or advisory directors (non-voting).

Based upon our experience as board advisors and having personally served on several family business boards, we advise our clients to consider the following:

- Having a non-CEO as Board chair; at times, even a passive shareholder so that issues of concern by shareholders not actively involved with the business are addressed.
- Establishing a standard "baseline" agenda for meetings so that certain key metrics, initiatives, and business issues are always addressed.
- Coding agenda items as "discussion", "informational", "decision required" to keep meetings efficient. Minimize time "presenting" materials that were sent out in advance, typically 1 to 2 weeks prior to a meeting.
- Establishing the Board meeting calendar for an entire year at least three months prior to the beginning of the year.
- Having senior executives sit in for part of each meeting or ask them to make a Board presentation to expose the senior management team's capabilities to your Board.
- Having an off-site annual strategy retreat with your board and key executives.
- Developing written annual business and financial plans that require board approval to create a strong planning and review process within the company and to create an empowered Board.
- Establishing an independent director based Compensation Committee to address senior executive compensation and an Audit Committee to obtain feedback directly from the auditors.
- Conducting an annual or bi-annual performance review for each board member.
- Establishing minimum meeting attendance, age or term limits, independence, and conflict of interest rules for board members.
- Offering competitive board compensation (excluding company executives) for meetings, phone calls, committee, etc.
- Being certain board members visit your facilities/operations.

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By establishing an effective Family Council and company Board of Directors, your family enterprise will be well organized and will be able to properly address sensitive family issues separate from running the business. The result is both family member needs and their sense of values, fairness, and rewards and the business' needs can be independently governed, resulting in satisfied family members who will support a successful multigenerational family enterprise.

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