# Case Study: Developing an Independent Family Business Board

*The steps a family-owned manufacturing business took to build a board which now has three independent directors.*

**By Doug Baumoel**

Best practice for any family business seeking to transition to the next generation is establishing good governance that is appropriate for the particular circumstances of the family and its enterprise. But, practically speaking, how does this evolve? Consider the following case of a family-owned manufacturing firm and the factors that led the founder to invest in the development of an independent board.

The family had just finished a six month family business consulting engagement and now had a basic management and ownership succession plan in place. In addition, a family bank was set up to manage a vacation property, help avoid family conflict over money, and as a resource for entrepreneurial family members not in the family business. Satisfied with the work done to date, the founder asked, 'What's next?'

## State of the business

The family business in this case is complex, with over 500 employees and several international offices. It is a C-Corp, and several employees own a small amount of stock. The company was founded on the strength of the founder's proprietary technology and had grown rapidly in its 25-year history. Although senior leadership had accomplished a great deal in bringing a start-up from an idea to a $150 million operation, they understood that the next growth phase exceeded their direct experience.

The company had a technology advisory board that consisted of a group of key technical leaders within the company, select outsiders from academia, and others with expertise in investment banking and intellectual property. There was also a statutory board of directors that met on occasion to review tax and ownership matters.

To meet future challenges it was clear that the next phase of work would need to focus on corporate governance. Accordingly, Andrew, the company's founder and CEO, was asked to consider building a formal, independent board of directors. His initial reaction was: 'Why would I spend time and money creating a board that I would have to report to, and who would decide my salary?'

Andrew's reaction was not atypical for private company leaders who are unfamiliar with controlled-company boards. To help Andrew better understand why an independent board made sense at this point in the company's evolution, several reasons were presented.

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## Reason one: succession planning

Andrew and his wife had 4 children who were to be next generation owners and, potentially, employed at the company. The eldest, Margaret, now 35 years old, was already on a leadership track at the company and was being groomed as a potential future CEO. Upon succession, or in the event something happened to Andrew, Margaret would be the trustee of the controlling interest in the company. Unlike the current situation, where the founder, chief executive and majority shareholder are one person, Margaret's role would be quite complicated.

In addition to her fiduciary obligation to beneficiaries, her role as a future board member (i.e. chairman) would require her to consider all shareholders, including shareholding employees. She would also have a vested interest in her own employment with the company, as well as the possibility that her siblings might also work at the company. Navigating such a complex landscape with so many potential conflicts of interest would be difficult. Margaret would benefit greatly from independent board members who could more objectively consider the ownership interests of all shareholders and, potentially, the employment interests of family members. Moreover, an independent board might be necessary to help Margaret manage the inherent conflicts of interests that might exist in her dual fiduciary role of Trustee and Director.

Most importantly, from the business' perspective, if Margaret did succeed her father, she would be a first-time CEO and would benefit greatly from the counsel of seasoned business leaders and industry experts who could help her direct the company's path going forward.

Such a board takes time to build and beginning that process now, while Margaret is in a subordinate role, would enable the board to help mentor and guide Margaret's development into the leader that would someday enjoy that board's confidence. Margaret would also have the opportunity to develop personal rapport with the board members and perhaps even have some influence in the selection process. As such, the board would be *her* board, as well as her father's.

## Reason two: business necessity

None of the existing managers had led a business from $150M million to $1 billion (the company's goal), and they were aware that this required different skill sets. Too often such senior leaders either do not realize this, or realize their limitations and hold the company back from growth to protect their own positions. This group, however, embraced the idea of independent governance. They understood the need for the strategic guidance, accountability and structure that an independent board would bring. They also understood that an independent board would continuously evaluate the senior management team and guide the CEO/Founder in identifying leadership gaps and management needs, going forward.

It was apparent that organic growth was nearing its limit. Future growth was expected to come from the acquisition of new products and services, strategic alliances with larger companies, and investment in new technologies. These initiatives would require both expertise and, possibly, access to additional capital. An independent board could provide the experience needed to advance prospective alliances and provide lenders and investors with an additional level of confidence.

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Additionally, if certain technology developments proved successful, a public offering might be a way to fund the significant growth such new technology might demand. Similarly, some acquisition strategies being discussed might make more sense within the context of a public offering. Regardless, any initiative to raise money in the capital markets would require an independent board. It would make more sense for the current owner to create an independent board with which the company could go public, rather than having one imposed upon it by its investment banking team.

## Reason three: control

Because the CEO/Founder owned a controlling interest in the company, there would be no loss of control. However, a proper independent board would expect to have significant influence despite the lack of formal control. A CEO who routinely does not listen to his or her board will eventually lose independent directors. A CEO who has a reputation of losing directors will soon find be unable to attract good directors. Therein lies the power of a good director. Yet, there would be some comfort for the owner that ultimately he still calls the shots and is in full control.

## The green light

Andrew asked for the preparation of pro-forma board documentation and policies for review. Among these initiatives were board mission/vision statements, director compensation & indemnity, director independence criteria, committee structure and charters, company prospectus and director contracts. The founding documents of the firm (bylaws, shareholder agreements, etc.) were also reviewed and modified to include components necessary for an independent board.

The costs of directors' salary and D&O insurance were considered, as well as the costs of meetings and time involved. It was apparent that this would be a significant financial and time commitment for the company. Since an independent board is not mandatory, it was clear that the board would have to create value far in excess of its costs to be sustainable.

> THE COMPANY WAS ABLE TO ATTRACT THE CEO OF A PUBLICLY-TRADED FAMILY BUSINESS IN A RELATED INDUSTRY AS ITS FIRST INDEPENDENT BOARD MEMBER.

A timetable of one year was set to have the first independent board meeting with a minimum of two independent directors. Andrew would be chair and lead director. The COO and CTO would each sit on the board, and in-house counsel would serve as secretary to the board. Margaret, the heir-apparent, would serve as board facilitator. She would be responsible for communicating with board members before and after each board meeting to ensure that all directors had needed information and to see if they had comments or suggestions for the proposed meeting agenda. She was invited to participate as a non-voting attendee at all board meetings.

## The first independent board member

Selecting the first board member is probably the most difficult and the most important challenge for family businesses developing independent governance. The first board member would be signing on for the purpose of building the board—not merely serving on the board. He or she would be mentoring the CEO in good governance practice and would also be pivotal in attracting additional members. In addition to having the business experience needed, this first director also needed to understand and appreciate the value of family ownership and private control.

As Seneca wrote: 'Luck happens when preparation meets opportunity.' The company was able to attract the CEO of a publicly-traded family business in a related industry as its first independent board member. This industry leader had taken his family business public and knew full well the advantages of staying privately controlled. He also appreciated the unique level of commitment and passion that family members often have for their business. His personal rapport with both Andrew and Margaret developed rapidly.

Now that the independent board had a 'face', the process gained the traction. Soon thereafter, the second director was engaged and the first meeting was kicked-off.

It has now been three years since that first independent board meeting. The company has grown and the board has expanded to a three independent directors. The value of this board has proven indispensable in its guidance on leadership issues, as well as several business challenges and opportunities that faced the company

The board has also been a significant development opportunity for Margaret, the heir-apparent, and has given her father the piece of mind that reliable governance brings. ■

Reprinted from *Private Company Director* • March 2015 • Volume 2, Number 1