Why should you form a board of directors?

BY DENNIS CAGAN

Most family businesses of any meaningful size already have a board of directors. If the company is organized as a corporation, a board is required. Yet most of these boards are made up exclusively of family members. If the CEO is non-family, he or she may also serve as a director. Is this the best we can do?

One notable trend in American business over the last two decades has been the pressure on public companies to upgrade their governance practices by having a majority of independent directors. Many private companies, including family-owned businesses, have quietly been doing the same. There are a number of reasons, both material and cosmetic. Why consider it? Why not?

There are many good reasons to consider forming a fiduciary board (as opposed to an advisory board) with one or more outside independent directors, and also a few negatives. How well a family understands both, and moves forward, can have a dramatic and material long-term effect on the success of their enterprise.

What problem does a board solve?

Owners will comment, "We are doing just fine without a board." Understandable. They can rely on their paid advisers like their attorney and CPA, other family members and even fellow business-owner friends. However, just being an attorney or accountant does not automatically "license" one to give *business* advice. Years of direct experience are generally the only true path to the expertise and authority required for giving sophisticated business advice. Many companies have upgraded to outside board members to provide advice on serious strategic issues.

Expert seasoned outside directors can offer invaluable counsel on a variety of key issues. The objective is to add to and expand the breadth of resources already available within the family and among its employees, not to simply duplicate the already accessible experience of the existing management and ownership.

Perhaps the most compelling reason to form a board is to strive to have a best-of-class example within your industry. Another more basic reason might be improving your company image in the eyes of customers, vendors, bankers and even employees. One of the most important byproducts of a board is the increased accountability of management—whether or not that includes family. There is no business leader who has never made a mistake or an occasional error in judgment. Having a qualified and balanced board can dramatically reduce these missteps. It gives even the most capable businessperson a critical check and balance.

The CEO reports to the board, and the ownership elects the board. Therefore, the board reports to the CEO and family.

When any decision is questioned by the board, a yellow flag is raised, allowing management to studiously reconsider based on the concerns surfaced by the board. Perhaps management was already aware of these concerns, perhaps not. Regardless, this process substantially reduces potential problems. In the end the company and family may decide to stick to their original plan anyway, but they will certainly be more prepared and smarter for the process.

Aside from the governance aspects of an independent fiduciary board of directors, which a family business does not require, there is the benefit of assembling a small group of true experts, at a relatively low cost. It gives the family leadership the opportunity to augment any weaknesses in skills or experience without hiring another expensive full-time employee. Could you use some fresh ideas? Is senior management all family members? Do all the family members always agree? A director from another industry might be a source of innovative ideas. Do you have some tough competitors? A director who has previously dealt with

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those issues could be helpful. Would you like to acquire another company, sell internationally or outsource manufacturing to China, but have never done it? An independent director may know how. A mix of outside directors can be a practical solution when family owners and their managers admit that their personal experience in some critically important business areas is just not what it needs to be in today's competitive environment.

Why would we give up control?

A common misconception within closely held companies is that having independent directors will lead to loss of control. In actuality, control is not sacrificed. Independent directors enable you to have access to more knowledge, use your resources more wisely and leverage as much experience as you possibly can. You can work smarter and be better prepared than your competition. A board is a strategic weapon when wielded by wise management.

What are the reporting dynamics of a board? A fiduciary board reports to the shareholders. Their sole responsibility is to protect the interests of the ownership. All employees, including senior management, generally report to the CEO. The CEO, in turn, always reports to the board. In a case in which the CEO is not the majority owner of the company, for example a large-cap public company, the reporting is a straight line—very simple. He or she can be directed and even fired by the board. But what about when the CEO and their family own the company? This creates a circular reporting structure, but it is still simple. The CEO reports to the board, and the ownership elects the board. Therefore, the board reports to the CEO and family. But this is not like rock-paper-scissors, a circular game where one element always trumps the next. In a family firm, the majority owners almost always have the final say.

A board composed solely of family and management will usually include directors who are experts about the business itself, and the industry. The board will certainly represent family interests. However, the directors' individual expertise and skills can be somewhat limited. In addition, the possibility always exists that disagreements between family members can compromise a director's judgment on some issues. Independent directors' fiduciary responsibility will require them to consider the greater good of the firm and all its owners, as opposed to the benefit of any given faction.

Why take the time and spend the money?

What is the downside? If business has been going well, you might question the need for an independent board. On the other hand, ask yourself if things could have been even better had management and the family known more, or had they had anticipated some of the things that negatively affected your company. It is likely that expert independent directors could increase the chances of coming up with a game-changing innovation before your competitors do. If it's that simple, then why not?

Forming a board in the first place, and maintaining it, is very time-consuming. Ultimately it is the owners who undertake this. If an insider-only board already exists, then at least the organization and structure are already there. It can easily add or exchange directors. It will, of course, take valuable time. But what makes it worth the trouble is an independent board's potential for dramatically upping your company performance.

Cost can also be an issue. When forming a board for a family-owned company it is not usually feasible to compensate a board with equity, e.g., stock options. You can consider some form of phantom stock or synthetic equity, but ultimately it boils down to paying the board in cash. I have seen small or early-stage private company directors paid as little as $3,000 to $6,000 per year. Compensation for directors of larger concerns can range from $50,000 to more than $250,000 per year. Usually additional fees are paid to certain committee members. Costs will also include travel expenses for attendance at meetings, the additional hard and soft costs of preparing board materi-

Wow, what if I had a group of those?

Drew is CEO of family-owned manufacturer of very specialized electronic components. The company generates annual revenues in the multimillions and holds more than 50 patents. His board was not formal and consisted entirely of family members. One day he was talking with the CEO of a large customer. The customer was highly satisfied with Drew's products and service and asked Drew to let him know if he could ever help him in any way.

This was an unusual interaction for Drew, but he took a chance and mentioned that in fact he did have a problem. He told his customer that he was having trouble finding a reliable supplier of a particular item, and asked if he had any suggestions. The CEO quickly offered to introduce him to his vendor for those items and invited Drew to accompany him to visit the vendor in China. The result was dramatic: higher quality, a lower price and more reliable delivery.

This got Drew thinking. What if he could upgrade the board to include some members who could add this kind of value across all the areas of his business? This triggered him to start, and he now has five high-level experts on his board.

— D.C.

Back of the Envelope

Why?

1. Receive first-class advice from experienced experts.

2. Get fresh, innovative ideas, competitive advantage.

3. Impressive optics for customers, vendors and investors.

4. Mediate family issues.

5. Best governance practices and process.

Why not?

1. Puts a strain on management time and resources.

2. Costs too much money.

3. The board of directors may question your judgment.

4. You don't understand the board process.

als for meetings, and directors and officers (D&O) insurance.

All things considered, the biggest reason for not forming a board may be the cost in management time, focus and resources, in addition to the monetary costs themselves. An independent board is not for the thin-skinned. If you have well-qualified and experienced directors, they will be questioning everything. They will press your family and management for your reasons and expectations at every turn. If the family owners tend to represent diverse opinions, even-tempered independents can significantly decrease tensions and increase objectivity.

A board gives the family leadership the opportunity to augment any weaknesses in skills or experience without hiring another expensive full-time employee.

In the end, most family companies that do not pursue independent board members simply do not understand how they work and how the governance process in general can build a stronger corporate infrastructure.

For a family business, a fiduciary board with independent directors can be a game changer. It will add key experience and expertise. It can provide unbiased perspective on contentious issues, and ease family differences. It will improve company prospects and enhance the business image. And the business will still be *your* family company. FB