NARVA & COMPANY
ADVISORS TO FAMILY ENTERPRISE

Corporate Governance of Family Controlled Enterprises

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The Common Place View

The popular view of corporate governance in family business is that efforts to improve the situation are as likely to succeed as efforts to reform financing of American political campaigns: It simply isn't going to happen. Commonplace wisdom has it that family businesses range from secret to hermetically sealed and that both fiduciary and non-fiduciary governance bodies are rubber stamps at best.

These historic assumptions about family business governance are correct in many cases, just as they could be applied to the governance of many public companies and foundations. But it is as unfair to treat such assumptions as universally true of business enterprises controlled by family shareholder groups as it is to assume that all members of **Fortune 500** corporate boards are henchmen of the CEO or that all boards of non-profit organizations are inattentive to all matters except fundraising.

One of my favorite illustrations of how supervisory governance of a family controlled enterprise works best occurred during one of the initial meetings of a new, non-fiduciary council of advisors created by the shareholders of a high-end regional retail company. The senior executives of the company, which had experienced decades of rapid growth and success in its core business, presented a new plan to expand beyond its basic business. One of the five advisors listened carefully to the plan presented to the meeting and then responded as follows:

> "I know that I am not a director and that I have no authority to vote on this decision, but I have been working in the industry you are contemplating entering for my entire career. Non only are your answers to the questions posed by your strategy wrong, but, based on my experience, you have failed to ask most or the truly important question. It is not my money you are planning to invest, but if it were, I would tell you to return to the drawing board.

Management listened, returned to the planning process, and three years and three business plans later, emerged with a strong strategic entry into a new market.

Which Families are likely to Establish Effective Corporate Governance?

When the board of Ford, Wal-Mart or any publicly traded company controlled by a family shareholder group convenes, the reality of family control is always present. When Ford changes CEO's the succession process differs from the succession process at GM in one crucial way: The family stockholders must approve. In some family groups such approval is near impossible to obtain: think of the business owning families whose divisive and public dysfunctional behavior imitates the [soap opera] life of Jock Ewing and his progeny, late of Dallas. These families are unlikely to establish corporate governance primarily because there is insufficient power in the family's relationships to tolerate the disclosures required for effective governance. In my experience, the primary indicator that a family is willing to address the emotional issues which all families share, both within and between generations, is the strength of family relationships.

Strong families should not be equated with conflict free families. Families steeped a culture of cordiality, who can discuss any subject pleasantly as long as it is trivial, are unlikely to sustain family control of a business enterprise for more than one generation; nor to permit the creation of effective corporate governance. One can denominate these groups as "Business Owning Families"—essentially stockholders linked by blood, but not by cohesive identity, shared values, or respect for a legacy or culture. By contrast, Family Controlled Enterprises is a descriptor that names families whose members relationships are strong enough to support the risk of discussing hard questions, whose commitment to the family's heritage means that on most morning they think two generations back and two generations forward before having their first cup of coffee, and who are open and willing to learn new modes of communications and other skills needed to support both business success and family harmony. Such families can surely accomplish the lesser task of establishing supervisory corporate governance for the enterprises they control.

Why a Family Controlled Enterprise Should have Effective Corporate Governance

As noted above, the primary usefulness of governance to a family controlled enterprise is as an enduring place and process for owner-managers [insiders] to meet and work with non-management owners [outsiders], non-owner managers [professional management] and voices of experience, loyalty, and commitment to the long term success of the enterprise [directors or advisors independent of management]. In too many family firms the insiders resent disbursing dividends or distributions to outsiders while the outsiders, who may live far from the realities of the business competitive environment resent the "high" salaries and perks enjoyed by the insiders. Assumptions abound on both sides. And, given the taboo of discussing issues of money or power in most families, conflict looms when the founder or other unifying authority figure retires or dies. A well-conceived and well executed program of governance is the best insurance for continued business success and continued peace in the family. Yet there are many other tangible benefits to the family controlled enterprise that follow from establishing effective governance.

Credibility with Non-Family Executives

Recruiting and retaining superior non-family managers has always beenan issue for smaller and middle market firms, made even more difficult by the rise of private equity firms offering equity positions to managers who remain with the post-acquisition enterprise. The primary concern of non-family managers being recruited by even the most competitive family firms is concern over the lack of checks and balances on entrepreneurial business men and women. The active presence of a board of directors or council of advisors, including using directors or advisors to interview candidates prior to hiring, lends real credibility to any family firm owner's claim that while the family controls the business, decisions are made in the best interests of the firm, not the family.

Credibility with Financial Institutions

Financial institutions are similarly impressed by a private family controlled company with truly supervisory governance. A primary concern for all lenders to family firms is how they will be repaid ion the event of the death or disability of a founder/CEO by a new generation of owners. Where the provider of capital to the company sees that there is a forum and a process in place and functioning to manage process of management and ownership succession and to ensure that the best interests of the business continue to be the primary criteria for decision making, the impact is often favorable: And seen in the form of favorable underwriting and pricing decisions when capital is sought to address the concurrent capital needs of the business and the family. Moreover, know that a board of directors or council of advisors is engaged in regular strategic reviews of operations and planning gives comfort to the bank that the owners of the corporate borrower are managing their business affairs prudently.

Disaster Management

I once advised a family firm owned by two brothers who died in a private plane crash. While the team of senior managers was talented, only one had been at the company for any length of time. The brothers' deaths left not only grieving widows and children, but also a total vacuum of authority at their company. From mundane matters [no one was authorized to sign checks] to the sublime [shall the business be sold?], the absence of a supervisory board of directors magnified the problems faced by the family and the management team left behind by the tragedy.

Coordination with Non-Management Owners

Businesses grow linearly, but families grow exponentially. John D. Rockefeller begat John D. Rockefeller, Jr., who begat six children, who begat 84 cousins. To fund the cousins' personal goals, a crown jewel of the family's holdings, Rockefeller Center, was refinanced and ultimately lost. One cannot argue a priori that effective governance would have prevented this outcome. But I a world where intellectually able cousins, having both ownership interests in a family controlled enterprise and legitimate personal liquidity needs, a process for keeping them realistic regarding the affairs of the firm constitutes the primary defense to such sorry a outcome.

Strategic Planning

A few general observations can be made based on our work with more than 400 substantial family firms over more than 30 years. One is that such firms tend to be excellent operators, manufacturers, and marketers when dealing with current competitive pressures. But they are usually unversed in the conceptual process of planning for the future. Access to other owner/managers of similar enterprises as well as professional advisors, who serve on the boards of directors or council of advisors, is often an effective way for owner/managers of family controlled enterprises to overcome their unfamiliarity with and/or resistance to strategic planning.