How to Create Effective Governance In a Family Controlled Enterprise

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> "A family in harmony will prosper in everything, says a Chinese proverb. In family businesses, harmony is essential…"
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> — from an editorial entitled, "Bacardi's Rum Deal," *Financial Times*, May 7, 2003

A key issue facing family firms is: How do the family members who control a business balance the art of maintaining family harmony with the duty to all constituencies of the enterprise to develop a dynamic business enterprise effectively pursuing competitive long-term strategies? This article suggests that one fundamental tool available to family firms is effective corporate governance and, in particular, offers specific advice about how to create a non-fiduciary council of advisors for a family controlled enterprise ["FCE"]. It also details many specific suggestions to both future council members and the family control groups who recruit them about how to utilize this governance tool to maximum effect.

Introduction

First, some framing of the problem: We are not writing about "family business," because this term has little analytic utility, burdened as it is with numerous misconceptions about what "family businesses" are. To many people, family business equates to small business, or to owner managed business or to unprofessionally managed business. All of these assumptions invoke models of management and are as true as all other generalizations.

Secondly, it is important to note the inherent barrier to establishing governance presented by most FCE's: primarily, an abiding commitment to privacy and to the specific culture of the FCE, rooted as it often is, in the unique, multigenerational history of the founding family. Too often advisors fail to understand why families are resistant to reducing barriers to their private business lives, even though the advisors may clearly experience that resistance. Explicit respect for the family's right to privacy and culture help to overcome this resistance.

To those advisors educated at the best law schools and business schools, the utility of governance may seem self-evident. But to a family that has controlled enterprises for generations, making crucial contributions to the community by creating jobs—all without formal governance mechanisms—the importance of enhancing governance is not self-evident.

NYSE-listed companies may be required to have a majority of outside directors by 2004. Other FCE's may not understand the substantial benefits of opening their businesses to outsiders, including adding objective perspectives, connections to resources not currently available to the business, and knowledge of markets and skills that are absent from the FCE's executive ranks.

How a Council of Advisors Differs from a Board of Directors or Family Council

A council of advisors is significantly different from a board of directors and from a family council in terms of purpose, composition and fiduciary responsibility.

Purpose

In a corporation, a board of directors is a governing body that makes decisions for the company. (In a limited partnership or limited liability company, the governing body is comprised of some or all owners. In a limited partnership, the decision maker for most issues facing the partnership will be one or more general partners. In a limited liability company, the governing body will be one or more managing members or a group of members.) The purpose of a council of advisors is to provide informal counsel to the business, bringing the expertise and objectivity of individual advisors to the process. In times of crisis, the advisory council may function as an interim transition team or as chairpersons of a transition team. Rather than taking control away from a CEO, a council of advisors can and should balance the CEO's strengths.

We refrain from using the term "board of advisors," since a board (of directors) is a legal entity with collective legal duties. A council of advisors, by contrast, is a periodic gathering of a Company's advisors acting in their individual, contractual roles.

Composition

In an FCE, the board of directors is typically comprised of family members, key management of the business and advisers to the company who are compensated for their relationship with the business (such as the business' lawyer, accountant, insurance broker, banker or outside investor). Often, the non-family members are part of the board of directors in order to have enhanced contact with the business (a) to further their ability to provide better services or, (b) in the case of a banker, investor or strategic partner, to protect their interests in the business.

Members of the council of advisors, however, have the sole purpose of enhancing the business' success. Optimally, they may achieve a positive impact equal to that of independent directors. But such impact is not a function of hierarchy or legal status. The composition of an advisory council should reflect the mix of skills or experience needed in such advisors. Often, a council of advisors can complement a private FCE's board of directors with the same function and power as the independent directors serving on a public company board.

The experience of the advisory council members need not be limited to the business' particular industry. The key factor for membership in an advisory council is the willingness and ability to provide objective expertise to guide the business. For example, the advisory board of a construction company poised for reinvention does not need to be comprised of construction company executives but rather might consist of the CEO of a successful hotel chain, a former engineering company executive with experience in expanding her company's products and a finance expert not affiliated with the business, if those individuals have valuable expertise and advice to offer.

We recommend that an FCE review a matrix of skills that its owners and key managers possess, those that are readily available from compensated consultants and those areas of experience that are missing. The advisory council should provide missing experience at a broad level of oversight (rather than at the level that a paid consultant could provide).

In general, it is useful to exclude from consideration the following types of individuals: anyone who has a conflict of interest in being an advisor to the company; suppliers or vendors to the company; friends of the owners who have no relevant experience to offer; anyone who will be a "yes-man;" anyone who is already over-committed and would not be able to devote attention to this role; and existing providers of service to the company (since their advice is available in other forms).

An advisory council should be of a size to facilitate discussion by its members. It should not be so large as to discourage participation. Rarely should the council exceed nine. Five advisors plus four owners and/or managers are ideal.

Family Councils

Unlike a board of directors and an advisory council, the purpose of a family council is to include family members who are not involved in the business in the oversight of the full panoply of family enterprises: operating companies, investment vehicles and foundations. Family council meetings are typically held once or twice a year to update family members on the status of the business and to obtain input into certain strategic decisions that may affect them. For example, how to compensate successor generation members or whether to sell the business.

Fiduciary Responsibility

Directors (or general partners or managing members, as appropriate) have a fiduciary relationship to the company. Governed by the law of the state in which the company was formed (and by agreement in case of a limited partnership or limited liability company), this governing body has specific responsibilities to the owners of the company. If a board of directors fails to uphold these fiduciary responsibilities, any owner of the company may enforce the company's rights against individual directors on behalf of the company.

Members of an advisory council serve as individual persons under contract to the company under a plan adopted by the board of directors to create a collective advisory process for management and the board of directors. Therefore, they are unburdened by statutory or common-law fiduciary obligations to the company or its owners (assuming a well drafted agreement to provide services). Because of this lack of fiduciary responsibility, we address below the need for advisory board members to sign confidentiality, non-competition and non-solicitation agreements prior to joining the advisory council as protection for the company. In order to provide protection for the advisory council members, it is important for the board of directors of the company to adopt resolutions appointing the advisory council members and defining their relationships to the company.

Inviting Prospective Advisory Council Members to Join

Though the advisory council is technically an informal group of advisors, the invitation to join an advisory council and the use of the advisory council should be formal in order to maximize its usefulness. Seeking and engaging advisory council members should be as thorough a process as engaging independent directors.

We suggest the following process:

1. Determine the company's needs as described above;
2. Identify potential advisory council members who can fill those needs;
3. Conduct one-on-one discussions between the company's President or CEO and each prospective advisory council member, outlining the role of the advisory council, the company's expectations of the advisory council members (including agreements that all members will be required to sign) and why the company would like this individual to join. Follow up with a second round of interviews for each candidate with all major stakeholders (family, managers, and directors).
4. If there is mutual interest in the prospective member joining the advisory council, a formal letter should be sent from the company's President or CEO inviting the individual to join the council of advisors, repeating the role of the advisory council and the company's expectations, specifying the compensation for the advisor's participation, and asking for written acceptance of the position by the individual. The letter should also inform the new member of the advisory council's meeting schedule.

After acceptance by the advisors, the board of directors should adopt formal resolutions appointing the advisory council. These resolutions must make clear that council members are not directors and do not have the duties of directors and that they are not agents of the company (and, therefore, have no authority to bind the company in agreements).[*] The

[*] If advisory council members make inquiries on behalf of the company (for example, in seeking strategic partners for the company), it is important that advisory council members be instructed to be explicit that they are not acting as agents for the

resolutions should require the officers and directors to obtain confidentiality, non-competition and non-solicitation agreements from the advisory council members.

The resolutions should specify one-year terms for the advisors. Terms benefit both the company and the advisors: they provide a limited obligation on the part of the individual advisors and enable the company to permit changes in the council's composition over time without awkward relationship issues arising.

All such resolutions should be included in the company's minute books.

Finally, it is crucial that the family/shareholder group and each member of the advisory council understand each other's expectations of the governance process. The advisors should know that the family expects the same level of informed analysis, understanding, integrity, candor and loyalty expected of a director, even though the advisor can only recommend and will never have a vote. In addition, advisors must understand the role of the FCE's history and culture. The family should recognize that they will only be able to retain the presence and participation of the very best advisors if matters of substance (including those that are emotionally charged) are on the agenda. The family should commit to listening and debating. Both the family/shareholders and the advisors should recognize at the outset that for the advisory council to achieve mutual understanding and an optimal working relationship could require three to five years. And at the foundation of everything must be the common understanding that advisors advise, but family shareholders decide.

How to Prepare for a Meeting of the Council of Advisors

Despite superb and continuing success growing a company, many entrepreneurs have no experience preparing for meetings. As a result, many avoid meetings as a general rule. Thus, one key to successful governance at FCE's [even well established firms with ample management structure] is for an advisor to coach the ownership team on how to prepare for the first council of advisors meeting. Central to this process is preparation of the briefing book for the inaugural meeting of the council.

Entrepreneurs and managers with little governance experience rarely realize that one of the fundamental benefits of advisory council meetings is the discipline such meetings impose on the persons conducting the meeting. The discipline of preparing agendas, briefing materials, and even position papers on important topics, often constitutes a fundamental and salutary cultural change. However, any advocate of an advisory council must recognize that mentoring the company on using these basic written tools of corporate governance can be the difference between success and failure of an attempt to begin the development of effective governance.

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company. The members' position as advisors to the company could be easily misconstrued as an agency relationship, resulting in unwanted legal entanglements for the company.

One final caveat: The purpose of a council of advisors is all business. Family owners should draw clear boundaries between the business' agenda and the family's agenda. Attendance at council of advisors meetings may present family members with a window on how to debate emotionally powerful ideas successfully. But creating a successful council of advisors marks the arrival point, not the departure point for a family's journey through its relationship and other family issues. Family conflicts acted out in the business must be addressed before the company installs effective governance techniques.

How to Conduct an Advisory Board Meeting

As with meeting preparation, few successful entrepreneurs--and even many managers--have little training in running effective meetings. This caveat is especially true when the meetings are not task oriented, but rather essentially policy or strategy discussions. Here, as in meeting preparation, mentoring from a key advisor, such as legal counsel, can prove indispensable to the successful launch of corporate governance.

Meetings of a board of directors, advisory council or family council are all most effective when purposeful roles are chosen that enhance the process. We recommend that there be a chairperson of the meeting whose role is to facilitate the agenda items and their discussion. If the chairperson desires to add substantive points to the discussion, he or she should ask another individual to take over the role of facilitator for that time period.

There should be an individual acting as "recorder" whose role is to take notes of the advisory council' discussion of agenda items. The recorder is most effective when using flip charts so that everyone attending the meeting sees what has been said and all participants are assured that their input has been heard (thus, allowing the chairperson to cut short repetitive remarks). Discussions of key issues without attribution result in a free discussion of ideas and options.

A third role, for at least the initial meeting of the advisory board, is a process observer whose purpose is to keep the meeting on track. The process observer is given permission to actively participate with suggestions solely related to the process (e.g., "We are about to run over the time allotted for this agenda item. Do we wish to continue or to cut off the discussion?").

Between meetings, it is important to avoid making strategic decisions without consulting the advisory board members. If acting on their advice, it is useful for the CEO to update the advisory board in order to show them evidence of their value to the business.

Liability Issues for Prospective Advisory Board Members

State statutes include indemnification provisions for corporate directors that enable corporations to indemnify directors against liability for actions taken in the course of their roles as directors. Since advisory board members are not directors, state indemnification statutes are not applicable and do not protect advisory board members.

Companies should consult their business counsel for individual state laws that might apply. Additional protection is the adoption of resolutions by the company's board of directors, as outlined above, that delineate the role of advisory board members.

Important Housekeeping Matters

Because a council of advisors is not a fiduciary body whose members, like members of a board of directors, have duties governed by statute and common law, it is best to utilize contracts to establish their duties. Thus, to ensure confidentiality, advisors should be required to sign non-disclosure and confidentiality agreements. Advisors will likely learn a great deal about the company’s intellectual property, business know-how and customers. This information belongs to the company and it has the duty to insist that anyone not governed by privilege or statutory provisions submit to the discipline of such contracts.

Similarly, given their access to proprietary information and key personnel, they should also execute non-competition and non-solicitation agreements. Any advisor who resists signing such documents does not qualify for service on a council of advisors. Language may be negotiated, but, in this case, the family ownership group—like customers at some retailers—is always right.

Conclusion

Much is written about the need for effective corporate governance. But the secret is less in understanding the utility of governance than in learning how to do it. Pride, privacy and anxiety about disclosing family secrets often preclude families who control business enterprises from entertaining the idea of governance. But hands-on coaching and practical assistance from advisors familiar with councils of advisors can unlock the door to enhancing corporate performance through the creation and maintenance of effective governance techniques such as advisory councils.

This article appeared in a slightly different format in the August 2003 issue of Directors Monthly, a publication of the National Association of Corporate Directors, Washington, D.C. (nacdonline.org), and is reprinted with permission.

