Independent Boards of Directors Reduce Dysfunction and Force Accountability in Family Businesses

By Pascal Levensohn

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Many closely held companies, especially family businesses, are reluctant to establish boards of directors that include unrelated parties. Recruiting accomplished directors or domain experts who have no prior personal relationships with the family shareholders is even more difficult for family businesses to consider.

When a family business does take the step to add non-family board members, a common family business board configuration will include some or all of the following: (i) the family's estate planning lawyer; (ii) a long-serving accountant; and/or (iii) a close family friend who is a retired CEO from their own family business or a large corporation.

While these individuals may all be trusted and trustworthy, it is unlikely that this type of board of directors will best serve the business or its shareholders. Why?

Because pre-existing friendships or professional service relationships will severely inhibit these directors from calling out family dysfunction, voting against poor business decisions, and generally stating obvious but uncomfortable facts about the current state of the company or its prospects.

Family businesses should avoid establishing non-fiduciary advisory boards--these are typically not worth the costs and burden of hosting the advisors because the advisors have nothing at risk (they have no fiduciary liability for acting irresponsibly) and nothing to gain (they are not adequately compensated and won't take the advisory responsibility seriously).

If you are serious about getting actionable input from professionals who are not beholden to your family and who can actually make an important contribution to the growth of your organization, then you should establish a fiduciary board with a majority of independent directors. If you are not satisfied with their performance, you can (and should) replace them. Your family controls their election.

But be prepared to hear the things that you know deep down need to get done but that are too painful for you to do on your own.

Demand to be challenged and *expect* to feel uncomfortable. These are the signs that you're on the right path.

A Familiar Pattern?

If you have been experiencing any of the following in your boardroom, you are already late in acting to improve the quality of your board:

- Absence of a rigorous process in defining a long-term forward-looking business strategy;
- Poor communication between the company owners and its professional managers;
- Significant turnover among the <u>second</u> layer of the company's senior executives combined with very long tenure by the <u>top</u> layer of senior executives—conditions that have not been accompanied by strong business performance over the past three to five years;
- Board meetings that are too comfortable and always follow a familiar, unscripted script: nobody challenges anyone in the board meeting on any topic that is material;
- Look around the board table—is everyone at that table a family member, long-time family accountant, family estate lawyer, or a close friend?

If so, you have are likely to have a governance problem now, or it's coming…

The biggest mistake family-controlled companies make in establishing a board of directors is not being comfortable bringing on directors who will challenge the family to step outside their comfort zone in charting the path forward. This is because they populate their boards of directors with friends and people who are in some way beholden to the family.
To some business owners, being held accountable by a group of experienced outsiders is a scary prospect. But having an independent board is not a scary thing.

If you know where you want to go and have the courage to acknowledge that you are not going to get there by maintaining the status quo, putting in place an independent board should not inspire fear—conquering your fear of change is the first step towards positive change.

Lack of accountability among family members, whether they are passive shareholders or active members of the business management team, is a root cause of dysfunction in many family businesses. An independent director can do a number of things to shift members of the ownership group into a different level of accountability than they've been accustomed to:

- Establish a compensation committee, which has no members of the ownership group on it;
- Define the job descriptions of any owners who are also employees and make those owners report directly to the CEO if they are senior level employees, or to the appropriate level executive if they are junior members of the staff;
- Require a formal written review of the family member's performance twice per year that begins with a written self-evaluation of their performance—the mid-year review is there to make sure they are on track or to identify problems and fix them before the year-end review.
- Establish a rigorous review of owner's expenses and set clearly defined expense policies that are enforced by the CFO or CEO if necessary.
- Establish a process that has teeth in it and that is controlled by independent directors that can lead to the dismissal of the owner as an employee, and by the majority of the shareholders as a director, for poor performance or for Cause (legally defined).

What is the best way to go about finding independent directors?

Directors are best found through a formal search process that also clearly identifies disqualifying criteria as well as qualifying criteria—at the top of the "No Go" list, you must stipulate that the search exclude people the family knows as friends.

What You Should Expect from an Independent Director

A good independent director of a family business is respectful of the various family members while not being shy about expressing his/her opinion, knowing that it will often be at odds with one or more family members. It is important for that director to have plenty of experience working on other boards so that they can bring an informed perspective to the table. Ideally, the director should be a domain expert in some aspect of the company's business or have expertise in an area that the family company is weak—often operational finance is a relevant weak area.

An outside director should also be respected in the relevant business community and bring the strength of their reputation to bear on the board of directors to help send the message to the larger community that the family business is willing to rise to the next level of professionalism. Being insular is not a best business practice.

In many companies, there is either a dual CEO/chairman or the chairman is the retired CEO. In family-owned companies in particular, I feel strongly that the chairman should not be a family member and should be different from the CEO, even if the CEO is not a family member.

Why? Most importantly, because the chairman must be able to communicate freely with different stakeholders. Often, these shareholders, especially in family companies where there are multiple adult generations and multiple factions within them, are not on harmonious terms with each other. Because the chairman sets the agenda for the board meeting, the chairman must be able to reach out to management, to family members who are both owners and employees, and to the other independent directors, communicate freely with all of them, and find out where there are areas of agreement—and disagreement—as part of setting the stage for the meeting. The board chairman plays a very delicate role that is best accomplished as an independent director who carries the least amount of baggage and does not have a hidden agenda.

A good board has the following characteristics—would you like your family business board to have this type of profile?

- Defines and distributes to all of the directors a full agenda, including all board material in writing at least one week prior to the meeting;
- Does not hold excessively long board meetings that are devoid of substance;
- Is composed of directors who are fully engaged, properly prepared, and who are respectful of each other's time;
- Communicates well, both in and out of the boardroom, through informal conversations and formal committee meetings in between board meetings;
- Welcomes and invites differences of opinion at the meeting and successfully resolves these differences of opinion in a timely manner;
- Does not coddle or yield to directors who engage in emotional outbursts during meetings;
- Understands the meaning of conflicts of interest and can separate family matters and conflict from the business of running the family business professionally.

Another key element to a healthy board is that it refreshes itself through turnover in an orderly manner. Many studies have found that family business boards have very low turnover. Succession planning should be built into the structure and fabric of the board itself. This is easily done by enforcing time limits for board service, for both family and non-family directors. For example, force the turnover by allowing no more than two consecutive three-year terms. People will welcome the freshness of cycling off, even if they come back on after their year off. And if not, you fixed your problem.

Based on my 31 years of professional board experience, I believe that the biggest mistake made by every board, public or private, startup or multi-billion dollar corporation, for-profit or non-profit, is the following:

The presumption that board consensus exists on a given matter when, in fact, it does not.

Before every board meeting, every director should ask him or herself the following question:

"*Do I actually know how each of my fellow directors feel about important question X that I do have a strong feeling about and want to act upon?*"

If the answer is NO, then you need to speak with the board chair, or contact each of your fellow directors, in advance of the meeting, to socialize the idea. This will significantly improve your overall board process—and you will know if there is a consensus view or whether you are going into a knife fight.

About the Author:

Pascal Levensohn is the founder and Managing Partner of Levensohn Venture Partners (LVP) and the CEO of Levensohn Global (LG). Since 1996 he has advised family offices and institutional investors on challenges related to corporate governance, principally in closely held companies.

A graduate of Harvard University (1981), Pascal is a former director of the National Venture Capital Association (2007-2011) and a former faculty member of the Kauffman Fellows Program Center for Venture Education (2006-2021) where he taught best practices for VC-backed company board members. He is a Life Member of the Council on Foreign Relations.

Pascal has served as board chairman, audit committee chairman, compensation committee chairman, and board secretary for dozens of venture-backed companies since 1996 and as a public company director since 1993. He has worked with the Dolby Family since 2012 as the Senior Managing Director of Dolby Family Ventures and has advised the Hixon family since 1996 in various capacities. He has made over 130 investments in startups since 1996, achieving liquidity events through 16 IPO's and over 20 mergers/acquisitions of these portfolio companies. He currently oversees 57+ active venture investments across several single-LP funds. He is currently the chairman of the board of SoundThinking, Inc. (NASDAQ: SSTI), a company in which he originally invested in 2004 and which went public in 2017.