Special Report

U.S. Edition

The Role of Governance in Family Business Leadership Succession

The Right Leadership. **Worldwise.**

Introduction

Family-owned businesses represent a critical component of economies in all parts of the globe, generating significant business activity and prosperity. However, research suggests that few of these businesses survive into the second generation, and even fewer into the third, fourth or fifth. Beset by family politics and tension around selecting the next leader, family businesses often follow flawed succession plans, or lack one altogether. As a result, many are unprepared for leadership transition and struggle to demonstrate the value of the business to subsequent generations. This often results in the breakup and sale of the enterprise.

Rigorous governance and oversight through independent board membership provides a critical foundation for family-owned businesses to protect against this vulnerability. By adding independent oversight to the board of directors, family businesses can more objectively choose successors, manage the expectations of family members and, most importantly, successfully manage leadership transition through the discipline of proven management processes.

How can family businesses navigate this process and successfully engage independent directors? What adjustments must the family make to accommodate "outside" directors? What skills and characteristics must independent directors bring to the business? And what will this change in governance mean for the business moving forward?

These are the hurdles family business owners face as they embark upon the often challenging but inevitable process of succession. Drawing upon Boyden's experience, research, and exclusive in-depth interviews with experts on the topic, this report will unpack the challenges ahead and offer solutions and best practices for cultivating multigenerational family businesses.

Lifecycle of Family Businesses

The Value of Family Businesses

Family-owned businesses are significant contributors to the national economy, serving to fuel wealth and job creation. In North America as a whole, family businesses comprise 80-90% of all enterprises and represent about 35% of Fortune 500 companies. They account for nearly 65% of the United States' GDP, 62% of the nation's employment, and 78% of all domestic new job creation.[1] The U.S. economy is therefore intrinsically bound to the success of family-owned businesses.

"Family businesses are a growth engine for the economy, one of the reasons I'm so passionate about family businesses thriving in America."
Rob Ferguson, President and Principal, CEO Advisor, Ferguson Interests, LLC

In addition to their service to the economy, family businesses provide considerable social benefits through their participation in philanthropy and community service. As Dr. Charles Cowart, a licensed psychologist specializing in organizational development, leadership development and assessment at Cowart Consulting Group illustrates, "Family businesses represent a very positive expression of core values marked by community involvement and support." In fact, research by Ernst & Young suggests that 81% of the world's largest family businesses practice philanthropy, and 47% have a family foundation.[2]

[1] *http://www.familybusinesscenter.com/resources/family-business-facts/*
[2] *https://www.forbes.com/sites/ey/2015/05/01/why-philanthropy-is-essential-to-family-businesses/#472b05011a91*

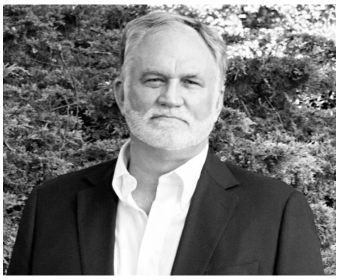
Rob Ferguson
President and Principal, CEO Advisor, Ferguson Interests, LLC

Rob Ferguson, President and Principal at Ferguson Interests, LLC, points out that family businesses also provide a critical source of innovation in our country. One Chairman of a large, multigenerational family-owned business explains that "in hoping to pass on value and purpose over generations, family businesses hold a longer-term perspective than the next quarterly report. This outlook encourages them to take an innovative approach to challenges, looking past the short-term to make decisions that enhance long-term opportunities."

Research conducted by Patricio Duran, Nadine Kammerlander, Marc van Essen and Thomas Zellweger, published in the Academy of Management Journal, demonstrates that family businesses are more efficient innovators than other public and private firms. Though working with smaller average R&D budgets than other organizations of similar size, family businesses realize more innovative output for every dollar invested in R&D, as measured by number of patents, number of new products, or revenues generated with new products.[3]

Through their economic significance, philanthropic heart and innovative thinking, family businesses are bedrocks of the economy and its communities. "This value proposition drives my interest in helping these businesses perpetuate their legacy," Ferguson asserts.

Leadership Succession Challenges



Dr. Charles Cowart
Licensed Psychologist
Cowart Consulting Group

According to a recent study by PwC, only 15% of family businesses worldwide have a plan in place for management succession.[4] With founders holding onto management control for too long and children insufficiently mentored in the business, succession planning often falls by the wayside, leaving the business exposed to internal conflict and management upheaval.

Experts concur that the leader of a family business, particularly in the founding generation, is often reluctant to relinquish control. "These leaders become so deeply enmeshed in the business that they become fearful of leaving the company they have worked for so long to create," explains one expert in a recent conversation with Boyden. "As a result, they avoid thinking about what will happen when they leave the company and subconsciously begin to envision themselves working at the company forever."

Thus leaders often delay succession planning until they are in their later years, when health problems could begin to arise, demanding that the leader consider the company's management future, perhaps for the first time. However at this point, one expert suggests, "The next generation frequently has had minimal exposure to the business and its processes, as the leader has been running the business on their own. In these cases, the next generation is not always ready to assume real responsibilities and is often not interested in doing so."

With the founding generation no longer able to lead, and the second generation unprepared or unwilling to assume control, the source of power becomes unclear. To fill this void, a variety of people with different stakes in the business and varying perspectives begin to vie for control. This causes tension and gives rise to conflict, jeopardizing the business's long-term prospects.

Due to such flawed succession planning, most family businesses do not succeed beyond the first generation. According to The Family Firm Institute, a mere 30% of all family-owned businesses survive into the second generation, only 12% into the third, and just 3% of all family businesses reach the fourth generation or beyond.[5] With these losses, so too go the economic, philanthropic and innovative contributions of family businesses.

[3] *http://amj.aom.org/content/59/4/1224.abstract*
[4] *https://www.pwc.com/gx/en/services/family-business/family-business-survey-2016/succession.html*
[5] *https://www.familybusinessinstitute.com/consulting/succession-planning/*

James Hertlein
Managing Partner
Boyden United States

Thomas Zay
Managing Partner
Boyden United States

Boyden Case Study

Boyden's James Hertlein and Thomas Zay, Managing Partners in Houston, encountered similar challenges while selecting and placing independent board members for a family-owned industrial company in the energy sector. The company founder ran the business himself for years, and under his stewardship, it grew into a multibillion-dollar enterprise. However, despite transitioning his middle-aged children into leadership roles, the founder began to age with no single successor positioned to lead the company and carry forward his vision of maintaining the company as a family-owned enterprise.

Faced with this dilemma, the founder's children recognized the need for a more formal governance and oversight mechanism to handle succession. The scions therefore established a family council to separate family affairs from business matters. They also engaged Boyden to identify three independent directors to sit on the company's board alongside themselves. Collectively it was decided that one of the three independent directors would serve as chairman to ensure objective leadership. Boyden identified the chairman first, and subsequently worked with the chairman to select two additional directors.

In constituting a board with three independent directors, the family business added a layer of rigorous oversight to its corporate governance. The independent directors are positioned to manage the succession process objectively and professionally, ensuring a successful transition of the business to the next generation.

The Importance of Independent Directors

As Boyden's experience illustrates, bringing outside directors onto the board of a family business offers a promising solution to the challenge of succession. By offering an objective viewpoint, detached from family politics, independent directors can provide an unbiased voice of reason to guide the process. They can help identify promising successors, establish firm plans for transferring leadership, and execute the plan in a smooth, professional and impartial manner.

Daniel Hatzenbuehler
Former Chairman and CEO
E. Ritter & Company

Independent directors also bring valuable prior experience to their role in the family business. This background is often more varied, reflecting the director's own professional ambitions as well as their experience serving on other boards. Daniel Hatzenbuehler, recently retired Chairman and CEO of E. Ritter & Company, a fifth-generation family business, notes that "independent directors bring a deep level of business acumen, technical skills and experience that family businesses might not otherwise be able to access."

Family business leadership specialists suggest that this previous experience serves to professionalize the board, management, and the company at large. "A few years ago, we identified an opportunity to professionalize our board to better manage succession and associated issues surrounding interest and talent," explains the Chairman of a high-profile global family concern. "As a result, of our seven board members, six are independent. These independent directors bring their other work and insights to our board, guiding management through issues in a professional and competent manner. This drives our management to run the company in an equally competent manner, thereby elevating the entire company."

In addition, independent directors bring an added layer of accountability and meritocracy to the family business. As CEO advisor Ferguson illuminates, "This revised structure then cascades down throughout the company, increasing accountability and escalating trust immeasurably."

Processes and Best Practices

Family Alignment

In order to successfully bring independent directors into a family business, several important steps and processes must take place. The first is for the family to align around the notion of independent directors and agree to the change. Many families are skeptical of independent directors, as they fear losing control of the business to them. However, as Cowart points out, "The family is not relinquishing control to the independent directors but rather learning to approach their company with a more objective understanding of themselves and their work."

Once this fear is resolved, the family must adapt its business processes to create an environment that is conducive to independent oversight. This means carefully separating family issues from business operations. "In many family businesses, conversations include both family and business issues, as the two are tightly interwoven," says one governance and management expert. "However, with an independent individual overseeing business processes, it is important that the two become detached, so the independent directors can handle business issues without dabbling in family dynamics." With this adjustment in place, independent directors are able to more easily and effectively access relevant business information.

Hatzenbuehler, the retired E. Ritter & Company Chairman & CEO, explains that early in his tenure, he identified a need to establish a majority independent board to enhance the board's experience and skillset. He also proposed creating a family council separate from the majority independent board. Hatzenbuehler suggested that the family council act as a non-legal entity responsible for family social events, educational opportunities, family employment policies, and bridges to the next generation. Serving as a counterweight to the board and an informal voice of the family to communicate its interests, the council assuaged the family's fears of losing control of the business and aligned them with the notion of an independent board.

Understanding Family Nuances

Just as the family must adapt to support independent directors, so too must independent directors possess an understanding of the family's dynamics. Despite efforts to remove family issues from business processes, to a certain degree the family's essence and values will always remain core to the organization. Thus, independent directors should have the skill and experience to navigate and appreciate family attributes that may be imprinted on the business. As Cowart suggests, "While deep business acumen is important to be a successful independent director, a deep appreciation for family systems is also critical. Effective directors must be able to understand and reconcile both sides of the equation."

Meeting Current and Emerging Needs

In addition to having a level of empathy for family issues and values, independent directors selected for the board of a family business must also meet the company's particular current and emerging needs. This requires a proper audit, selection and vetting process to determine the issues and objectives of the business, identify the associated skills and qualities necessary in a director, and ensure selection of individuals who possess these specific skills.

Needs can also change over time. While at one point a family business might be manufacturing-oriented, this may evolve into a marketing focus, and then over time shift to an emphasis on acquisitions. It is thus imperative to ensure that independent directors possess the skills that are currently important, as well as those on the horizon. These needs should be continuously reassessed and the board re-evaluated to adapt to any changes that may take place within the business. "It is therefore essential that a rotation cycle be designed that governs a periodic partial refresh of the board," advises Hatzenbuehler.

Uwe Hasseldieck Paulmann
Founding Partner and Executive Director, ILTIS Consulting

Creating a Cohesive Portfolio

While independent directors must be aligned around the family business's current and emerging needs, they must also complement one another. Each must offer something that the others do not, so that together they create a complete portfolio. Therefore, when selecting independent directors, the first seat is always the easiest to fill, as the broadest set of skills remains to be acquired. However, with each successive appointment, a degree of freedom is lost in working to meet a narrower profile and a more specific set of skills. To avoid this potential difficulty, it is key to select independent directors with an eye toward the composition of the entire group, rather than simply selecting a series of individuals.

Numbers and Ratios of Independent Directors

When it comes to determining the appropriate number of independent directors to serve a family business, Boyden's Hertlein and Zay advise that companies designate an odd number to avoid handing the chairman the deciding vote in every split decision. Uwe Hasseldieck, Corporate Governance, Family Governance & Strategy Consultant with ILTIS Consulting, adds further specifics, suggesting that such boards have at least two independent members, as it can be difficult for a single director to pose an opinion that diverges from that of the family.

"The board should begin with two independent members, which should then be increased as necessary," advises Hasseldieck. Cowart provides additional direction, suggesting that while few family businesses start this way, a majority of the board should ultimately consist of external directors. This helps ensure that the family can access counsel from this beneficial resource. Finally, Ferguson proposes that the chairman be independent, explaining that this composition provides objective insurance against an unforeseen situation demanding emergency succession.

Conclusion

While family businesses offer substantial economic and social benefits at the local and national levels, many face significant challenges planning for leadership succession. With founders and leaders often reluctant to relinquish control of the business and subsequent generations unable or unwilling to assume responsibility, the transfer of power becomes contentious. As a result, businesses are exposed to cracks and wounds, threatening their brands, their longevity, and ultimately, their legacy.

By onboarding independent directors, companies insure against these challenges, and owners are able to focus on their vision and goals for the business, as well as plan for appropriate leadership succession in a more objective and methodical manner. Independent board members further professionalize the business by increasing trust and accountability, and bring fresh ideas and best practices based on outside experience.

Still, with the addition of external governance, it is important that the business retain the core values imparted by its founding family. The characteristics, composition, number and nuances of a board with independent directors must be carefully constructed. The independent directors must individually and collectively meet the current and emerging needs of the business, and their business acumen must be matched by an appreciation for the family dynamics at play.

While this process demands meticulous consideration and specialization, upon assembling a tailored set of independent directors, family businesses can function with renewed efficiency and achieve greater success over the long term. Daily business processes and pivotal decisions alike are enriched by an added layer of insight and objectivity. Succession planning and execution can be handled with foresight and care, cementing the family business's legacy for future generations.

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