BOARDS

# Managing the Trickiest Parts of a Family Business

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Serving on any board of directors is hard, but in a family-owned business, it's even harder. Unlike their public-company counterparts, which focus mainly on increasing shareholder value, family-business boards must act on behalf of stakeholders with multiple and potentially conflicting agendas – for example, coowners with equal power and completely opposing financial timelines. And because interpersonal dynamics in family businesses are much more complicated, discussions of critical issues like leadership succession, compensation, and the performance of management often become uncomfortable, messy, and emotionally fraught. It's not unusual for family directors to shy away from them and, when they do, for the independent directors to follow their lead.

Yet accepting the notion that it's OK to have taboos – areas of conflict that boards hesitate to tackle – is bad for business. In our decades of working with family-owned firms, one thing we have seen is that avoidance doesn't work. It can seriously undermine the board's effectiveness, as it did at one global infrastructure company where a frustrated director told us: "The board is almost evaluating situations on a case-by-case basis rather than forming processes, procedures, and rules."


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Learning to move through these uncomfortable issues constructively is one of the biggest challenges that boards of family businesses face. That came across clearly in a series of interviews we conducted with 19 external and family member directors of major businesses in six countries in early 2019. Those discussions surfaced the most common taboos, as well as approaches for addressing them. They also highlighted, as one director described it, "the additional interpersonal skills and courage to deal with the issues that the board has to have."

## CEO Succession

Choosing a successor to the CEO can be an extremely sensitive topic in a family business. The relative currently at the top may even be deeply resistant to the notion of being replaced – and vocal about it. Says one CEO of a listed company in South Asia: “As long as I’m holding a large percentage of the company, I will ensure that the board will always remain ‘my board’ that stands by me in times of conflict…This is a company that I have built with my own sweat and hard work, and as long as I’m active even my sons will be subservient and do what I want.”

Yet if a board abdicates its responsibility to address succession, it can lead to inappropriate leadership choices that threaten the business. The people we spoke with had some advice about how to encourage open and honest discussions on the subject:

**Build trust.** It’s critical for directors to develop trust with one another; the company’s leadership, including both family and nonfamily members; and the broader shareholder group. But doing so is likely to take a lot longer than it would in a regular company because a direct approach frequently doesn’t work. Directors must learn to listen patiently and be empathetic about the family’s dynamics, egos, and fears. “On a family board I need to be thoughtful about how I put things across,” says one India-based director. “It’s not what I say that is important – it’s how each family member will perceive what I’ve said.”

In one U.S. business the directors, both family representatives and independents, agreed that an outsider should succeed the CEO. But they had to manage the expectations of multiple stakeholders, including family owners, a young and capable next-generation family member in management, and more-seasoned nonfamily executives. An outside CEO would be a first for the company, and the owners needed to feel confident it was the right choice. To ensure their comfort, some directors suggested a completely external and unbiased evaluation of potential candidates, including the young family member; others suggested that the family member be given special consideration; others simply wanted her to feel included and valued; and still others just wanted the best decision for the company. The board nodded to all these viewpoints in designing a succession process, which ended up being lengthier and less efficient, but helped deepen trust.

Directors at another company came up with a unique but effective trust-building tactic: They organized a retreat at a vacation spot where much of the family owned homes – which allowed them to get to know other directors better *and* to develop ties with family members beyond the boardroom. When trouble later emerged at the company, the directors already were at ease with one another and were able to communicate clearly with the family.

**Assess independently.** It's crucial to avoid any hint of bias in the selection process; otherwise, firms may not get the best person for the job and the new CEO may be seen as a weak leader chosen out of favoritism. Yet it's difficult for people inside the company to be completely objective; even HR managers may be viewed as being swayed by the family, especially if they report to a family executive.

To get an unbiased perspective and a view of comparable external market talent, some firms task a subset of directors to manage succession, recusing those who have close family relationships with potential candidates. Other businesses lay the groundwork by having formal evaluations of all family executives conducted by an outside firm that reports to an independent director, rather than by the internal HR department.

**Be transparent.** Perhaps what differs most from nonfamily businesses is the level of communication required. Every step in the succession process must be carefully explained to make all feel that their needs have been considered.

**Next-Generation Talent Development**

Figuring out how to bring the next cohort of potential leaders in early enough to learn the business and gain the skills needed to run it is another major challenge.

If directors don't tackle this, a lot can go wrong. Consider the quandary that one South American company found itself in. The problem there was not that the next generation wanted in – but that they wanted out. When two third-generation family members were offered executive roles, they declined, leaving the business with no successors. "They see the business more as a source of wealth than a family legacy to develop," a director told us.

Here are some suggestions for preparing young family members for roles in the business:

**Agree on the rules *before* they're needed.** Next-generation talent discussions are much easier when they're theoretical, broad conversations rather than focused on elevating some relatives to leadership roles. In our experience, it's best to set up norms for when and how the next generation will enter the business, making sure that they emphasize capabilities and eliminate biases and that young relatives understand them long before they're old enough to join the company.

One Italian firm we spoke with worked with the board on a formal family talent-development plan when the founders were in their forties and fifties and the next generation were still young children; that discussion was purposely general, deemed "about the future." The firm also created a family council whose objectives were to keep a regular stream of information flowing between the board and the family and to help the next generation learn organically about the company as they matured. Other companies start to include family members in meetings when they enter high school or college to expose them to the business.

Families often take responsibility for developing guidelines around family employment in the business, such as requiring a certain number of years of work outside the company and demonstrated success at it, or prohibiting jobs from being created just for family members. But the directors should ensure that these policies are actually followed and weigh in on rules they don't think serve the business or the family well.

**Codify the rules.** Many businesses document next-generation talent-development processes in formal family constitutions or protocols, which also detail agreements made about the business's vision, values, and decision-making approach. These might include such things as whether spouses have a formal say in decisions or who inherits the shares if a family member with no direct heirs dies.

Developing a constitution is hard work and often creates tension. If it feels too daunting, a good alternative is to set up a committee of outside and family directors and executives to oversee family member development, as one Latin American firm did. The committee designed a formal program in which relatives under 40 were made directors of subsidiary boards for up to two years, which helped them figure out whether they were interested in continuing in the business and allowed the directors to see their capabilities in action.

**Compensation**

Directors often struggle with questions about pay for family members. How much should they make relative to outside executives? Is it clear that outsiders may need to be paid at the scale of large or public companies? Are there guardrails in place to avoid allegations of favoritism?

In one multibillion-dollar U.S.-based enterprise, brothers in different roles were paid the same amount to keep the peace. The situation came to a head as next-generation members began to seek employment and expected similar pay. While families often equate fair with equal, it isn't always, especially as later generations join the business. It's important to break this paradigm, both to manage expectations and to attract nonfamily talent. Often it makes sense for a board to create a compensation committee of independent directors and have them hire an outside consultant who can help craft a pay philosophy and support it with objective data.

### Underperforming Family Executives

This is one of the thorniest problems deal with, but there are ways to nip it in the bud. Ideally, family members in the business should report to nonfamily bosses, who get the reinforcement they need to provide honest assessments. Nonfamily supervisors of family employees are in a sensitive position, so should be given clear direction on how to support and evaluate them. As family managers rise through the ranks, however, reporting to a nonfamily member may become unfeasible, and at that point, additional oversight by a committee of board members can be useful. In addition, every family executive should be assigned a coach or a mentor. Often the senior independent director makes an excellent coach for the senior family managers, and it helps to include other board members in their performance reviews.

Like other underperforming executives, struggling family members should be put on an improvement plan, given an opportunity to do better, and if they can't, be offered other opportunities in the business where they can succeed or a path to an exit. If it's clear to everyone they can't do their jobs, it harms the culture of the company to keep them around. But it's extremely important to handle their exits delicately and allow them to save face with the family. If they're put on a performance plan, that information should be kept confidential, not shared with the broader family.

Addressing an underperforming family CEO is especially tricky. Businesses can get themselves into this predicament if they don't do a thorough job of evaluating family CEOs and fail to give them clear performance metrics. Then when the CEO needs to be removed, family directors feel uncomfortable confronting their relative. One thing we've seen help in such situations is to have the lead independent director introduce a "long-term" succession process that starts with designing the ideal *future* CEO profile and clearly defining the performance expectations. Then the board can suggest comparing current CEO performance with the ideal to identify gaps and areas for development, and quantify the opportunity cost of keeping the current CEO. This approach depersonalizes the discussion of the current CEO and helps directors better understand the downsides of not making a change. The family may ultimately decide to keep the CEO, which is their prerogative, but the board will have fulfilled its duty to generate options for them.

## Asking Questions

Creating a board culture where asking questions is not only encouraged but expected will help directors of family companies navigate all sticky issues. Even if independent directors can't always act, their probing questions can catalyze the family to do the right thing.

It's good to suss out what the hot buttons are. In one U.S. company, the board sent an independent director to the annual family council meeting specifically to gather insights on this. The director asked the family: "What are the sacred cows? What topics are fair for consideration and what should we avoid bringing up?"

Such information helps directors understand what to move more slowly on (not what to avoid forever). Equally important, one director told us, is to listen to "what's *not* being said. You have to get comfortable triangulating a conversation – you really have to take the time. The family isn't one voice, it's multiple voices."

Ultimately, serving on a family business board requires more appreciation for multiple points of view than serving on other boards, as well as much more finesse and patience. It's a challenge – but a deeply rewarding one. These companies are often longtime contributors to local or national economies, and with the right support, they're able to thrive across generations.

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