



Outside directors' role in family businesses

Family firms can benefit from independent directors' expertise. Here are tips on how to get the most benefit from their advice.

MANY SUCCESSFUL family-owned businesses have asked independent directors to join the board, undertaking an active role and sharing the rewards (and risks) of directorship.

How can a family business make best use of an outside director? What can family firms learn from directorship practices in public companies?

Directors' roles and duties

Director's roles include meeting the challenge of enterprise risk, ensuring the board includes people with the right skills to meet corporate needs, controlling compensation and preventing violations of law.

Directors' duties are legally the same in both public and private companies. All directors owe the duty of exercising due care, the duty of loyalty (not acting in self-interest) and

been brought into the company to provide specific expertise, or to act as a sounding board. When there are no minority shareholders, the outside director is free from a lot of the politics of a more complex situation.

In this instance, the CEO/shareholder should urge the outside director to speak his or her mind. Board meetings are likely to be informal. In this circumstance, perhaps a simple, non-binding "contract" can be reached between the CEO and the outside director, more in the nature of establishing communication ground rules: for example, "we will meet every two months for three hours, over dinner; I will send you an agenda; you will send to me a list of things you wish to discuss; company information will be periodically sent to you."

The outside director might be compensated for a fixed term whether

In such a circumstance, how can a family make best use of the outside director, and also convince the director that he is not being set up as either the hatchet man for the majority or the strident voice on behalf of the minority?

The outside director might suggest the preparation of a written statement, or "white paper," that lays down the ground rules for certain aspects of governance of the family company. If not, it is wise for the family to undertake this task of its own volition.

White papers can be legally binding, or just general expressions of direction and viewpoint. They should address fundamentals like job descriptions and reports; salaries, dividends and distributions; and direction of the business (growth, growth without leverage, strategic positioning against competition, growth by acquisition, and becoming an acquisition target). They also might address the role of future generations, often a highly volatile topic.

Using the outside director to facilitate preparation of the white paper, smooth over communication and act as a mediator can be highly effective. Perhaps the best use of an outside director in a family business is to facilitate the clarification of goals and roles.

Obtaining a white paper may be more complicated if later-generation family members who inherit minority ownership do not share a loyalty to the company, or if employees have obtained shares through stock options or other plans. There are

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the duty to act with utmost good faith. Family businesses can benefit from the expertise, perspective and experience of outside directors. How to get the *most* benefit often depends on the company structure.

Sole shareholder

When a company's CEO is also the sole shareholder, an outside director functions as an adviser more than a true director. The director likely has

or not the CEO fires the director in the interim, so as to take the implicit financial control exercised by a single "boss" over a single subordinate off the table to the maximum extent possible.

Multiple shareholders

By definition, most family businesses involve multiple family shareholders and, virtually inevitably, one or more of them are in a minority position.

more issues to resolve among this wider group, and preparing a white paper is therefore more complex. In such cases, the neutrality of the outside director can be a big benefit.

Family management and outside directors can work together to implement numerous governance best practices. Families may want to bifurcate economic interest based upon activity—i.e., family members active in the business hold equity interests in the company, while inactive family members hold ancillary economic interests (such as ownership of the real estate tenanted by the business). All directors should take particular care to establish a sense of financial equity between these two groups, so that economic pressure does not become a festering subject.

Some amount of social interchange also is useful. Social events, retreats or meetings (where the formalities of director or shareholder meetings are not observed) can foster open communication and mutual respect.

An independent director can spearhead an educational process, particularly when all shareholders are also board members. Without specifically challenging the owners (by suggesting that they are doing anything improperly), outside directors can deliver a broad awareness of the proper functioning of a board and best practices in board management.

Expert advice

The benefits of having an outside director include the ultimate protection of all directors from claims that they have violated their fiduciary obligations. Rules of governance are controlled by the law of the state in which a business is formed; all state laws provide protection to all directors (including family members) who rely in good faith upon the advice of expert third parties. Consequently, when an outside director suggests the retention of experts in the areas of, for example, compensation or

succession or leverage, family business owners (including those in control of the enterprise) are sometimes best advised not to resist. Indeed, this could prove a useful shield for the controlling family members.

One issue, not often recognized, is the difficulty of balancing the board's duty of risk management oversight with the private company setting. A company white paper typically does

are likely to ask for further shields from individual liability, should they fail to meet their standard of care. Some states permit a company charter to absolve directors of personal liability for failing to meet the duty of care, provided the director receives no personal benefit. Business entities also can indemnify and defend directors from any claim that they breached their duty, including pay-

Boards must ensure that management considers how risky strategic business judgments may be.

not give blanket absolution from liability for directors' failure to manage risk, although that is not a bad idea in some cases. A discussion of fundamental risk in a family-dominated business might prove difficult but should be welcomed by the business owners; after all, *their* equity is at risk.

Liability concerns

Theoretically, directors can be sued by lots of people: shareholders, employees, customers, suppliers, company creditors, regulators and community entities. As a practical matter, the primary concern is the minority shareholder.

There are a variety of defenses and protective techniques available to the outside director, and management must be ready to deal with the issue when it comes up.

A legal principle known as the "business judgment rule" provides (absent conflict of interest or breaches of the duties of loyalty) that a director is not liable for any decision taken in good faith with the reasonable belief that the action was lawful and was in the best interest of the company. Courts won't second-guess business decisions made by directors in good faith.

But outside directors nonetheless

ing for a defense attorney. These protections may be contained in bylaws or reflected in a separate written agreement. The outside director may ask for such protections; management should consult company counsel in this regard.

Finally, it is appropriate (and becoming increasingly common in private companies) for an outside director to demand directors' and officers' liability insurance (D&O coverage) to insure against claims for breach of duty.

In-depth assistance

Family businesses can benefit greatly from outside assistance. The most in-depth and committed assistance can come from the inclusion of an outside director on the board. Legal issues are not overwhelming. Well-managed family businesses will do well to consider engaging one or more outside directors as part of their governance regime. FB

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