INDEPENDENT DIRECTORS IN FAMILY BUSINESSES

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Corporate governance is considered crucial to business sustainability and growth of any economy. The implementation of a proper corporate governance framework can lead to unparalleled growth and sustainability while opening up opportunities for businesses. In this context, corporate governance is essential for family businesses to grow and thrive over generations. This is particularly important since family businesses are one of the fundamental pillars of any growing economy. Yet, most of the approaches towards better implementation of corporate governance frameworks encourage family businesses to improve governance practices over time first and then, at the end of this process, to appoint independent directors to their boards. This article presents another perspective towards this issue: it advances the approach to introduce independent directors as the first step in the governance journey.

Approaching Corporate Governance in Family Businesses Differently

The appointment of independent directors as the first step provides a number of advantages to the board composition within family businesses and it accelerates the implementation of corporate governance frameworks.

Changing Board of Directors Dynamics

The presence of non-family board members automatically introduces a different dynamic to the board of a family business. Firstly, by bringing new skill sets to the board room, it enhances decision making. Secondly, the presence of external persons puts pressure on the board members to act more professionally on different levels. Meetings often become more organized and regular and family members start to separate between the nature of family meetings and board meetings. When it comes to the decision making process, on the one hand, family members become gradually more familiar with the presence of non-family components. On the other hand, independent directors become more aware of the dynamics of the family and start taking that into consideration. Their presence also brings an objective point of view to the decisions and mediates the process of moving business decisions away from family dynamics. Additionally, the presence of independent directors enables the creation of an independent audit committee that enhances the independence of the board.

As in many cases where the executive managers are members of the family, the presence of independent directors changes the dynamics between the management and the board. Independent directors start questioning management decisions and holding the management accountable. The management gradually starts being aware that board meetings are becoming different. Consequently, executive reporting and presentations improve over time. The presence of top-notch experts on the board makes it easier on one hand for the management to get professional advice and on the other hand forces the management to professional business conduct. This balance between scrutiny and guidance has a positive impact on the overall efficiency of the business.

Streaming Consultancy Services with the Business

In businesses of small and medium size, the costs of introducing independent directors are relatively low compared to getting outside advice or consultation. When the remuneration is based on participation in board meetings, advice from an experienced independent director can be affordable. This gives small businesses a chance to gain top-level hands-on expertise incorporated in their boards. Additionally, directors themselves become more engaged as they are part of the business rather than only consultants. They are held accountable for their advice and should follow-up on its implementation. This forces them to give their best and participate actively in the decision making process. Moreover, presence of diversified professionals on the board allows interactional expertise development and turns out to be an excellent tool for improving the level of awareness and expertise among family board members.

Embedding Corporate Governance Advocates

Lastly, independent directors have the potential to gradually turn into internal advocates for corporate governance and compliance. Their presence inside the family makes it much easier for them to introduce and follow-up on the implementation of corporate governance. Independent directors will become aware of any resistance points within the family business and develop mechanisms to handle them. This enables them to identify priorities and set the proper plan for a smooth transition. It also puts them in a position to mediate certain conflicts that might arise during the transition process.

Potential Challenges for Introducing Independent Directors

Despite the advantages of this approach, it is not without its challenges. This is why the process should be dealt with cautious to ensure a successful transition.

Convincing the family of the importance of introducing non-family outside independent directors to their family board might be difficult. This step touches on the core of the family, which makes it challenging. Family members may not feel comfortable with the presence of a non-family member in their meetings. They may question whether a non-family member shares the same interests as the family, and whether these interests have the same time horizon as the family. Accordingly, the family may start questioning how a non-family member can take care of their money better than themselves. They may also have justified fears regarding confidentiality and competition. For these reasons, this phase needs much assurance and clarification.

The choice of the independent directors is crucial. In terms of technical skills, the choice needs to be in areas needed on the board. It is important to avoid expertise already present in the family, as this might create potential conflicts between expert opinions at the very initial fragile phase of the transition. It is usually important to have people from different disciplines to diversify the expertise on the board. Also, it is very important to have directors with expertise in corporate governance as they will be involved much in corporate governance improvement processes for the company. Additionally, it is important to have people with high level of reputation and integrity as the family has to trust them in this initial phase. The personal skills of the independent directors are considered an essential dimension, as these directors need to perform tasks and roles outside of the technical scope. Independent directors have to be aware of the fact that they represent the first confrontation of the family with the transition. In accordance, they should be prepared to handle this and be alert that the whole success depends on their personal capacities. At the first board meetings, it can be anticipated that there will be an atmosphere of rejection expressed by some board members. This could be manifested through hostile attitudes that independent directors have to handle cautiously without becoming aggressive. Additionally, they will often be confronted with subconscious defensive attitudes from family board members. Over time they must be able to understand the underlying dynamics of the family, include themselves in family related decision processes and build trust with different family members. They should be able to play the mediator role in some cases.

Independent directors are considered a catalyst for change. Leveraging on high levels of motivation to the board, instead of adopting disruptive approaches, can help it embrace the change. In other words, independent directors have to facilitate and channel change without upsetting the core of family hierarchies and sensitivities. That is why these directors need to be extremely emotionally intelligent, calm and have very strong communication and negotiation skills. Accordingly, outside directors need orientation and preparation before serving on such boards.

An enormously important issue is to add independent directors to the current board, even if there is a high potential for the board size to be too large relative to the company size. Starting the process by replacing board members will kill it from the very beginning. Choosing which family board members would have to replaced by new ones is the wrong step. The family should always feel that there is an addition to the business and not replacement.

Introducing non-executive directors from the family might not be helpful in this context, as this notion does not project the needed independence on the board. Adding to that, family businesses introducing outside directors who have served as consultants or have had other relations with the family or company makes it more difficult for them to lead the needed change in the board construct.

Another important point to highlight is that the number of independent directors added to the board should not be large at the beginning. Irrespective of the size of the current board, it is important to limit the number of outside directors to two or maximum three directors. More than that would become too much for the family to handle at the same time. As the process matures over years, the number of independent directors can be increased and the overall number of board members decreased.

Finally, one should bear in mind that outside directors will inevitably lose their independence over time. They may become too involved with family relations and thereby become emotionally biased with time. They will be forced to get involved into operational decisions, they will give advice to the management and they might be involved in the design of audit processes. These activities become part of their role on the board. This should be seen as a natural process and should not be a problem as long as they are not awarded extra remuneration for it. Placing too much emphasis on safeguarding "independence" may be counterproductive in such cases. After some years when the processes mature and develop, those directors would need to be replaced with fresh board members offering a higher degree of independence.

Conclusion and Recommendations

The appointment of independent directors as the first step can be an effective way to implement corporate governance in family businesses. Independent directors act as agents for change within the company and help in its transition to better corporate governance practices. It brings independent decision to the family, includes outside perspectives, opens up new networks and brings new expertise to the board.

It is understandable that the inclusion process is not an easy task for both the family and the independent directors, but, if managed well, it can bring along unparalleled success with relatively little resources. Accordingly, there is a need to highlight this issue to family businesses and raise their awareness on the role of independent directors and their importance for the growth and sustainability of the company. Focusing more on independent directors rather than only on following corporate governance frameworks might make it easier for family businesses to capture the concept. Moreover, there is an apparent need for pooling independent directors and making it easier for family businesses to reach them. Finally, special awareness and skills development for directors on their roles is needed. They need to be aware of the challenges they are likely to face while serving on a board of a family business as the first independent director.