



Getting on Board: Corporate Governance in Family Firms (Part II)

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In this second installment in its two-part series on corporate governance in family firms, the Business Families Centre (BFC) considers the complex subject of board composition and, in particular, board independence.

Declaration of independence: The argument for independent boards

In examining board composition for family firms, a key consideration is the ideal ratio of insiders (e.g., family members or those close to the owning family) to outsiders (e.g., external executives, attorneys, accountants, or consultants).

Most family enterprise literature suggests that boards of directors with independent external members are more effective than no board at all or boards made up entirely of inside members. For example, a 2004 study of large public firms concluded that firms with founding-family ownership and relatively few independent directors performed significantly worse than non-family firms,

with performance deteriorating once the ratio of family to independent representation exceeded 0.50 (Anderson & Reeb).

Internal boards are said to be ineffective because they allow the family firm to become a victim of itself, pose a threat to the health and success of the enterprise, and potentially die as a result of infighting. Even when there is ample executive talent within the family, many experts recommend that independent outsiders be appointed to the board for the purpose of regularly challenging the family perspective – not to mention avoiding the dangers of nepotism and the entrenchment of incompetent family managers.

“I believe [implementing an independent board] is the single most valuable step a family business owner can do,” says Dr. John L. Ward, a professor, author, and co-founder of the Family Business Consulting Group (FBCG) in Chicago, IL, in an interview with the BFC. Ward, who frequently has the opportunity to see how independent gov-

ernance can be used to benefit family firms, is strongly in favour of independent directors because they bring objective oversight and perspective to enhance board value while “insiders bring nothing new to the party”.

The late Marcel Côté, senior economist, consultant, and corporate director who sat on the boards of some of Canada’s largest family firms, stressed that a board with independent directors can be particularly crucial once the business transitions beyond the founding generation. “An independent director can bring a lot to the family-controlled business, whether it’s a private company or a public company,” said Côté in an interview with the BFC. “For example, when you get into the second, and more importantly the third generation, you always need honest brokers. Because the cousins, you know, are not the same age, not of the same ability, [or of] the same interest. But at that stage of life cycle, a company usually generates dividends, and some of these cousins live off the divi-

dends. So [the directors' responsibility] that the company be well managed is very important."

Likewise, according to Dr. Stephen McClure, principal consultant with the FBCG, independence provides objectivity. "[O]bjectivity can play a key role in helping the family come to a conclusion that a group governance decision was made that didn't have bias or where one family group wins out over another family group. So the benefit of the independent directors getting highly involved in critical decisions -- such as who should be the next leader of the business, or should we pay dividends of X or Y -- is that if a family can assume objectivity, then they can trust one another."

Does independence necessarily lead to increased efficacy?

While the majority of family enterprise literature praises board independence, there are some notable studies that challenge the notion that board independence leads to better boards or increased firm performance.

A 1988 study found that the presence of 'outsiders' may actually reduce a board's influence (Ford).

Nearly 20 years later, Simon Fraser University's Beedie School of Business sampled 263 Canadian firms to conclude that external boards were actually negatively related to the performance of family firms. Dr. Daniel Shapiro,

an author of the study, stresses that the results rely heavily on context and that it is not a black-and-white issue, given the complexity of conditions surrounding a family firm's ownership structure, motivation for installing the board, and stage of the business. "There is some evidence that, under specific circumstances, having external boards is not helpful, unless they are very carefully aligned with the goals of the business," says Shapiro. "[W]hen you go to external boards, you often go to people who are outside the core business. And sometimes that's useful; sometimes that's not useful. So it's very contextual."

More recently, a 2013 study from the Clarkson Centre for Board Effectiveness at the University of Toronto's Rotman School of Management found that Canadian family-controlled public issuers outperformed their non-family counterparts from 1998-2012, despite generally not adhering to typical best practices in share structure and board independence. Although the sample size of the study was small, the results are worth exploring further, as they again defy the popular notion of the necessity of board independence.

So what does this mean for families?

With discrepancies on how or if board independence is correlated to board efficacy and firm success, it is not surprising that many academics advocate for

more research on the relationship between firm performance and board composition.

Where does this leave family firms in need of immediate actionable advice? Perhaps some comfort can be taken from the fact that, despite the lack of empirical proof, many authoritative experts are adamant that corporate governance, combined with independent board members, remain among the most important factors to ensure family firm success and longevity.

The BFC is not suggesting that independent boards or even corporate governance structures are right for every family firm; rather, as with most issues pertaining to business families, each family's unique context will dictate the right structures for the family, business, and owners at any one time. The BFC's hope is that, with an increased understanding of the various opinions and issues surrounding corporate governance in family firms, each family will be able to engage in a more informed contextual analysis while making these important decisions.