THE ACTIVE BOARD SYSTEM (TABS)™

Using Governance to Strengthen Family Businesses in Transition

By Larry D. Hause and Cary J. Tutelman
founders of The Board School™

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When family business consultants discuss succession planning, they usually talk about what a business owner[2] wants to accomplish, different structures to achieve the business owner's goals, and the processes to use. While family business consultants have different ideas on how to help a family business, its owner, and the owner's family, they all tend to agree that succession planning is essential to the long-term survival of the family business[3] and long-term health of the family.

But when family business consultants and family members talk about governance as part of succession planning, they often do not start with asking what approaches, structures, and processes are available and what might be most helpful to a particular business and ownership group. Rather, the starting point is generally whether a Board of Directors[4] is needed or not. The reason for this is not hard to find. Founders tend not to want a functioning Board, especially with outside directors, while family business consultants tend to assume that a Board of Directors with some outsiders on the Board is a necessary component of a successful transition plan. This article recommends that these biases be set aside in favor of a more discerning approach to governance.

If a Board is assumed to be unnecessary, the planning typically uses the existing governance arrangement or some form of a Board of Advisors to assist the existing governance arrangement. Every business has some form of governance, however unclear or informal it may be. For example, a business owner who is the sole owner, Board member, and CEO, and who never has a formal meeting of the legal Board, continues to exercise the functions of governance.

If a Board of Directors is accepted as having a role, the conversation is usually limited to structure, focusing on such matters as the size of the Board, the mix of inside and outside directors, the experience of the outside directors, where to find outside directors, and how much directors ought to be paid. In either case, little planning seems to go into determining what the Board is to do, what owners and managers do, and how this Board relates to owners and managers. This demonstrates a lack of understanding of how effective Boards can really help family businesses.

Treating governance lightly fails to take advantage of an effective means to resolve difficult transition issues in a family business. Some of these issues are: How does the business owner transition to a new role yet stay involved and best use his or her power? How are competent managers trained to succeed the business owner? How do owners who are not managers stay legitimately connected with the business so they feel involved with their interests protected? How do multiple owners let managers know what the owners want from the business? How does any succession plan continue to operate over a long period?

The Active Board System (TABS)™ offers a foundation to use effective governance to help solve such difficult transition issues.[5] TABS is "active" in that the Board actively directs both owners and managers. It is a "system" in that the Board is an integral part of the process of owning and managing the business, and it has specific responsibilities, authorities, priorities, and boundaries that are defined and respected, while at the same time tailored for each family business.

The best way to present TABS is to focus on the fundamental questions involved in developing an effective governance arrangement that complements and strengthens a transition plan:

The first two questions identify the primary elements that lead to effective governance:
- When is a Board needed?
- What does a Board do?

The third question explains the process of effective governance:
- How does a Board direct?

The fourth question explains different structures available to develop a governance arrangement that is consistent with the approach and process of effective governance and that best meets the needs of the business, its owner, and family:
- What is the best structure?

When is a Board needed?

The first question TABS addresses is "When is a Board needed?" For a functioning Board to succeed, the person with the power must have a reason for the Board that is understood and accepted[6]. When we first talk to family business clients about Boards, they usually list one or more reasons why a Board is not necessary or would actually hurt their business. These reasons include:

"A Board just slows us down; we need to be quick and nimble."
"We are too entrepreneurial for a Board; directors don't want to take any risks, and you have to take risks to stay in business."
"We are too small for a Board."
"I have been on a Board and it was not helpful."
"I don't want to give up control or be questioned or outvoted in my own company."
"I never needed a Board so why does my family need a Board?
"I have a good management team, so a Board won't be needed when I'm not involved.
"My family can be the Board when they own the stock."
"My CEO does not want a Board."
"Directors cannot know my business by meeting just four times a year."
"Nobody would want to serve on my Board."

In response to this resistance, we explain why a family business needs a Board, using one of the three following reasons. One of these reasons almost always fits a client's situation.[7]

First, a Board is a natural step for a business owner who wants to transition out of the day-to-day running of the business but who wants to stay active and make a contribution and definitely does not want to retire. Creating a Board can also help a business owner do other things outside the business. Or, the need for a Board may arise if the business owner believes the company has outgrown its "home-grown" expertise and wants to seek expertise from the business community to help the company grow to the next level. Shifting from one person who runs it all, and who has all the power and control, to a group of managers who run the daily business, perhaps for a group of owners, is much less painful and risky if the business owner uses a Board as an active platform to stay involved before leaving the business entirely. The business, its managers, and its owners almost always need the business owner to remain involved for some period of time. Using a functioning Board allows the transitioning family member to retain power and contribute to the family business in meaningful and appropriate ways. When the transitioning business owner is ready to "retire" from active service to the business, he or she can transition from the Board to an owner role or even to a retired owner role.

So a Board is needed when the business owner is in transition or wants to be involved in the business in a different way. In these situations, others must become more involved. Of course, involving other people raises questions such as who makes what decisions, who has what power and control, and what power and control the business owner wants or needs to retain. By having a seat on the Board, the business owner can exercise power and an appropriate level of control in meaningful and helpful ways and can help guide owners and managers in learning their separate roles and responsibilities.

Second, a Board is necessary when owners and managers are different people. In family businesses, it is essential that owners and managers have separate, distinct roles. The most important role for owners is to develop a unified statement of their values, needs, and goals. The most important role for the managers (besides running the company) is developing strategic and annual plans. The Board makes sure that the owners' values, needs, and goals, on the one hand, and management's plans, on the other hand, are integrated, consistent, and doable.

Without a functioning Board, owners often believe they need to influence management, which can result in the owners' getting involved in discussions about management matters, making decisions for the managers, and, worse, managing the managers. What's more, without a functioning Board, owners may not communicate their values, needs, and goals, which can leave management guessing about what the owners want. This situation increases the managers' risk, because they may guess wrong and make decisions that displease the ownership group. With a Board in place, however, owners can concentrate on owner issues, managers can make management decisions and run the company, and the Board can make sure that the process is working and that owners and managers are doing what they are supposed to do. So a Board is needed when owners and managers blur the lines as to what each group needs to do.

Third, a Board becomes imperative when there are multiple owners. In family businesses, there are often contentious issues that result in long-term conflict and a possible lifetime of family dissension. A couple of examples illustrate the point. In companies where siblings report to a sibling president, compensation can be a dicey issue. A Board, though, relying on the values of the ownership group, can determine compensation for the family member, president and

perhaps for all of the family members working in the company. Also, a Board can determine dividends, based on the owners' values, needs, and goals and on management's strategic and annual plans for the company. In these two instances, the Board can avoid serious conflicts that sometimes cause family members to fight as owners or cause managers to leave the business. The Board is effective if it can keep the ownership issues within the owners' group and management issues within the management group. So a Board is needed when the ownership of the company is held by more than one person and the multiple owners have not worked out a common plan to share power.

What does the Board do?

The second question poised by TABS is "What does the Board do?" TABS is based on the premise that an effective Board is the "balance point" between owners and managers. In other words, the Board keeps the owners and managers "in balance" by making sure that these two working groups solve their distinct issues and problems. The Board does this by owning the process of directing the managers and owners to address and resolve their respective issues and problems.[8]

The Board directs in two main ways. It directs the owners and managers by how it interacts with and assists them in completing their separate responsibilities. It also directs by making sure that the Board calendar is followed. Let's look at each of these concepts more fully.

Directing Management. The Board directs management by helping the managers discharge their distinct responsibilities. One responsibility of managers is to develop and implement strategic and annual plans for the overall well-being of the company that are consistent with the values, needs, and goals of the owners. Another responsibility is to manage the company in such a way that meets these values, needs, and goals of the owners and is consistent with the company's current strategic and annual plans. Directing management is generally understood and accepted, since overseeing management is inherent in a Board's legal responsibilities. In fact, this is typically the only responsibility a Board is thought to have. TABS, though, extends the Board's role to directing owners.

Directing Owners. In addition to directing managers, an effective Board "directs" the owners, which means holding owners accountable to complete their unique ownership responsibilities.[9] The primary responsibilities of the owners include the following:

> Understanding and agreeing how the owners will do their work and what the owners want from the Board and management[10];
> Identifying the owners' values, needs, and goals as a single owners plan[11];
> Reviewing the owners' understandings and agreements and the owners' plan at least annually and communicating their plan to the Board;
> Electing qualified directors;
> Staying knowledgeable about the company and the functions of the owners, Board, and managers; and
> Making sure the Board is fulfilling its responsibilities.[12]

How does a Board direct?

The third question–"How does a Board direct?" addresses the process used by the Board. TABS assumes that the process used by the Board is critical to a successful transition plan. The following is a summary of the different ways a Board directs according to TABS.

Approving and accepting plans. The Board first asks the owners for their plan, setting out the values, needs, and goals of the owners as a group. The Board reviews the owners' plan with the owners. In evaluating the owners' plan, the Board asks the following questions:

> Does the owners' plan reflect their values, needs, and goals as a group?
> Is the plan complete?
> Is the plan internally consistent?
> Is the plan doable? In other words, is the plan clear and sufficiently detailed, and does the plan include the risk-reward ramifications for the company and the owners?

Once the Board answers the questions pertaining to the owners' plan in the affirmative, the Board accepts the owners' plan and then gives the owners' plan to management, which prepares its strategic update and annual plan for the company.[13] When management completes its plans, they are then presented to the Board. The Board evaluates each of management's plans by asking the following questions:

> Is management's plan consistent with the owners' plan?
> Is the plan complete?
> Is the plan internally consistent?
> Is the plan doable? In other words, is the plan clear and sufficiently detailed, and does the plan include the risk-reward ramifications for the company and the owners?
> Does the plan include an implementation plan?

Once the Board determines that management's plan meets these criteria, the Board approves it. At the end of this process, the owners' plan and management's plans should be integrated. The managers should know what the owners want and what they as managers need to do. For their part, the owners should understand what they can expect from management. Finally, the Board should know what the owners want and how to evaluate management.

Owning the Board process. According to TABS, the Board does not create or develop either the owners' plan or management's plans. The owners create and maintain their plan, and the managers develop and maintain the strategic and annual plans for the company.

What this means in practice is that the Board does not tell the owners what they should have in their plan. The Board expects the owners to come up with a plan that addresses ownership issues, although the Board is available to help the owners think through their plan. Similarly, the Board does not tell management what the strategic plan or annual plan should be. The Board expects the managers to come up with these plans, and the directors use their experience and insight to make sure that management's plans are well thought out, clear, detailed, and integrated with the owners' plan, and that they include an implementation plan.

Managers own their plans, and the Board makes sure that the managers understand their plans and the consequences before the Board approves them.

If management's plans for some reason cannot meet the plan of the owners, the Board determines whether management must re-plan or if the owners need to reconsider parts of their plan, or both. If the owners' plan is not complete, consistent, and doable, the Board directs the owners to continue to work on their plan and helps the owners get any assistance they need to do their work. Likewise, if management's plans are not complete, consistent, and doable, or if they do not contain an implementation plan, the Board requires the managers to continue to work on their plans and makes sure that management gets any help they need to address these matters.

By following these guidelines, the Board owns the process by which all plans become fully integrated, while the owners and managers own the problems. Said another way, the Board makes sure that the right group, the owners or managers or both, are working on their problems. In addition, any problems among the owners are identified early on and kept in the ownership group so a plan can be put in place to help the owners deal with their differences. Also, competency issues within management are more easily identified, so a plan can be put in place to help management succeed.

Understanding the differences among directing, advising, and managing. Another key to TABS is for the Board to differentiate directing from managing and advising. Blurring the distinctions among these three ways a Board interacts with owners and managers causes confusion and usually results in the Board taking a problem from either the owners or managers or both, and then solving it. Once this occurs, the Board no longer owns just the process. The Board then also owns the problem.

For the most part, directors should direct. That is, they should direct the owners to deal with owner issues, and they should direct managers to deal with management issues. Directing in this manner, of course, requires the directors to be able to identify for each issue coming before the Board what input may be needed from the owners and from the managers, respectively. Acting in this manner requires directors to direct as third parties. This means that they should have no self-interest in the plans or any particular decision. This also means that they are "other-centered." In other words, the decisions of the directors are not necessarily what they themselves would do or how they themselves would do things if it were their company; rather, their decisions are based on what is in the best interests of the company.

One key to directing is the skill of asking questions to draw information out of owners and managers, rather than simply giving an opinion as soon as an issue is presented. This skill helps the director ascertain whether the owner or manager really understands the issue, has thought it through, and has potential solutions that meet both the owners' and management's plans. While directors are often eager to give their opinions and offer solutions, doing so doesn't allow the owners and managers to own their respective issues.

Directors should not manage. When directors manage, they become either agents of the owners or the managers. In essence, they represent one group or the other when they manage. They either push the owners' plan onto the managers or push management plans onto the

owners. When directors manage, they own the solutions and the results. When directors manage, they are self-centered. Their decisions are based on what they would do and how they would do things if it were their company. They cease to be a balance point between owners and managers.

When directors advise, they are being a resource, expert, or guide. This is appropriate when management asks for their perspective, especially when managers are putting their plans together. Advising can be overused, though, especially when directors feel the need to tell management what to do and how to think. In essence, "over-advising" becomes managing the managers, and, in this process, the directors begin to "own the result." They lose their ability to be the balance point between owners and managers. When a Board advises, the Board and management should understand that the Board is advising. One way to do this is for the Board agenda to have a time in the meeting devoted to topics on which the managers want the Board's advice. Another way would be for the managers to seek the advice from directors outside regular Board meetings. Even outside the Board meeting, however, the directors still act as the balance point.

<u>Using the calendar to control the process.</u> TABS allows the Board to control the process through the Board's calendar. The Board has certain fixed items that are addressed throughout the year and that tend to drive the owners and managers in developing and presenting their plans. Since the Board is holding the owners and managers accountable for their plans, it is reasonable for the Board to set the time frames for the plans to be completed. Of course the Board's actual calendar is always reviewed with the owners and managers to make sure that the dates work for them.

Aside from having fixed dates for these plans, the Board routinely addresses other items throughout the year. Some examples include:

Setting compensation for officers and/or family members;
Establishing dividend policies and bonus arrangements;
Discussing results of the prior year;
Asking due diligence questions;
Inquiring about succession matters;
Evaluating the CEO and perhaps other senior managers or family members; and
Participating in training for the Board.

A well-thought-out calendar keeps everyone aware of and focused on the fundamental elements of the ownership and management plans. Here is an example of such a calendar:

August	Discuss owners' plan presented to the Board by the owners. Resubmit in September if necessary.
November	Discuss, and approve if appropriate, the annual plan and any changes to the strategic plan presented to the Board by management. Resubmit in December if needed. Set compensation for officers, dividend policy and bonus arrangement for upcoming year upon approval of the annual plan.

February	Discuss results of plans for the prior year and review bonus and dividend issues for prior year. Ask legal due diligence questions. Inquire as to the general succession and transition matters, among owners, the Board, or management and what plans, if any, exist, and general leadership and management development plans for top managers.
May	Evaluate Board, directors, and the CEO, and perhaps other senior management. Owners elect directors as required. Elect chair and officers. Plan Board training.

Meeting legal responsibilities. By following TABS, directors are fulfilling their legal duty to oversee management[14], their legal duty of care[15], and their legal duty of loyalty[16].

Satisfying the legal duty to oversee management is based on the owners' being clear about what they are looking for from the business. An owners' plan that reflects what the owners want as a group and that is consistent, complete, and doable provides the Board with a standard by which to oversee management. TABS provide a system that delegates to one group, the Board, the primary responsibility for the accountability that keeps the directors focused on oversight. The Board is less tempted to take on problem solving which, as noted, increases the risk of the Board becoming managers or alienating either the owners or management through its perceived siding with one group or the other. Finally, following TABS makes the Board active. Such a Board is not an afterthought or "rubber stamp" as is often the case with Boards of family businesses. Yet, the level of activity expected of the Board is achievable in the time normally allocated to Board and director involvement.

Satisfying the legal duty of care is easier with TABS because the system makes the Board the balance point between the owners and management, requiring both groups to define what they believe is in the best interest of the business and requiring the Board to evaluate their results based on an objective, independent standard that does not reflect what is in the best interests of the Board or any particular director.

For example, the owners are responsible for determining what they want from the business as owners. Management is responsible for identifying what the company can do. The Board evaluates what the two groups developed to make sure their respective plans are complete, consistent, and doable. In addition, the Board makes sure that both groups reconcile any differences between them. We recognize that this is not always easy, but the Board does have the responsibility for following through with consequences. If, over time and after attempts to address the issue, management continues not to act in the best interest of the business, the Board may need to make a change within management. If, over some period of time and after attempts to address the problem, the owners are not acting as a unified voice, the directors need to resign.

Satisfying the legal duty of loyalty is easier to prove by following TABS because the system focuses the Board's attention on the process and not the results. By not focusing on the results, directors are less tempted to become involved in achieving a particular outcome in which they have a real or perceived vested interest. Further, the process recommended by TABS stresses the third-party nature of the Board. The owners will delegate to the Board the responsibility to hold the owners accountable only if the owners trust that the directors are true to the process rather than to any particular outcome. If the Board is not acting as a third party, the owners will likely be aware of this early on so the owners can make any necessary changes.

What is the best structure?

Once it is accepted that some form of a Board is needed and once it is determined what the Board will do, the next question to analyze is "What is the best Board structure?" Here is where the business owners' values, needs, and goals come into play.

We suggest that choosing which Board structure to adopt be done in the context of the following significant principles that every family and closely held business has.

> First is the underlying reality of all business activities: that those with the power must accept and endorse every element of the transition plan. This also holds true with the Board. In other words, those with the power must accept the approach to and structure of the Board, including a commitment to the Board process and to participating in the process effectively. Otherwise, the Board as a balance point between ownership and management has a short life, and the Board becomes merely another body for those in power to command, or the Board is discontinued or ignored.
>
> Second, the owners with the control elect the Board. As a result, it is essential that at least all of the voting owners be involved at least at some level. At a minimum, all of the owners should at least discuss the roles and responsibilities of the owners, Board, and management; what they want the Board to do; what they expect from the Board and its individual directors; what attributes they want the directors to have; and what skills they want represented on the Board. Input from management can also be helpful to these discussions.
>
> Finally, the type of Board selected must reflect the answers to the questions of why a Board is needed, when the Board is to be put in place, and what the Board is to do. For a Board to work, it must serve a legitimate, practical purpose, not just exist because it may be legally required. In essence, the type of Board that is needed at the outset must respond to a need accepted by those persons with the power.

To help understand and evaluate the different governance structures, we propose the Alternative Board Structures™.

The Alternative Board Structures (ABS)™

ABS progresses from Level 1, in which the business owner gets input from individuals he or she trusts and respects, to Level 7, in which a Board Directors is composed of all independent,

outside members.[17] Below are the different levels of governance structures and their basic description.

Level	Description
Level 1:	A business owner getting input from individuals as he or she chooses.
Level 2:	A business owner meeting with an identifiable group on an as-needed basis to get input.
Level 3:	A business owner meeting with an identifiable group on a regular basis to get input.
Level 4:	An elected group of insiders with legal decision-making authority.
Level 5:	An elected group with legal decision-making authority consisting of a majority of insiders.
Level 6:	An elected group with legal decision-making authority consisting of a majority of outsiders.
Level 7:	An elected group with legal decision-making authority consisting of all outsiders.

Successful transition plans can use any of these Board levels. What level is most appropriate depends on the defining characteristics that the business owner wants the governance structure to include.

Defining Characteristics of ABS

Role of the business owner. How does the business owner want to be involved? In Levels 1, 2 and 3, the business owner is the Board of Directors.[18] The Board functions are transitioned to the group in Levels 4 through 7.

The business owner can decide to be the only member of the Board and still have effective, functioning governance. This is true even if the business owner seeks advice from others, including forming an Advisory Board. What is essential, though, is for the business owner to realize that he or she has the sole responsibility to follow a process that provides effective, functioning governance. All too often, when the business owner is the sole member of the Board, the process of governance reverts to the status quo. Reverting to the status quo will likely not allow the business owner to achieve the kind of change he or she is seeking. In addition, if the business owner wants the business to continue after he or she is no longer involved, the status quo will likely not adequately prepare the managers and successive owners. The reason for this phenomenon is simple. If a business owner wants some change, the way the business owner is involved and the way decisions are made must change. Change simply does not happen without the business owner changing.

As we noted above, TABS encourages the business owner to remain involved in order to achieve the desired change. TABS does not require or even encourage the business owner to give up all of his or her power or control. In fact, the opposite is true. TABS encourages the business owner to continue to be involved, but involved in a way that allows the business owner to achieve his or her goals. Also, TABS allows the business owner to control the pace of change, based on the abilities and desire of the business owner and successors. The business owner can choose how much power and control is transitioned at any particular time.

If the business owner wants to follow the process suggested by TABS most effectively, he or she should consider Levels 4 through 7 structures. In these levels governance is shifted to a group that can help the business owner maintain an effective governance process.

Role of others. Does the business owner want to involve others? Does the business owner need to involve others to facilitate the change the business owner has identified as necessary to accomplish his or her goals? If so, others can be involved in the governance structure in two ways.

First, others can be involved to give advice (Levels 1-3). As the advice of others is sought on some regular, permanent basis, a Board of Advisors is formed. The defining characteristic of involving others in this way is to seek advice. The business owner retains the Board functions. So long as the business owner is the Board, even if an Advisory Board has been established, it is essential that the business owner and others understand that the business owner retains all of the governance functions and that others understand how the governance functions are carried out.

Second, others can be involved as members of a Board of Directors (Levels 4-7). Involving others on a Board of Directors has several defining characteristics. One is that the legal authority to make decisions (that is, the vote) is moved from the business owner to a group. This is a big step for the business owner, who is now bound by the vote of the Board.

When family businesses have Level 4 Boards consisting of more than the business owner, a problem frequently arises when the business owner, in practice, retains the vote, essentially relegating the other members of the Board to the role of advisors. This result can either be overt or subtle. In some cases, the business owner can make it clear through statements or actions that he or she needs to continue as the sole decision maker. In other cases, the message is delivered in more subtle ways, but the result is the same: the other members of the Board come to view themselves as merely advisors, deferring to the business owner. This latter situation often occurs in a family business where the Board consists of a strong business owner, a spouse, and the children. Whether overt or indirect, the result is equally damaging–a Board that genuinely involves others is not created or maintained. To involve others on the Board, the business owner must be committed to shifting decision-making authority to the group and to put in place policies that will require the group as a unit to exercise that authority.

For example, the business owner may decide not to vote at all unless there is a tie. Or, the business owner may always decide to vote last. Whatever policy is adopted requires a business owner to act with some restraint, since others on the Board will have a natural tendency to defer to the business owner. Likewise, the other members of the Board need to clearly understand that they are expected to act as directors and not as advisors.

The business owner can also empower others on the Board by sharing control over how the owners and managers are involved in the business. Sharing this control requires that the business owner be committed to changing how he or she has controlled the process in the past. Once that commitment is made to share control, the business owner greatly enhances the

probability of achieving the change required to achieve his or her goals. Having this support and assistance can be a great relief to a business owner who up to this point has had to "go it alone."

Role of outsiders. An Advisory Board or a Board of Directors can open up to the input of the outside world, either in an advisory capacity (Levels 1 - 3) or as members of a Board (Levels 5 - 7). In either case, involving outsiders shows a willingness to receive input from the outside.

At some level, of course, outside input is always occurring. Business owners may read a relevant article in *The Wall Street Journal*, say, or discuss a business issue with golfing partners. But when the business owner involves others in a continuing advisory capacity or as members of the Board, this outside influence becomes less easy to dismiss. ABS provides different levels a business owner can use to regulate how the input of others is received based on the business owner's goals and transition plans.

Majority of Insiders. In Levels 1-3, having a majority of insiders is not a major change because the advisors have no legal authority to make decisions. But in Level 4 and beyond, there is a shift in the voting power of the Board and hopefully a corresponding increase in the quality of the Board discussions.

The shift in voting power comes from the fact that outsiders have the same legal power as the insiders. This means that outsiders can significantly impact Board decisions. For the business owner who wants an outside voice on the Board to facilitate change, help accomplish his or her goals or help the next generation, Level 4 is a good Board starting point.

With Level 4 also comes an increase of the quality of Board discussions. It becomes less acceptable for old family conflicts to dominate the discussions or for the Board meetings to have that private "we can do what we want" feel. Outsiders, because they are outsiders, have a way of moving discussions forward, getting back to agendas, and/or suggesting that the family address family issues outside the Board meetings. Outsiders can and should have a positive impact on Board effectiveness.

Majority of outsiders. In Levels 1-3, having a majority of outsiders is not a major change because the advisors have no legal authority to make decisions. But in Level 6, this structure changes, with a major impact on the family business. In this structure, the outsiders have the majority of the vote, enabling them to outvote those with the majority of the stock or the management experience, or both.

Some may question the value of having a majority of outsiders on the Board. The fact is, though, that having family members, majority owners, and managers dominate the Board can, and often does, present problems. They can compromise the Board process and undermine the balancing role of the Board and its ability to truly direct. We recognize that excluding these individuals from sitting on the Board also has its problems. Those not on the Board can undermine the Board process, use their power in harmful ways, get the Board dissolved, create havoc in the owners' and management groups, and be so uncomfortable with their own roles in the transition process that they can disrupt or even destroy the process.

Family businesses have demonstrated to us over and over again that the more owners, family members, and managers on the Board, the harder it is for the Board to be the balancing point between owners and managers. While the reasons for this have many nuances, two essential characteristics underlie most conflicts relating to Boards that include owners, family members, and/or managers. First, the Board is not perceived to be a third party. Rather, the Board is seen as siding with the owners, or, more commonly, some faction within the ownership group. Or, the Board is perceived as siding with management. Whichever is the case, when others think the Board is not acting as a third party, the credibility and effectiveness of the Board suffer significantly.

Second, it is much more difficult to maintain the boundaries between ownership and management if owners and managers are on the Board. If the owners on the Board act as owners and not directors, they begin to address and solve owner problems or "pull rank" at Board meetings. If this occurs, the ability of the owners to speak as one voice is diminished if not eliminated entirely. Likewise, if managers on the Board act as managers, they are much less able to critique management plans and are less likely to work as a third party on helping owners come up with their owners plan. As a result, owners on the Board acting as owners tend to become advocates for the views of owners, and managers on the Board who act as managers tend to advocate management's position. This completely compromises the Board process.

Having a majority of outside directors on the Board, on the other hand, tends to lessen the dominance of owners, family members, and managers on the Board, but only to the extent that these outside directors are committed to exercising their authority to adhere to the Board process and committed to the Board as a "balance point" between owners and managers. The best chance to preserve both the third-party nature of a Board and the proper boundaries between owners and managers lies with a Board consisting entirely of outside directors.

All outsiders. At Level 7 the Board has the best opportunity to be truly independent and function as the "balance point" between owners and managers. Only Level 7 offers the opportunity to mitigate the significant problems that can exist with having owners, family members, and managers on the Board. For one thing, Level 7 offers the best structure to address power struggles that exist within the ownership group or power struggles between owners and managers. Moreover, Level 7 helps business owners who are concerned about how their presence influences the involvement of other owners and managers, by regulating their effect.

We acknowledge that there is a lot of resistance to a Level 7 Board structure. And we are not advocating a Level 7 Board structure for every family business. We do, though, contend that a Level 7 Board structure offers the best chance for a successful transition within a family business over the long term.

In considering a Level 7 governance structure, we encourage weighing the advantages of such an arrangement with the perceived disadvantages, and encourage the discussion to include how the perceived disadvantages can be adequately addressed without including owners or managers on the Board. For example, we frequently hear the complaint that the owners cannot be kept adequately informed unless they are members of the Board. We believe, though, that policies can be established to satisfy this legitimate concern. For example, owners can require

that they receive information about the Company's activities. By creating an owners' plan and evaluating how the company is meeting that plan, the owners are monitoring whether their needs are being met or not. In addition, owners have the responsibility to evaluate the Board as a whole and each director individually, and to find qualified and competent directors to serve on the Board. We have found the evaluation and searching process in most cases to be significantly lacking. Finally, owners can assemble their own group of advisors to help them monitor the industry and how the company fits within it.

Some people also argue that owners lose control over their business if the Board consists entirely of non-owners and non-managers. In reality, the owners retain their power by being able to work together to come up with an owners' plan. This plan should identify all aspects that the owners believe need to be addressed for the owners to remain committed as owners for the long term. In addition to common needs and goals such as dividends and debt levels, the owners' plan might require management to evaluate perceived risks affecting the owners or to review policies the owners believe conflict with their values. In addition , the owners retain control by establishing structures guiding what the owners, Board, and managers are expected to do and how they will work together to accomplish their respective responsibilities. The owners also exercise control by evaluating these structures from time to time, and in particular by assessing how the Board is guiding the process.

Conclusions

Within each PBS, the Board that uses TABS will be a more effective Board. For example, a Board that guides the development of the annual owners' plan and the development and approval of annual management plans will profoundly affect the well-being of the company. Also, a Board that commits to really addressing and working through the annual calendar items will fully exercise the duties of care and loyalty to the corporation that is expected. Additionally, Boards that direct, but do not manage, will fully exercise their duty to oversee management.

A Level 7 Board structure best avoids many of the contentious issues facing family businesses. At the same time, owners have to decide where they want to go, what is the best way of getting there, what type of governance they want, and what Board structure the powers that be will accept and work within. These big decisions for the owners are not to be taken lightly.

The owners should decide where to start on this Board transition plan, how far they want to transition, how fast, and for what purpose or end goal. The owners always have control over the answers to these questions. No one Board makeup is right for every family business.

Governance is as individual to the owner group and families as succession planning. By choosing the right governance option for a particular business, the owner group can enhance succession planning, strategic planning, the education of the next generation, and the long-term well-being of the company and the family.

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The Board School is for owners, directors and senior managers of family and closely held businesses. It explains The Active Board System and helps owners, directors and senior managers apply the basic principles of TABS to their particular business and unique circumstances.

[2] Business owner is used in this article to refer to entrepreneur, founder, creator, senior generation and the person or persons with the power in the family business.

[3] This article is written from the perspective of a family business. The principles of this article, however, apply equally to any closely held business, whether a family business or not. In addition, many of these principles also apply to publicly held businesses. Historically, models involving public companies have been applied to privately held companies. We believe the current crisis with many public companies suggests that it may be time for public companies to start studying some basic principles relating to private companies.

[4] Boards in this article refer to a an effective, functioning Board of Directors as opposed to a Board for legal reasons only, an informal Board, or an Advisory Board. We point out at the outset that an effective, functioning Board as used in this article can be structured in many different ways. For example, such a Board may consist only of the business owner.

[5] We make a distinction between succession planning and transition planning. Succession planning is designed to help business owners (or others involved in the planning) determine where they are and where they want to go; in other words, to understand the current situation and their goals. Transition planning focuses on how the goals are to be achieved. We believe that an effective, functioning Board is an essential part of transition planning because such a Board can greatly assist achieving the goals identified in the succession plan.

[6] A fundamental principle of TABS is the distinction between power and control. By power we mean the ability to influence a result regardless of the control retained or delegated. By control, we mean the level of authority (whether legal or not) delegated by the one with the power to another to accomplish certain responsibilities. Power is more important to retain than control, although usually a founder assumes that control is more important than power. This assumption seems primarily based on “legal” control being more effective than “nonlegal” power. While this may be true in court cases, it is not true in the practical business world, and continuing to hold on to this mistaken belief will tend to keep the founder in the same position he or she is currently in (that is, in control) when in fact the change sought by a founder is almost always based on a desire for others to take on more responsibilities (that is, have more control) subject to the ability of the founder to guide the results (that is, the power to achieve the desired end.)

[7] This article deals primarily with the first reason because we are using the entrepreneurial company as a way to explain TABS. However, the second and third reasons are most often used to explain TABS to closely held companies that are not owned primarily by a single business owner. Each of these reasons deals with a separate yet prominent reason for troubles in a family business. The first reason deals with a business owner wanting change yet not being willing or able to change. The second reason relates to non-performing or under-performing owners, that is, owners not letting the Board and management know what the owners really want and need from the company. The third reason relates to not having clear boundaries and understandings about the distinct and separate roles and responsibilities of owners and managers.

[8] Directing in this way requires the directors to be able to identify what issues and problems belong to the owners and what issues and problems belong to managers. This is difficult because every issue and problem has an

ownership component and a management component. This is also made more difficult because usually the owners have not identified their values, needs, and goals as a group. The ownership component of any issue or problem is more readily identified the more the owners have clearly described their values, needs, and goals. This type of planning done by the owners helps the directors identify what the owners are interested in which in turn helps them identify how the owners should be involved when any particular issue or problem arises.

[9] The accountability is the same whether the Board directs managers or owners. What is different is the authority. The Board has the legal and inherent authority to direct managers. The Board's authority to direct owners is granted to the Board by the owners through the owners' structures and owners' plan. The reasons owners would grant the Board the authority to hold them accountable arises from the owners' desire to increase the probability that owners will focus just on ownership issues and that power struggles within the ownership group will be kept from leaking into the Board and/or management. Of course, this assumes that the owners accept the assumptions that they and their business are better off; that is, there is less risk if owners let managers run the business with appropriate guidelines given to them by the owners and with appropriate levels of accountability by the Board.

[10] These structures are most beneficial when they are written down in some form of a manual that owners, directors, and managers can refer to and that owners can review on a regular basis and update as needed.

[11] The owners' plan usually is written and describes the values, needs, and goals of the owners as a group. The more developed the owners' plan, the more the owners make sure they receive what they want and need from the company, and, as importantly, the more appropriate controls and guidelines are in place to protect the company, minimize their risks as owners, and provide the owners with the information they need to monitor their risks. We have been told that it is naïve to expect owners to be able to come up with a single plan for all of the owners. We believe this position is based on the lack of desire to identify and resolve differences that may exist in the ownership group. By addressing these differences early on, before significant dissension arises, owners are usually more flexible, more willing to change and, most importantly, more willing to dissociate from the business as an owner because they understand the essential reasons for leaving.

[12] Making sure the Board does its job, including specifically making sure that the owners' plan is being met, is the primary way the owners control their risks.

[13] The questions the Board asks the owners (and managers as noted below) are specific and objective. Also, note, that consistent with the authority granted to the Board to direct owners, the Board accepts (rather than approves) the owners' plan once the Board determines that the owners' plan meets the objective criteria.

[14] The duty to oversee management is based on a legal requirement in the corporate context that a business and affairs of a corporation shall be managed by or under the direction of a Board. We doubt any Board actually assumes the responsibility for the entire management of a company, although that historically was legally required. Rather, the Board typically delegates the management of the business to managers. However, even though the Board may delegate management to others, the Board retains the ultimate responsibility for actions taken by the managers.

[15] The duty of care can be generally described as the duties to act in good faith and in a manner that director reasonably believes to be in the best interests of the company, with the care that an ordinary prudent person in a like position would exercise under similar circumstances.

[16] The duty of loyalty is essentially the duty to avoid conflicts of interest and not to usurp opportunities belonging to the company.

[17] It is important to understand that each of the seven levels of Board structures may exist in many facets, reflecting unique goals and objectives of a particular business owner, business, or dynamics.

[18] Note that the business owner retains all of the Board responsibilities even if there is an Advisory Board. Advisors are not directors, and an Advisory Board is not a Board of Directors. It is common for the primary business owner to view an Advisory Board as the actual Board of Directors which tends to create significant confusion. Members of

the Advisory Board are confused because they rarely view themselves as having the responsibility of a director; instead, their view is that the primary business owner continues to make all of the decisions and their role is to simply advise. Managers are often confused because they may not know who actually makes the decisions – the business owner or the Advisory Board. Owners are sometimes confused because they usually continue to see the business owner as making all of the decisions yet are told that the Advisory Board is making the decisions like a real Board.