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Level Up: The Stages of Growth for Boards of Directors at ESOP Companies

By Hillary Hughes

For companies with an Employee Stock Ownership Plan (“ESOP”), the need for governance is greater than other private closely-held companies. At the heart of long-term employee ownership is a high functioning, effective Board of Directors (“Board”). ESOP ownership begins at the purchase of stock by the ESOP but is sustained and achieved through generations of successful leadership transitions. Guiding these transitions is a high-functioning Board.

Unlike a child, there is no internal biology to generate the growth and maturity that will allow a Board to operate at peak performance. Instead, a Board must evolve over time. This evolution is not defined by the age of the company but rather by the Board’s attributes and its individual members. The goal for an ESOP company is to grow the Board thoughtfully and carefully from an infancy stage to full maturity. In general, Boards at ESOP companies fall into one of the following stages of maturity:

Infant – In this stage, the Board fulfills the minimum legal requirements for a corporation

located in their particular state and is often comprised of family members, friends, management team members and possibly service providers. Boards in the “infancy” stage lack clear agendas for their meetings; do not take meeting minutes; do not regularly schedule meetings; and focus on company operations rather than on strategy.

Adolescent – Boards in the “adolescent” stage tend to have a semblance of structure; meetings are regularly scheduled and may have agendas and minutes. However, the focus is still daily operations, with the Board functioning as an extension of the management team. Moreover, a Board in this stage generally only has internal members, including people with direct ownership, family members and managers of the company. As a result, the Board will not likely have much oversight of the firm’s president and CEO—who will almost surely be Board members—due to the fact that the other Board members may either be related to them or report to them as part of their employment.

Adult – In the “adult” stage, Boards move away from operational discussions and focus on strategy, succession and sustainability. While the Board may still have some internal directors, it also consists of one or more independent members. Independent Board members help provide companies with different perspectives; reduce conflicts of interest; add credibility and trust; and build networks and resources. Having independent Board members may also satisfy lender requirements and is generally looked upon favorably by the U.S. Department of Labor. Since Boards in the “adult” stage tend to have a number of independent members, they usually have a solid recruiting process for Board members as well as a good performance evaluation process for members. More mature Boards will also have a robust CEO review process and succession plan in place. Further, Boards in the “adult” stage contain established committees; these allow for strategic discussions during meetings. Most Boards at this stage have an Audit/Finance Committee and a Compensation Committee. Other committees may include an ESOP Administration Committee; a Governance/Nominating Committee; an Executive Committee; and some “Special” Committees.

Sage – At this point, a Board has all the aforementioned attributes of a Board in the “adult” stage but is comprised of a majority of independent members. In addition to having robust CEO and Board performance review processes, succession plans and committee structures, a Board in the “sage” stage also achieves effective oversight and governance of any equity-linked compensation plans and implements a thorough ESOP Trustee review process. A fully mature Board has high levels of trust among members, who are willing to share opposing viewpoints and engage in deep strategy discussions. Moreover, Boards at this stage implement a diversity plan in order to ensure that the Board is composed of members with different backgrounds and views so that they can create the best plan possible for the firm.

In order to grow a Board to its most mature stage, finding potential independent members is crucial. When networking within an industry or utilizing

resources provided by ESOP groups and associations, such as the National Center for Employee Ownership or Private Directors Association, ESOP firms should be strategic about what attributes the company requires in a Board member. For instance, Boards may need to be rounded out with members who have expertise in the company’s industry, leadership development, succession planning, financial reporting, mergers and acquisitions or cybersecurity, among others. By seeking out individuals with a variety of backgrounds and expertise, an ESOP company can build a mature Board that will further the strategic initiatives of the firm.

Unlike human biology, Boards can regress to an earlier stage of maturity. An unplanned loss of an independent board member, or sudden change in executive leadership, could send an “adult” Board back to the “adolescent” stage or a “sage” Board back to the “adult” stage. Thoughtful and strategic succession planning at the Board and executive levels is essential to provide continuity of leadership in order to sustain employee ownership over the long term.

Progressing through the stages of growth typically takes at least a few years to achieve. The addition of an independent director fosters the opportunity for development to the “adult” stage. Once that occurs, we generally see a marked shift in the content of Board meetings to more executive leadership and strategy. For ESOP companies, this is an important milestone to ensure a strong foundation of employee ownership for future generations of employee-owners.

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