All in the family

Families can often play a significant role in the running of small companies, but that doesn't mean it's an easy job. **Barbara Hauser** explains why family firms need proper governance.

Family firms are different. Unsurprisingly, unlike listed entities, these companies will often closely reflect the nature of the family that controls them. For example, the family will be a very active shareholder, and can often have difficulty differentiating the roles of director-oversight and hands-on management. The classic quip in the United States is for the founder of a family firm to say 'yes, I have a board of directors: I have a board meeting each morning when I look in the mirror to shave'. Where there is an actual board, the directors are often close friends and long-standing advisors of the founder. To grow and prosper, however, what the family firm needs is an excellent, independent board. How can this be achieved?

Family governance

First, the bad news: the odds, on a global basis, of a family firm continuing on to the third generation are somewhere between six and ten per cent. The single biggest factor in the disintegration of the family firm? Internal family conflict.

Now the good news: there is now an awareness, which is rapidly increasing, that with strong family governance procedures and practices in place, a family firm should be able to continue for an indefinite number of generations. With strong governance the family, as shareholders, can create and support a strong board of directors. What are the steps in this process?

To begin at the very beginning, I would normally recommend that an outside advisor (one who is familiar with family firms) would interview each family member separately. This should include children as young as 16, since they have a vested interest in the future.

I suggest asking: 'What does the family business mean to you?' 'Do you have areas where you would like more information?' 'Do you see business issues where family members might disagree?' 'What do you hope for the future the business?' When I have asked these questions of those in control for family firms, I have found that there are often many serious issues simmering in the background.

Often, some family members feel that other members receive more favourable treatment (and benefits) from the business. Others are worried that the future ownership of the stock could cause serious disruption. Everyone who does not work directly in or for the business complains that they do not receive enough information about its decisions and strategy. Younger family members are not sure if they can, or should plan, to work in the business. Without a good sense of the governance requirements of a business, a family has no way to address these issues.

So, the next step is for the family to agree on whether or not it will choose a smaller 'council' group to represent the larger family. This council is given authority to make certain decisions and to communicate them to the larger family. Some major decisions might need ratification by the larger group. Vacancies in the family council may be filled by the remaining members or by the larger family. In many ways, this council has a role that is similar to the board of a company. An effective family council will have regular, formal meetings, often on a quarterly basis. There should be written agendas, and decisions should be recorded in writing after the meeting.

Family constitutions

It is my suggestion that families think of themselves as being like a small country. One of the first steps most countries take is to adopt a system of making joint rules that will apply in their country. The first procedural step is often to agree on a constitution.

Accordingly, most families who are engaged in governance will work to create a written document that will contain the key elements of their governance system. Often called a family constitution, it is also sometimes called a 'protocol' or a 'code of conduct'. (For a template of a family constitution, including a 'two-tier' proposal – see my article, *International Family Governance: A Proposal* in the *STEP Journal*. Sometimes they are detailed enough to form a rule book to cover every possible situation. Other times they are very short, and simply establish the procedure by which the rules will be created. If they create a family council, for example, they may limit all company decision-making discretion to the council.

It is often said that a family constitution may not a binding document, but that might be changing. I am aware of at least one family that has obtained the equivalent of a private court ruling that their constitution is enforceable. If the family controls a business that generates income, it is also possible for the constitution to include penalty provisions such as a reduction in dividend payments. In countries that use or recognise trusts, there are many ways that enforcement can be tied to trust distributions.

The final point to be aware of when putting together a written constitution is to address the need for future flexibility. I always recommend that some provision be included to allow a procedure for amendments.

Liason

Transparency within a family is even more important than transparency within the business.

A step family firms can take toward this goal is the creation of a 'liaison' group to maintain an active relationship with the board. The family group may even be entitled to a representative position on the board. This liaison position is very useful in ensuring that business information is shared with the larger family.

The larger family's role is to give input to the business on long-term goals and strategies, from a family perspective. The biggest question is always whether the family wants to keep control of the business for the next generation. If not, then the planning will be concerned with getting the business into good shape for outside investors.

> "With strong family governance in place, a family firm should be able to continue indefinitely"

If the primary goal is to continue as a family business into the next generation, then the family has a number of issues to address. What are the requirements for a family member to work in the business? Should the family member have a certain educational qualification? Should they work outside the business for several years first? Should they report to a non-family member, or have a special training programme? How is compensation to be reviewed? How are dividend policies to be set? What role should the board play in determining those issues? All these issues must be considered thoroughly if the business is to survive.

Directors in family firms

Finally, the role of an independent director is different in a family firm. I see three distinguishing characteristics.

Firstly, there is a somewhat 'collapsed' representation of different constituencies in the board meetings. Unlike listed companies, where the board meeting might consist only of the chief executive and independent directors, the family board is likely to include top management and key shareholders (often, but not always, the same individuals). Thus special attention needs to be given to keeping the various (and sometimes conflicting) roles straight. This blend of roles can be confusing to directors from a listed company background. It can also be confusing for the family – independent directors can help here by clarifying roles and responsibilities wherever possible. Secondly, it is clearly the family (as shareholders) who set the primary direction of the firm. At the end of the day, the firm belongs to the family, and all of the major decisions rest with them. The board serves at the discretion of an involved family, not from election by detached and dispersed anonymous shareholders. On the other hand, the family firm that has chosen to have independent directors has done so because they value the contribution of 'negative' feedback even more than they value praise. The special role of the independent director in a family firm is, unsurprisingly, to give an 'independent' view; the value such directors bring to the table.

Thirdly, as is often mentioned, the family can take a long view of investments and profits. The family firm should be patient and thoughtful. It is not up against the pressure of analysts or the need to file quarterly returns. This allows the family to shape its own future. The value of advice and feedback from independent directors is invaluable in this process. Being a director in a family firm does have special challenges, as described, but also has very rewarding possibilities: the views of independent directors contribute invaluable benefits to family firms.

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Family firms are different. It is all too easy for them to slowly slip away as the family grows less concerned with the running of the business and more concerned with the trappings it provides. To combat this, families must have a clear system of governance set out, with significant thought given to succession, potential future growth and long-term sustainability. If these goals can be achieved, a family firm can be just as transparent and well-governed as any publicly-listed company.

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