Corporate Governance in Family Businesses

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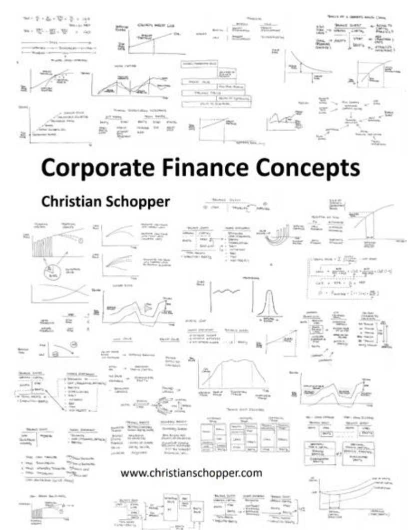

Introduction

Introductory Thoughts

- Family businesses constitute the world’s oldest and **most dominant form of business** organizations
  - In many countries, family businesses represent more than 70% of the overall businesses and play a key role in the economy growth and workforce employment
  - In Spain, for example, about 75% of the businesses are family-owned and contribute to 65% of the country’s GNP on average
  - Similarly, family businesses contribute to about 60% of the aggregate GNP in Latin America
- Family businesses range from **small and medium-sized companies to large** conglomerates that operate in multiple industries and countries
  - Italy: Salvatore Ferragamo, Benetton, and Fiat Group
  - France: L’Oreal, Carrefour Group, LVMH, and Michelin
  - South Korea: Samsung, Hyundai Motor, and LG Group
  - Germany: BMW, and Siemens
  - Japan: Kikkoman, and Ito-Yokado
  - US: Ford Motors Co, and Wal-Mart Stores
- It is also a fact that most family businesses have a **very short life span beyond their founder’s stage**
  - Some 95% of family businesses do not survive the third generation of ownership

Family Business Definition and Characteristics

- Family business refers to a company where the voting majority is in the hands of the **controlling family**; including the founder(s) who intend to pass the business on to their descendants

Strengths

- Several studies have shown that family-owned companies **outperform** their non-family counterparts in terms of sales, profits, and other growth measures
- Some of these strengths include:
  - ***Commitment****.* The family—as the business owner—shows the highest dedication in seeing its business grow, prosper, and get passed on to the next generations
  - ***Knowledge Continuity****.* Families in business make it a priority to pass their accumulated knowledge, experience, and skills to the next generations
  - ***Reliability and Pride***. Because family businesses have their name and reputation associated with their products and/or services

Family Business Definition and Characteristics (cont´d)

Weaknesses

- Many of them fail to be **sustainable** in the long term
  - 65-75% of family businesses either collapse or are sold by the founder(s) during their own tenure
  - Only 5-15% continue into the third generation in the hands of the descendents of the founder(s)
- Some of these weaknesses are:
  - ***Complexity***. Family businesses are usually more complex in terms of governance than their counterparts due to the addition of a new variable: the family
  - ***Informality***. Because most families run their businesses themselves (at least during the first and second generations), there is usually very little interest in setting clearly articulated business practices and procedures
  - ***Lack of Discipline***. Many family businesses do not pay sufficient attention to key strategic areas such as: CEO and other key management positions' succession planning, family member employment in the company

Stages of Growth in a Family Business

Stage 1: The Founder(s) (Controlling Owner(s))

- Business is entirely owned and managed by the founder(s)
  - Most founders will make the majority of the key decisions themselves
- Strong **commitment** of the founder(s) to the success of their company
- Relatively **simple** governance structure
  - Bboth the control and ownership of the company are still in the hands of the same person(s): the founder(s)
- Most important issue: **Succession planning**
  - For the family business to survive into its next stage, the founder(s) should make the necessary efforts to plan for their succession and start grooming the next leader(s) of the company

Stages of Growth in a Family Business (cont´d)

Stage 2: The Sibling Partnership

- Management and ownership have been **transferred** to the children of the founder(s)
- As **more family members** are now **involved** in the company, governance issues tend to become relatively more complex
- Common challenges:
  - Maintaining siblings' **harmony**
  - Formalizing business **processes** and **procedures**
  - Establishing efficient **communication** channels between family members, and
  - Ensuring **succession planning** for key management positions

Stages of Growth in a Family Business (cont´d)

Stage 3: The Cousin Confederation (Cousin Consortium or Family Dynasty)

- Business' governance becomes more **complex**
  - More family members are directly or indirectly involved in the business, including children of the siblings, cousins, and in-laws
- Many family members belong to **different generations** and different **branches of the family**
  - Diverse ideas on how the company should be run and how the overall strategy should be set
- **Conflicts** that existed among the siblings in the previous stage would most likely be **carried on**
- This stage involves most family **governance issues**
  - Family member employment
  - Family shareholding rights
  - Shareholding liquidity
  - Dividend policy
  - Family member role in the business
  - Family conflict resolution; and
  - Family vision and mission

Family Businesses Development Cycle

Ownership Stage	Dominant Shareholder Issues
Stage 1: The Founder(s)	• Leadership transition • Succession • Estate planning
Stage 2: The Sibling Partnership	• Maintaining teamwork and harmony • Sustaining family ownership • Succession
Stage 3: The Cousin Confederation	• Allocation of corporate capital: dividends, debt, and profit levels • Shareholder liquidity • Family conflict resolution • Family participation and role • Family vision and mission • Family linkage with the business

Family Member Roles in the Governance of Their Business

Owners (Shareholders)

- Owners in a family business have several **roles and motivations** that can sometimes lead to conflicting opinions
  - Eg: Decision to **reinvest** profits in the company instead of distributing them as **dividends**

- Some of the **roles** that an owner in a family business can have are:
  - Owner only
  - Owner/manager
  - Owner/family member
  - Owner/family member/manager
  - Owner/director
  - Owner/family member/director
  - Owner/family member/director/manager

Managers (Senior Management)

- Managers in a family business will have different motivations depending on their other roles within the business
  - Eg: **unequal treatment** of family and non-family managers, such as part or all of the senior management positions strictly reserved for family members

- Hard for many family businesses to **attract and retain talented non-family managers**
  - Clear and fair employment policy (for both family and non-family employees) key for family businesses to keep their very best employees motivated and interested in the growth of the company

Directors (Board of Directors)

- Most family businesses reserve this right to members of the **family** and in a few cases to some well **trusted non-family managers**
  - Used as a way of **keeping the family control** over the direction of its business

- Most decisions are usually taken by the family-member directors
  - Eg: dividend distribution: Family directors who are also managers in the business would rather encourage reinvesting profits in the company …

Family Members (the Family and its Institutions)

- Can have **different responsibilities, rights, and expectations** from their business
- This situation can lead to **conflicts** and issues, potentially jeopardizing the continuity of the family business
  - Eg: **Access to information**
  - Eg: **Communication** channels and institutions to keep all family members informed about the business, strategy, challenges, and the overall direction where the company is heading

The Role of Corporate Governance

- Corporate governance refers to the structures and processes for the direction and control of companies
  - Concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders

Hence, Corporate Governance focuses on three **key elements**:

- **Direction**
  - Long-term strategic decisions
  - Large-scale investment decisions
  - Mergers and acquisitions
  - Succession planning and appointment of key senior managers

- **Control**
  - Oversee the management's performance
  - Follow up on the implementation of the strategic decisions

- **Relationship among the main governing bodies**
  - Interactions among the shareholders, the directors of the board, and the managers

Family Governance

Outline of a Family Governance Structure

A well functioning family governance structure will mainly aim at:

- Communicating the family **values**, **mission**, and long term **vision** to all family members
- Keeping family members - especially those who are not involved in the business - informed about major business **accomplishments**, **challenges**, and strategic **directions**
- Communicating the rules and decisions that might affect family members' **employment**, **dividends**, and other **benefits** they usually get from the business
- Establishing formal communication channels that allow family members to **share** their **ideas**, aspirations and issues
- Allowing the family to **come together** and **make** any necessary **decisions**

The major constituents of a family governance structure are:

- **Family Constitution** and
- **Family Governance Institutions**

Family Constitution

… states the family **vision**, **mission**, **values**, and **policies** regulating family members' **relationship with the business**

Components

- Family values, mission statement, and vision
- Family institutions, including the family assembly, the family council, the education committee, the family office, etc.
- Board of directors (and board of advisors if one exists).
- Senior management
- Authority, responsibility, and relationship among the family, the board, and the senior management
- Policies regarding important family issues such as family members' employment, transfer of shares, CEO succession, etc.

- The form and content of family constitutions differ depending on the size of the family, its stage of development, and the degree of involvement of family members in the business

Family Constitution - Family Member Employment Policies

Rationale

- Business may end up with more employees from the family than the company needs
- Some of these employees might not even be suitable for the jobs
- Some family businesses find themselves acquiring businesses that have no relationship with their original business or keeping some unprofitable business lines just to make sure that everybody in the family gets a job within the company

General Terms

- Clear rules about the **terms and conditions of** family **employment** within the firm
- Clearly state the conditions of **entry**, **staying**, and **exit** from the business
- Cover the **treatment** of family member employees in comparison with non-family employees

Family Constitution - Family Member Employment Policies

Example for a structure of a Family Member Employment Policy

- Employment Philosophy
- Existence of Open Position
- Prerequisite Qualifications
  - Educational Requirements
  - Outside Working Experience
  - Age Limit
  - Family Employment Specifics
- Compensation
- Other Family Employment Policies
  - In-laws Employmnt
  - Supervision an Reporting Relationships
  - Short-term Internships and Summer Employment
  - Continuing Education

Family Constitution - Family Member Shareholding Policies

- For some families it is crucial to clearly define shareholding policies at the earliest stages of the family's existence
  - This usually helps set the right **expectations** among family members **regarding shares' ownership rights,**

Illustrative Parameters

- Allowed to own shares or not
- Exit mechanisms
- Dilution mechanisms
- Share Redemption Fund
- Buyback Mechanism
- Conflict resolution (eg. with salary receiving family members)

Family Governance Institutions

… help strengthen the family harmony and relationship with its business

- Increase the **communication links** between the family and its business
- Opportunities for family members to **network** and **discuss** aspects that can be related to the business or the family
- Increase understanding and **build consensus** among family members

- Ensure that family members distinguish between the role of these institutions and the governing bodies of the business such as the board of directors and senior management

Family Governance Institutions - Family Assembly

Definition

- Formal forum for discussion for all family members about business and family issues

Purpose

- Reflect on areas of common interest (**family and family business issues**)
- Stay informed and voice opinions about **business development** and other family issues
- Help avoid potential **conflicts** that might arise among family members
- Usually held about once or twice a year
- **Issues handled**
  - Approval of any change in the family values and vision
  - Education of family members about their rights and responsibilities
  - Approval of family employment and compensation policies
  - Election of family council members (if the council exists)
  - Election of other family committees' members
  - Other important family matters

Membership

- Usually, **open to all** family members
- However, some families prefer to set certain membership **restrictions** such as minimum age limits, participation of in-laws, and voting rights during the assembly

Family Governance Institutions - Family Council

Definition

- Working governing body that is **elected by the Family Assembly** among its members to deliberate on family business issues
  - Usually established once the **family reaches a critical size**, i.e. more than 30 members
  - Representative governance body for the family assembly in coordinating the interests of the family members in their business

Purpose

- Being the primary **link** between the **family**, the **board,** and **senior management**
- Suggesting and discussing names of candidates for board membership
- Drafting and revising family position papers on its vision, mission, and values
- Drafting and revising family policies such as family employment, compensation, and family shareholding policies
- Dealing with other important matters to the family

Membership

- Manageable size (eg. 5-9 members) and meeting 2-6 times a year
- Elected by the family assembly considering qualifications and availability to perform
- Can impose certain restrictions such as age limits and experience requirements
- Good practice: Set limited terms for the council's membership
- Decisions are usually approved by majority votes of the council's members

Family Governance Institutions – Assembly vs Council

	Family Meeting	Family Assembly	Family Council
Stage	Founder(s)	Sibling Partnership/ Cousin Confederation	Sibling Partnership/ Cousin Confederation
Status	Usually informal	Formal	Formal
Membership	Usually open to all family members. Additional membership criteria might be set by the founder(s).	Usually open to all family members. Additional membership criteria might be set by the family.	Family members elected by the family assembly. Selection criteria defined by the family.
Size	Small size since family still at founder(s) stage. Usually 6- 12 family members.	Depends on the size of the family and membership criteria.	Depends on criteria set up for the membership. Ideally 5-9 members.
Number of Meetings	Depends on the stage of the business' development. When the business is growing fast, can be as frequent as once a week.	1-2 times a year.	2-6 times a year.
Main Activities	• Communication of family values and vision. • Discussion and generation of new business ideas. • Preparation of the next business leader(s).	• Discussion and communication of ideas, disagreements, and vision. • Approval of major family related policies and procedures. • Education of family members on business issues. • Election of family council and other committees' members.	• Conflict resolution. • Development of the major family related policies and procedures. • Planning. • Education. • Coordination of the work with the management and the board and balancing the business and the family.

Family Governance Institutions – Family Office

Definition

- Investment and **administrative center** that is organized and overseen by the family council
- Usually common within large and wealthy families in business, whose members express a need for getting personal financial, banking, accounting, and other advice

Purpose

- Advice on personal investment planning, taxes, insurance coverage, estate planning, career counseling and other topics of interest to individual family members

Membership

- Usually run by professional managers who monitor the investments, tax compliance, insurance, financial planning, and intra-family transactions such as gifts of stocks and estate plans

Family Governance Institutions – Other Family Institutions

Education Committee

- Responsible for nurturing the family's human capital and its capacity to effectively collaborate in the tasks of governance
- Anticipates developmental needs of family members and organizes educational events and activities for them

Shares Redemption Committee

- Overseen by the family council, and manages an established fund for shareholders who wish to cash in their stock at a fair price in order to pursue other activities with this money
- Fund usually built by contributing a percentage of the company's profits to it each year

Career Planning Committee

- Establish and oversee entry policies for family members interested in joining the family business
- Helps monitor the careers of family members, offers career mentoring and keeps shareholders and the family council informed on their development

Family Reunion and Recreational Committee

- Plan fun and other events in order to get family members together

Board of Directors in a Family Business

Advisory Boards

Role

- Group of experienced and **respected individuals**, especially when own boards of directors remain only composed of family members and company senior managers
- Relevant in cases, when the board may lack **expertise** and seek **outside perspective** in certain strategic areas (marketing, finance, human resources management, and international markets)
- Often considered a "**compromise solution**" between a family dominated and a more independent board

Composition

- Practical 3-7 members
- Either experts in the family business' industry, or in other, complementary areas
- Usually meets 3 - 4 times a year
- Ideally not part of the Advisory Board:
  - Suppliers or vendors to the company
  - Friends of the owners with no relevant expertise to offer
  - Existing providers of service to the company (e.g., bankers, lawyers, external auditors, consultants)
  - Individuals who have a conflict of interest in being advisors to the company
  - Individuals who are already overcommitted and would not be able to correctly perform their roles as members of the advisory board

Advisory Boards (cont´d)

Advisory Board

Advantages	• Its members have no legal responsibilities; this reduces the company's cost (insurance is not necessary) and makes it easier to recruit members (since membership is not as risky as being part of the company's board of directors). • Can provide the company with additional skills, technical expertise, and knowledge that are not available at the current management and board levels. • Its advice is usually unbiased. • Its members may offer new contacts that can lead to additional sales or sources of capital.
Disadvantages	• The advisory board functions like a group of experts whose advice is not systematically followed by the company. As a consequence, the advisory board might not be taken as seriously as a real board of directors. • The advisory board has no authority to request information from the management, so its recommendations can only be based on what management is willing to share with its members. • Advisory board members have little or no influence on the strategy and performance oversight of the management. • The lack of legal responsibility makes it difficult to hold members of the advisory board accountable for their advice. • Some advisory board members might not take their role seriously and put in the necessary preparation and contribution as they would as real board members.

Board of Directors

Role

- Set the overall **strategy** of the firm
- **Oversee** the **management performance**
- **Ensure** that an appropriate **corporate governance structure** is in place
  - including a robust control environment, sufficient disclosure levels, and an adequate minority shareholders' protection mechanism
- In addition
  - Securing senior management succession
  - Ensuring the availability of financial resources
  - Ensuring the adequacy of the company's internal controls and risk management systems
  - Reporting to the owners and other interested parties

Composition

- Depending on size and complexity of the company's operations 5 - 9 members

Personal Traits	Professional Qualifications
• Personal integrity and accountability • Team work ability • Good communication skills • Leadership skills • Strong analytical skills • Courage, self confidence and ability to challenge other directors, family members, and senior managers	• Industry experience • Proper business judgment • Expertise and skills in relevant areas (to be defined by the company). These could include: Strategy; Marketing; Law; Finance and Accounting; Risk Management and Internal Control; Human Resources; and Corporate Governance • Useful ties and connections

Board of Directors (cont´d)

Duty of Care

- Carefully study any material information available to them before taking any decisions
- Act with diligence and competence
- Make decisions on an informed and deliberative basis
- Regularly attend the board’s meetings, come prepared to these meetings, and actively participate in them (this part of the duty of care is also referred to as the “duty of attention” or “duty of obedience”)

Duty of Loyalty

- Put the interests of the company above any personal or other interests
- Immediately disclose any conflicts of interest to the rest of the board
- Abstain from voting on matters that could involve a personal conflict of interest

Independent Directors

Rationale

- Adding new skills and knowledge that might not be available within the firm
- Bringing an independent and objective view from the family
- Making hiring and promotion decisions independent of the family ties
- Acting as a balancing element between the different members of the family and, in some cases, serving as objective judges of disagreements among family-member managers
- Benefiting from their business and other contacts and connections

Definition

- An independent director should be free of links to management, controllers (family), and others that could influence his/her judgment

Independent Directors – Indicative Definition

Indicative Independent Director Definition[27]

"Independent Director" means a director who is a person who:

1. has not been employed by the Company or its Related Parties in the past five years;
2. is not, and is not affiliated with a company that is an advisor or consultant to the Company or its Related Parties;
3. is not affiliated with a significant customer or supplier of the Company or its Related Parties;
4. has no personal service contracts with the Company, its Related Parties, or its senior management;
5. is not affiliated with a non-profit organization that receives significant funding from the Company or its Related Parties;
6. is not employed as an executive of another company where any of the Company's executives serve on that company's board of directors;
7. is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the Company or its Related Parties as an executive officer;
8. is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the Company or of a Related Party; or
9. is not a controlling person of the Company (or member of a group of individuals and/or entities that collectively exercise effective control over the Company) or such person's brother, sister, parent, grandparent, child, cousin, aunt, uncle, nephew or niece or a spouse, widow, in-law, heir, legatee and successor of any of the foregoing (or any trust or similar arrangement of which any such persons or a combination thereof are the sole beneficiaries) or the executor, administrator or personal representative of any Person described in this sub-paragraph who is deceased or legally incompetent,

and for the purposes of this definition, a person shall be deemed to be "affiliated" with a party if such person: (i) has a direct or indirect ownership interest in; or (ii) is employed by such party; "Related Party" shall mean, with respect to the Company, any person or entity that controls, is controlled by or is under common control with the Company.

Senior Management in a Family Business

Family vs Non-Family Managers

Ensuring that a firm has the right senior managers is a process that should start early, even as early as during the founder(s) stage of the family business

- **Analyzing** the organizational structure and contrasting the current and optimal roles and responsibilities (compared to peer companies) of each senior manager
- **Designing** a formal organizational structure that clearly defines the roles and responsibilities of all senior managers
  - This should be based on the company's current and future business operations' needs
- **Evaluating** the skills and qualifications of the **current** senior management based on the new organizational structure
- **Replacing** and/or hiring senior managers
- **Decentralizing** the **decision-making process** and approval levels as necessary
  - Decision-making powers should be linked to the roles/ responsibilities of managers and not to their ties to the family
- Establishing a **clear family employment policy** and making its content available to all family members
- Developing an **internal training program** that allows skilled employees to be prepared for taking on senior assignments in the future
- Establishing a **remuneration system** that provides the right incentives to all managers depending on their performance and not their ties to the family

Family vs Non-Family Managers (cont´d)

Issue	Family First Companies	Business First Companies
Employment Policy	*Open door policy for all family members.* The family-owned company often becomes a safety net for those who can not succeed outside the business.	*Only qualified family members join the company.* Conditions for family employment are clearly set and contain requirements concerning education and prior work experience outside of the family business.
Compensation	*Equal pay for all.* Everyone is paid the same, regardless of their experience and contribution to the business. Competent family members are expected to care for (via compensation, benefits, etc.) their less-than-competent siblings or cousins.	*Compensation is based on performance and responsibility.* Compensation is based on market and industry measures, not on family needs. Accountabilities and reporting relationships are clearly communicated and understood. High performers are highly paid. Family members may be terminated for poor performance.
Leadership	*Leadership is based on seniority,* rather than demonstrated competences or successes. Longevity in the family business may be more highly valued than working and succeeding outside the business.	*Making sure leadership is earned.* The family mantra is to have "the best and the brightest" running the business: family or non-family. Non-family senior executives may be recruited from within the industry although some companies successfully grow their own top managers.
Business Resources Allocation	*Business resources are used for family members' personal needs* (housing, cars, personal purchases, etc.)	*Business resources are used strategically.* There is a clear separation of business and family assets. Budgeting and planning are important; earnings are used for growth initiatives or paid out as dividends.
Training	*No formal training programs.* Family members are expected to intuitively learn business practices.	*Need for formal training is timely recognized.* Trainings are scheduled and delivered to teach family members necessary business practices.

CEO and Senior Management Succession

Families in business might ignore the necessity of planning for the succession of their CEO for a multitude of reasons. Some of these reasons include

- Family members delaying the decision in order **not to create potential frictions** among family members in case several potential CEOs are available within the family
- Family members delaying the decision because **no current family member or outsider is deemed capable** of replacing the current CEO
- Family members avoiding to address this issue in order **not to discuss the topic of the eventual loss** of a family leader (the current CEO)
- Current CEO refusing to admit that the company can survive without him/her and/or is afraid of retirement and refusing to address succession issues

CEO and Senior Management Succession (cont´d)

Starting Early

- Start even as early as when the current CEO is appointed…

Creating Career Development Systems

- Selects the best possible candidate for the job, regardless of whether this candidate is related to the family or not

Seeking Advice

- From the external independent directors of the board

Building Consensus

- The success of the future CEO is largely dependent on his/her acceptance by the key stakeholders involved in the company

Clarifying the Transition Process

Family Business Going Public

Why Going Public

Advantages

- Improved Marketability of Shares
- Improvement of the Company´s Financial Position
- Potential Increase in the Value of Shares
- Greater Visibility

Disadvantages

- Loss of Privacy
- Loss of Autonomy
- Increased Liability
- Possibility of a Takeover
- Additional Costs

Getting Ready for an IPO

Governance Attributes	Examples of Best Practices
Shareholder Rights	• Clear protection of minority shareholders in charter, by-laws, and company governance code. • Adequate notice and shared agenda of all shareholders' meetings. • Ability to participate and vote meaningfully at shareholders' meetings (e.g., cumulative voting for directors). • Fair treatment regarding information disclosure (material shareholder agreements, conflicts of interest, etc.) • Clarity in rights of different classes of shares – voting rights vs. economic rights. • Equitable treatment in changes of control (e.g., tag-along rights).
Board of Directors	• Right mix of professional skills (e.g., marketing, strategy, international financial markets, and audit committee expertise). • Strong independence component. • Separate chairman and CEO roles. • Regular schedule and agenda of meetings. • Existence of board committees responsible for oversight in key areas (Audit, Governance and Nomination, and Remuneration). • Initial and continuous director education. • Periodic evaluation of directors.
Transparency and Disclosure	• Information prepared and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure. • Annual audit conducted by an independent, competent, and qualified auditor in accordance with the International Standards on Auditing. • External auditors accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of their audit. • Channels for disseminating information should provide for equal, timely, and cost-efficient access to relevant information by users.

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