# Family governance: the issues, the concerns and the strategies to deal with them

Family businesses that continue to prosper from one generation to the next often do so because they have robust governance structures.

Nevertheless, many family businesses have not given enough thought to governance. They rely too much on a carefree attitude toward issues such as succession, ownership and management, and they wait until one of these issues becomes an unavoidable problem before attempting to deal with it. Often, that is too late, and the business will suffer as a result.

Here are some of the more common governance problems that can arise within family businesses:

- **Succession and the business's dependence on its owner.** The family business owners are often the leaders of their businesses. But they are also a potential risk through their failure to plan for succession or to relinquish control when it would benefit the business to do so.
- **Internal family conflicts.** Internal conflict between family members can, at its worse, disable a company. The assets of the business can often be abused by family members for their own personal benefit.
- **Nepotism.** This can undermine professionalism in the business and discourage non-family business staff.
- **Tunneling.** This refers to a situation in which family owners create a complex set of ownership structures that undermine non-family minority shareholders. This can ultimately damage the efficiency of the business.

There are also likely to be concerns about how the family interacts with the business:

- **Who can or cannot be a shareholder?** The limiting of shareholding to bloodline family members, as opposed to in-laws, can often be an issue.
- **What are the different classes of shares?** This is a less common issue, but different classes of shares can sometimes be used to give voting powers only to those active in the business.

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### Case study: a family that had sold the family business

**Background**

The business was sold for a considerable sum of money, and the family wanted to establish a family office to manage the newly liquid wealth for the benefit of the future generations.

**Project approach**

- Holding family meetings to advise on the various possible structures and arrangements — in-source versus out-source — and helping the family redefine their goals and objectives
- Introducing the family to various external providers to allow them to explore the market and different options
- Advising the family on the services EY can provide in relation to the setting up and running of a family office
- Advising on the possible structures for holding of family wealth, highlighting taxation and family governance implications
- Advising on succession issues and estate planning
- Advising on foreign real estate structures and planning for family members living in foreign countries.

**Added value**

- Leveraging the wider family office team within EY, with subject matter experience in setting up family offices
- Leveraging contacts in the family office network to introduce relevant third-party professionals and service providers
- Using EY knowledge of the client to pinpoint the key issues and concerns and to guide the client in its decision-making process

### Case study: a family business transitioning to the fourth generation

**Background**

The business is currently under the control of the third generation, but it is transitioning to the fourth generation.

**Project approach**

- Identifying and analyzing the issues facing the family and the company
- Facilitating family meetings and introducing various concepts in the areas of governance, family council, family employment policy, charity and conflict management
- Developing the family governance structure and business structure
- Developing the family constitution

**Added value**

- The development of the family governance structure and business structure
- The development of the family constitution

### Contact EY to learn more about how we can help you succeed for generations

EY offers a wide range of professional business services specifically aimed at the unique needs of family businesses and family offices. We know that one size does not fit all, so all our services are personalized to your family.

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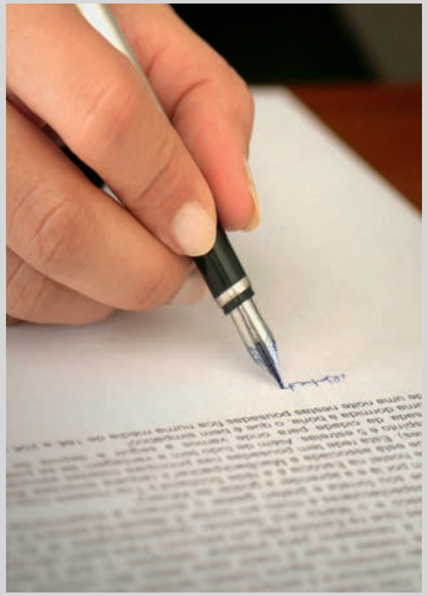
- **How are the owners to be represented on the board?** When a family business is in the second generation or beyond, there is likely to be a growing number of owners who are not on the board. In such cases, owners might require representation in the form of one or two family owners on the board, usually in a non-executive capacity.
- **How will the owners set objectives and challenge management?** Ownership and management are two different aspects of the family control of businesses. But family members are typically involved in both aspects. This means that a clear distinction must be drawn between the two. Owners need clear ownership governance structures with management.
- **What are the key issues on which management should consult the owners?** Having set the overall objectives, the family owners should leave the management of the firm to manage the business. But, from time to time, issues will emerge on which owners expect to be consulted, for example, when an offer to purchase the company is received or when the company is appointing a senior non-family manager to the board.
- **What are the rules on exits for shareholders?** If family shareholders are locked in, it can create long-term conflict. It can also create a fragmentation of power and can undermine the desire to continue the business. Allowing or even persuading uninterested family members to sell their shares is an excellent way of ensuring successful business continuity.
- **What is the basis of share valuation (for all) on exits?** This is one of the most controversial issues, and it is essential to reach an agreement before the situation arises. The valuation needs to be fair, not just for the exiting shareholder, but also for the continuing shareholders because they still carry the risk, a commitment to make the business work and a responsibility to keep the family business together for the next generation. Such fairness requires an appropriate discount on the market price.
- **How will succession in management be dealt with?** Without clear rules, there is the danger that some family members will stay in their managerial positions for a lifetime. What is the term of office? When should they retire? Who is in charge of the succession process and how will this process be implemented? Should those in major management positions have contracts of employment, as they would in a public corporation?

If the family has clear rules on bloodline ownership, how can the family make sure that they are followed and are properly communicated at the right time to the next generation so that they will know the rules?

Of course, family businesses that fail to implement robust governance structures are unlikely to face all these questions and issues at once. Nevertheless, not being able to effectively answer one of these questions could undermine the strength of the business and, ultimately, its chances of survival.

But those family businesses that take a practical approach to governance and that build structures to reinforce best practices are likely to benefit tremendously from doing so.

At the heart of good family business governance is a family charter. A family charter is a framework that defines how the family relates to the business, as employees, owners and family members.



There are no set rules about how to create a charter. But following these three stages will help to maximize a charter's effectiveness.

### **Stage one:** develop an understanding of family history and vision

This part of the process usually involves a mixture of workshops and individual meetings with the family members. These are designed to inform all generations about the purpose of the process, but also, critically, to ensure that the family's vision will be supported by the next generation, and to address any variances.

At this stage, it is also important to find out which issues the next generation members believe must be addressed if they are to operate the business successfully. These issues become the action points for the next phase of the exercise.

The deliverable for this stage would be a detailed report of the issues facing the family and the family business.

### **Stage two:** develop the principles of the family charter

To succeed, it is important for family businesses to anticipate future issues and talk about them — as a family — before they become problems. These discussions can be formalized through the creation of a family council for the family owners. The family council (or shareholders' assembly) will address the family and business issues identified in the previous stage of the process. In so doing, it will establish structures, an agreed constitution or rules that will form the basis of the business relationships between family members.

In this way, the family council will evolve into being the ownership governance vehicle for the business. By enabling all generations to build their business relationships, to establish greater awareness and to increase their understanding and capabilities, such councils can help ensure that continuity, rather than conflict, is the most likely outcome.

At the conclusion of this stage, a complete family charter should be presented to all family shareholders, who will be invited to confirm their commitment to following the agreed rules.

### **Stage three:** putting the charter into effect

This stage involves incorporating the charter into new shareholder agreements and into the articles of the company. This work will be primarily carried out by the family's lawyers.

It is important that the charter is prepared with the participation of the shareholders. And the charter should be designed on the basis that what is good for the family business is good for the individuals. A comprehensive family charter usually seeks to answer all the questions outlined above and to cover the following points:

1. The family's vision and philosophy
2. The governance of the shareholders' assembly, which typically will include:
   a. The role of the shareholders' assembly
   b. The voting mechanism for decision-making
   c. Membership of the shareholders' assembly
   d. The election of a chairman
   e. Duties and responsibilities
3. Family representation on the holding company board, which will typically include an election process and terms of office
4. The family council, which will include:
   a. The role of the family council
   b. Membership and the voting mechanism
   c. Terms of office
5. How to deal with exits (family members wishing to leave), which will include:
   a. Guidance on valuation
   b. The building of reserves for exits
6. Conflict resolution mechanisms
7. Family employment policy, which should include:
   a. Criteria for family employment
   b. How family members will be rewarded
   c. Restrictions on what family members can invest in their own name
   d. Family joint ventures
8. Charitable activities
9. Family office
10. Dividend policy
11. Confidentiality policy and a code of conduct

## Case studies

Here are three case studies on how EY helped family businesses develop governance structures. The examples show how potentially contentious problems can be dealt with by following a coherent and logical approach to governance.

### Case study: a multi-branch family business wanting greater transparency

**Background**
The company was a prominent family business with multiple branches. The objective was to ensure family business continuity and to develop a governance structure that would minimize areas of conflict and encourage transparency.

**Project approach**
- Identifying and analyzing the issues facing the family
- Focusing on various concepts in the areas of governance, family council, family personnel policy, charity and conflict management
- Developing the family governance structure and business structure
- Developing the family constitution
- Developing the structure and roles of multiple family committees (family council, family personnel committee, charity committee and family office)

**Added value**
- The development of the family governance structure and business structure
- The development of the family constitution, as well as the structure of the family office