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CORPORATE GOVERNANCE OF FAMILY OWNED BUSINESS

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Introduction

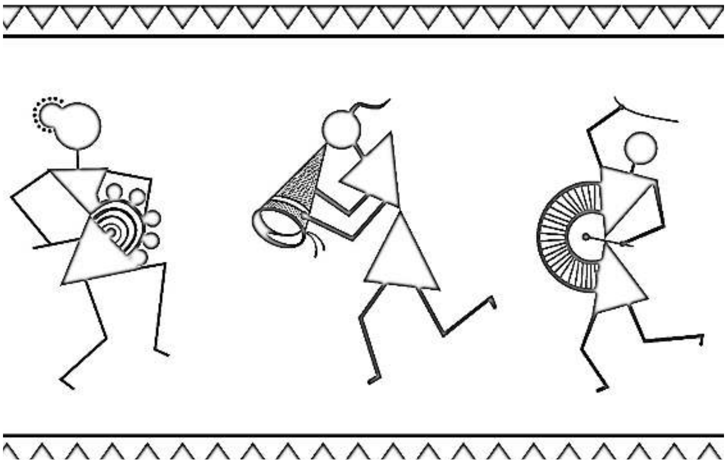
Family ownership is the most prevalent form of an ownership structure in many countries. Family business can be a single-owner firm to large industrial houses. Studies indicate that 9 out of 10 businesses have shut down within 5 years after the death of the founder and only about 3 out of 10 survive in second generation. Family businesses suffer from interdependencies between the family, the business and ownership (Taiguiri and Davis, 1992). The family members don several roles, with thin lines between executive and governance facets. They may not have a clear demarcation between personal and business assets and thus many family business owners even lose their personal fortunes because of business liabilities. Powerful owners or directors (or other stakeholders) may drive the appointment of nominees to extend and preserve their vested interests. Interlocking directorships, intermediate relationships and tacit dependencies are common among family business directors.

In our view, most family business are designed to fail as they do not address successor planning and training, balancing family concerns and business interests, including non-family members in the Board of Directors, and a host of many other issues relating to family firm governance (Addae-Boateng et al, 2014). However, family businesses can build governance structures and process not just to meet regulatory requirements, but help them sustain themselves for future generations. Family businesses require simple and flexible governance mechanisms that can be easily adopted and evolve with the family and the business as their needs change over time. Family business governance is all about preserving the action-oriented mind-set that allowed the family and its employee to turn an opportunity into a thriving business, but also preserve and sustain the business for long term (Egloff and Bhalla, 2014). Crisis handling procedures and systems, both formal and informal, are required to govern and sustain a family business (Faghfouri et al., 2015). To be effective, family governance needs to forge the emotional and relational ties of the family with formal governance mechanisms required to meet regulatory and other requirements. Family business governance code must be cognizant of the size and stage of development of both the family and the business and flexible enough to meet the business context (Howorth and Kemp, 2019).

In this paper, we present formal and informal structures and processes that family businesses can adopt to comply with good governance practices and in turn preserve their business for the future.

Corporate Governance Dimensions of Family Business

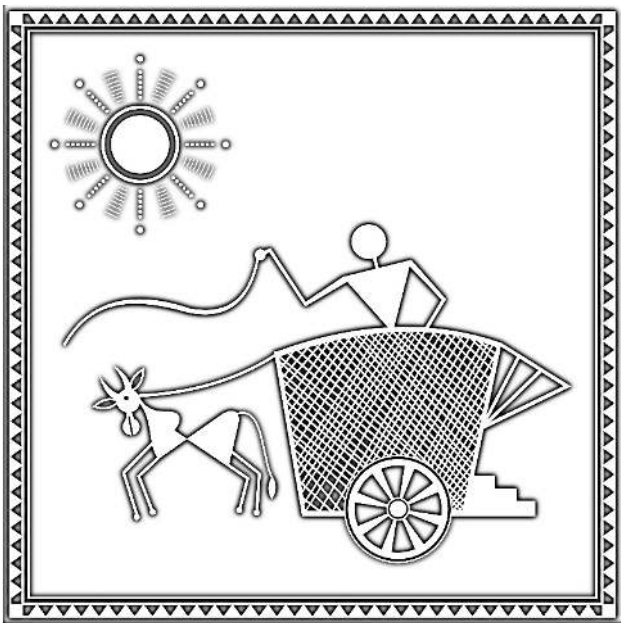
Corporate governance commonly refers to the structure and processes used to direct and manage the business towards enhancing prosperity, corporate accountability and to realize the long-term shareholder value, while taking into account the interest of other stake holders (Keasey and Wright, 1993). From a family business perspective, Taguiri and Davis (1996) propose a three-dimensional model consisting of the owners, the operating business and the family. Each of these entities work with their own distinctive objectives, memberships, tasks and control process.



Two schools of thought, the nexus of contract model and the stakeholder model, broadly define the law and economic layers of the family business governance. The nexus of contract model describes a family business as a bundle of formal and informal contractual relationship between many entities.

These include shareholders, directors, suppliers and customers. Accordingly, relationships in a family business is made up of expectations of each other's responsibilities, behaviour, reduce imperfect and asymmetric information, adopt incentives to drive and reinforce positive behaviour and discourage conflicts.

Most of governance, risk and compliance structures, process and procedures find their grounding from nexus of contract model. Accordingly, a family business must maximize the value by ensuring the business are profitable and are supported by structures and process that ensure principal-agent risks are minimized (for a comprehensive view of Goel et al, 2014). Governance therefore includes investing in structures and processes that ensure broad compliance with all legal and accounting requirements, have adequate risk management and controls to alleviate any wrong-doing or leakages, HR development, performance and remuneration, and so on. Stakeholder's theory, on the other hand, focuses on the idea that family business owes duties not only to the shareholders but also to other stakeholders and preserve the value to the next generation. Governance therefore includes the mechanisms and procedures to retain the commitment of the family in the business, communication and decision-making methods to maximize trust, continued sense of belonging across generations, and reward family member investments in the business and its functioning.



In our view entity maximization and sustainability theory (EMS) holds much relevance to family business governance. EMS holds that governance is to maximize the wealth of the entity, but also sustain the business as a going concern, that is to ensure the survival (Keay, 2011). Accordingly, wealth maximization is not the overriding concern guiding the family business, but it must also balance the interests of all stakeholders, including shareholders, against each other, to see it is a going concern, that the business survives. Sustainability is the central theme of EMS and both formal (from principal-agent perspective) and informal (from sociological bonding, and identity perspective) become key mechanisms.

Governance plays two important roles in family businesses. Firstly, it safeguards the interests of all stakeholders and improves transparency. Both formal and informal governance mechanisms will help the business check fraud and revenue leakages; improve regulatory compliance and effective risk mitigation. These mechanisms also help business move from founder to next generation addressing succession and business continuity. Good governance processes and structures clarify relationships, rights and responsibilities to ensure that businesses are managed professionally and responsibly, regardless of whether managers are family or non-family members (Howarth and Kemp, 2019).

Formal mechanisms of corporate governance include professionalization of the board by bringing in independent directors, nomination of an independent women director, formal audit, remuneration and risk committees and adoption of robust GRC tools including software to track and report. It may also include hierarchical structures family business build to manage the boards and respective business. Informal mechanisms are process that are not required by law, but are practices and methods that help family's bond deeper and manage family side of business better. Let us look at formal mechanisms and process to ensure effective family business governance.

Board

In family businesses a strong board of directors with a significant presence of independent directors is expected to improve corporate governance. In some families, each business has a separate board consisting of nominated family members, independent directors and professional executives. In some families, senior most family member or an elected member becomes the chairman of the board. This structure helps in preserving the dual nature of chairman and executive roles at the business level.

The Companies Act 2013 provides for at least 3 directors in a public company, while it is 2 directors for a private company. A family business can appoint up to 15 directors and as per LODR Regulations, top 2000 listed companies are required to have a minimum of 6 directors. Clause 49 of SEBI states that the board should consist of both executive and non-executive directors with not less than 50% (1/3rd if the chairman is non-executive) of the board of directors consisting of non- executive directors with relevant professional qualifications and personal traits. Under the companies act of 2013 it is now mandatory for all listed companies to have at least one female director. Based on Kotak Mahindra Committee Report 2019, SEBI has proposed an independent director for listed companies. The women director can't be from the family of the promoters or the wife and daughter of the directors. For family businesses what it means is it also rules out in-laws and cousins to be considered as independent women director.

SEBI has also proposed separation of non-executive chairman and Managing Director/CEO for top listed companies effective from April 1 2022. Non-executive chairman must be a non-executive director and not related to the Managing Director or the CEO as per the definition of the term "relative" defined under companies Act, 2013. Family business can appoint successor as non-executive director to expose them to the nitty gritty of the business and elevate them to Chairperson of the Board to manage transition. To ensure, continuity of experience and guidance of the incumbent Chairperson or the founder may be designated as the Chief Strategy officer of the company and he/she could continue as the Managing Director of the company.

Family Office

Family office is an operating set up, often employing investment experts as in-house staff or consultants to provide asset management, wealth protection and tax mitigation services to the family assembly. Family office can be a LLC, Branch office, HUF, private trust or Foundation. Family offices can be either Single family offices (SFO) or multi-family offices (MFO) depending on whether they serve one particular family or group of families. In India, most SFO are set by family members and is largely deployed from wealth management considerations. Considering the high cost of managing an SFO, many family businesses opt to engage an MFO. Family office facilitates aggregation of cash flows generated by different business and makes investments within the business and outside to maximize wealth for owners. Its role in succession planning is limited in India.

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Cousin's Consortia

When a family business has evolved beyond 2nd generation, it can explore formal "cousin's consortia" for the management and operations of the business and/or hold dual shares. When establishing a cousins consortia, care must be taken to address the balance of authority (amongst the family tree, chairman by rotation or by voting, decision rights and executive controls), dispute resolution structures (within family group and the business) and how independent directors and advisors would contribute to address inefficiencies, non-performance and remunerations.

Independent Directors

Existence of independent directors is expected to lead to transparency, more objective decision-making (hence more documentation of what transpires at board), more data driven evaluation, more efficient use of management bandwidth and as an overall resultant, a highly sustainable family business. Independent directors are expected to offer guidance and assistance in finding opportunities for the firm to grow, align with new partners, explore new markets and change the status quo. In some companies, the family ownership may be seeking specific guidance to reduce CEO stress and bringing in professionalism.

In many a first-generation family business, independent directors are seen as sounding boards where partially defined or tentative plans can be bounced off to obtain feelers. Moreover, they may also be involved to act as a neutral party to minimize “self-seeking behaviour” of the family members and to arrest “private gains over company losses”. Finally, Independent directors act as audit committee members, validate whether the taxes are paid in time and regulatory requirements are complied.

In our view, a higher percentage of independent directors who have not been employers or advisors of the controlling owners lend more independent views, more transparency and more objective decision-making. In many family businesses, especially first-generational, successful entrepreneurs may be wiser about other’s problems than about their own. Independent directors who are unrelated to the owners are more likely to help address the “Solomon Paradox” syndrome (Grossmann, 2017), especially related to matters of succession.

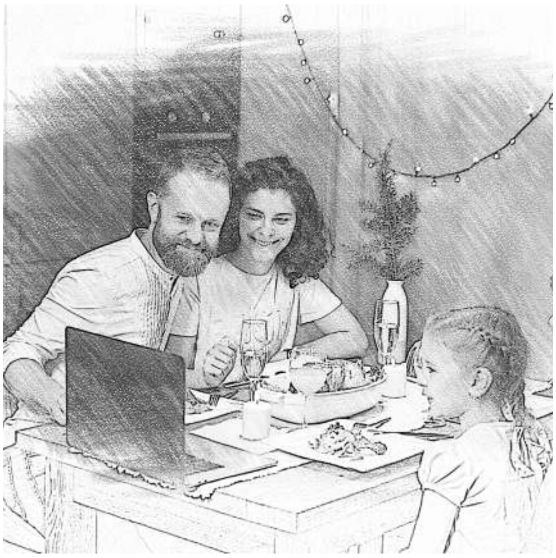
In our view, for family business, while independent directors are important to meet regulatory and other compliance, it is the “affiliate” directors who make an impact. Affiliate directors have prior business relationships or professional service engagement experience or investment history to the company or family are more likely to offer valuable contributions for product diversification, divestment or even innovation. (Jones et.al. 2008).

Family Courts

While German family businesses have adopted the supervisory boards approach consisting of equal number of shareholder representatives and employees, no such legal apparatus exists under the Companies Act 2013. Family businesses in India have an option to create an informal structure to manage branches of family business and the business. They adopt a family court (with clear representation to different branches with clear dual class stocks to preserve family equity) to act as a body overseeing the accountability of the independent boards of companies under the family (similar to accounting council suggested by Keay, 2017).

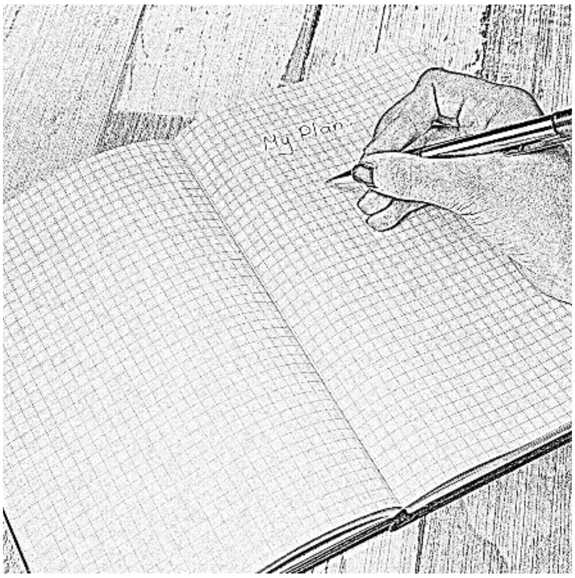
The key role of family court is to:

- Act as an informal governance mechanism to forge family ties, deepen family bonds and reinforce identity with the business
- articulate a common workable strategy for all business
- eradicate conflict zones by creating a policy driven culture that promotes ownership driven outcome-based culture for family members rather than entitlement led



Some family businesses also provide for limited seats of independent advisors to bring an outside-in perspective and mediation services. The family court conducts its own informal reviews of the performance of boards, removal of professional directors (even family members), philanthropy, CSR and other areas and share inputs with executive board of companies whenever required. It is an all-inclusive, elected or nominated working group of all the branches of the family, with representation limited to majors. The objective of setting family court is to formally discuss and decide decisions involving diversification, expansions and investment among other issues. Family court is the overreaching single decision-making body. It is a forum in which family members can articulate their needs, expectations and apprehensions about businesses. In some families the senior most family member or an elected member becomes the chairman of the family court. This structure helps in preserving the dual nature of chairman and executive roles at the business level. In some companies the chairperson is by rotation amongst different generations or geographies or family sides (paternal or maternal).

Some families have formally registered the “family court” as a trust; and shares of the family business are owned by the trust. A trust structure allows the family business to pre-empt possible conflicts and device mechanisms to avoid potential family disputes and ensure effective operation of the business. A trust structure also leads to a structured format of a family office, thus enabling efficiency in balancing the interests of the family and the business. To ensure separation and marriages do not impact the business, all family members sign documents to forego their inheritance of shares of companies. This ensures all businesses are owned by the trust only. Dual-class stocks are issued to control family ownership and ward off any potential hostile takeover. One class of stock, easily transferable and tradeable, may hold the majority equity of the companies, while the second stock (closely held within family or generations) controls the governance rights (Masulis et al 2008).

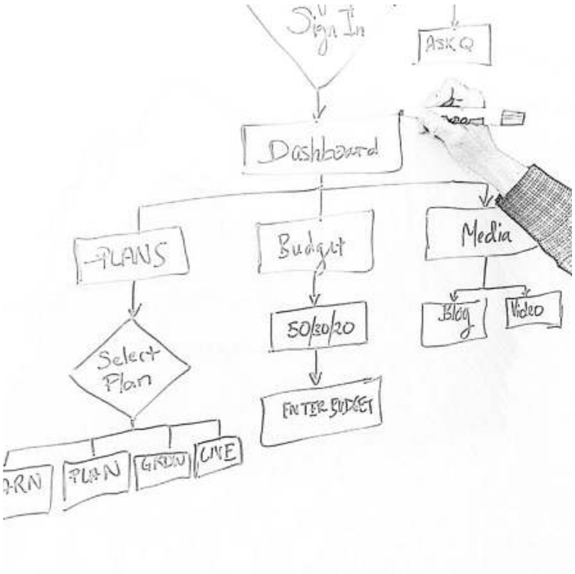


Innovation and Diversification Council

Family businesses need a platform that screens innovation ideas, validates the quality of the idea and supports realization of innovation. These innovations could be incremental or radical. In a large diversified family business, innovation council is effectively used to encourage the next generation to immerse in the business through internship programs during undergraduate or graduate studies. Family businesses realize they need to spawn alternate routes to institutionalization and de-risking their family to the business cycles. Education, healthcare and other areas that are independent to the economic cycles need to be encouraged and developed. Diversification council in some family business is chartered to allocate a portion of the corpus to encourage next generation to try out business opportunities outside the business areas of the family.

Family Charter

Like a company, family supervisory board or the family council must have a memorandum of association (MOA) or what is known as Family charter (FC) that define the very purpose of family court and procedures similar to articles of association. Family charter can act as a family constitution detailing the vision, values, relationship of the family with businesses. It could also detail the number of board representation, voting rights, nomination, decision rights, meeting rules, accountability of trustees; removal of members, dispute resolution mechanisms, financial and proprietary audits. Family charter must also detail short-term and long term goals, who will lead, and work in business and outside it, compensation for working and advisory roles for family members, extended members rights (in-laws, and step-children), criteria for participation and employment in the business, inheritance rights, equity treatment in diversification experiments, policies on information sharing, guidelines for advancements for family members, and code of conduct. Continual board refreshment and democratic election of chairman, and ensures no “special resolution” routes for key decisions by one person or group to hijack the agenda are key point to be noted.



Governance Process

In a family business, while governance structures are required to offer the institutional framework to govern and control, it is the ubiquitous processes that family uses to standardize the management, tasks and risk management and business continuity that make significant contributions. Corporate governance processes provide both vertical (executive to board) and horizontal information flows as necessary to accomplish family business's overall corporate governance goals. Family business organizations that invest and realize higher process maturity levels consistently outperform those that have not. Corporate governance process defines the generic activities and tasks that need to be performed in a systematic way to achieve the desired outcomes. Corporate governance process such as succession planning, risk reporting at business and family levels and others keep a family business stay on its objectives, promote strength and efficiency of governance operations, reduce risk and help to ensure compliance with laws and regulations. We present some key governance process for a family business.

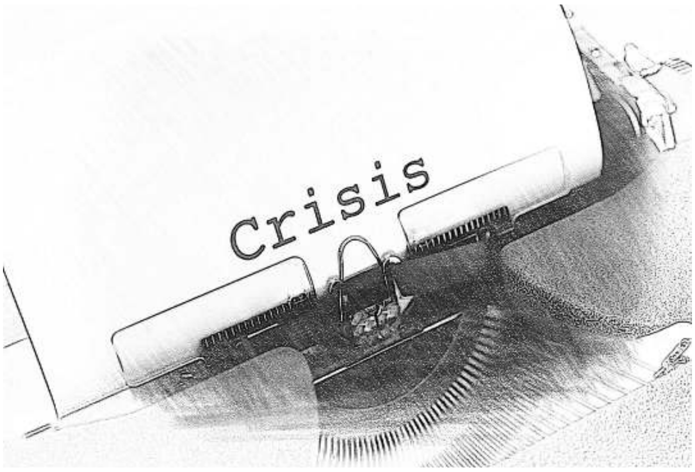
Succession Planning

Succession planning is the most difficult issue to deal with in a family business. In most family businesses, it is the family board that is tasked with the selection of successor with help from independent advisors. In case of any sudden void created by demise of the founder, and in absence of clear succession, family board may nominate a member or an outsourced executive until the next leader with appropriate capabilities is chosen. Succession can be managed through multiple modes: intrapreneurship, stepping-stone experience, advanced degrees with newer skills complementing businesses and induction into the business. A Successor candidate for a family business must possess: alignment with personal dream, strong family (sibling) ties, commitment to family identity and strong leadership skills.

Annual dinners of "family courts" are where children are exposed to family growth, business challenges and markets. Children are encouraged to carry out school projects, summer internships and perform light activities in the family business. Family trusts created a corpus for professional, academic development and even business building experience of the successors. Intra-family internship is common in cousin consortia so that both bonds are forged stronger at young age and exposure to the arm of business is achieved. In some families, the family office may fund a project after approval from the court and the independent professionals running the family office shall provide guidance, review and required support to the project. While family elders and board may have high access and knowledge of a successor as an individual, whenever many contenders exist, family may prefer to expose them to prove their mettle in other related business, create alternate investments that may not blow a big hole in the family books, but de-risks existing business from transition. Succession process must never be a fixed time (2 years before she takes over) but more of a continuous transfer from one generation to another. Family boards must plan in advance the process along with exits (if the prospective successor leaves midway) and alternate forms of governance. In some family business, the board can guide the CEO/owner to identify other family members involved in the business to be potential stand-ins and ensure that they get the various operational roles to help prepare them for the executive role. Directors can also participate in coaching and mentoring family members who have joined the business and may aspire to run it one day. The board can provide continuity and guidance to the younger generation and help preserve the founder's vision for the company (Cloyd, 2014).

Risk Management

Risk appetite of owners can break a family business. Family businesses are exposed to two classes of risk: business risks and family risks. Business risks include compliance, economic, political, operational and reputational issues. Intra-family litigation, divorces, business separation, assets and expenses of personal use billed as business use and many more are family related risks (Frigo and Richard 2011).



Family business use family charter and associated notes to address family risks. It is important to cover rules of managing and controlling business. Distributions amongst owners, mediation options, restrictions on transfer of shares due to divorce or death, buy-sell provisions, dissolution of companies, spousal consents, automatic buy-out mechanisms to protect ownership interests among others are the risks that may be covered under the charter. Some family businesses task the family office to oversee documentation of business plans and company policies, employment related issues, government compliance, communication policies and professionals gaining control through wills and nominations.

In large family business houses that have formally adopted ISO – ISO 31000:2018, Risk management – Guidelines or three lines of defence ERM model, family courts hire external consultants to address risk appetite and risk profile, high risk exposures, risk taking in comparison to its peers and competitors and assessment of executive board's risk management. Family boards and family offices also conduct annual audits of Director and Executive claims, employment related lawsuits and liabilities.

Compensation and Performance

Compensation and managing non-performing family members are amongst the major challenges that family businesses face. Most family businesses evaluate these situations on a case-by-case basis rather than forming formal process and procedures. Some family courts have adopted formal tests such as a multi-factor test or independent investor test to address pay for family members. In some cases, family courts have also established norms to avoid allegations of favouritism and free rider issues (because each arm of founders has to be paid the same).

Related Party Transaction

Likelihood of related party transactions in a family owned business is greater than compared to non-family business (Bertrand et al 2002). Related party transactions are also often seen as a median through which the family members extract benefits. Family businesses are prone to RPTs to be used as a mechanism to tunnel resources outside the firm.

Adopting Ind AS 24 for reporting is a good practice from compliance and minority shareholder's perspective. Family council's also pay a crucial role in discussing and limiting exposure of the companies to leading transactions between companies and family, buying and selling of assets, advances and security deposits, write-offs, and guarantee's to lenders. Family council's also use family charter to address family associates owning competing business in their personal capacity. Some family courts formally discuss and review related party transactions in their half-yearly meetings.

Conclusion

Embedding effective family governance is a dynamic process. Initially, the focus may be to establish and adopt governance procedures and systems to meet regulatory compliance, transparency and improved reporting. However, when family businesses mature from entrepreneurial to an established business, systems and process that provide for transfer of rights across generations, revenue sharing, succession and others issues related to institutionalization of "family" side of business need investments. Resources and processes such as family trust and family charter get created to define the roles and responsibilities of a family business, informal and formal mechanisms for the review of business and strengthening family bonds are created to sustain the continuity of family and the survival of business. The focus shifts from formal mechanisms to preserve value to a combination of formal and informal mechanisms to eschew family values and vision into the business. The key to family business sustenance is by building mature governance practices and capabilities that will make it stronger in terms of management, process, systems and culture. In particular, it is the governance processes that are of importance to strengthen family and ownership commitment, and regulating the role of the family in the business.

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