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Governance mechanisms that work in a family business

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Introduction

Family run businesses are a significant segment of any nation's industrial structure. According to CII, in India 95% of business are family run, and 30% of BSE listed companies are family owned. According to RBI and SME Chamber of India estimates, 79% are family owned, provide employment to 43.3 Million people, contribute to about 45% of Industrial output, 40% of exports and produce more than 8000 quality products for domestic and international markets. Family run businesses life span is highly correlated with their founder. Studies across different geographies indicate 9 out of 10 businesses shut down within 5 years after the death of founder and only about 3 out of 10 survives second generation. While no official figure for closure/exit rates is available in India, informal estimates suggest only one in five businesses survive beyond second generation. Many family businesses suffer from:

1) limited use of capital budgeting, risk management and working capital management techniques and long term planning
2) no clear plan to sustain the profitability of their business
3) limited wealth management and long term investments portfolio,
4) lack of a corpus,
5) fraud and risk management, and
6) lack of succession planning and business continuity.

Many family businesses do not have a clear demarcation between personal and business assets and have lost even their personal fortunes because of business liabilities. In many families, the time required by existing family members to manage the assets distracts them from effectively manage their family business. Unlike a corporation, family members and their extended relations may have different rights, expectations and responsibilities in the business. This sometime can lead to conflict and jeopardize the sustainability of the business. Unique privileges, access to privy information and independent management are issues family businesses have to grapple with. Governance plays important roles in family businesses continuity and growth. It safeguards the interests of all stakeholders and improves transparency. SME family business can adopt formal and informal mechanisms to improve corporate governance.

Family assembly or family court

Family court or family assembly is the extensive group of all family members. It is an all-inclusive, elected or nominated working group of the family members. Usually the representation is limited to majors. The objective of setting family assembly is to formally discuss and decide decisions involving diversification, expansions, investment etc. 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. Family court may be registered as a trust and all shares of the family business can be owned by the trust. To ensure separation and marriages do not impact the business, all family members sign documents to forgo their inheritance of shares of companies. This ensures all businesses are owned by the trust only.

The key role of family assembly is to:

- forge family ties, deepen family bonds and reinforce identity with the business
- articulate a common workable strategy for all business and wealth management

- eradicate conflict zones by creating a policy driven culture that promotes ownership driven outcome based culture for family members rather than entitlement led

Formation of family assembly

Family assembly can have representation from multiple generations to ensure fair coverage and responsibilities. Family assembly define the processes that define "family affairs" and "governance affairs". Family assembly clearly laid out roles for effective communication, reporting, fora and rules governing meetings, accountability, dispute resolution and administrative institution.

Like a company, family court 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 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.

Few areas that must be addressed in creation of a family assembly are:

1) broader representation of the family, skills on boards at trustee and supervisory levels
2) young adult inheritors have in depth involvement with the family assembly
3) continual board refreshment and democratic election of chairman
4) representation across gender and generation base
5) ensuring no "special resolution" routes for key decisions by one person or group to hijack
6) platform for board members of different business entities attending other business meeting
7) structure that does insulates, promote dependencies in task management and shields family from taking risk

Committees of Family assembly

In second and subsequent generation family business, it is imperative to involve family business on several fronts of the family business, not just business itself. In large undivided HUF family business it is common to see education committee and value committee. Education committee focus is on the education, and skill appreciation of the family stock. Value committee objective is to ensure the wards and business embrace and live the value of the founders, periodical immersion programs are conducted to guide and reinforce values in the succeeding generation. To eliminate frictions due to misappropriation and leakages, some family businesses create investment and audit committees. These committees oversee functions related to personal wealth maximization (outside the ambit of family office), independent review of business and develop score cards for each arm of the family business. Some family business create a personal matters committee which oversee individual concerns of family members, act as sounding board and usually chaired by matriarch of the family.

Family Office

Family office is an operating setup, 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. They may have a separate budget and staff to operate the business of managing and growing the family's wealth. A key governance control in family office is to ensure the family office involvement is formal with the assembly. Care should be taken to ensure the family office personal do not share information and administration selectively with any particular person or family groups. A formal quarterly review of the family office at Family assembly or board is a must.

Board and Independent directors

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. These board members may hold senior positions in the family assembly. However, they make formal presentations to the family assembly on the performance of each business. 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. Higher business focus and greater inclusion of number of family members can be achieved by creating supervisory board (also known as Board of Directors). The supervisory board may involve family members and outside professionals. Supervisory board works to protect, direct and review the executive board. All transactional decisions and implementation are driven by executive board. Some companies the chairperson is by rotation amongst different generations or geographies or family sides (paternal or maternal). 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.

Shareholders assembly

In families that are widely spread across geographies or have grown to have multiple branches due to marriage and separation, they create a shareholders assembly. The objective of creating a shareholders assembly is to involve all living members (including minors) to meet on a particular day (for example, founder's day). Shareholder's assembly is key to sustain relationships and motivate potential next generation members to participate in the family business.

Innovation council

Family business need a platform that screens innovation ideas, validates the quality of idea and supports realization of innovation. These innovations could be incremental or radical. In large diversified family business, innovation council is effectively used to encourage next generation to immerse in the business through internship programs during undergraduate or graduate studies.

Diversification council

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.

While formal governance mechanisms have their role in improving the monitoring and review of SME business, informal mechanisms serve to strengthen the "family" bonds in family business. (show a large group of cousins, uncles). To keep the family spirit alive, ensure

- regular family meetings are held to address the needs and aspirations of each generation
- support both intrapreneurship and entrepreneurship platforms for next generation
- encourage transitions amongst business, let them explore and find the depth
- conduct an annual family office meeting with all family members (children is a choice) similar to an annual business plan meeting on the status and directions of the businesses.
- Weekly or monthly lunch and dinner business meets for information sharing and decision evaluation

Corporate governance mechanisms fail if the objectives, activities and outcomes are not tightly integrated. Align individual's role and responsibilities, ownership and accountability with the intended change or outcomes. Implement a simple measurement system that integrates strategy, resources, process, people and results. Family business can adopt balanced score card or results based management approaches that improve decision making, transparency of the case and effect, and accountability at various levels. Mid-period review using output and outcome measures are useful indicators of what is working and what is not working. The company can quickly calibrate alignment between activities, resources and outputs to see the returns are on expected line. Smart family businesses realize adoption of good corporate governance practices sustain founder's dream and business continuity. Small efforts on governance make a huge impact on how your business grows and remain robust.

Bibliography

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