

Juliette Johnson again:

*"A Family Constitution can replace much of the uncertainty of the future with the certainty of a fair and equitable structure created in advance of any issues arising. These written 'statements of intent' set out ground rules governing the family's relationship with, and responsibilities within, the business, and cover such things as visions and values, family job specifications and remuneration, family meetings, and employment of non-family personnel..."*

**(b) Ownership**

A formalisation of succession to ownership will typically involve a lifetime strategy as well as succession plans for death or retirement. Where jurisdictional issues permit, flexible testamentary arrangements can enable the estates of deceased owners to retain or sell the business interests as is appropriate when the time comes. This may also involve option agreements in favour of surviving family members (or the company itself). The majority shareholder's shares may benefit from drag-along rights to preserve their value on a subsequent sale by the estate of the majority shareholder. Moreover, pricing formulae can be agreed so that minority shareholders do not receive an unpleasant surprise when their shareholding is valued at a discount. Formalising the succession to ownership can also contribute considerably to the mitigation of estate taxes and help enhance the availability of any reliefs<sup>12</sup>.

Formal arrangements to safeguard the business, for example transferring ownership to a trust (either inter-vivos, on death or by a combination of the two) to be managed for the benefit of the family as a whole, can protect dissipation on a subsequent divorce, disability or death of family members; the family can continue to own the business (and perhaps continue to address issues of strategy) while management is undertaken by a team chosen for the task on ability alone.

A subject in itself is perhaps the formal steps that may be taken to minimise the threat presented by

divorcing family members. Although the English courts have complete discretion to order the redistribution of the resources of divorcing spouses, agreed procedures (for example shareholder rights that are triggered on the commencement of divorce proceedings) can help keep business assets within the family and prevent a divorced shareholder spouse remaining and representing "nuisance value".

Creating an appropriate management and ownership structure is clearly not an "event" but a "process", and formal arrangements introduced should not only secure the advantages or clarity and fairness but retain the flexibility to adapt as circumstances change.

**6. Conclusion**

The effective management of a family business occasionally requires a light touch<sup>13</sup> and a keen awareness of when adjustments to the organisation are required. As the business grows, the need for consistency, clarity, fairness and a shared understanding of the business aims will increase too; it is easy to see how the introduction of a formal process to crystallise these principles in the relationship between owners, managers and staff becomes increasingly important.

<sup>12</sup> Note the restriction on relief from UK Inheritance Tax in respect of "relevant business property" that on death is subject to a binding contract for sale (s113 Inheritance Tax Act 1984).

<sup>13</sup> An old Chinese proverb implores: "Govern a family as you would cook a small fish - very gently..." - many would agree that a similar principle would occasionally apply to managing the family business...

**Formalising the Informal**

**Many family businesses are run informally with little in the way of governance structure or recognised process. Addressing at an early stage questions relating to succession, managerial change, conflict and promotion (the majority of which will inevitably arise at some point) can prevent a business stalling when these issues are presented**



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The family business that has continued for longer than any other is believed to be the Japanese temple-builder Kongo Gumi founded in 578<sup>1</sup>. One must advance to 1541 before finding the comparative "start-up" that is (reportedly) the earliest surviving family business in the UK namely the former wool business John Brooke & Sons.<sup>2</sup>

If Kungo Gumi was able to answer the question "To what do you attribute your longevity?" it might refer to a number of familiar factors: a stable market, sustainable expansion and careful management. One factor that undoubtedly contributes to corporate well-being is orderly procedure and structure. Although not in itself a wealth generator, such order can help significantly protect a business as it grows. As Juliette Johnson, Senior Family Business Advisor at Coutts, comments:

*"By establishing a governance structure and a family charter, the boundary between family and business is clarified; 'structure' helps the family develop a cohesive approach to the business, which can combat the tensions that interfere with the effective functioning of the business."*

Many family business owners may take the view that "It was good enough in Dad's day so why change now?". Indeed, advisers can't impose a structure on the family business. However, explaining the benefits of more formal organisational structures can often lead to the same end. This brief article looks at some of the benefits that illustrate best the advantages a formal structure can bring.

**1. Identifying roles and the business participants**

Clarifying the extent of individuals' responsibilities, authority and who is included in and excluded from the business can avoid future problems and the importance of this clarification will increase as the business develops. As Sir Adrian Cadbury has commented:

*"It becomes particularly important to define jobs and the responsibilities that go with them more clearly when non-family managers are appointed....unless jobs are reasonably defined there will be no objective basis for determining how they should be rewarded."*<sup>3</sup>

The absence of this formal demarcation of roles in a growing firm is likely to increase the risks of confusion both internally and externally, of individuals acting beyond their remit and of matters inadvertently not being addressed.

<sup>1</sup> Businessweek reported on 16 April 2007 that the company's run had come to an end when its assets were acquired by Takamatsu, a large Japanese construction company, and it was absorbed into a subsidiary.

<sup>2</sup> Family Business magazine's "The World's Oldest Family Companies" survey (update due in Autumn 2008)

<sup>3</sup> Family Firms and their Governance – Creating Tomorrow's Company from Today's (2000)

The Court of Appeal was asked to wrestle with the question of who was included in a business and who was not in the case of *Mehra v Shah*<sup>4</sup>. Ultimately the court had no option but to sift evidence at length (and publicly) to assess the terms of the family partnership. An express agreement would have avoided the parties seeking to assert their claims pursuant to the Partnership Act 1890.

## 2. Avoiding future conflict

There are a number of ways in which a more formal arrangement can serve to reduce the impact (and the possibility) of family conflict:

- (a) procedures can be agreed for resolving any future conflicts; this might involve the appointment of a third party mediator, referring the issue to a family constitution procedure or a resolution by a family council.

(It is perhaps surprising that a recent survey of 1,454 small and mid sized family businesses from 28 countries found that more than two-thirds of family businesses have not adopted any procedures for resolving conflict between family members)<sup>5</sup>;

- (b) formalising the previously unwritten processes can help bring to the surface underlying or future sources of conflict at an early stage; there can be considerable advantage in addressing differences when times are good rather than at a time not chosen by those involved; and
- (c) formalising the management of conflict can depersonalise the resolution process.

Many family conflicts arise when the management or the ownership of the business is about to change hands. Agreeing recognised procedures to deal with conflict can help provide continuity and clear management at such a time when (arguably) it is needed most.

## 3. Business Structure

As with any business, a family business should assess its legal structure regularly to make sure it is operating in the best form possible. For example, the legal structure which is appropriate at the outset may not be suitable as the business grows; it is easy to see how the flexibility and informality of a partnership arrangement can become incompatible (as the business develops) with the need to attract external investment or to introduce non-family managers as stakeholders in the business. Indeed, reviewing a family business structure is not something that should necessarily be limited to the early days:

*"As family businesses grow older and larger, they have to deal with increased levels of risk and complexity that global companies already have the processes for. They also face pressure from various stakeholders to increase transparency and make quantum leaps in their profitability"*<sup>6</sup>

When taking Virgin back into private ownership in 1988 Richard Branson was widely reported as acting against what he saw as the City's "short-term" attitude to investment – an approach that he presumably viewed as not right for his business group at the time.

When a family business begins, it is understandable why the confidentiality and flexibility offered by an informal partnership is commonly preferred. However, in the absence of a formal written agreement, the partnership will be regulated by the Partnership Act 1890 which can lead to unexpected and unintended consequences, in particular regarding the distribution of profits and the partnership's termination.

<sup>4</sup> *Mehra v Shah and others* 2004 ALL ER (D) 283

<sup>5</sup> The PricewaterhouseCoopers Family Business Survey 2007/2008

<sup>6</sup> Omar Bitar, Managing Partner, Advisory Services, Ernst & Young (Middle East)

As the business develops, a limited liability company will often seem more appropriate. Typical reasons for this are the need to raise external funding, the introduction of employee incentive schemes, or the development of stakeholder positions for managers. Other drivers will of course be tax as well as issues of liability limitation, this latter point being particularly relevant if the business is a trading business rather than one dealing in investments.

## 4. Staff management

A written policy regarding promotion, appraisals, remuneration and discipline can enhance trust within an organisation and incentivise staff. The absence of a consistent promotion procedure can have the opposite effect. Dr Nick Bloom<sup>7</sup> comments:

*"You need to have formalisation to have consistency. Particular problems arise with promotion systems – there should be systematic 360 degree review processes.....rather than relying on good individuals trusted by the family to do this."*

The understanding that members of management occupy their position by demonstrable merit can both enhance trust and motivate non-family members of the business.

## 5. Succession

A recent survey found that 49% of the firms surveyed have no succession plan in place<sup>8</sup>. Given the effort taken to build most business and the poor rates at which businesses successfully survive generational change<sup>9</sup> this might seem surprising. The significance of orderly succession arises in the context of both management and ownership.

### (a) Management

In the absence of a management succession plan there can be a temptation for a founder to select a CEO himself from, say, family members. There are clearly disadvantages to this approach:

*"Selecting the CEO from among the small group of potential family members severely restricts the available pool of managerial*

*ability...the CEO needs to be highly able, which the family may not be able to provide"*<sup>10</sup>.

As Dr Nick Bloom comments: "Can you imagine if the current England football team was picked from the sons of the team of 1966. We wouldn't win anything." (!).

The introduction of an effective management succession structure will be particularly important at the point when an organisation based on family relationships becomes one based on business relationships. Attention may then be turned to the formation of a board:

*"The absence of a clear organisational structure and of a board that can stand back from the day-to-day management of the firm and think about strategy is likely to cause problems with the family."*<sup>11</sup>

A formal arrangement in this context need not mean "rigidity". However, the development of a set of guiding principles in respect of management succession (set out for example in a family constitution) can bring an important transparency to the process.

<sup>7</sup> Dr Nick Bloom: Associate – Productivity and Innovation, London School of Economics and Assistant Professor, University of Stanford

<sup>8</sup> 1,454 firms surveyed as part of The PricewaterhouseCoopers Family Business Survey 2007/2008

<sup>9</sup> See research by Stoy Hayward Consulting/London Business School (1989) which found that only 24% of family businesses were transferred to the second generation, and just 14% to the third. See also the DTI Small Business Service paper "Passing the baton – encouraging successful business transfers" (2004).

<sup>10</sup> *Inherited Family Firms and management Practices: The case for Modernising the UK's Inheritance Tax* – Dr Nick Bloom, The London School of Economics (15 March 2006)

<sup>11</sup> Sir Adrian Cadbury: *Family Firms and their Governance – Creating Tomorrow's Company from Today's*