

# Mastering Global Corporate Governance

Editor

**Ulrich Steger**



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## How Governing Family Businesses is Different

**John Ward**

**F**amily businesses are fundamentally different in corporate governance from widely held public companies. This difference derives primarily from the discrete nature of their ownership. Family ownership concentrates control and allows greater agency in governance. The family can play many roles across the business system, often facilitating and simplifying decision-making processes. This can both lower the costs of governance and enable unconventional, but strategically advantageous, decisions. In addition, the governance practices of family businesses often evolve, reflecting the stages of development in the business and the family. This need to adapt governance over time is both an opportunity and a challenge of family business. Renewing effective ownership agency at different stages in family business development is one of the keys to sustaining the family business advantage in performance.

## The nature of family ownership

Family ownership groups are distinct in many important ways. They not only concentrate control, but they often have a strong emotional attachment to their business. Their stake in the business goes beyond economics, and often becomes a source of self-identity and pride. Families can have a sense of moral obligation to other stakeholders, or even view their business as a vehicle for making a positive contribution to society. Family owners often see their business as a social legacy built by past generations, and their sense of mission often includes a desire for this legacy to continue in succeeding generations. Indeed, it is family ownership's combination of a long-term mission and a desire to enable continuity across generations that makes decision making in family businesses so different.

Family ownership is distinct in another important way: it is often a captive economic interest. The lack of readily available liquidity is an important difference between public and family ownership. Often, exiting ownership of family companies is difficult. Some families create legal restrictions on the sale of stock, and many are privately held. In these circumstances, making a market for the sale of stock can be complex. Valuation discounting can complicate questions of pricing, and many transactions are impacted by their tax treatment in transfer. Often, taxation issues make holding an investment in the family company a better economic option, so long as it achieves a certain threshold of performance.

Owning stock in a family company tends to concentrate the wealth of individuals in a single asset. In family ownership groups, a disproportionate

percentage of the net worth of many individuals is often tied up in the family business. This means that family business owners, as a group of investors, have less diversification and higher risk than they would as investors in the broader stock market. This concentrated risk makes family business owners more attentive to their investment and tends to keep them more active and engaged.

The combination of concentrated economic and emotional investment is the key difference found in family business ownership. The security of family owners, both emotionally and economically, is often closely tied to the fate of their business. This makes families more committed to fixing what is wrong with their businesses, rather than fleeing them economically. At times, concern for the family's reputation can seem as important as safeguarding the collective family business investment. This combined emotional and economic ethic is often reflected in the family's traditional business values. The continuity of these discrete family business values is what enables family ownership groups to effectively engage their businesses over time through evolving governance practice.

## **Business governance in public companies**

Governance in the public market is built on a paradigm that relates directly to the nature of widely held ownership. Ownership in the stock market votes with its feet, selling when performance is below expectations. The individual shareholders of widely held public companies have little recourse

to effect the decisions of their boards or managers. Instead, they join other individuals in the market and create pressure for performance through their collective short-term decisions to buy or sell stock. The governance of public companies reflects this paradigm of inactive but mobile shareholders creating market pressures for performance.

Public companies have independent boards that act primarily as fiduciaries of potentially mobile shareholder interests. These boards operate under the paradigm of maximizing near-term share value in order to sustain and grow their pool of shareholders. Market demand for the company stock is the measure of success, and this market fluctuates daily based on the fluid relationship of many economic factors, both inside and outside of the company. Because of this, the board of directors is the locus of power in the governance of public companies. The board is charged with the oversight of management, and must assure that management is creating value that will be recognized in the market.

In widely held public companies, management is often perceived as self-interested. Active governance is seen as necessary to curbing management abuses, as well as assuring the effective alignment of management interests with ownership interest. The boards of these public companies spend a great deal of time and effort designing systems to control and monitor management activities and compensation, reinforcing a potentially adversarial relationship. In addition, boards and their practices are under increasing scrutiny today, and many new laws and regulations are being written to reform the governance of public companies. Many of these laws are designed to strengthen the independence of boards and increase their accountability.

As the boards of public companies become more independent and powerful, the expectation that they should provide more than oversight increases, as does the expectation that they should actively direct management on behalf of ownership interests. However, boards focused on corporate performance and share value can become averse to taking risks that may have significant short-term impacts. They can become captive to the conventional wisdom of the market, and forgo more unconventional strategies that might better capture long-term value in their unique market segment. Often, management is better positioned to see how dynamic, new strategies will create value for customers, and improve business performance. Unfortunately, the governance paradigm of public companies does not always enable the pursuit of creative new business strategies.

## **How governance differs in family companies**

Family business governance systems are more uniquely suited to the pursuit of unconventional strategies. Because of the characteristics of their ownership, family businesses can more readily by-pass the adversarial qualities of conventional business governance. Ownership can exert influence and care on multiple levels, making the family an agent of more effective decision making in management, on the board and among owners. Rather than functioning as a costly system of checks and balances, governance in family firms often serves to enable transparency and partnership across the system. This, in turn, can enable the pursuit of strategies that are potentially more productive in the long term, despite short-term costs or risks.

Conventional business governance often focuses on establishing boundaries and defining the separation of decision-making powers. In contrast, family business governance is often focused on establishing productive, procedural engagement across the system. Practices that provide for simultaneous consultations among owners, directors and managers are both cross-fertilizing and enabling of business decisions. Active processes providing for engagement across the system assure an ongoing alignment of interests and objectives over time. In this way, family business governance systems often provide more effective agency for decision making. Rather than struggling over checks and balances, all parts of the system are focused on creating value together.

The active participation of ownership is the key to effective family business governance. Family ownership defines the values, vision and objectives of the business. It articulates the financial goals and performance expectations that guide board and management decisions. Ownership also provides an overall vision of the company, which generally defines the strategic parameters of the business. This clarifies and focuses objectives across the system, and helps set appropriate strategic constraints on board and management decisions. The active engagement of owners is what enables the more effective alignment of decision making in family business.

But good family business governance requires more than the participation of active owners. As in other businesses, the board and management have important functions to fulfil, and well-designed practices are essential. Building clear, shared understanding of the separate functions of the ownership, board and management is an important part of effective family business governance. All the more so because family members often wear multiple hats,

functioning as owners, directors and managers. In this situation, clarity of governance functions and roles is often vital to enabling the effective functioning of the system.

While the direct involvement of the family on multiple levels complicates the system, it also provides an important link among the different areas of governance. This built-in link, combined with a positive development of family ties and relationships, can fundamentally change the dynamic of trust that pervades the governance system. A well-functioning system helps build trust within the family, and a good family dynamic in turn becomes an asset to the business. A positive family dynamic enables each separate piece of governance to function better and add more value, while remaining aligned with the other components of the governance system. This spiral of trust is an important factor in facilitating effective business decisions. It is also the chief source of the governance agency advantages found in family businesses.

## **The stages of family business development**

No discussion of governance would be complete without a close look at the patterns of development commonly found in family business evolution. Most family businesses begin with an entrepreneurial founder. Initially, the founder embodies the governance system, being the all-powerful owner and operator of the business. Founders sometimes make use of advisory boards, but they generally retain all decision rights. In many cases, the chief challenge of founders is deciding how to sustain their family business

through succession. Passing the business on to the next generation is the great challenge of family companies. Some founders seek a single heir, who can recreate the concentrated power of the owner–operator. More, however, see ownership as a collective economic inheritance of their family, and divide ownership of the business among the members of the family.

When ownership passes down across generations, it passes through distinct stages. The first stage is the sibling or family partnership. This stage often begins with parents sharing ownership with their children. Eventually, the involvement of the parents ends, and the siblings come to share ownership in a partnership spirit. They must decide among themselves how to govern the business, and often this is described as the ‘kitchen table’ period. The siblings can sit down together and consult informally, and sometimes they form a board to help build consensus for strategy. Often, roles begin to separate at this stage, as some siblings may be active in the business while others are not. From this point on, the level of trust in the family often determines how formal governance practice becomes.

The third generation succession often involves a diverse group of cousins. This generally changes the scale of the family, and differentiates family roles further. Family members may continue to be involved in management, the board and ownership. Ownership holdings can become increasingly variable in size, with some remaining quite concentrated. Family members can be active to varying degrees in the business and governance, and their level of involvement may not necessarily reflect their level of economic interest. These complications generally lead to the development of more formal governance practice. When majority ownership moves outside of management, the board will often take on more of a fiduciary characteristic.

The extent that trust is cultivated directly between the controlling owners and the leaders of management often determines how formal governance practice becomes at this stage, and whether the family can continue to create effective agency in governance.

The next family succession causes another significant change in ownership scale, and often brings to an end the concentration of interests that allowed individual owners to create agency. At this stage, the development of family governance, which functions in parallel to business governance, is often an added feature of an increasingly formal and complex governance system. Effective family governance can continue to enable agency even in widely dispersed family ownership groups. This is particularly true when family members continue to be involved across the governance system, linking ownership, the board, and management. Often, the business at this stage has become a holding company, creating the need for a board that can strategically manage a portfolio of businesses.

## **The evolution of family business governance**

Changes in family scale are a common driver of governance evolution in family companies, as are changes in business scale. As a business grows, it becomes increasingly complex, creating its own demands for a more formal organizational structure. While adapting governance practice to the emerging needs of families and businesses as they grow is a very complex and challenging endeavour, over time it is also unavoidable. Success drives the need to adapt and change. At certain stages, business or family growth

will tend to become exponential. All family businesses eventually face this reality. Their ability to respond to these challenges is tested again and again, with each change in scale of the business or the family.

Because family and business life cycles often challenge the effectiveness of existing governance practices, family businesses are actually quite attentive to adapting their practices over time. With each generation succession or change in business scale, family companies are often confronted with the need to recreate their business governance. Family business life cycles can lead to fundamental changes in the roles, functions and practices of the governance system. Faced with the dilemmas of change, families frequently study current best business practices. However, rather than simply adopting prescriptive best practices, families tend to adapt practices to their historic business culture, and so renew the effectiveness of their governance agency over time.

## Types of owners and governance

Critical to this process are the different types of owners that emerge and how the family adapts governance roles in relation to these ownership types. Here are five different types of owners found in family businesses.

- *Operating owners* work in the business and are responsible for leading management.
- *Governing owners* are employed to lead governance and monitor operations.

- *Active owners* are family members not employed by the business, but who add business value by remaining knowledgeable, engaged and committed.
- *Investing owners* are family members who focus on the financial performance of the company, and may buy, hold or sell their stock.
- *Passive owners* are family members who pay little attention to the company or the return on their investment.

Most family businesses begin with owner–operators. Often, succeeding generations will also have operating owners, as family members continue to lead management. When ownership is dispersed over time, however, the stake of owner–managers declines. Some families deal with this by creating voting control that is separated from beneficial economic interest. Through voting trusts or special voting stock, the concentration of control is retained and passed on to a group of owner–managers and/or governing owners (or their designated fiduciaries). Businesses that develop a strong culture of family management often try to recreate family leadership of management in succeeding generations by concentrating voting control. In these situations, family managers retain more power than their ownership stake represents, and they can continue to provide business agency to the governance system.

Governing owners are family members who do not work in day-to-day management, but who have a direct, professional involvement in the governance. They can be trustees of voting trusts, directors on boards, or heads of family councils and family offices. In contrast to cultures that favour strong family leadership in management, some families find management involvement problematic. In their experience, family members have often abused positions in management or proved ineffective managers. In order to assure the highest professional standards, some families decided to become governing

owners, and prohibit family members from employment in operations. In this case, the family's governing owners are paid to oversee a fiduciary governance system. All business practices become performance based and professional. Governing owners in this system add value by assuring pursuit of the highest business standards and by providing strategic agency between ownership and management in the governance system.

These two examples illustrate the extremes at either end of the spectrum. In cases like these, the history of the family often determines whether the family is deeply involved in management or consciously removed from involvement. Families that chose one or the other extreme tend to have had family problems in the past that impacted the business. Sometimes, their businesses have grown quite rapidly, and the family sees itself as either poorly prepared to share ownership control or without a good candidate to direct management of the business. Some families respond to these challenges by creating governance structures that can 'protect' the business from the family. The perceived purpose of these structures is to assure that control is retained in a way that maintains business agency. Often, they also serve to perpetuate the family business by preventing excessive extractions of capital by ownership.

Most family businesses evolve governance roles less dramatically and over a longer period of time. Family successions gradually lead to a broadening spectrum of ownership types. Governance roles evolve in relation to this general shift toward decreasing concentrations of ownership. Many family businesses continue to have both operating and governing owners, often working as a team and also incorporating non-family professionals. This leadership group tends to represent an increasingly smaller ownership interest over time. As the family business matures, choosing individuals

to fulfil these leadership roles becomes one of the most important and difficult functions of the governance system. Equally important is creating engagement and commitment with the ever-expanding ownership group. As ownership interests are broadened and diluted, maintaining a coherent ownership culture that remains an asset to the business becomes increasingly important and challenging.

In mature family business systems, controlling ownership is often widely scattered across a large family. With each generational succession, individual shareholders have less intimacy with the business and tend to become more like investors in the stock market. When this happens, governance can increasingly evolve toward the fiduciary public ownership model. In order to retain their unique governance agency, family businesses at this stage must develop family governance that can create a controlling pool of active owners. Family shareholders will naturally become investors or passive owners if they are not engaged in meaningful governance. The development of family governance that is effectively linked to business governance can help transform large, dispersed ownership groups into coherent, active ownership groups. Families that succeed in this effort build in the cultural foundation that enables ongoing governance agency within ownership.

## **The governance practices of mature family business**

The examples above describe different ways that family businesses mature. In addition, some families 'prune' the ownership tree by buying out

disinterested branches of the family. Occasionally, one family branch will buy its way back into control. Often, the goal of these processes is to enable the renewal of ownership agency in governance. The more the ownership of a family business becomes dispersed and disinterested, the more it loses its special ability to add value. In addition, large families with mature businesses may increasingly seek to extract capital rather than reinvest it for growth. The family ownership itself, through its economic dependence on the business, can become a drag on the ability of the business to pursue the best strategies for long-term value creation. The fact that some family businesses will expend considerable amounts of their capital to reconsolidate ownership control is a measure of the importance of renewing ownership agency to long-term value creation.

Family business systems can move forward or backward in their evolution. Many become fundamentally unstable because of family or business pressures and are sold or taken public to generate liquidity. Competing demands for capital need to be strategically managed, if family businesses are to achieve long-term continuity. If family ownership does not effectively renew its strategic agency over time, then the system will move increasingly toward a market-driven paradigm or seek to reconsolidate control. Families can follow many different strategies to renew their ownership agency as their business systems mature. An increasing number of mature family businesses are developing family governance practices as part of this effort. They recognize that to renew effective agency in their ever-larger ownership groups, they must engage a vast majority of family shareholders in building a shared vision of the business.

As family businesses mature, both the family and business sides of the system are transformed. Governance faces increasing functional challenges

from both sides and must evolve in response to both. One common approach to this dual challenge is to create parallel family and business governance. In this governance model, parallel structures are created for the family and business. The business governance responds to the increasingly rigorous functional needs of the business by pursuing ever-more professional practices and competencies. The family governance responds to the fragmentation of ownership by generating collective processes that can re-engage the family and generate an active voice and vision of ownership. The parallel sides of this governance model are then linked by processes, which enable agency at key points in decision making. Ideally, each side of the system functions well, and the links are strong enough to assure ongoing alignment of governance across the parallel system.

Typically, parallel governance features an increasingly professional business board and a democratic family council, which often develops increasingly formal practice over time. The board of directors, elected by the shareholders, sits at the top of business governance. These boards typically have a family chairperson and include family managers and/or governing owners, as well as a significant number of independent directors. These boards function much like the boards of public companies, providing oversight and direction to management, and acting as fiduciaries of shareholder interests. Family governance is built separately and is usually based on democratic principles. Family cultural practices around issues of branch representation, variable ownership interests, blood versus in-law relations, etc. can all impact the development and evolution of family governance. Practices can be quite variable, ranging from informal gatherings to the development of highly structured and professional institutions like family councils and family offices. As families and the

resources they manage grow, so generally does the formality of their governing systems.

## **The special role of the family business board**

Even early in their development, family businesses can benefit from a board of directors. Often, advisory boards can assist founding entrepreneurs achieve the first succession transitions more successfully. Founders are frequently so focused on the development of their business that they do not prepare effectively for succession. A good advisory board can help a founder refocus on the task of creating continuity through transmission. Succession is the single greatest challenge of family businesses at all stages of their development. A good board of directors will help assure that a process for succession is in place and that leadership candidates are being developed well in advance. This can be particularly challenging in family businesses, especially early in their development.

The boards of first and second generation family companies can also play a vital role in transmitting the business knowledge necessary to continue value creation. Founders and their successors often need help consolidating an understanding of the core competencies of their businesses, as well as transmitting this knowledge. Boards can help build management and operational structures that can take the business through the next level of growth. Independent directors can serve to bring significant professional

experience to family business boards even in the early stages of development. Business perspectives from outside of the company often provide added insight and creativity.

As family businesses grow, their boards tend to become more and more involved in strategy. The development of strategic planning processes puts the board of directors directly between management and ownership. The board must review the planning processes of management, and assure that the business strategy reflects both the reality of the company's capabilities and the opportunities provided by the economic environment. The board must also assure that this strategy reflects ownership's financial objectives, both in the short and long term. At a higher level, the board must assure that ownership and management share the same strategic vision of the company. The board must understand the aspirations of the family for the business, as well as the competitive capabilities and market potential of the business. If there is misalignment of capabilities and expectations, the board has the special role of fostering communication around these issues and assuring their resolution.

The early use of independent directors can be highly valuable to family business boards. Non-family directors can often induce the family to consider difficult issues that would otherwise be avoided. This enables the family to achieve a more effective level of planning. Succession transitions and the strategic alignment of ownership and management visions are two areas where families often struggle. Another is the allocation of capital. As family businesses grow, they often face difficult choices about how to prioritize

capital investments. Multiple family and non-family managers may come before the board and 'compete' for investment capital. The board must assess these decisions rigorously, reviewing their financial and strategic importance. Independent directors can help assure that these decisions are made objectively, without being influenced by family ties or biases. The objectivity of independent directors is an important asset on a family business board. Many families recognize the benefit of empowering their independent directors to help resolve the issues that are most difficult for the family.

As family businesses mature into holding companies, their boards become managers of a portfolio of businesses. The board must develop a portfolio strategy, which identifies both the markets it wants to serve and the financial performance parameters it expects from the companies it owns. The board must assess the performance and potential of its companies and decide whether to grow, harvest, or divest each business unit. When targeted market segments with strong potential are underserved, the board must weigh the possibilities of deploying capital for new ventures, partnerships or acquisitions. These decisions are often difficult in family businesses. Family managers can have a personal stake in existing businesses that make divestiture decisions difficult. Management also tends to be enthusiastic about investing in new ventures, partnerships or acquisitions, and there can be a tendency to 'sell' these decisions. A good board will set financial benchmarks for all these decisions in advance, and set timetables for achieving these benchmarks. Managing new ventures, strategic partnerships, acquisitions and divestitures is an important function of boards in mature family companies.

## The role of boards in conflict resolution

In the governance systems of family businesses, many important decision rights rest with the board of directors. When making important decisions, a good board will remain ever vigilant to the impact of these decisions on the family. Many difficult decisions can stress the coherency of the family ownership group or management. Sometimes, boards must work to mitigate conflict, and trusted independent directors can often play a special role in this process. When there are conflicting views about a decision, independent directors can lend their objectivity to both the discussions and the decision-making process. In many cases, an effort must be made to educate the wider family about the issues and to clarify the intended purpose of board actions. Independent directors are sometimes called upon to offer their impartial views and ultimately the board itself becomes the final mediator of some decisions dividing ownership.

When the board acts as final mediator it enables decisions. Family business conflict often leads to indecision, and the authority of the board assures that important business outcomes are achieved in a timely way. Frequently there is little room to compromise and the board must function like a panel of judges making a final judgement. This dynamic can perpetuate conflict if adequate attention is not given to the process of decision making. Family business boards must assure that there is thorough consultation with the family ownership in decision making. Family owners need to be informed, as well as given an opportunity to voice their opinions. When people feel they have been heard, they more readily accept outcomes, even if they are contrary

to their views. Creating adequate, ongoing consultation with ownership is one of the key challenges facing family business boards.

This is the main purpose of parallel family and business governance in mature family companies. Parallel governance provides a framework for consultation processes between the board and the family. It supports the sharing of information and the education of the family, as well as providing a mechanism for ownership to be given a voice as decisions are made. Good family business boards will not only support the development of good family governance practice, but they will recognize the future value of this effort to renewing family business agency. As a family ownership group expands and individual holdings shrink, it becomes increasingly important to have a well-designed and functioning structure for educating and consulting with the family. Without this, fragmenting ownership views will move business governance toward the market-oriented paradigm.

The key to family business agency is building trust between management and ownership. At the mature stage of development, family businesses increasingly rely on their board of directors to help build this link. Creating direct, mutual support between owners and managers takes effort and time. Communication must be valued, and the board is often the conduit of information flowing back and forth across the system. A good board will work to enhance mutual understanding, and it will deal directly and openly with issues and conflict. This transparency becomes more important as the family business system gets larger and more complex. For the board to act effectively as final mediator it must be trusted by both management and ownership and it must work openly to foster trust across the system.

## Board composition and director selection

Boards have the central governance role in family companies, which makes board composition and director selection processes more critical. Over the course of family business development, governance works best when it aligns board composition with both the development of the type of family ownership and the strategic situation of the business. As controlling ownership moves from operating owners to investing owners over time, the composition and functions of the board will change. Likewise, as a business matures, its strategic situation changes. The board will need to develop new competencies and practices that enable ongoing, rigorous assessment of business strategy over time.

The evolution of board composition can be quite variable in family companies. Most often, this is linked to the level of family ownership involvement in management and the size of the business over time. While management holds a controlling ownership stake, boards tend to be composed of managers, and may or may not include outside directors. Many of the first non-management directors on family business boards are family shareholders representing significant ownership interests found 'outside' of management. The presence of governing owners on boards becomes increasingly common as ownership successions move control out of management. Families that do not have management successors evolve their board composition more quickly, and often include a significant number of independent directors. These directors assist the family in generating effective oversight of their professional managers. Generation succession can shift the types of owners holding controlling interest in the family company over time, and

this tends to drive the pace of evolution in board composition. Company size can be another driver in this process. The boards of smaller businesses tend to evolve their composition and practice more slowly, whereas the boards of businesses that grow rapidly must be more responsive to the increasing functional demands of the business.

Choosing directors in family companies can be very complicated and challenging. Many families begin with boards composed entirely of family. Adding non-family directors for the first time can raise many issues, particularly in families with a strong tradition of leading management. In this case, some family members tend to view independent directors as a potential threat to owner–manager agency. As we have seen earlier, independent directors can play vitally important roles on a family business board, and their expertise and objectivity tend to add considerable value to governance at all stages of business development. Many mature family businesses have a significant number of independent directors on their boards, and some have a majority of independent, outside directors.

Family businesses have an opportunity to add considerable value to their governance by carefully selecting the right independent directors. Candidates should be highly experienced, objective and knowledgeable. To assure independence, they should not be drawn from associated businesses, vendors or clients, such as banks or law firms. Active chief executives often make the best independent directors because they bring an understanding of strategic issues, and they know what business criteria should be considered in making board-level decisions. Good independent directors can also bring specific industry knowledge or functional expertise that enhance the competency base of the board. Well-rounded candidates who bring leadership experience

can add the most value to a family business board. This is particularly true if they are sensitive to the challenge of governing a family company, and have the interpersonal skills to help build dialogue and understanding.

The conventional wisdom of best practices in public companies is for the board to be composed almost exclusively of independent directors. Often, this is seen as necessary in order to create a balance of power with the CEO. In family companies, this is rarely the case. Most families maintain a significant number of family owner–directors on their boards, and some families maintain a family ownership majority. The selection of family directors is another challenging and highly variable practice in family business governance. Early on, selection is often based on management responsibility or relative ownership interest. The largest shareholders and the leaders of management commonly sit on the boards of young family companies. As long as family managers continue to lead the company, they usually remain on the board and are seen as representing the family as well as management.

Choosing family directors who are not leaders in management becomes more difficult as ownership interests are dispersed. Many families initially pursue representational models based on family branches, but as generations branch further this tends to become cumbersome. Family boards often expand to an inappropriate size when they try to accommodate branch representation in succeeding generations. In addition, branch representation does not reflect governance best practice, which holds that all directors must represent the best interests of all shareholders in their fiduciary capacity. Representation by branch, while a common practice, tends to institutionalize a factional view of the family ownership. Many families have significant historical and cultural

branch differences, which are often related to their level of management involvement early in the family business's development. Often, in later generations, governance must adapt to overcome these historical patterns, and create practice that is more consistent across the family.

Ultimately the best family business boards use a competency-based selection process to choose family directors. Family candidates must have a high degree of business knowledge, as well as a thorough understanding of the business itself, including its history and strategy. They must be financially literate, and willing to spend the time necessary to prepare for meetings. Many families look for candidates who have already demonstrated a commitment to both the business and the family, and sometimes a previous active involvement in family governance is a prerequisite. Prospective candidates are often trained over a period of time in business concepts, and their aptitude for learning is assessed. Finally, personal qualities are an important consideration. Are candidates open-minded? Are they good communicators and capable of engaging in board deliberations? Do they exhibit good character and sound judgement? Will they be trusted by other family members, directors and managers?

## **Adapting governance practice in mature family businesses**

Mature family business systems have to respond to the increasingly complex functional demands in both the family and the business. Parallel family

and business governance allows the simultaneous pursuit of new practices in both areas. The proper alignment of decisions depends upon clearly delineating roles and processes across the system. Management, the board and the family ownership all have distinct jobs to do, and defining these roles clearly is important. Written policies can help clarify boundaries in governance. Policies can help designate decision rights and also create clarity around decision-making processes in advance.

Management, boards and family governance institutions often develop their own, separate, written policies. This creates the need for consultation processes that enable deliberation and alignment of these policies across the system. The family ownership should be aware of decision-making policies at every level, and these practices should be acceptable to a plurality of ownership. Building clarity of expectations about the roles and processes of governance is critical across the family business system. This clarity is especially important within the family, and can help individual family members better differentiate their roles as managers, directors and owners.

Equally important are fair processes that enable ongoing consultation across the system in decision making. While clarifying decision rights is vital to the system, so is the ability to inform and influence decisions. Each group must be willing to be informed by and consult with the other two in decision making. There must be a commitment to hearing a full articulation of arguments for and against a decision, as well as a willingness to fully explain the final outcome. Family business systems that do not create governance structures and processes that enable consultation and full explanations can ultimately face ongoing conflict over decision rights.

Family business systems frequently need clarity about how governance consultation is triggered and how it will be conducted. This can be vital to enabling decision-making processes to function optimally. Sometimes decisions made easily by one part of the system have unforeseen consequences or effects in another part of the system and end up unexecuted or contested in follow-up deliberations. At other times, the most difficult and complex issues may necessitate coordinated decision-making across multiple levels of the governance system. In both cases, the effectiveness of both major and minor decisions may depend upon an ability to trigger advance consultation and then efficiently conduct consultation processes. Having ready-made processes in place can create clarity about governance practices and build trust across the system. This in turn can help enable more efficient and appropriate decision making without extensive consultation. Many decisions are most effective when they can be made at the right level of the system. When those responsible for a decision have ownership of it, they will also tend to assure its best execution.

Active communication that flows freely across the system is the most critical component of building fair processes for decision making. Good communication builds understanding, flushes out hidden issues, and helps articulate the most important criteria in decision making. Good communication also goes two ways, and involves listening as well as explaining. Fair processes enable decisions. When the governance system is perceived as impartial, consistent and capable of making well-reasoned decisions, it builds trust. The willingness and ability to deliberate across the system is a key measure of this trust component. A breakdown of trust at one level of the system will often impact the entire system, and care must be given to develop fair processes at each level. The most effective family businesses create clarity

about roles and processes across their governance system, and they also bring the same high expectations of excellence and fairness to practise at all levels of their governance system.

## **Organizing the family and ownership**

There are many sources for learning about the best practices of business management and boards, but family and ownership practices are not nearly as standardized. Family governance is highly variable and must usually be carefully adapted over time. Organizing the family and establishing ownership practices can be difficult in large families, and often requires ongoing adaptation for over a decade. Families can sometimes establish their governance practices early on, but often they find that changes in the scale of the family create new challenges and a need for new structures. Models for family councils suggest potential structural solutions, but each family group must explore its own culture and create the combination of practices that best expresses its collective values.

The degree of inclusiveness is a key cultural component of family governance. The family must decide who is a family member. Some families exclude in-laws, some require share ownership, and others include any and all descendants and spouses. Representation is another cultural issue families must address in creating family governance. How important is broad representation from all family branches or representation of the different generations of the family? Participation requirements and restrictions can be another consideration in creating family governance. Should family members

be required to participate or restricted from governance roles if they fail to participate regularly? What about the participation of family managers and directors in family governance – should their roles be restricted or should they lead in this effort, too? Each individual family has to wrestle with these questions, and craft a governance practice that reflects its culture and values.

Even the most carefully crafted practices will be challenged by the test of time, and most will need revisions and renewal. Family governance can also develop greater and greater complexity, becoming a multi-faceted governance system of its own. It can include professionally run family offices, charitable family foundations, voting trusts, family councils and ownership councils. Each of these layers in family governance can have its own organizing structures and functions, and these, in turn, must be linked and interrelated to one another and to the larger family business governance system. Wealth creation is often the driver for development of these more complex systems of family governance. Helping the family to manage its wealth can become an increasingly important function of family governance, and one that at times can be critical to enabling the ongoing continuity of the entire family business system.

More typically, family governance functions to enable the family to create coherency and consensus in the widely held ownership group. The chief purpose of family governance is to promote the anticipation of issues and to enable deliberation processes that can resolve these issues. Family governance adds value by preparing the family to make decisions in advance and by building a common sense of identity and mission. In large family groups, transmission of business values and ownership vision is a key function of family governance. Educating the family about the business and

about family business practices and governance generally is also important. Providing a structure for information flow and education, for planning family meetings, for preparing the next generation, for assuring the family has fun and builds relationships – these are all important functions of family governance.

Fundamentally though, the most important function of family governance is to create and renew itself. Creating a framework that can organize the family to achieve these many functions is challenging and often takes ongoing effort. Building effective family governance that can foster communication and bring the family together to make decisions is difficult but important work to accomplish over time. Establishing family governance takes leadership and an investment of resources.

The funding of family governance and the process for selecting council members and leaders are two challenging issues that must be resolved. Some families establish trusts that distribute income from the company to the family, and a portion of this money is used to fund family governance. Others treat family governance as a shareholder-relations expense of the company. Most family governance is built on a democratic model, where a family council is elected. The family will hold an annual assembly that functions as a meeting of the entire family where a smaller, representative body can be elected. This smaller family council in turn elects its leadership. Some councils are selected, rather than elected, and sometimes leadership is appointed. This is more often the case in other areas of family governance, such as trusts, foundations, and family offices. Voting in family governance can be based on one vote per family member or one vote per share. Sometimes, separate family and ownership councils are constituted

in order to better represent both family and ownership interests and to more effectively fulfil their specific functional areas. Election techniques, as well as representation and qualification requirements can vary across the different structures of a family governance system, depending upon the different functions they fulfil.

Participation in family governance can be professional or voluntary. This frequently depends upon the structures and their functions. Many family governance systems incorporate both professionals (non-family and family) and family volunteers. Expenses are usually paid for participants in family governance, and some families will compensate particular positions within the system that require a serious time commitment, such as council and foundation leaders, trustees, etc. Compensation is sometimes based on a board model and uses per-meeting fees, with additional compensation for chairpersons who organize the meetings.

## **The value added by family governance**

Good family governance can add value in many ways. Some of these are abstract and emotional, while others are very tangible and important. Effective family governance generally allows for the creation of family and ownership policies. Creating and updating these policies over time is an extremely important function of family governance. Family policy can help guide decisions in a number of key areas, including family employment and the family's expectations about leadership positions in management. Many families express preferences for family CEOs or chairpersons. These

and other policies governing family employment can guide management and board decisions. Family policies sometimes also include codes of conduct, which create expectations for how family members should interact with each other and with the family business system. They can also establish processes for raising issues and resolving family conflict.

Ownership policies are quite important, and have a wide-ranging impact on the entire system. Ownership policies set the guiding principles of business governance, including the composition of the board, and the director selection process. Ownership policies can set financial goals, risk expectations and performance measures for the company. They can also determine appropriate dividend and reinvestment levels, and set out the principles governing shareholder liquidity, including policy regarding share redemptions and company loans. Some ownership groups create formal shareholding agreements that establish rules for share ownership and transference, while others create less formal policies that seek to clarify the standard rights and responsibilities of ownership.

Good family governance recognizes existing family practices, and tries to write them down in clear statements of policy. The articulation and exploration of practices illuminates many issues and gives the ownership family the opportunity to better understand itself and to learn about other trends and practices. Creating policy is forward-looking work. It frames principles for making decisions in the future. Effective governance works within a framework of well-articulated principles. Decision making is the test of this policy framework, and the best governance systems will recognize the ongoing need to adapt policies over time. Written policies that are thought of as fixed are often inappropriate. When policies can

be adapted and changed over time, governance remains responsive and forward-looking.

Family governance can add considerable value by actively creating and adapting family and ownership policies over time. This takes ongoing engagement in the family, as well as between the family and its business. This engagement is critical to maintaining family business continuity as the family grows and ownership becomes increasingly dispersed. Families that can continue to work together for their mutual benefit and in support of their businesses can add considerable value. They can come to speak with one voice, in this way building coherent ownership views and family consensus that adds intangible, emotional value. It is the emotional and financial commitment of the family that enables the special agency found in family business, and the creation of this vital, abstract asset is the chief value added of effective family governance.

## Summary

Family businesses outperform other businesses. They accomplish this despite being in many different industries and following many different patterns of development. One important factor shared by all family businesses is the discrete quality of their ownership groups, and the agency that this can allow in business governance. Family businesses and their ownership groups go through patterns of evolution in their development, which can impact ownership's interaction with the business. Changing levels of ownership involvement, in management or business governance, has an

impact on ownership agency over time. The size of the business and the size of the family also impact agency, and changes in business or family scale can often create the need to renew governance agency.

Effective ownership families adapt to the changing needs of their business and family groups. They recognize the interrelated and symbiotic relationships of the business and family systems, and work to renew the strategic agency they share. Developing and adapting governance practice is the key to enabling the continuity of this strategic agency over time. Well-adapted governance practice becomes increasingly vital as the family and business grow older and larger, and the number of people and resources being managed increases exponentially. This constant need to adapt and change keeps family business systems focused on the future. When combined with a family commitment to continuity and transmission, this can create governance systems that remain more active and responsive, even as they increase in complexity. Families that succeed in building effective governance are often capable of renewing the intangible assets of ownership trust and commitment. These are the key ingredients of agency in the family business system.