



**The Family
Business
Constitution: A
Roadmap for
Business
Continuity &
Family Harmony**

**Ten Key Insights into the process of making your
own Family Constitution**

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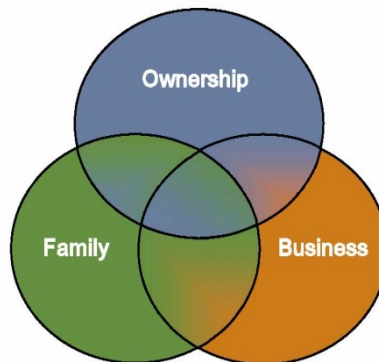
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1. Introduction to the Family Constitution

1.1 Family Businesses: Predictable Problems

What is a family business? One common aspect of the definition of “family business” is an intention to continue the business under family control. Another way of defining a “family business” is to refer to a business in which there is a significant overlap between (i) a family emotional system and (ii) the ownership system and (iii) the business system.



Notwithstanding that a family business, by definition, is one where there is an intention of keeping control in the family, the challenges of successfully perpetuating a family business are well known, leading to the often quoted universal proverb that “wealth only lasts for three generations”, or “from shirt sleeves to shirt sleeves in three generations”.¹

Research into Asian family businesses² has concluded that the majority of family businesses in Asia fail as a result of internal factors, rather than external factors. These internal factors include failure to plan for succession and family conflicts. Yet the surprising fact is that many family business conflicts are predictable and can be planned for.

¹ This is the starting point of the popular book “Family Wealth: Keeping it in the Family” by James E. Hughes Jr., Bloomberg Press

² Tong Chee Kiong, National University of Singapore, Feuds and Legacies, Conflict and Inheritance in Chinese Family Businesses, International Sociology, March 2005, Vol 2091); 45-70.

One reason for family business failure can be traced to share ownership. Over time, the number of shareholders increases, share ownership becomes fragmented, resulting in it becoming harder for the family to make decisions concerning the business. It is said that: “Families grow faster than businesses.”

Over time, as the share ownership becomes fragmented, the shareholders start to lose emotional commitment to the family business.³ Emotional commitment to the business⁴ and having “active owners”⁵ has been identified as a feature of successful multi generational family businesses.

It is also predictable that over time, there will be more family members who are owners rather than managers, and that the interests of these “outside shareholders” will be in conflict with the interests of the “inside managers”. Again such conflicts are predictable problems.

There are examples of successful Asian family businesses where the business has been continued as a result of a consolidation of share ownership. This points to the importance of having a mechanism for allowing for share ownership to be consolidated. The need for such a mechanism (often called an “Exit Plan” or a “family shareholders agreement”) is highlighted by cases where (i) a family conflict starts over the issue of how to value the shares in the business or (ii) the exit of one family shareholder creates a liquidity crisis for the business.⁶

Another challenge for the family business is the basic inconsistency between the goals and values of the “family system” on the one hand and the goals and values of the “business system”. An example of a family policy designed to address such a conflict between family goals and business goals is the family “Employment Policy”, which will set out clear rules for entry into the business by family members.

³ Wong Siu Lun, Family Business Review, vol VI, no. 3, Fall 1993

⁴ Carlock & Ward: Strategic Planning for the Family Business, Palgrave

⁵ Responsible ownership of the family firm, Lorraine M. Uhlaner

⁶ Tong Chee Kiong.

1.2 What Is Family Governance?

If the goal is long term business continuity, this points to the need to institutionalize the roles and relationships that are present in the family business, rather than simply to rely on current relationships. In short, long term business continuity requires there to be clarity as to how the family business will be governed.

“Governance is concerned with all of the ways that the interests of owners are reflected and implemented in the organizational system...In general the purpose of governance is to formalize the involvement of key stakeholders in the decision-making process at the apex of a family enterprise...Governance is inherently about institutionalizing control.”⁷

Governance in a family business can be thought of in terms of:

- (i) Structures for example, deciding to create a family learning and development committee;
- (ii) Processes for example, creating and running ongoing ownership education programs and the annual preparation of a personal development plan; and
- (iii) Policies for example, an aspect of the Family Employment Policy could be that family member employees are expected to participate in the family learning and development programs.⁸

For another definition of governance, taken from the context of a family controlled listed company in Hong Kong:

“Corporate governance can be broadly understood as the interrelationship among the company’s stakeholders, including shareholders, the board of directors, the management, and other relevant parties...Good corporate governance depends largely on the separation of ownership and

⁷ Tradition and Adaptation in Chinese Family Enterprises: Facing the Challenges of Continuity, Ivan Lansberg & Kelin Gersick.

⁸ You can also add “Agreements” to this list, e.g. the shareholders agreement.

management. Under a good corporate governance structure the responsibilities of different units in a company are clearly delineated.”⁹

This points to the importance of ensuring that there is a clear distinction made between the role of ownership and the role of management.

1.3 Family Governance Structures

Another form of predictable problem in a family business is where an issue or concern from one dimension of the family business system (for example, an ownership issue) arises in the “wrong circle”.

“If the needs of one domain have no way to be represented they don’t just evaporate, they find another outlet. This is like the displacement of an emotion. For example if there is no way for ownership issues to be expressed expressed they may appear in the board and board meetings turn into shareholder meetings.”¹⁰

This points to the importance of having appropriate structures and forums so that the interests of the family circle and the interests of ownership can be properly expressed. An example of this would be the creation of a “family council” or of an “owners council”.

“One of the most pervasive lessons we have learned is that when the legitimate interests of ownership do not have a forum for expression, issues of control and return on investment will find a way to emerge in either the family or the operating business. When those issues do come to surface in the “wrong” circle, they are almost always disruptive – and sometimes destructive.”¹¹

Basic governance structures in a family business can include (i) a family assembly (ii) a family council; (iii) it might include a separate ownership council or forum; (iv) the board of directors; and (v) perhaps also an advisory board. From there a particular

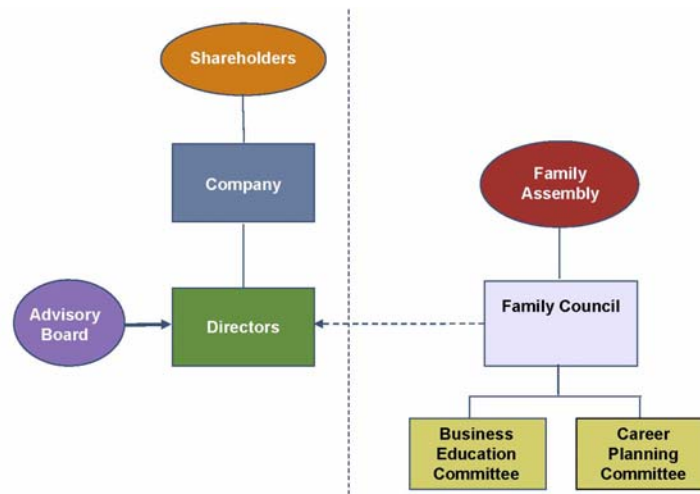
⁹ 100 Years of Li & Fung, by Feng Ban-Yan.

¹⁰ Getting Along in Family Business; the Relationship Intelligence Handbook, Hoover & Hoover.

¹¹ Generation to Generation, HBS Press.

family might decide that it also needs one or more committees (see the below diagram) or, for example, a career planning committee.

A simple diagram reflecting a basic governance structure for a family business could be as follows¹²:



1.4 How Family Governance Structures Help

Well functioning family governance structures aim at:

- (i) Communicating the family values, mission, and long term vision to all family members.
- (ii) Keeping family members (especially non-executives) informed about major business accomplishments, challenges, and strategic directions.
- (iii) Communicating the rules and decisions that might affect family members' employment, dividends, and other benefits they usually get from the business.
- (iv) Establishing formal communication channels that allow family members to share their ideas, aspirations and issues.
- (v) Allowing the family to come together and make any necessary decisions.

¹² Advising the Family Business: A Guide for Professionals” David Bork, Dennis Jaffe, Sam Lane, Leslie Dashew, and Quentin Heisler, Jossey Bass

1.5 How Family Policies Can Help Avoid Predictable Problems

Because family business have predictable problems, these problems can be planned for and family policies developed to address the issues before family conflict arises. Accordingly another aspect of family business governance is the creation of an ongoing process for the creation of relevant family policies and for their periodic review.

Family policies have many advantages. Making family policies can:¹³

- (i) avoid problems or solve them before they occur;
- (ii) reduce future family tension;
- (iii) strengthen the family with experience in coming to agreement;
- (iv) clarify your family's positions and reduce misunderstandings;
- (v) help the family sort out its values and what it stands for;
- (vi) improve future decisions by ensuring that policy formation is informed and objective rather than made in the heat of battle;
- (vii) create more enthusiasm for and knowledge of the business;
- (viii) increase the likelihood of long term business and family success, survival and prosperity.

1.6 Examples Of Family Policies & Agreements

Examples of family policies include:

- an Employment Policy
- a Dividend Policy
- a Remuneration Policy
- a job description for directors
- a learning and development curriculum
- a Code of Conduct
- a policy dealing with Conflicts of Interest
- a Charity / Philanthropy Policy
- a Statement of Family Values

¹³ Developing Family Business Policies: Your Guide to the Future” by Craig Aronoff, Joseph Astrachan and John Ward, Family Enterprise Publishers.

- a family shareholders agreement (note, unlike the above policies, this is normally a legally binding agreement)
- an operating agreement for the business (again, this might be a legally binding agreement)

1.7 What Is A Family Constitution?

The family constitution defines the “rules of the road” for the family with respect to its relationship to the business.

In simple terms a family constitution can be thought of as a collection of key family policies. It would also reflect the mission vision and values of the family and important principles for working together or for the business.

It could also include a description of the composition and role of the family council, and how the family council makes decisions and resolves conflicts.

It could include a description of the other governance structures that go to make up the family business (or the wider family enterprise if you make reference to the family foundation and the family office, for example). There is no fixed definition and there is no one way to do it. Here are some more descriptions of what a family constitution is:

“A Family Constitution is a formal document developed collaboratively by family members to encapsulate the values, beliefs and objectives of the family, as a family, with specific reference to the family’s relationship and dealing with its family business.”

Ivan Lansberg, Succeeding Generations

A Family Constitution is “... a legal, or quasi legal, guide for family behavior, decision-making, and setting up the succession from one generation to another. Beginning with the mission statement, the constitution then extends the mission into practical actions. It sets up a framework and a forum for a group of equals to deliberate issues, create policies and procedures, clearly define family member’s rights and obligations, and make decisions about the important issues they share.”

Dennis T. Jaffe, Ph D, Stewardship in your Family Enterprise

1.8 What Are The Benefits Of Having A Family Constitution?¹⁴

What are the benefits of having a family constitution? As you might expect there are actually two dimensions to this question. First, you should ask, what are the benefits of going through the process of creating a family constitution? Second, what are the benefits of having a family constitution?

(i) What are the benefits of going through the process of creating a family constitution?

The process can help to include or involve family members or family branches that have not had a role to play or that have started to become distant from the family business.

It can be fun. It can strengthen family bonds and family unity.

It should help to improve family communication and problem solving and conflict resolution skills.

Ideally it should help to improve the level of individual self awareness.

It makes the family members think about how they need to develop and what new skills they need to learn.

It provides an opportunity to talk about and to plan for the future. Often without a structured platform to have such discussions, families tend to avoid such important but difficult conversations.

It helps to bring the family members /shareholders onto the same page together.

(ii) What are the benefits of having a family constitution?

Family business guru John Ward says of the family constitution:

“The Family Constitution, a comprehensive articulation of philosophy,

¹⁴ Source: Credit Suisse Private Bank

principles and policies for the future that balances and synthesizes the welfare of family, owners and the business, is among the most important steps a business-owning family can take to secure and strengthen its business and, most precious, its family.”

Daniela Montemerlo, Ph D and John L. Ward, Ph D

A family constitution helps to avoid family conflicts and prevent unnecessary misunderstandings. By clarifying roles, this helps to avoid role conflicts. By providing forums for discussion of family and ownership issues, this prevents such issues from exploding in the wrong forum. By providing an “exit mechanism” this provides a way to “let off steam”. Having things in writing helps ensure family members are all on the same page. The family constitution will normally include a process for dealing with family conflicts.

The family constitution helps to shape the expectations of the members of the next generation with respect to their roles in the business and as future owners.¹⁵

Having a family constitution helps to give the business a strong foundation and to build the confidence of non family managers and business partners.¹⁶

With respect to family ownership the family constitution helps to keep the ownership united and to forge family commitment to the future of the family business.

Finally, the preservation of family wealth across generations ultimately comes down to having the best possible process for joint family decision making.¹⁷ The heart of the family constitution is a fair process for making joint decisions together as a family.

¹⁵ Credit Suisse Private Bank White Paper

¹⁶ Credit Suisse Private Bank White Paper

¹⁷ James E. Hughes Jr. Family Wealth, Keeping it in the Family.

2. **The Key Insights into the process of creating a Family Constitution**

The following points are worth keeping in mind when preparing to work together as a family to create a family constitution. A key concept throughout is that the family get to make their own rules - the rules that make sense for them.

2.1 **It's the Process That Counts**

It is often said that when making a family constitution the process is more important than the output. The process gives family members the chance to work together and make decisions together and talk in a structured logical way about the future of the family business.

As such there is very limited value in “model documents” or templates which are likely to be put in the draw. The goal is to create shared understanding among the family members and create a set of family norms of behavior.

2.2 **Not a Legally Binding Document**

Family constitutions are not normally legally binding documents – although a family shareholders agreement is usually legally binding. Again it is about clarifying roles and expectations and creating family norms.

2.3 **The Family Make Their Own Rules**

The family members should decide on what goes into the family constitution as well as the approach to be taken, and the on the terms of policies etc. It has to be the family's project. There is no defined list for what must be in a family constitution so it should be tailored by the individual family for themselves.¹⁸

2.4 **Family Project Leader**

Ideally there will be one or more family members who drive the family constitution project (the “family task force”). The more the family members own the project and

¹⁸ On the other hand it will be helpful to have a checklist of issues to be considered for inclusion.

and put their own thinking into it; the more effective and robust it will be. It often makes a lot of sense to have one family member at least who is charged with (i) acting as the coordinator and liaison between the outside consultant and (ii) who is responsible for coordinating the work that needs to be done by the family members.

2.5 The Concept Of Fair Process

- (i) In working on a family constitution the concept of “fair process” is very important.¹⁹ If a person feels that they participated in making a decision, if they have a “voice”, if they believe the process for making a decision is fair and transparent, they will accept the outcome of that process even if it may not reflect their own personal view.



- (ii) Fair process is about participation and having a voice in the process. However you may be able to get the input and participation of a group of persons without having to cede decision making authority to them. Decision making authority and participation can be different things.²⁰
- (iii) The principles of “fair process” might dictate that normal decision making processes of a family should be suspended while working together on the family constitution.²¹
- (iv) In the context of a family business, it will also be important to consider the non family members who should be asked to give feedback on the proposals and policies the family members develop, e.g. non family directors and senior managers; and to consider how & when their feedback should be obtained.

¹⁹ See Blue Ocean Strategy, by Harvard Business School Press.

²⁰ Professor Randel Carlock.

²¹ “Family Governance, Beyond the Basics” Barbara Hauser, STEP Journal

2.6 A Change Process

- (i) Working on a family constitution might involve making a change in the way the family do things. For example if an ownership council is formed and starts to meet and starts to get reports that were not given in the past, this would be a change. It is important to understand that change takes time and is usually met with resistance.
- (ii) If new concepts are involved, if a change is contemplated, in practice it might be necessary for new information or feedback to be presented more than once to the family. .

2.7 A Social Contract

- (i) If, for example, you are asking a family member who is a shareholder to participate in the family council and to abide by its decisions, to put the interest of the family group in front of their own personal self interest, then you are talking about forming a "social contract".²² A "social contract" means that people are willing to give up some of their own personal freedoms "for the greater good".²³ The theory is that you are going to be "safer" and better protected as a member of the group, even though it involves giving up some of your personal freedom.²⁴

“Every attempt to create governance by and for a family group will of necessity involve an accommodation or curtailment of the individual’s freedom for the greater good of the whole. Accordingly, each individual must be convinced that this accommodation will result in an overall benefit to the individual by being part of the larger group.”²⁵

- (ii) In practical terms it follows that it is very important to get everyone to think carefully about the benefits of having a family constitution and what are the

²² Generally see Family: The Compact Among Generations by James E. Hughes Jr.

²³ See John Locke and his Second Treatise on Civil Government 1689.

²⁴ This is subject to the proviso that the leadership of the group has to be seen as good leadership.

²⁵ “Family Governance, Beyond the Basics” Barbara Hauser, STEP Journal

benefits of working together as a united family group.²⁶ Working together might hold up the value of the family voting bloc. Working together might provide the opportunity to ensure that the family company continues to be run in line with the family values.

- (iii) Social contract theory posits that there is government by consent; by freely given consent. Membership of the family group therefore has to be voluntary.²⁷
- (iv) In order for it to be voluntary, there has to be a way to exit the group. This points to the importance of (a) a voluntary commitment to the family constitution, (a) having a way to amend and modify the family and (c) having an Exit Plan (for example a family shareholders agreement).

2.8 What Are The Existing Arrangements?

Work on a family constitution will not occur in a vacuum. The family business will already have its existing governance arrangements in place, even if they might be relatively informal or even if they are not documented.

2.9 How Long Does It Take?

How long does it take? Just like there is no set formula for what should go into a family constitution, there is no one right answer for the question of how long it would take.

- (i) Some families hold a series of family meetings over a period of several months and create a family constitution which reflects their shared view on a list of important questions that can impact on family business continuity (for example, “Can in laws work in the business?” or “What will we do if there is a dispute?”). They would then plan on reviewing it at an annual family meeting and if necessary updating it.
- (ii) Some families focus on forming a family council and articulating the rules for

²⁶ A related concept is that of examining Emotional Commitment to the family company.

²⁷ Family, The Compact Among Generations, James E. Hughes Jr. Bloomberg Press.

²⁸ Though amendments should not be taken lightly.

participation in the family council and its role and purpose and the process by which that family council will make decisions and resolve conflicts. This is documented in the family constitution. They then hold quarterly family council meetings which debate important family agreements, policies & issues. This then becomes an ongoing process.

- (c) At the other end of the spectrum, there is a well documented example of one Indian family, the GMR Group, that spent considerable effort over a 3 year period developing a comprehensive family governance structure and family constitution.²⁹

2.10 What If They Don't Follow The Rules?

This is a common question. There are two aspects to this. The first is that the family should consider the alternatives and make their own decision as to (i) whether there will be any express consequences for a breach of the family constitution and (ii) what those consequences will be. The family should make their own rules.

For example, there is a family constitution prepared by a wealthy Japanese family in 1722, called the Mitsui Constitution, which contains the following clause 15:

"In principle, the eldest son is to succeed his father as head of the family; but if his conduct should cause harm to the family, he shall be expelled, even if he is the only son, and sent into the priesthood. In such a case, a successor will be adopted from among the other members of the House. Those members who prove incapable of maintaining their families or who conduct themselves immorally shall also be sent into the priesthood."

The second aspect to this question though is the question of whether complying with the family constitution and being a member of the "family group" is an attractive proposition or not. This also includes the concept of fair process again; i.e. has there been an adequate opportunity provided to participate in the rule making process?

²⁹ This case is referred to in Family Business The Essentials by Peter Leach.