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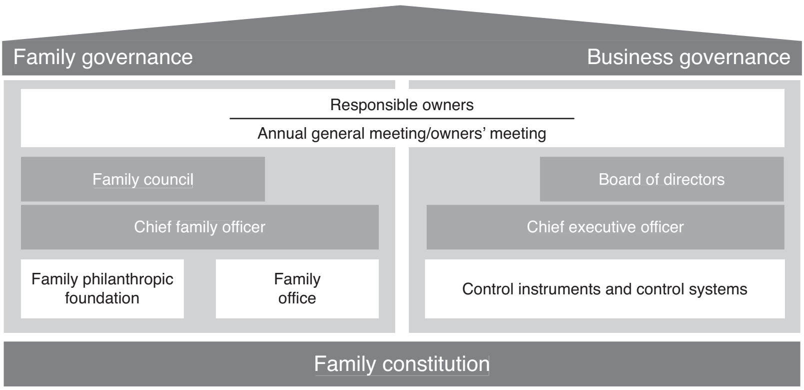
part I

Structures for Family and Business: Family Business Governance



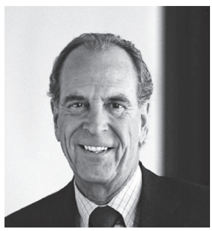
This figure illustrates the family business governance model and acts as a navigational tool for the reader.

chapter 1

Maximizing Success through Professional Family Business Governance*

"Family-owned businesses need to align their governance with that of public companies to some extent."

Interview with Dr. Jürgen Heraeus, Chairman of Heraeus Holding, Hanau, Germany



Dr. Jürgen Heraeus, chairman of the board of directors at Heraeus Holding, gives an account here of how the most important aspects of leadership, control, and family structures are implemented in his company. Heraeus is a globally active precious metal and technology group based in Hanau, near Frankfurt in Germany. The company has been family-owned for more than 160 years. With more than 12,200 employees, Heraeus generated product revenues of €4.2 billion and precious metals trading revenue of €16 billion in 2012.**

* Alexander Koeberle-Schmid would like to thank Peter May, Peter Witt, Karsten Schween, Hans-Jürgen Fahrion, and Bernd Grottel for their support in developing this chapter from prior work on which they collaborated.

** This interview is translated into English and has already been published in the book Führung von Familienunternehmen (Leading the Family Enterprise) by Alexander Koeberle-Schmid and Bernd Grottel, published by Erich Schmidt, Germany.

Alexander Koeberle-Schmid: **Dr. Heraeus, governance in family-owned businesses differs from that in publicly-held companies. In your opinion, what is the most significant difference?**

Jürgen Heraeus: The most important difference is the time factor, really. Owners usually have a planning horizon that is measured in generations, whereas to managers and shareholders of listed companies quarters and quarter figures matter the most. This fundamentally different perspective of family-owned businesses has a major impact on the requirements for and the development of governance.

A family enterprise that has reached a certain size needs to have its own family business governance. To what extent is this true for your company?

We first established a family governance code within our company in 2006, on the basis of which we then adopted the Heraeus family code in June 2011. In its function as the code of the shareholder families, it forms a common basis for all shareholders and furthermore provides a knowledge base to all young and new shareholders.

The board of directors takes a special position within the governance system. What significance does this board have in your company?

True to our motto, "Good governance at Heraeus," we think it is important that the board is as professionally staffed as it would be in a public company. Also, we decided that owners must play an active part in our company's boards, thus taking on a great deal of responsibility for the company. In order to be eligible, candidates must comply with a range of criteria such as suitability and qualifications as well as commitment and acceptance within the ranks of owners. You see, we have set the bar very high.

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You have about 200 shareholders. This results in some shareholders becoming less attached to the company as well as an increase

in heterogeneity. How do you handle this situation?

Our dividend payout corresponds to our system of values and is most appropriately characterized by the term “modest.” Therefore, the links that bind shareholders to the company are more emotional than monetary. There is a considerable vested interest in the company and its development. In addition to our annual shareholders’ meeting, we organize special activities such as young shareholders’ meetings, family weekends, and education days.

How do you proceed if a shareholder wants to drop out?

Our share price, a so-called ceiling price, is determined annually. This price is announced at our shareholders’ meeting. If a shareholder wants to sell his shares, he has the option of choosing a buyer from within the family or otherwise the shares are tendered. Should no shareholder be able to buy the shares, our asset-managing holding company will need to buy them.

It is your wish that family members be represented within management. How do you ensure that the managing director in your family enterprise is suitably qualified?

Before they can hold a position in the family company, family members must have proven themselves in other companies. They can then apply for a position two levels below group management level. The shareholder committee will determine whether that family member is a good match for the company in terms of character and experience. They must be capable of leading the company but also of communicating with the family.

They must be capable of leading the company

What can be done if there is more than one candidate from within the family for a certain position in management?

It is obviously easier if only one family member is applying than if there are several applicants for a position in the company. If there is more than one it might be preferable not to allow any of those family members to join the management team, in order to avoid conflicts. So far we haven’t had this situation.

Especially in times of crisis, a family enterprise needs to be able to rely on its management. We have seen family businesses overcome numerous crises over time. Do family enterprises cope with crisis situations more successfully?

The best prerequisites for overcoming a crisis are sufficient liquidity, a sound equity basis, a broad, globally competitive business portfolio, and tailor-made governance. Speaking on behalf of Heraeus, I'm confident that, being an internationally operating family-owned group, we meet the most important requirements for coping with future crises.

What kind of advice would you give to an entrepreneurial family wishing to further develop their governance?

Family-owned businesses need to align their governance with that of public companies to some extent; that is, complying with those regulations stipulated by the German Corporate Governance Code that make sense. That being said, some of those regulations don't make sense for family businesses, in my opinion. For example, a retiring managing director should not have to take a two-year cool-off period before joining the supervisory board. If he is a family member, he should be allowed to join the supervisory board immediately to ensure the same standards continue because, after all, it is his own or his family's money that is at stake.

Family enterprises are special

Three brothers jointly run their businesses.[1] They form a unit; a powerful team. They have divided up the tasks among themselves. One is responsible for finance, controlling, and human resources. The other runs the internet companies. The third takes care of the manufacturing businesses. The situation today is clear. But in the next generation, six cousins – the children of the three brothers – take up roles in the business. The brothers ask the following governance questions: Will all children inherit the shares equally? Which of the six cousins will manage the enterprise in the next generation? What happens when conflicts arise? How should the children be best prepared for their future role as owners? How can we ensure cohesion between the cousins?

Here is another example. An entrepreneur has five children from two marriages. He plans to retire from management in three years' time. A daughter from his first marriage and a son from his second marriage are interested in taking on a management role in the company. The company is just big enough for two managing directors and owners. The daughter, aged 35, has already made a career outside of the family enterprise and would like to start in a year's time as managing director. The son, 23, has just completed a university degree. The father considers the following governance questions:

- Shall the shares be handed over to both children; and at what time?
- How can he compensate the children who do not get shares in the company, if he has no personal assets?
- What if conflicts occur between the half-siblings?
- Should a board of directors with external members be created? What succession plans do we have?

A third family runs a mechanical engineering firm. It has developed a technology with great potential. The entrepreneur has ambitious plans: sales are expected to rise over the next five years from €150 million to €500 million. For expansion in France and the establishment of subsidiaries in the USA, India, and China, an external minority investor has joined forces with the company. The relevant governance questions for this family enterprise are:

- What changes in the management and control structures need to be anticipated?
- What role should the new investor play on the board of directors?
- How can appropriate control systems prevent wrong decisions?
- How can we ensure that employees in all subsidiaries comply with the legal rules and compliance standards?

These **three enterprises have the common features** that they are under the dominant ownership of one or more families, with a dynastic intention or generational approach.[2] However, the three family enterprises differ in ownership and management structure, whether they have a focused or a diversified business, and in size, culture, and whether or not they have nonfamily owners.[3]

dominant ownership of one or more families, with a dynastic intention

Family enterprises differ not only among themselves, but also from other types of businesses. For instance, publicly-listed companies have dispersed ownership of unknown shareholders that can buy and sell their shares at any time. Family enterprises also differ from state-run organizations, those held by private equity firms, or cooperatives.

Family enterprises constitute a unique and special category of businesses, with features that include: long-term strategic orientation, low disclosure obligations, and the increased continuity in management positions. Some of these characteristics give them competitive advantages; on the other hand, family enterprises face enormous risks, such as internal family conflicts destroying the business. In this book we seek to create a practical resource for approaching governance in family firms to help equip companies to face these issues. Below we highlight some of the **principal opportunities** that family firms enjoy, linked to the related risk factor:

- Family values can create competitive advantages, *but* continuous conflicts among family members undermine this.
- Family managers are more engaged with the company, and do not need so much control, *but* family managers may be less qualified and competent, act in their own interests, and require more control.
- Family members are oriented towards the long term, *but* some family members often want to maximize short-term dividends.

- Family enterprises focus on a sustainable business model, *but* family enterprises have risks associated with the business life-cycle.

Some family enterprises are highly successful and able to increase their value over generations, while others fall prey to internal disputes and crisis. The difference is that those that fail do not react properly to the challenges, do not have common vision and mission, a sound strategy or appropriate governance structures, and the roles of family members are not clearly defined and incorporated by each family member. The following chapters set out approaches for different aspects of governance, both for the family and the business, addressing not just the structures, but matters such as values, conduct, and principles.

Employees who can identify with a corporate culture demonstrate an increased motivation for their job

Sound family business governance

Empirical analyses show that family enterprises are more successful when they have established optimally designed management, control, and family structures.[4] Despite this, many family enterprises neglect governance. A report published in 2010 indicated an alarming number of insufficiently governed family enterprises.[5] This neglect exposes them to considerable risks. **Indicators of inadequate governance** are:

- No obligation for family members to prove their competence when working in the business.
- No clear definition of the board of directors' competences for exercising control.
- No management of opportunities and risks in the company.
- No rule regarding an exit mechanism.
- No rule regarding interactions with nonfamily shareholders.
- Limited family cohesion.
- No arrangements for managing conflict in the family and the company.

It is surprising that family enterprises pay insufficient attention to governance, because this began to be discussed many years ago. In 1996, Craig Aronoff and John Ward published *Family Business Governance*.[6]

This laid the foundation for a structured discussion about the professionalization of governance in family enterprises. Between 1996 and 2003, only about 10% of published work about family businesses in academic journals was about governance in family enterprises, whereas today that has risen to about 20%.[7] A governance model for a family enterprise was comprehensively presented for the first time in *Family Business Governance – Successful Management of Family Enterprises*.[8]

Nonetheless, family firms are now paying more attention to governance, partly reflecting the fact that there are, internationally, 12 governance codes for family enterprises. The world's first formal code for family enterprises only was published in Germany in 2004.[9] As a result, around 60% of owners' families in Germany know the code, and 90% think that good governance influences the performance of the family business.[10]

The **aim of good family business governance** is to set the basis for a sustainable increase in economic value and emotional well-being.[11] Family owners want "deep pockets and warm hearts." A study published by Ernst & Young established that the value of a family enterprise consists of around 70% economic value and 30% emotional value.[12] It is disquieting to note, however, that the emotional value can become negative when conflicts erupt, which in turn can reduce the economic value. However, with the help of sound family business governance, both economic and emotional value can be maintained.

Economic and emotional value

A higher **economic value** is demonstrated by higher sales, better results, a higher company value, and increased dividend payouts. **Emotional value** has been called the "family Pattex" (Pattex being the brand of a glue produced by the German family business Henkel). Some family business owners say that it is not the dividends but the emotions that create an attachment to the company; the individual family members are proud to belong to a business-owning family that has no conflicts. Further indications of a high emotional value are:[13]

family Pattex

- The family owners have common values and goals, which followed and passed on from generation to generation.

- Specific family traditions and rituals are performed by all family owners.
- The family owners have a strong willingness to learn.
- Participation in joint family activities is a pleasure for all family owners.
- The family owners support each other.
- There are clearly defined boundaries between the rights and duties of the owners in relation to the family enterprise.

A family business governance system[14]

Effective governance helps a family business to achieve both economic and emotional value. Because family enterprises are different, each enterprise has to establish its own governance, which is optimally summarized in a family constitution. A structure for doing so is the family business governance model (Figure 1.1). Governance in family enterprises consists of two overlapping components:

each enterprise has to establish its own governance, which is optimally summarized in a family constitution

business governance, which deals with establishing appropriate structures of management and control within the company; and
family governance, which deals with managing the family and establishing cohesion among family members.

Better business governance increases economic value by **transparency and accountability** with regards to management and control of the enterprise.

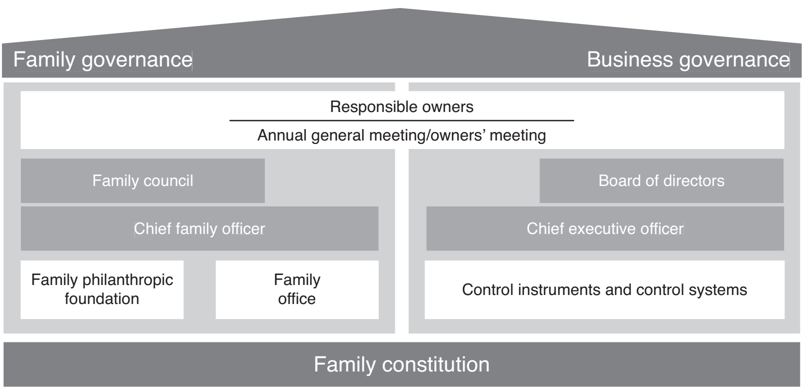

FIG 1.1 The family business governance model (adaption of the model by Alexander Koeberle-Schmid, Peter Witt, Hans-Jürgen Fahrion, and Bernd Grottel)

This fosters long-term success through the professional conduct of owners, the board of directors, and managers. In addition, a management system covering risk, control, and compliance allows managers to ensure that monitoring can be carried out throughout the whole company. Additional supporting roles are played by the auditor and the internal audit function. Ethical codes, regulations about liability, and an appropriate remuneration system are also important governance instruments.

Good and adequately formulated family governance can increase the emotional value owners associate with their company by strengthening the cohesion of the business-owning family, by **increasing the engagement** with the company on the part of the family, and by **reducing the likelihood that emotional conflicts** will arise. To do so, a family council and family manager (also known as a chief family officer) play an important role by organizing family activities, by implementing a family intranet, or by being the first point of contact if conflicts arise. In addition, a family philanthropic foundation and a family office play important parts in increasing emotional value and in organizing the business-owning family. One could also think about a family bank, a family assembly, a family residence, a family history book, a conflict-management procedure, rules about dealing with each other and with the public, and family development programs, where the next generation is prepared for becoming future CEOs or board members. Not all family enterprises, however, will need all family governance instruments.

How the individual aspects of family business governance are configured depend on the individual circumstances of the family enterprise and their challenges (see Chapter 2). It depends on whether the business is owned by a sole owner, a sibling partnership, or a cousin consortium, and whether it is managed by the owners only (owner-managed), by some of the owners (family-managed), or is only supervised – not managed – by the owners. It also depends on the size of the business, its culture, and whether there are nonfamily owners or not. According to the classifications and the various factors listed above, different aspects of family business governance are necessary. Figure 1.2 shows how these different aspects of family business governance may become relevant. It is important to note that family

Ownership structure	Management structure
Sole owner • Ownership succession plan • Board of directors	Owner-managed • Management succession • Board of directors • Risk control compliance management system
Sibling partnership • Annual general meeting • Ownership succession plan • Conflict management	Family-managed • Management succession • Board of directors • Risk control compliance management system
Cousin consortium • Annual general meeting • Conflict management • Chief family officer • Family meeting/assembly • Family educational programme • Family philanthropic foundation • Family office	Family-monitored • Management succession • Board of directors • Family council • Risk control compliance management system

FIG 1.2 **Definitions of the different stages in family business governance solutions for various types of family enterprise**

business governance needs to be individually formulated by each family enterprise in order to fit the situation of each family and business.

Sound family business governance depends upon **strong decision-making by the owners** about the values and goals of the family, and about family ownership and the enterprise. Important family values include tolerance, respect, honesty, and mutual responsibility. Business-owning families should also set values for the business. It also helps to establish strategic principles, such as being an innovative market leader, maintaining an equity ratio of more than 40%, or prioritizing organic growth. Families should decide what they want to give the company (such as responsible ownership, and reinvestment of profits) and what they expect from the enterprise (fair processes, interesting business model, dividends).

Responsible ownership and fair process

The principles of family business governance are **"responsible ownership"**[15] and **"fair process."**[16] **"Responsible ownership"** consists of four fundamental roots: family values, stewardship, emotional ownership, and patient capital (see Chapter 4 for full definitions). In practice, a **responsible owner** has the following traits:[17]

- He/she acts like a long-term affiliated owner.
- He/she wants the family enterprise to survive long term, preferably in family hands.
- He/she identifies him/herself with his/her own company.
- He/she maintains a relationship between family and business.
- He/she is fully informed about the current situation of the company.
- He/she wants to transfer his/her knowledge to the next generation.
- He/she wants both the family and the company to be successful.

"Fair process"[18] consists of three aspects. First, there should be individual arrangements or rules. These are set within the governance system and documented in the family constitution and articles of incorporation. These cover rules for succession, for distribution, or for exit. The rules must be clearly formulated, changeable, and consistent with the goals and values of the family business. They must be communicated to all owners and they need to be accepted. The second aspect of fair process is that compliance with the rules is to be ensured by a defined institution, such as the board of directors. The nonexecutive and nonfamily board members can, for example, objectively decide whether the agreed requirements for the new CEO are met by the candidate from the family. Third, transparency about all rules needs to be assured for all involved family members such that that they accept the decisions taken. "Fair process" means that decisions do not lead to emotional conflicts, because they follow clear and formally accepted rules.

"Fair process" means that decisions do not lead to emotional conflicts

Business first or family first?

The culture and the country of origin have significant influences on family business governance.[19] Western cultures are more business-oriented, and Eastern cultures more family-oriented. In Western countries, few family members may work in the company. In Eastern countries more family members do so – sometimes they all do. Word pairs can illustrate whether a culture is more **"business first"** or **"family first."** Examples are:

- meritocracy versus representation
- most competent leadership versus personal growth
- ownership rights versus family membership equality
- efficient versus effective
- individual responsibility versus collective responsibility
- accountability versus protection
- results versus process
- formal versus informal
- legal contract versus moral commitment
- controlled versus open
- decisive leadership versus participatory
- profit versus fun
- high trust in outsiders versus low trust in outsiders
- independence versus security.

Families have to decide whether governance – both of the family and of the business – is oriented more towards the family's or the business's interests. In a **"family-first"** business, the CEO is usually a family member; family members can work in the business, sometimes without limit as to their number; remuneration and dividends depend on family needs. If the approach is **"business first,"** the position of the CEO is held by the most competent person, and often only one family member can work in the company and only as CEO; remuneration is market-based, and dividends are only paid out if the company is profitable.

Irrespective of the company's orientation, families should always consider the two principles of "responsible ownership" and "fair process." This is especially important when the culture is more family-oriented, because otherwise conflicts can easily arise and the family might end up destroying the business.

families should always consider the two principles of "responsible ownership"

BEST-PRACTICE RECOMMENDATIONS

1. Business-owning families should implement a strong and healthy governance system.
2. When developing appropriate family business governance, owner families should consider their individual challenges (Chapter 2).
3. Owner families will find that strong governance can help build emotional value as well as economic value.
4. Business-owning families should consider that the business needs appropriate strategies, structures, and rules, both for the business and for the family.
5. Owner families should develop their family business governance individually according to the ownership, family, and management structure as well as the size of the company, and if there are owners other than the family.
6. When designing family business governance, business-owning families will find it helpful to be guided by the principles of "fair process" and "responsible ownership."
7. While every firm will have a tendency towards being oriented more towards the business or the family in its overriding culture, governance should encourage the business towards an orientation of "business first", *and* the family to the principle of "family first."
8. Business-owning families are advised to document their family business governance in a family constitution.
9. Business-owning families should regularly review their family business governance, and further refine it if there are changes to the family or business.

IMPORTANT DEFINITIONS

Annual general meeting (AGM): The meeting of the owners once a year where important decisions are made, such as the election of the board of directors, the approval of the annual accounts, or a decision about profit distribution. In some countries, it is also called an owners' meeting or shareholders' meeting.

Board of directors: A governing body of a company that consists of executive and nonexecutive members. The latter provide advice and/or monitor the executive members. In some countries, the board may consist only of nonexecutive members with clear monitoring tasks; it is then called a supervisory board. When the board has no or little formal decision power, it is often called an advisory board.

Business governance: Structural organization of management and control in a family enterprise aiming to ensure the long-term success and term continuity of ownership in family hands.

Chief executive officer (CEO): Person who manages the enterprise. As well as developing and implementing corporate strategy, s/he is also responsible for the implementation of business governance and the family business culture, a lean organization, and ensuring that company policy aligns with the family's goals and values.

Chief family officer (or *family manager*): The person who is mainly responsible for family governance issues. The chief family officer manager performs the function of chairperson or president of the family council and helps to keep family members united. S/he often acts as a mediator, facilitator, and communication conduit for a family. S/he is responsible for ensuring family cohesion, and organizing family activities.

Chief investment officer (CIO): Person in charge of all investments in a family office. The CIO heads the family office when its sole purpose is to manage the financial investments of a family. However, when the role of the family office is larger, it is usually headed by a chief executive officer (CEO).

Conflict management: Procedures that are used to resolve problems when conflicts arise.

Family activity: Joint activities of the owners' family to increase cohesion and commitment, such as family weekends, youngster days, and family meetings.

Family bank: A way to provide family members with financial support under specific conditions. It can help individuals create their own entrepreneurial endeavors.

Family constitution: A document that clarifies the relationship between a family and its business, and defines the strategy and structure of the enterprise. Mission, vision, important issues about the owner business model, governance, as well as rules that apply to family members, are normally documented. Other terms often used for a family constitution are family protocol, family code, family charter, generation contract, etc.

Family council: A governance body that focuses on family and ownership matters. The family council represents an institutionalized form of periodically holding family meetings. The primary advantage of this formal format is the disciplined approach to holding these meetings, even when they appear not to be needed. Family councils primarily promote communication, provide a safe harbor for the resolution of family conflicts, and support the education of next-generation family members in responsible ownership, family dynamics, financial issues, and philanthropic issues.

Family residence: Historic place where the family gathers for special occasions.

Family education: Activities to educate business-owners in a sense of responsible ownership, such as education days, development programs, or seminars.

Family enterprise: An enterprise that is predominantly owned by a family with the aim of handing it over to the next generation.

Family governance: Organization of the family owners aimed at strengthening cohesion within the family as well as their identification with the business, and therefore family solidarity

Family history book: A comprehensive book about the history of a family, preferably with many pictures and written in a journalistic way.

Family meeting or family day: Meeting of owners and other family members where issues about the family and the business are discussed. It is often combined with an AGM as well as fun activities.

Family office: The family office is the person, desk or legal entity that manages the wealth of a family. It usually also provides legal and fiscal advice to family members related to their wealth.

Family owners: The owners of a company, originating from the owner family.

Family philanthropic foundation: A family philanthropic foundation, or family charitable trust, is an institution that organizes and funds the charitable activities of a given family. It can be set for the lifetime of a person or a specific generation, or may be an enduring entity.

Management board: The group of executives who manage a company. Those are the executive directors.

Owner family: The family who owns an enterprise. The boundaries of the owner family need to be defined. Normally it consists of the owners, their partners, and their children.

Owners: The shareholders, partners, or limited partners of a company.

Risk, control, and compliance management: Instruments that allow for control of the processes in the company. They help monitor risks and to ensure that employees comply with laws, rules, and regulations.