Newsletter

BURGES SALMON

Family Business

February 2015

Welcome

Welcome to the February edition of Family Business. This edition looks at strengthening the structure and governance of a family business.

Family business governance

Identifying shortcomings in how their business is managed can be tough for owners, for a number of reasons. Firstly, it can be hard to find time to step back and look at things objectively. Secondly, control and governance often intrude on emotive areas such as succession. Thirdly, it is not a simple issue and there's little guidance on how to make improvements.

However, the rewards that can be reaped from ensuring that the business is well governed can be very significant. In some cases, finding the right balance of governance for both the business and the family can mean the difference between the failure or survival of the business and the prevention of acrimony within the family.

This edition sets out a number of areas which can be explored in this process and looks at governance of both the business (ie the way in which it is directed and controlled) and of the family, including its relationship with the board of directors. The solutions will be different for each family and will depend on a range of factors including, the stage the business is at and the number of family owners.

Business governance

Effective board procedures

Family businesses often take an informal approach to governance. Directors and shareholders are the same people, decisions are made where and when required and owners are wary of introducing greater formality for fear that this will reduce flexibility and speed of decision-making.

While this approach may work for a business which is in its early stages there are good reasons why it doesn't work for more established businesses, including that:

- the business comes to rely entirely on the knowledge of a few people (making risk management much harder)
- there is no record of decision-making or the information on which decisions were based
- the process lacks transparency for other members of the business, such as employees
- it paints an unprofessional picture to the outside

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world (for example lenders may want to see board minutes and evidence of good corporate procedures)

- it requires the owners to be constantly involved in the day to day running of the business, with little time to step back and make strategic decisions.

A more structured approach to board proceedings will allow delegation, greater clarity and better business continuity in the event of an unforeseen absence. So where to start? Initially it is worth thinking about:

- timetabling regular board meetings, with a system for circulating papers in advance and detailed minutes of the meeting afterwards.
- delegating responsibilities at board and management level
- consider whether the board could use additional input from a non-family member (see below)
- formalising risk management within the business, ie recognising the key risks facing the business and putting time into planning how those risks will be addressed.

Non-executive involvement

Early stage family businesses are wary of non-family involvement for fear of interference and disturbing the unique character of their business. However, a good non-executive director can add huge value by bringing knowledge, sector experience and contacts. Moreover a non-family director can bring impartiality and perspective to decision-making, simply by being independent from family politics.

For example, a trusted non family director can assist in deciding remuneration policy, mentoring younger family members and helping to assess those best suited to assume management roles. Where this decision making is backed up by policies (eg a remuneration policy, and a fair and equal system of performance appraisal) this can help to release the head of the business from the stress of being asked to justify decisions which some members of the family or the business may otherwise complain are unfair.

It is hugely important to find the right person to take up a non-executive role, ie someone you like and trust, but you don't have to commit long term. A potential non-executive director can be "trialled" on a short term basis to see how they fit into the environment and can be removed as a director at any time.

Family governance

Family involvement in the business is rarely an issue whilst the family business is in the first generation. However it may well become an issue as the business transitions to the second generation or at any time thereafter. Therefore even for fairly new family businesses, if the intention is to pass on the business to the next generation it pays to think ahead.

Long term planning

One of the key facets is that planning family involvement needs to be clear, fair and considered. Succession planning is an ongoing process which may take months or years and the best decisions are taken after careful thought and consultation within the family. During this process people are likely to change their minds and personal circumstances will change (for example a child who has not previously worked in the business may declare an interest in joining). It is important to ensure that everyone has an opportunity to make their feelings known and to discuss the future of the business. Moreover since succession planning will involve financial planning and selection and coaching of successors, plenty of time should be allowed.

> *"There is a lot to be said for keeping ownership in the hands of a very few if it is achievable, because this makes control of the business much simpler in the long term."*

Should ownership be restricted?

A key decision for family businesses passing into the second generation and beyond is whether to allow ownership to pass down each branch of the family or whether to take active steps to ensure that ownership remains with a small number of individuals (or possibly even with a single successor). There is a lot to be said for keeping ownership in the hands of a very few if it is achievable, because this makes control of the business much simpler in the long term. However, deciding to restrict ownership in this way requires careful planning and may not be possible (or desirable) for many families.

If ownership is allowed to expand so that there are a large number of family owners, particularly where some have little involvement with the business and may not know each other, steps may need to be taken to ensure that the family shareholders speak with one voice and that the risk of factions emerging is minimised. The exact measures will depend on the size and circumstances of the family.

Once the extent of ownership is determined appropriate controls can be put in place to suit the business. The following may help as a rough guide:

- **Single ownership/control:** where the ownership and day to day control sits with one person (eg the founder or a single successor), no family governance arrangements may be required. This does not mean that the company should overlook effective board practice (even if decisions are in effect taken by the owner) and thought should also be given to implementing effective arrangements well in advance of a handover to the next generation.
- **Restricted ownership:** if ownership is held by a small number of individuals who are all closely involved in the business it may be appropriate to have a shareholders' agreement which, together with the company's articles of association sets out how decisions are made and also what is to happen to someone's shares if they want to sell their shares or if they die, get divorced or become bankrupt. It is important to think carefully about these situations because any of them can result in ownership inadvertently spreading outside the family group.

  If a mechanism is being put in place to ensure that shares are retained within the family, thought should be given as to how this will work in practice – ie how would the family members who want to remain in the business pay for the shares of the departing shareholder? It may be that insurance can play a part in this, or that the articles can be drafted so that the company buys the shares (rather than the other shareholders) although all of this needs careful financial planning (for example the company may take steps to ensure that it has sufficient distributable reserves to enable it to buy shares).

  Finally it is worth giving thought to the financial implications for wider family members. For example, if a shareholder dies and their shares must be transferred will their spouse be properly compensated for the loss of dividends going forwards (pensions and life insurance may play a part in this calculation).
- **Unrestricted ownership:** where ownership is allowed to pass freely down the branches of the family, business families can find themselves struggling to reconcile the different interests of various family members, including those who work in the business and receive remuneration, and those who do not work in the business but rely on regular dividends. This area is fertile for disagreement and it pays to take active steps to manage these.

Family Constitution/Family Charter

Steps can be taken as early as the first/second generation. Where children are working in the business and there is a need to set out intentions as to the direction of the business and succession, it may be useful to draw up a family constitution. This is generally a non-binding document which sets out agreed objectives of the business and the family and may also cover other areas such as a fair method for determining succession and allocation of roles. This can often give families a much-needed opportunity to air important issues and can allow the younger generation to address concerns about their own prospects.

A charter can also cover other keys areas of family "policy" such as the family's values and its approach to share ownership and employment within the business, some of which may be incorporated in legally binding documents, such as the articles of association. It is often helpful to address these issues directly so that the expectations of family members are set at an early stage.

Family Council

Where ownership is widely spread, regular communication with shareholders is key and it makes sense to have a more formal constitution and a forum (often in the form of a "Family Council") in which family members can both receive information about the business and express their views. A well-managed family council can bring the family together and prevent minor grievances becoming major issues.

The role of the Council and the extent to which it has representation at board level or an active role in decision making at a business level will vary from company to company, but it will at the least have a formal process for receiving and contributing information about the business. Its role is also likely to change over time as the business grows and becomes increasingly professionalised (ie moves out of the day to day control of the family).

The Council will also need a constitution which sets out its objectives, ensures that branches of the family are fairly represented (usually according to the percentage of the shares they hold in the family company) and that there is a clear and fair method of decision making. However, the Council's role can develop to include a much wider remit that simply acting as a voice for the family, and it is often the case that the Council becomes a more effective way of engaging family members the more responsibility it is given. Clearly its role needs to be delineated so that it cannot interfere with the board's power to manage the day to day business of the company, but it could have roles which include approving family policies, and approving fundamental decisions relating to the business.

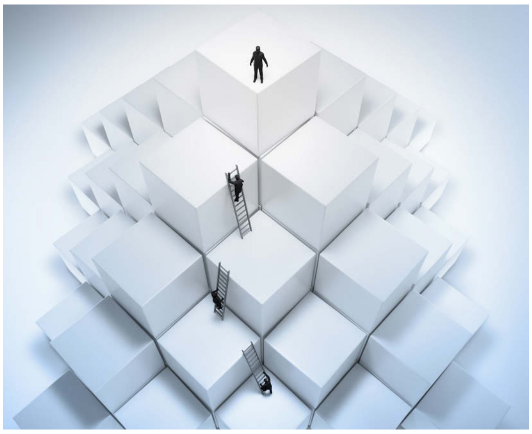
Liquidity

A fundamental factor in keeping family members aligned is ensuring that the value of their investment is protected, that they receive predictable dividends and that there is a system which enables family members to realise the value of their shares, ie that either the other shareholders, or the company, or a family trust will buy their shares if they wish to sell.

Structuring

Although not strictly part of the governance of the business, the family needs to review periodically whether the structure of the business is appropriate. Initially it is likely that the business will consist of a single company (or partnership) but over time this may grow into a group of companies, set up perhaps to exploit different opportunities or to give different members of the family opportunities in which to take responsibility for a part of the family business.

Another common reason for establishing a corporate structure is to aid with succession and retirement planning so that, for example certain assets are held by the individual and form part of a pension pot. It is important to keep this sort of structuring under review to ensure that it is fair, workable and that it achieves the tax objectives for which it was set up.



Small steps

Adjustments to the way in which the business is run generally need to be taken slowly and with buy-in from family members at all stages if possible. In our experience the first step is to discuss the current position of the business and what are perceived to be the issues which are likely to arise in the foreseeable future and then discuss a range of possible approaches to find a solution which best suits everyone.

If any of the information above is of interest please contact Doug Streatfeild-James or Jim Aveline.

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Our Family Business team

Burges Salmon are unusual in being a leading commercial firm that also specialise in private client issues. We combine our business and family expertise to advise family businesses of all sizes through our specialist Family Business team - a group of experienced advisers dedicated to advising family businesses of all sizes across range of sectors.

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