

Note on Family Constitution by Varsha Kewalramani

- **Definition of Family Constitution.**

A Family Constitution is a system of joint decision-making, most often by a board of directors and a family council, which helps the owner family govern its relationship with its wealth and enterprises. It is often assisted in this mission by a family constitution capturing the family's vision and important family values, a family employment policy setting the requirements for the employment of family members in the firm or family office, an ownership structure that allows for corporate control, and capable non-family managers that set a standard for the professional management of the family enterprise. The desired outcome is rational economic and family welfare decisions that are not overwhelmed by traditional family dynamics. A family constitution is a formal document which sets out the rights, values, responsibilities and rules applying to stakeholders in the family business and provides plans and structures to deal with situations which arise in the course of the family business's operation.

- **When to create a family Constitution.**

A family constitution may be entered into any time throughout the life of the family business. However, it is advisable to enter into a constitution as early as possible before the creation of the business or any important transitions. It is important that when the time comes to draft the constitution the family has a clear idea of the goals of the business, the roles of the family members and the internal structures of the family business.

- **Advantages of Family Constitution.**

(a) Unexpected Events

A business must be able to withstand the effect of sudden events which can paralyse the operation of the business, unravel the management or legal structures in place, and cause uncertainty amongst family members and other persons who have a stake in the business. Such difficulties may arise where:

- a family member dies or suffers a severe illness or injury;
- there is a divorce or serious dispute between family members; and
- a creditor enforces a substantial claim against the family or the business.

While not every conceivable situation can be thoroughly planned for, it is very useful to have processes and protocols in place, such as the formation of a committee to meet periodically, restrictions on incurring any large liabilities until the issue has been resolved, and consulting a specialist lawyer or accountant. This can all be outlined in the family constitution.

(b) Keeping Focus

A family constitution can serve as a valuable motivational tool to help family members stay on the same page, be informed of the goals of the business and be encouraged to actively consider plans for the future. Although family constitutions are generally not legal binding, they are said to be 'emotionally-binding'. Given the family relationship, a family constitution acts on the conscience of those involved. Although non-compliance with its provisions may not result in legal sanctions, there is a pressure on a family member or other employee to comply with the constitution, as if they don't they will appear to be departing from the family's vision and values.

(c) Generational Transitions

The success or failure of generational change of a family business depends significantly not only on business issues, but on family issues as well. When a new generation of a family enters into the business, this may cause:

- changes in the number of shareholders in the business;
- new sources of input into the management of the business; and
- expansion of the business and greater demands on management

Given the variability associated with generational change, and the views and values of the new family members who may be involved, a family constitution cannot set out comprehensive rules which can be strictly adhered to. Instead, a family constitution directs the family's attention to the key issues which will need to be resolved, provides a vision to govern the change, and outlines internal structures which can be referred to when dealing with specific scenarios (e.g. disputes, apportioning ownership interests).

(d) Managing Disputes

A family constitution can provide for informal and internal dispute resolution processes to help minimise costs and avoid publicity. While the constitution will not prevent conflict entirely, it provides guidance and mechanisms as to how conflict can be most efficiently resolved. This could involve a compulsory mediation procedure and the appointment of an impartial mediator to refer disputes to. In addition, the mere existence of the constitution may reduce disputes as there is less likely to be confusion and ambiguity in how the business should be run.

(e) Current Leaders Inability to let go

The critical and urgent need to build institutions of family governance is often lost on the family CEO. In a study conducted by the author, the most statistically significant finding was that CEOs of family businesses perceive both the enterprise and the family much more favorably than do the rest of the family and non-family managers. The findings further indicate that CEO/parents perceive the business in a significantly more positive light than do other family members along the dimensions of business planning, succession planning, communication, growth orientation, career opportunities, and the effectiveness of their boards. In the absence of expressed dissatisfaction with the status quo, the CEO/parent may be the last to recognize the importance of engaging in still one final leadership

responsibility—creating the institutions that will effectively govern the family- enterprise and family-wealth relationship in their absence.

(f) Affluenza

Another significant challenge from wealth to multigenerational families is the entitlement culture, a symptom of *affluenza*, which can be defined as an unsustainable culture of acquisition for acquisition's sake. Warren Buffett is credited with a principle that aims to curtail its harmful effects on families: "*Give each child enough money so that they can do anything, but not so much that they can afford to do nothing.*" Families that develop a list of principles that guide their relationship to wealth and enterprise and capture them in a family constitution (see a sample family constitution in Appendix 1) are also proactively governing the family and leading it towards responsible stewardship of its wealth and enterprises.

(g) Dilution of Wealth

Besides the erosion that may result from unnecessary expenses, taxes and a culture of entitlement, distributions and the break-up of the enterprises or the pool of family capital can negatively affect the family's access to new investments and to the financial resources needed to take advantage of these opportunities. A smaller capital base is presented with fewer investment opportunities. Distributions motivated by needs for current consumption and the break-up of business interests fueled by family conflict — as happened with Reliance Industries in India — prevent families of wealth from reaping the benefits of patient family capital; that is, capital that stays together.

(h) Lack of Transparency

Neither boards of directors nor professional managers can make their value-adding contributions to family enterprises without good metrics and clear scorecards. Shareholders themselves can seldom act as responsible shareholders in the absence of financial knowledge and financial controls. While entrepreneurial cultures often resist the call for greater transparency, after all the founding entrepreneurs stayed on top of everything, next generation leaders are well served by investing in the pulse of the enterprise in real-time terms. Lack of transparency can also give rise to an absence of caring for the enterprise within the extended family. Absent caring, continuity is threatened.

(i) Lack of oversight and keeping it in the family

Family Governance, then, is an essential discipline for the long-term well-being of the family enterprise and the family's wealth. It refers to a family's ability to optimally discipline and control the nature of the relationship between family members, shareholders, and professional managers in such a way that the enterprise prospers and the family promotes and protects its unity and its financial, human and social capital — as much for the family's sake as for the company's. After all, a family's unity and its human and

social capital are the source of long-term comparative advantages of the family enterprise form. Patient family capital, reputation, and influential knowledge and networks represent unique resources that family enterprises can translate into competitive advantage. The current CEO or president of a family office can hardly leave a finer legacy and contribution to family-business continuity and continued family wealth across generations than the creation of an effective governance structure.

- **Enforceability of Family Constitution.**

Unlike company constitutions, a family constitution tends not to be legally binding on the family members. This has the advantage that it can apply to members of the extended family network who may be affected by the performance of the family business, yet it would not be fair or practical for them to be bound by the constitution as they have little input in any of the business's affairs. This is why it is best to complement the family constitution with separate documents which are legally binding, but which no external family members are parties to. Common examples of such documents are shareholders agreements, confidentiality agreements, and documents concerning conflict resolution. Enforceable documents should be kept separate from unenforceable documents to prevent confusion.

- **How Family Business Managers can use Family Constitutions to plan for their Business**

(a) Consult the family members to determine the goals of the business and plans for its operation.

(b) Obtain professional advice concerning how to draft the provisions of the constitution.

(c) Have a family constitution prepared before the commencement of business or before undergoing any significant changes.

(d) Continually monitor the level of compliance with the constitution and determine if any amendments to the constitution are needed.

- **The 7 Phases of Crafting a Family Constitution**

Phase One: Contracting

Contracting refers to the process of engaging with the external process consultant. A process consultant is different from an "expert advisor". A process consultant will work with the family to let them understand their options for how to structure the process, but should be cautious about telling the family members "what to do". When making a family constitution, the key factor is the discussions that the family members have, and that the solutions the family members design are their own. A process consultant will also be responsible for

guiding the family members through the change process that creating a family constitution often involves. Key issues in engaging with the process consultant will be to understand how the consultant works, the values and principles by which the consultant works, whether there is a good “chemistry” between consultant and family, and the experience and skill sets of the consultant. One critical skill set of the consultant will be the ability of the consultant to “listen with empathy” to the family members.

Phase Two: Assessment

The second step in the process is the assessment and fact-finding phase. Assessment involves the external consultant having one on one interviews with the key family members. It can also be considered whether it would be advisable to talk to any senior non-family managers and /or directors. The information from these interviews is usually kept confidential by the external consultant. The purpose of each interview is to gather facts and information. Minimal advice or feedback should be given to the family members during the conduct of these confidential one on one interviews.

- (i) The objective of the assessment process is to give the consultant a feel for the family system and the family culture. Given that a family owned business is one where there is a significant overlap between the family system and the business system, it is critical for the consultant to have some feel for what the family system is like. If you are a member of the family, it is very hard for you to see what the culture of the family is objectively like.
- (ii) Assessing the family system will normally include looking at communication, and how decisions are made; listening for common family messages; and listening for shared family values. In some cases, the family culture might suggest taking one particular direction rather than another, as the family works together to develop the family constitution.
- (iii) The one-on-one interviews helps the external consultant to appreciate the issues that are unique to the family.
- (iv) The one-on-one interviews also provides the external consultant with an opportunity to identify if there are key issues that should be put on the agenda as the process moves forward.
- (v) The one on one interviews provide the external consultant with an opportunity to see whether there appears to be a goal of business continuity that is shared by both the senior generation and the next generation.
- (vi) The process of giving each key family member the opportunity to tell his or her own story, in a safe environment, to a neutral party who is focused solely on listening to the story teller with empathy, is actually an important step in the process of starting to improve the family teamwork and dynamics.

It is normal that every individual in a family business will have their own slightly different perspective on what the business is like and what the important issues are. When the one-on-one interviews are finished, the external consultant has to sit back and look at the totality of the information presented to form an impression of the family business system. The objective is for the external consultant to look for big picture issues and recurring themes; to see the forest not the trees.

Review Basic Family & Corporate Information

During the Assessment and information gathering phase it will also be necessary for the external consultant to have a look at the basic family information (e.g. family tree) and corporate information such as the current share ownership arrangements and the current holding company structure and board role and composition.

The existing corporate governance structures and processes need to be considered. The process of creating a family constitution is not going to be a process of creating governance out of thin air. There will be existing governance arrangements in place. So it is more a question of examining the existing arrangements, and seeing if they should be continued or modified. It could be said that an important aspect of the process is making the governance arrangements explicit. It should also be considered whether there is an existing strategic planning process in place for the business and what this involves, and who is involved in it.

Feedback After The Assessment

There are several alternatives for making use of the information from the Assessment and fact finding phase. A process consultant will discuss the exact way for handling the feedback with the senior generation of the family:

- (i) First, the information from the assessment phase will be important information for the external consultant to understand when working with the family. In this case the information is just used as background information for the consultant so he / she has an idea of the unique family system.
- (ii) Second, the information gathered can be used by the external consultant as the basis for preparing the agenda for the family meetings that follow. In this way the issues raised by the family members are then discussed by the family members at a series of family meetings.
- (iii) Third, the feedback could be sent to all of the family members and then presented for discussion as part of the first family meeting. This is a common approach. In many cases once a written feedback report is delivered to a family, it starts the family members discussing issues among themselves and can be the catalyst for helping the family to resolve issues that they may previously have been struggling with.
- (iv) The final alternative is for the information to be presented as a written report which is only given to the senior generation of the family. However this last option is unlikely to be as effective as the case where the feedback report is provided to all of the family members.

Phase Three: Forming The Family Task Force

Conceptually there is a step of forming the family task force and agreeing how the family task force is going to proceed and make decisions. This involves deciding and agreeing on the process for the family meetings that will follow. In practice it is well worth it to invest the time on forming the working group (task force) and on process issues before getting into the substance of the work.

Phase Four: Foundation Issues

The next phase in the process is to spend time on “foundation work”. There needs to be a clear sense of what the shared goals and direction of the family are before it embarks on the process of designing its family governance arrangements and its family constitution.

Phase Five: Design

When it comes to the Design Phase, the goal is for the family task force to decide on what is to go into their family constitution and what type of governance arrangements should be in place for their family business. The key philosophy is that the family should make their own rules. There are various different ways of designing a family constitution.

Phase Six: Implementation & Establishing Ongoing Processes.

Once the Design phase is completed, the Implementation Phase refers to putting into practice the ongoing governance structures, processes and policies that have been agreed upon. At its simplest this might be a question of starting to schedule and hold family council and/or ownership council meetings.

Phase Seven: Ongoing Review & Assessment: The Annual Family Meeting.

The final phase is for the family council to institute the practice of holding an annual family meeting where they review (i) the effectiveness of the family governance arrangements and objectives, (ii) how the family rank themselves against “best practices” and (iii) how the family is going in terms of completing any tasks that it had set out to work on during the year. This annual review and assessment practice frames the work on the family constitution as an ongoing process for the family. It is important to appreciate that to have effective family governance, “there is no finish line”.

- **Components of a Family Constitution.**

1. Objective
2. Mission
3. Approval and Modification of the Family Constitution
4. Guiding Principles of the Family Constitution
5. Who are the Founders
6. What are the Values to be Passed on.
7. The Type of Company the Founders want it to be.
8. Expectations from Shareholders
9. Family Employment Policy
10. Ownership of Family Business with reference to Shares
11. Regulations with reference to the Governing Bodies comprising of Family Assembly , Family Council and Family Board.
12. Bye Laws Governing the Family Constitution.
13. Decision Making Process.
14. Family Conduct Behaviour Guidelines.

- **Family Constitutions in India**

Indian business families have increasingly been embracing the family constitution. The Hyderabad-based GMR family is another early mover in this space, and their family constitution is even considered a gold standard. Others like Emami, Dr Reddy's and Murugappa Group too have put constitutions in place. Marico Ltd has divided the succession strategy into two parts: defining a process for a "drop-dead" successor, and developing internal talent. The CEO, who is a family member, has appointed the individual who would take his place in the event of an emergency. However, this individual would hold the reins only for the short-term, defined here as six months. It would then be the board's responsibility to let this individual continue in the role or identify a permanent successor, either from the internal talent pool or from outside. The company has implemented this process for the entire top management and considers it a strong succession strategy. The Burman family council reviews the strategy of Dabur India Ltd, for example. A structured meeting is held every quarter where various independent business ventures are discussed. The council's role is to look into the broader business strategy and vision of Dabur India. Also, in the group, the positions of chairman and vice-chairman have, historically, been held by members of the family. Further, neither of them draw salaries; their income is only from dividends. These two roles are also rotated within the four branches of the Burmans by the family council. There are never more than four family nominees on the 12-member board at any given point in time. There are also instances of radically different models.