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FAMILY CONSTITUTIONS

The proverb 'From shirtsleeves to shirtsleeves in three generations' describes the common three-generation cycle of failure of a family business. Family life and business are a difficult mix that brings risks which may threaten a family's long-term wealth and well-being. If these are correctly understood and managed, however, family businesses can enjoy a competitive edge. With this in mind, wealthy families are increasingly recording their collective vision and principles for the family business in a family constitution (or family charter). By spending time focusing on and embodying their culture and shared goals at a time when decisions can be taken objectively, a family can create guidelines to help the management, board and family work together at a time of breakdown or stress, for example on generational transition. Younger generations should be invited to sign up to the constitution at the appropriate age and the constitution should be reviewed as the family expands or the business develops. Creating a family constitution takes time and effort but the unity and direction it brings will benefit the family in the long term.

WHY DO WE NEED A FAMILY CONSTITUTION?

In its infancy, a family business tends to be run by the founder or founders without material governance difficulties. As the business grows and evolves, however, typically unspoken and unwritten consensus on a number of key issues tend to predominate. Most family businesses can run well on these lines for years, or even decades. As new generations emerge the business finds itself with increasing numbers of family members with direct or indirect involvement. If, for example, the founder has three children, and they each have three children, in three generations there will be thirteen potential members of the business (omitting spouses). Each new member brings their own views on how the business should be run and its long-term strategy and it would be impractical to exclude family members from decisions and run the business on the basis of unwritten rules.

As the business grows it also becomes more exposed to both internal and external risks. These include divorce, death, improvidence, (in)competency of heirs, transition of leadership, tax, economics, changes in the family business climate, currency risk and civil liability. Without an agreed framework for operating, many family businesses may find themselves at risk of failure. Putting in place a family constitution is an important part of the family's long-term strategy to safeguard the business.

Many families may question the need for a family constitution if they have a legally binding shareholders' agreement. Both documents have a role to play however. A shareholders' agreement deals with the needs and direction of the business but does not take into account family dynamics or the relationship between the family and the business. These are issues which need to be dealt with in a different format, and one subscribed to by all participating family members. A family constitution therefore operates as a mission statement for the family and the business. Some of its content (such as long-term goals and values) will not be capable of being, or intended to be, construed as legally binding, although it may be desirable for some provisions (such as the procedure on exit) to be legally binding. A family constitution will typically also have signatories who are not shareholders or employees in the family business (and who are not therefore parties to the shareholders' agreement). Similarly, there may be non-family shareholders who will not be party to the constitution.

The process of developing a family constitution is designed to anticipate potential areas of conflict and provide mechanisms for resolution. It requires the members of the family to face delicate or taboo issues before they arise and provides an opportunity for everyone to 'have their say' (including those who are not involved in the day-to-day running of the business). Sensitive issues common to most family businesses include succession, control and remuneration, and potential disagreement on each of these can be avoided by setting out the family's agreed position in advance.

WHAT IS IN A FAMILY CONSTITUTION?

Simple forms of constitutions are produced by legal publishers but it is important to get specific legal advice when preparing one as every constitution, like every family, is unique. Family constitutions vary in length depending on the size and complexity of the family and the business. Typically, a family constitution will begin with a statement about why the constitution is being formed, and details of the family history, and will then cover:

- Vision, culture and values. What are the key values on which the family and business are run? Which is more important, the business or the family?
- Objectives and long-term goals. This might include an agreed strategy on whether/when to sell or float the business, where investment is to come from and whether external investment would be considered.
- Composition of the board. Are all family members appointed to the board? Are spouses appointed to the board? How is succession to the board (including representation from the next generation) managed? Are non-family members ever appointed to the board?
- Operations and governance. This is likely to form a significant part of the constitution and will include family members' entitlement, employment, appraisal, succession, share ownership, payment of dividends, sale of share and return on investment. The section on share ownership should cover whether in-laws are able to hold shares, how family members who prefer cash might dispose of their shares and how shares pass on the death of a family member. The governance section will cover procedures for meetings, voting and control and how decisions are reached and should therefore enable disagreement to be managed and resolved.
- Generational issues. How will future generations benefit from the business? The following are examples selected by families:
 - All issue equally
 - Along family branch lines with equal division at the second generation
 - Only family members involved in the business

- Bloodline family members only
- Male or female bloodline only
- Unequal division between male and female bloodline
- Illegitimate and adopted issue included

Who will exercise key powers?

The following are examples selected by families:

- All family members equally
- Each branch having an equal vote
- Male or female bloodline having power to vote
- Only those involved in the family business having power to vote

Are there to be restrictions on membership?

The following are examples selected by families:

- Children only over the age of 25
- Adults only under the age of 75 (except first generation)
- Only family members with university degrees
- Only family members of a particular faith
- Terms and conditions of family members' employment. This may include minimum entry education and experience levels for family member employees. This helps to avoid a culture of 'jobs for the family' within the business, or family members being given jobs for which they are neither suitable nor adequately trained. The constitution may also cover whether spouses are allowed to become employees.
- Methods of communication. This should establish channels of communication between family members (most particularly between business and non-business members) and between family members and the board. The establishment of a timetable for meetings is often helpful in improving communication.
- Conflict resolution. How are disputes to be resolved within the family? How are decisions to be made? What are family members' rights and obligations in relation to the business?
- Review. Provision for regular review is important to reflect changes to the family, the business and the economy. As these change quickly, a formal review is recommended at least every five years. The constitution should establish a

procedure to enable family members to raise concerns or request an earlier review, if appropriate, in the meantime.

Some families may also include the following specific subjects:

- Rules governing use of family assets (for example holiday homes, aircraft)
- Philanthropic aims
- Establishment of an enterprise fund to assist family members not employed by the business in their own business ventures
- Requirements for pre-nuptial agreements and divorce procedures.

The following case studies illustrate how family constitutions can help manage issues for family businesses.

**CASE STUDY ONE:
A BUSINESS WHERE NOT ALL FAMILY
MEMBERS ARE DIRECTLY INVOLVED**

The founder of a successful business had four sons. Two of the sons had chosen education and training compatible with the business and were keen to lead the family business in the future. The founder wanted to ensure that the two 'business' sons were adequately compensated for their involvement and employment in the business but wanted to treat his children equally so was anxious to make some provision for his 'non-business' sons. The family collaborated on a family constitution which defined the authority and responsibility of the two 'business' sons and detailed their employment, remuneration and share ownership. It also made provision for the 'non-business' sons to benefit from the business. The constitution dealt explicitly with provisions for succession and left open the possibility that the children of any son could be involved in the business in due course (provided they met the agreed employment and training conditions), thereby enabling the family to maintain control in the future.

**CASE STUDY TWO:
A CONSTITUTION COVERING THE FAMILY'S
PHILANTHROPIC AND ETHICAL POLICY**

The family matriarch had seven children and eleven grandchildren. The substantial family business did not require family input to continue to be successful as a non-family CEO had been hired. The matriarch's husband had passed away and she wished her family to deal with work, religion and happiness by expressing themselves through their philanthropic endeavours. The matriarch believed that 30% of the family wealth should be applied to philanthropic and charitable activities to leave a lasting legacy in terms of their religion and charitable beliefs. All the adult family members signed up to a constitution dealing with this and providing that funds were applied by a family committee (family members over the age of 25 were able to apply to be on the committee). The capital investment of the funds and application across various jurisdictions was implemented using trust / company / foundation structures.

**WHO CAN HELP TO PREPARE A FAMILY
CONSTITUTION?**

Formulating a family constitution is a significant undertaking, not least because it requires input and commitment from all the family members. Every provision must be considered, agreed and documented. In some circumstances, the decision-making process will take months or even years and will require a framework of its own! The procedure requires an intensive period of discussion within the family to encapsulate what is often many years of unwritten guidelines and principles. In some cases, dialogue about the running of the family business and long-term goals can throw up previously avoided issues which need to be resolved before progress can be made. The process is likely to be difficult in parts but overwhelmingly families find it cathartic and the advantages of a unified code of conduct subscribed to by the whole family make it worthwhile. In some cases, it may not be possible to get every member of the family to agree to every condition in the constitution but they may be prepared to put their name to it nonetheless.

Most families involve an experienced, independent 'facilitator', usually a lawyer, in the preparation of a family constitution. He or she will provide a forum for difficult views to be aired and should 'speak' for all members of the family so each member feels they have been involved in the document. The role of the 'facilitator' is to identify key areas for family discussion, assist with (rather than lead) discussions and record the family's agreement. It is important that the business's founder, or family patriarch or matriarch, does not dominate other family members. The 'facilitator' should therefore not necessarily be the existing professional advisor of the patriarch or matriarch, or if they are to be involved, it is important that someone impartial also participates. Once the constitution is agreed the family's lawyer should ensure that its provisions are incorporated into the family's wider governance structures.

CONCLUSION

Family businesses differ from non-family businesses in their culture and functions and the emotive blend of family, wealth and business has the potential to weaken the family unit as well as its business. A family business's unique dynamic requires a proactive strategy and, when carefully managed, the cohesion, pride and commitment provided by the family aspect can set family businesses apart from their competitors. More and more successful family businesses are recognising the value an agreed, unambiguous family constitution brings and how it can enhance the success of the family and business for future generations.

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