



PRIVATE ENTERPRISE

# Constructing a family constitution

AUSTRALIA

## Rags to riches to rags

Starting a family business is easy, relatively speaking; sustaining it beyond a couple of generations is the hard part. Indeed, it's often said that the typical family business goes from rags to riches and back to rags in three generations.

Research in Australia and elsewhere confirms the truth of this old saying. Fewer than half of all family businesses survive the transition from each generation to the next. Do the arithmetic – only around 10 percent will make it to the fourth generation. It's a sad commentary on the reality of family business.

The reasons for this failure are complex. However, it's increasingly recognised that family issues rather than business issues determine the outcome of generational change in family businesses. This document provides an overview of an important step in managing this change: the adoption of a family constitution.

## What is a family constitution?

A family constitution is sometimes called a family creed, family charter or family agreement. Forget the terminology – they're essentially the same things that do the same job.

That job is threefold.

- It documents the values and principles that will underpin the conduct of the family business.
- It defines the strategic objectives of the business.
- It sets out the way in which the family will make decisions affecting the ownership and management of the business.

Depending on the circumstances of the family and the business, the constitution can be either short and concise, or long and complicated.

Some people imagine that the creation of a family constitution will avoid family conflict over a family business. If only it were so. In truth, a family constitution won't circumvent or avoid conflict. What it should do is provide a mechanism by which conflict can be successfully managed and resolved. The act of creating a constitution also forces the family to consider important issues about the future of the family business that might otherwise be put aside.

## Do we really need one?

Many family businesses appear quite able to get by without concerning themselves with a family constitution. The *KPMG and Family Business Australia (FBA) Survey of Family Businesses 2008*<sup>1</sup> found that less than 15 percent of respondents had a family constitution. These findings are consistent with our findings of the Family Business Survey in 2005, 2006 and 2007.

Of course, this doesn't necessarily mean these businesses and families wouldn't benefit from a family constitution. Family to business mechanisms, such as a constitution or family council, provide a formal link between business matters and family affairs. The value of formal governance mechanisms is that it facilitates communication between the family, the owners and business managers.

As the family business evolves and successive generations enter the business, several changes occur.

- The number of individuals with an ownership interest in the business increases.
- The expectations of the business held by these individuals begin to diverge.
- As the business expands, it makes increasing financial and management demands on its owners.

A family constitution helps the family deal with these changes constructively. It requires the family to think about important decisions before they have to be made and to find agreement on important family and business goals. The importance of shared values and goals in sibling business partnerships has been explored at some length by family business authority John L. Ward.<sup>2</sup> Professor Ward likens a successful family partnership to the bunch of sticks in Aesop's fable. "If you take a bunch of sticks together, you can't break them. But if you take the sticks one at a time, they snap." Shared values and common goals bind the business owners and sharpen their business focus. A family constitution should articulate these shared vision and goals.

### What will we find in it?

Just as each family business is unique, so each family constitution will need to reflect the unique characteristics of both the business and the family to which it relates. Nevertheless certain matters are commonly covered in family constitutions.

- Strategic business objectives reflecting agreed family values and aspirations for the business.
- The process for hiring, assessing and remunerating family members employed in the business.
- The rules for nominating, training, assessing and appointing management successors.
- Processes for nominating and assessing individuals for appointment to the family company's board of directors and/or the family council (or equivalent) if one exists.
- The composition and rules of conduct for a family council or equivalent body.
- Communication and disclosure policies between company and family.
- The process for resolving conflicts about the business between members of the family.
- The rights and obligations of shareholders in the family company.
- Recommended or compulsory retirement age for family directors and managers.
- Processes for buying out family shareholders in the business.
- Policies concerning external, non-family ownership and management of the business.
- Procedures for amendments to the constitution.

A family constitution should be able to accommodate growth and change in the family business. For example, the business might reach a point where external management and independent, external representation on the board are considered desirable. How will this best be achieved? Or growth in the business can create financial demands that can only be satisfied through access to external capital, either in the form of equity or debt. The family has to make several trade-offs here involving its appetite for risk (debt) and the extent to which it wants to maximise family ownership and control (external equity).

### **When should we adopt a constitution?**

The quick answer is as soon as possible.

In practice, a family constitution is most likely to be adopted or revised at the time of generational change within the business. It can often be considered when the business is about to be passed on from the founder to his or her children. Suddenly two or more branches of the family can find themselves in charge of the business and unsure of where to go next. The transition from the second to third generation can further increase both the number of owners and the diversity of their ambitions for the business.

Generational change can be unplanned, typically as the result of the unexpected death or disablement of the existing proprietor. This possibility strongly suggests that the constitution should be drafted and agreed well ahead of the expected transition. Formulating a family constitution will take time to develop and may require a number of family meetings. Even if there isn't agreement on all issues, it will form a good basis for the family to work from when issues arise.

### **Defining guiding principles**

Before drafting the constitution itself, the family needs to agree on some general guiding principles.

- What comes first, the family or the business? Perhaps a decision will be taken to retain and manage the business so that it can provide jobs and financial support for future generations of the family.
- Is ongoing family ownership and management in the best interests of the business? For example, can the business' future capital requirements be satisfied under continuing family ownership.
- Is continuing ownership of the business likely to create tensions and divisions within the family?

Having answered these questions, the family can begin to articulate more specific principles and policies regarding the business, including its structure and ownership, its governance and the family's role in its management. In turn, these will feed into business objectives that will be reflected in the family constitution.

- Will we continue to grow and develop the business?
- Will we maintain family ownership?
- Will we seek to increase the strength of the family entity?
- All of the above?

Each objective or purpose gives rise to a range of specific issues that will need to be considered, a list of examples is shown on the next page.

Purpose	Policies and procedures to be considered
The continued development of the business	<ul style="list-style-type: none"> <li>Assessing the skills and frameworks required at board and management level to ensure that the best resources are available to facilitate the continued development of the business.</li> <li>Agreeing ground rules for planning for the succession of the business' leadership.</li> <li>Processes for clearly defining family and business governance issues.</li> </ul>
Facilitating the continued family ownership of the business	<ul style="list-style-type: none"> <li>Policies for the interfamily transfer or sale of shares.</li> <li>Dividend policies.</li> <li>Policies in relation to the timing, participation and quantum of liquidity events.</li> <li>Policies setting out the methods of communication of information to shareholders.</li> <li>Policies in relation to the representation of shareholders at board and shareholder meetings.</li> <li>Policies in relation to the nomination and assessment of directors.</li> <li>Policies setting out the behaviours of, and the relationships between, shareholders.</li> <li>Procedures for resolving conflicts.</li> </ul>
Bolstering the strength of the family	<ul style="list-style-type: none"> <li>Processes to establish and review unifying family values and vision for the business.</li> <li>Mechanisms for the family to get together and provide and receive information in relation to the business.</li> <li>Policies for making resources and/or services available to the broader family.</li> <li>Ground rules for selecting and assessing family members to join the business.</li> <li>Rules delineating family and business issues.</li> </ul>

### Getting to grips with the process

The key elements involved in developing, implementing and reviewing a family constitution are set out below. This should be used as a guide only.

Step	Purpose	Who could have responsibility	How could the family go about it	Estimated time required
1. Commencing	Seek to raise the awareness and gain support for the need for a constitution. Educate the family as to the need to adopt a set of guidelines to unify the family's values and decisions on matters before they arise.	External adviser, non-family director or one of the family leaders.	<p>Circulate newspaper or magazine articles about a family in crisis.</p> <p>Attending seminars or conferences on the issue, such as Family Business Australia (FBA) state and national conferences.</p>	<p>Depends on the family's leadership and willingness to accept and discuss the matter.</p> <p>May require some time for the initiators to build support to convince the family's leadership.</p>
	Decide which family members will be involved in the process.	<p>Smaller families = involving all stakeholders.</p> <p>Larger families = selecting or seeking volunteers.</p> <p>Need to consider a mix of generations, family members working in and out of the business and those who do and don't hold ownership interests.</p>	<p>Consider what perspective the family business is trying to represent: business first, family first or a balance of the two.</p> <p>If it is family first then family members should chair the process and not, for example, the CEO or chairman.</p>	
	Agree on a decision making process.	Family leader	Consider engaging a professional facilitator.	

Step	Purpose	Who could have responsibility	How could the family go about it	Estimated time required
2. Developing and reviewing	<p>Agree approach to address the exercise.</p> <p>Will it be a project where certain people are charged with working on the matter and reporting back to the family group?</p> <p>OR</p>	The consultant or adviser could be accountable to the board or family council.	<p>A consultant or adviser could be engaged to work on the matter and present to the group.</p> <p>The consultant or adviser could report to the family project team where progress is discussed and monitored.</p>	12 to 18 months
	<p>Will there be a committee approach where there will be a schedule of meetings and topics where all participants will be involved?</p>	<p>Again, this will depend on whether the family wishes to adopt a business first approach, in which case the CEO or chairman could have responsibility, or a family first approach, in which case the family council or one nominated committee member will have the responsibility.</p>	<p>Determine the committee to work on the process and set a schedule of meetings and discussion topics appointing someone to document discussions held and decisions made.</p> <p>The committee may consider appointing an external facilitator or adviser to assist with the process.</p>	
3. Adopting the constitution	<p>Agree the decision making and overall approval process.</p> <p>Consider who and how voting/decisions will be made.</p>	See Step 2 above.	<p>Family constitutions could address the issues of:</p> <ul style="list-style-type: none"> <li>Ownership</li> </ul> <p>Which should be approved/ratified by existing shareholders based on ownership interests.</p> <ul style="list-style-type: none"> <li>The family's values and its role in the management of the business</li> </ul> <p>Which should be approved/ratified by family members on a per capita basis.</p>	
	<p>The accepted outcomes of the constitution should be celebrated and communicated to all stakeholders who could include family members, external advisers and board members.</p>			

Step	Purpose	Who could have responsibility	How could the family go about it	Estimated time required
4. Implementing the constitution	<p>The above process will require a significant investment of the family's time and sharing of concerns and aspirations.</p> <p>If the constitution is not implemented, the family and non-family management may be reluctant to invest any more time on these matters in the future which may lead to family disharmony.</p>	See Step 2.	<p>Executing relevant documents:</p> <ul style="list-style-type: none"> <li>revising corporate constitutions/ memorandum and articles of association</li> <li>executing legal agreements, appointing new board members.</li> </ul> <p>Scheduled revisions to the constitution: Every 3 to 5 years, or at a minimum, on the introduction of a new generation to the business.</p> <p>Establishing the proposed structures and processes: For example, creating the family council, appointing additional board members, presenting the agreed ground rules on succession planning.</p> <p>Consistent application: If a matter arises which has been considered and addressed by the constitution, then the family should revert to the pre-agreed rules.</p>	6 to 18 months
5. Implementing the constitution	As part of Step 3, the family should agree and adhere to agreed milestones and key dates in relation to implementation.	The family council, the CEO or the board.	By communicating and performing agreed actions, the family and the business may sense greater accountability, professionalism and commitment.	
6. Reviewing the constitution	Periodic review to ensure that the constitution continues to address the needs and concerns of the family and business. The document should be a living document and be continually fine-tuned to ensure it continues to be relevant and applied consistently.	See above.	Set review dates which could be every 3 to 5 years or, at a minimum, when a new generation joins the business.	

## Beware the pitfalls

Constructing a family constitution is rarely a straightforward exercise. The steps outlined above can disguise the complexity of the process. It can be an emotional and stressful experience for all concerned.

It's useful to start the process by agreeing some basic ground rules.

- How should the decision-making process actually work?
- Who is entitled to attend family meetings concerned with drafting the constitution?
- Who should chair the family meetings?
- What matters can be decided by a majority vote? What decisions will require unanimous agreement?
- Who should be responsible for translating the group's thinking and decisions into words on paper?

You should also bear the following in mind.

- The decision-making process can become bogged down when the family fails to reach agreement on one or two issues. It can help to take these matters off the agenda temporarily and move on to those matters where agreement is more likely.
- Allow plenty of time for consultation and decision-making. As we've already noted, formulating a family constitution takes time. People will become disenchanted if they think the process is being rushed. If they are given plenty of time and space to consider the issues, and if necessary to obtain outside advice, individuals will often become more willing to compromise in order to obtain a consensus on the way forward.
- Start with the general principles outlined and then work through to more detailed matters. Accept that no constitution can cover every conceivable eventuality, rather it will explain what the family wants from its business and describe the procedure for resolving particular issues as they arise. It's important to recognise that the family constitution is a living document that will need to change and evolve as the family and the business does.
- The dynamics within a family business means that communication is not always effective. Improving communication amongst family members can assist the family resolve family and business issues. It is therefore worth assessing whether a family member is the right person to guide the process in an impartial and effective manner.

It may be more appropriate to engage an independent and appropriately qualified adviser who does not have any bias. Such a person can give the family the benefit of their experience working with other family businesses facing similar challenges. They can also encourage dialogue among members of the family and help them reach agreement on issues. In addition, they can alert family members to relevant business issues that might otherwise be overlooked and that could affect the nature of the decisions reached (e.g. the tax implications of particular business structures).

Overall, the successful development of a family constitution often results in better communication and greater harmony within the family that will help ensure the prosperity and longevity of the business.





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