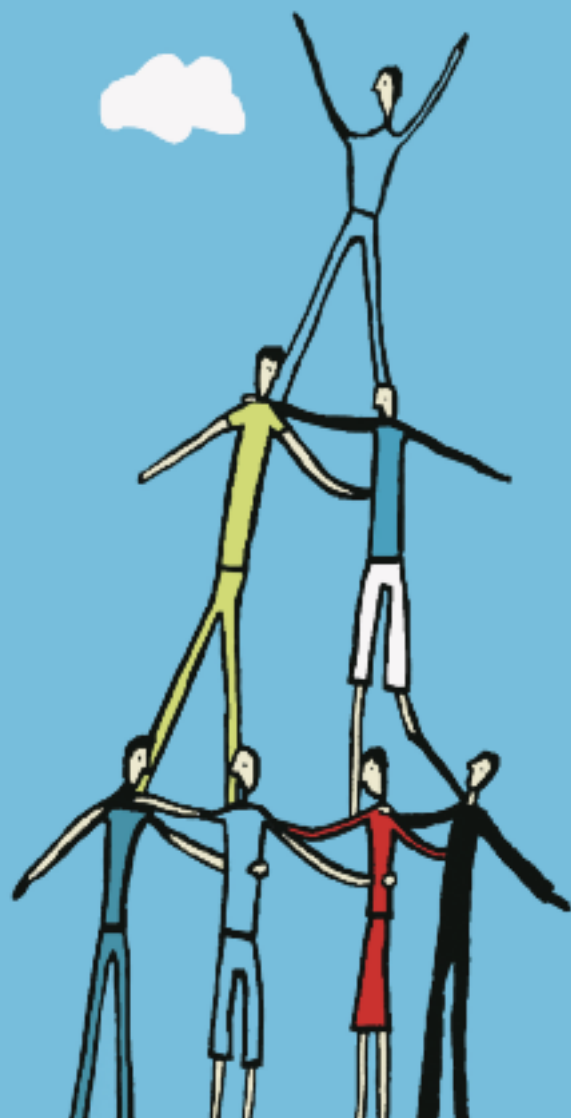


# FAMILY BUSINESS SOLUTIONS

## YOUR GUIDE TO A FAMILY CONSTITUTION



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# YOUR GUIDE TO A FAMILY CONSTITUTION

Successful family enterprises are different in many ways, but they have at least one thing in common; they are well organised. Their success is achieved through thoughtful planning, and part of this organised approach often involves creating a Family Constitution.

“Family Constitution” might sound a bit formal and “not for us”, but in fact your family will already have an unwritten version of a “family constitution”. It is the combination of assumptions, understandings and expectations that exist in every family about “how we do things around here”.

The problem is that over time a family and their enterprise usually become more complex; the family grows, ownership fragments as it passes down through the generations and the family enterprise changes, which sometimes involves diversifying into other assets and activities. It then becomes risky for the future health, wealth and happiness of the family and their enterprise to be based entirely on an informal constitution. The key decision that needs to be taken is whether to persevere with informal understandings

and assumptions in the hope that everything will continue to work, or to invest in getting a few things written down.

Here we explain the formal Family Constitution. We hope it will help your family to decide whether having one will allow you to achieve the balance you want between being a successful enterprise and a successful family.

## **Family Business and Family Enterprise**

We are often asked what we mean by the term “family business”. Our definition is an operating business in which members of the same family have most of the power. This could be one nuclear family (parents and kids), a multi-generational family (add in grandparents) or a network of families (a large extended family or clan).

Often all the ownership is concentrated in the same family but in reality a family will have power to do most things they want if they control more than half the ownership.

Many business families diversify their interests into other assets and activities that they share together, such as financial investments, land, property, farms, philanthropy, leisure assets (holiday home, boat etc), new ventures and so forth<sup>1</sup>. We’d describe this as a “family enterprise” and we believe that strategies that seek to optimise all forms of a family’s wealth need to include practical advice on how each of these assets and activities can be well organised.

The idea of a Family Constitution is relevant to a family business and a family enterprise, but to avoid endless repetition we mainly use the term family enterprise to include a family business. We hope this clarifies the matter.

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1. One client with an investment in a football club wondered which heading applied; investment, leisure asset or philanthropy!

# 1. YOUR EXISTING FAMILY CONSTITUTION

It might not occur to a family that they already have an informal Family Constitution. But the fact is that in every family there will be a mixture of understandings, assumptions and expectations that underpin how the family makes important decisions, or, put another way, “it is how we do things around here”.

The informal Constitution reflects the family’s beliefs and attitudes in relation to a wide variety of important matters, such as:

- Wealth
- Leisure
- Gender
- Education
- Family harmony
- Privacy
- Work
- Work-life balance
- Fairness
- Relationships and marriage
- Individual expression
- Philanthropy

The obvious risk with a Constitution based entirely on understandings, assumptions and expectations is that it can result in misunderstandings, mistaken assumptions and unfulfilled expectations. It is easy to think of examples.

“I assumed you’d want to work in our family enterprise.”

“I thought my spouse would get a job in the family enterprise.”

“I’d expected to become the next managing director” or “the majority owner.”

“I thought everyone would receive an equal share of the family enterprise.”

And, frequently, the answer from a relative is, “really, why did you think that?” Often these misunderstandings occur between generations who, unsurprisingly, have different ideas about wealth, work-life balance and so on, and these disagreements can easily result in harmful conflict.

Complex issues abound when the interests and ambitions of a family overlap with the needs of their enterprise. For example, in a family business the decisions that are best for the business might cause disharmony in the family, or what makes for a contented family life might cause ructions in the business.

The good news is that many of the challenges that enterprising families face are predictable and the predictable can always be planned for.

If families and other important stakeholders want to know who will be the next owners or how family members get a job in the family enterprise or how wealth will be distributed fairly, they can either wait for the issue to become a hot topic and hope it will be resolved (based on understandings etc) or they can plan for what they want to happen.

Families who like to plan for their futures rather than leave matters to chance prefer a written Family Constitution to the informal, unwritten version. They also tend to be very practical people who assume that there will be different views and opinions on important issues like succession, ownership and so forth, and they take the view that it is better to debate these issues calmly in advance of the need, rather than waiting for something to blow up.

## “Clogs to Clogs” and other clichés

Another way of making the case for a written Family Constitution is to address head-on one of the clichés about family businesses that is often expressed as “clogs to clogs” or “shirtsleeves to shirtsleeves” in 3 generations.

Or as one of our clients rather robustly put it, “the first generation starts the business, the second generation builds it up and then the third or fourth generations just p\*\*\* it against the wall.”

Statistics are often quoted about how few family enterprises survive to the 3rd generation. Rather than putting this low survival rate down to the ‘clogs to clogs’ cliché, we like to think that there is a better explanation.

In every family enterprise there are a number of people with an important stake, who make demands for resources that are inevitably limited in some respects. There is only so much time, money, love and opportunity to share around in a family enterprise to meet the demands of the enterprise itself, the owners, the family, the board and employees, outside investors, customers and creditors.

The informal type of Family Constitution emerges as a way of coping with all these demands. It is the family’s way of balancing the different interests, and this tends to lead to an expectation that everyone with a stake in the enterprise will understand and adhere to the informal norms and expectations that have evolved as “the way we do things around here.”

However, while the balance of interests at any time in a family enterprise may appear stable, it is never static; things never stay the same.

As already mentioned, the needs of individuals and the enterprise are constantly growing and changing so every family enterprise is always in a state of flux.

The response to these changes in family enterprises is often to try to adapt by absorbing as many changes as possible without radically altering the informal Family Constitution. This is often accompanied by phrases like “if it ain’t broke....” and “that’s how we’ve always done it.”

This strategy of adapting to change, without making any major changes, appeals to families who are in business together because, like most of us, they don’t like change because it always feels risky. However, the informal Constitution that worked for a nuclear family is less likely to serve the interests of a group of siblings (and spouses and grandchildren) who become involved in, or attached to, the family enterprise, and it is really going to struggle by the time the enterprise passes to a generation of cousins.

In order to keep up, the Family Constitution has to be changed, which means more than just adapting or tweaking the informal version. If this is not done, what worked for the first generation doesn’t work for the 3rd generation and the accumulation of misunderstandings and unfulfilled expectations combine and contribute to the demise of the family enterprise. Hence “clogs to clogs”.

Clichés can contain elements of truth, even wisdom, but in this case “clogs to clogs” is not because family enterprises are poorly run or because enterprising families are dysfunctional. It’s because the Family Constitution is not updated to keep abreast of developments.

In place of the cliché, the truism that should be broadcast is that success needs careful planning. Don’t leave matters to chance and don’t just hope that an informal Constitution will adapt naturally to fit changing circumstances. The practical alternative to hoping for the best is to step up to the challenge of creating a bespoke, written Family Constitution.



## 2. CREATING A FORMAL FAMILY CONSTITUTION

The best way to start creating a formal Family Constitution is by clarifying, “Why the family want to be in business together?” “What is this all about?” “What is the “glue” that bonds us to each other and to our shared investment in the family enterprise?” “What returns are we looking for?”

These questions might sound obvious; but the tricky part is that the reasons why a family want to stay connected through a family enterprise often change over time. It cannot be assumed that whatever drove one generation will necessarily persuade the next generation to devote part of their lives to the family enterprise.

For example, founders are often motivated by the entrepreneurial dream of being in control of building a new venture and creating a legacy to pass to the next generation. But the next generation face a different challenge.

Are they committed to preserving and extending this legacy? Do they have a shared understanding of what it is? Does it mean as much to them as it did to the founders? Does the family want the family enterprise to continue because it provides them with career opportunities, or a good investment, or because it is their name above the door, or because they feel responsible to the other stakeholders, or because it is good fun or because it is a bit of each of these and some other things besides?

A very important point about understanding the shared purpose in a family enterprise is that it is usually a combination of financial and emotional reasons.

This is one of the things that makes family enterprises different from other types of business.

In non-family enterprises, it is assumed that the sole purpose is increasing shareholder value for the current owners. In contrast, the reasons why a family want to be in business together might be a mixture of the following:

- Providing the desired level of financial security for a growing family.
- Achieving a lifestyle.
- Creating, preserving and/or extending a legacy of family ownership to pass to the next generation.
- Pride in a brand (especially if it’s the family name) or a reputation for being a family enterprise.
- Providing career opportunities for family members.
- Attachment to a particular industry, product or geographical area.
- Keeping a growing family in touch with each other as they get on with their own lives and grow up and grow apart.
- Putting something back through philanthropy.

This is not a tick list and every family has to articulate their own version of a shared purpose.

But when the family understand why they are in business together, there is no doubt that this can be a great strength. The “glue” binds them together and makes them willing to stick with the family enterprise through thick and thin.

Equally, the absence of a clear shared purpose poses significant risks and dangers. Without it, as time unfolds, there will just not be enough “glue” to bond the family members to each other and to their collective investment. In the absence of “glue”, things tend to fall apart. And when this happens, it often results in the family’s wealth and their personal relationships being wasted in needless conflict.

When families end up in conflict, it usually involves family members who have different ideas about what they want from their family enterprise. One might want to maximise the return on investment while another wants to preserve and extend a legacy to pass to the next generation of family owners. There is ample scope for conflict here but the real problem is perhaps that these family members should never have been joined together in a family enterprise in the first place.

Articulating and writing down the shared purpose, and putting it at the front of the written Family Constitution, makes it far easier for individual family members to decide whether a role in the family enterprise will either help them achieve what they want for their lives or constrain them and thwart their own ambitions. The standard against which family members should be encouraged to measure their enthusiasm for the shared purpose is ultimately very practical; is it “good enough” for me to want to be part of the family enterprise, in whatever role(s) I choose; owner, executive, leader or family member.

The standard of “good enough” is, frankly, as good as it can be in the real world, and if it cannot be achieved in the eyes of some, then the practical question that needs answered is how to let family members who do not want to be in the family enterprise exit gracefully, and allow others, who have a sufficiently strong sense of shared purpose, move forward together. If structures are created that bind people into a family enterprise against their will, the feelings of reluctance, disappointment and even coercion will leak out eventually, usually with troublesome consequences.



### 3. OWNERSHIP ISSUES

A Family Constitution should clarify who can own part of the family enterprise and the roles and responsibilities of those owners. The following should help a family to work out their answer to these deceptively simple questions.

#### **Return on investment**

There is a fundamental difference between owners who expect their investment to produce a market rate of return (we'll call them Value-Out owners) and those who attribute importance to returns that are not based on immediate financial reward (Custodians).

The commitment of a Value-Out owner will depend on receiving satisfactory financial returns. If these are not achieved then, like any other rational investor, he or she will want to be able to sell their shares and redeploy their investment in order to secure a better return.

The Custodian, on the other hand, is likely to accept trade-offs between financial gains and other types of "return";

such as the opportunity to create or maintain a legacy of family ownership to pass on to the next generation of the family.

The Value-Out owner and the Custodian might rub along together when the family enterprise is doing well enough to satisfy their different desires, but if – or should that be when – things get tough, the differences between them will be far more difficult to resolve. One might say, "it's time to sell" while the other thinks "that's not what this is all about".

One type of owner is not a better person than the other; the point is to decide which type of owner you want in your family enterprise. Many families mix a bit of both but usually have a tendency more to one type of ownership than the other.

The key is to make it clear what owners can expect, which makes it important to write it down and sort out the detailed rules that reflect the family's agreed attitude in relation to ownership.

For example, every family enterprise needs controls over how ownership shares can be sold. Value-Out owners will expect to have an opportunity to cash-in when they want or to sell if they are offered a premium price, for example, by a competitor.

This would not appeal to the Custodian who will be concerned about securing the longer-term benefits of family ownership and, consequently, would assume that there will be a limited opportunity to sell, even in good times, and that the potential purchasers will be limited to other owners and family members.

**ONE TYPE OF OWNER IS NOT A BETTER PERSON THAN THE OTHER; THE POINT IS TO DECIDE WHICH TYPE OF OWNER YOU WANT IN YOUR FAMILY ENTERPRISE.**



### Bloodline or spouses?

Some families limit ownership to bloodline descendants of a founder, while others want spouses and partners to be included as owners. Those in favour of spouses and partners being allowed to become owners will view their inclusion as strengthening the ownership group through introducing some diversity. It will also help to maintain the “glue” among a growing family as ownership passes down the generations. Since spouses and partners will be parents of the next generation of owners, they will be more likely to convey a positive message about the importance of the family enterprise if they are owners, than they would if they were excluded from ownership.

Those in favour of restricting ownership to bloodline would highlight the benefits of managing a smaller group of owners and argue that the bloodline descendants of a founder are more likely to have a shared understanding of ownership than people who marry into the family. They would also draw attention to the adverse consequences if some family members transferred ownership to spouses while others decided not to do so. Another concern might be what would happen to ownership in the event of matrimonial breakdown.

### Are shares “matrimonial property”?<sup>2</sup>

We are often asked this question by families who are concerned about what will happen to shares in the family enterprise or family business in the event of marital breakdown.

“Matrimonial property”, which a divorce court will look at with a view to equalising between spouses, consists of *everything* of value acquired individually or jointly during the marriage to the date when co-habitation ceases.

There are important exceptions to this, including gifts and inheritances, so any shares that are handed down by one generation to the next do not become matrimonial property, although subsequent changes to the shareholding may mean that the shares become matrimonial property.

If you don’t want shares to be treated as matrimonial property then you should:

- Acquire them before marriage rather than afterwards.
- Inherit shares rather than buy them.
- Receive them by way of gift from someone other than your spouse.

- Not change the shareholding during the marriage (before separation), or if the shareholding is to be changed (for example, a company re-organisation/ buy-back), make sure that there is a separate ‘post-nup’ in place (see below).

If the shares are sold during marriage, make sure that there is a separate ‘post-nup’ in place and put the sale proceeds into a separate account in the name of the seller and not an account in joint names of the spouses.

It is vital to keep the ‘paper-trail’ showing where the money came from. This money may still be regarded as matrimonial property by the courts, but there is a greater chance of avoiding the money being treated as matrimonial property if it can be clearly shown that it came from the sale of the shares.

However the following is worth noting. In the event of separation or divorce there might still be scope for argument over whether the value of the shares should be taken into account in negotiating a financial settlement, as any award made by a court must be reasonable having regard to all the resources of the parties.

2. Our text is based on our understanding of Scottish Law. In England & Wales and Northern Ireland, different rules apply to matrimonial property.

## 3. OWNERSHIP ISSUES

### Pre-nups and Post-nups

This stands for pre-nuptial and post-nuptial agreements. In Scotland, the general rule is that a pre-nuptial agreement is binding and can, on divorce, oust the jurisdiction of the courts in relation to future financial provision. If you want to enter into a pre-nuptial agreement, it's better done well in advance of marriage to avoid the claim that someone was railroaded into signing at the last moment.

Post-nups are very useful. They can allow the necessary contractual documentation to be updated when circumstances in the family and business change and so prevent difficulties at a later stage if a couple separate. This can allow for much greater flexibility when undertaking business reorganisations, especially if this might result in shares that are not "matrimonial property" before the reorganisation, becoming such afterwards.

### Working and non-working owners

Some families strongly believe that owners must work in the family enterprise and that if they choose another career, they will not be entitled to a share of ownership. The attraction of working owners is believed to be that it will avoid conflict between working and non-working owners, and especially resentment among the working owners that their efforts are profiting those who could not be bothered to help the family enterprise by the sweat of their brows.

However, others might take the view that restricting ownership to working owners can have unintended consequences. Family members who decide to pursue other careers and are cut out of ownership may feel they are also being cut off from the family, especially if the family enterprise represents a significant portion of the family's overall wealth.

Alternatively, they might decide to take a career in the family enterprise in order to qualify for ownership but feel they are being bound by "golden handcuffs" and resent the fact that they were forced to give up on their own career aspirations in order to become an owner in the family enterprise.

In truth, working and non-working owners can collaborate successfully provided the rules (in a written Family Constitution) are clear; for example by having a dividend policy for all owners and a remuneration policy for working owners that, together, make clear who gets what from the family enterprise. It would also be worth clarifying if any decisions need to be made by working and non-working owners together, rather than just by the working owners, for example, decisions that involve a significant risk to the family's wealth or reputation.



## 4. THE FAMILY PART OF THE CONSTITUTION

Family issues always affect a family enterprise and it is pointless to try to treat a family and their enterprise as if they were entirely separate entities. As the family grows and becomes more complex, the governance of the family becomes important.

Where there are a relatively small number of family members with an interest in the family enterprise, important discussions concerning the family can usually take place spontaneously – “around the kitchen table” – whenever needed. But as a family grows, this type of informal governance needs to be replaced by more thoughtful structures, like a Family Assembly. The rules about the role of the Family Assembly should be set out in the Family Constitution.

### **Family Assembly**

The Family Assembly is a forum where the interests and concerns of the family can be addressed. Because it is a flexible structure that can be adapted to suit the needs of different families, it is very important to define clear goals and tasks for the Family Assembly. Otherwise there will be ambiguity about its role and it will be difficult to evaluate whether or not the Family Assembly has been successful.

The goals could be social, formal and educational. As a family grows and the demographics become more complex, a Family Assembly can generate the type of social interaction that will help to create and sustain the “glue”. The importance of this tends to be better appreciated by families than advisers, who tend to devalue the importance of establishing a social role for the Family Assembly.

However, it is essential to understand that if the “glue” that binds the family together is not maintained and, instead, is allowed to dilute, over generations there eventually will come a point where it is not strong enough to hold the family enterprise together. Hence the social value of the Family Assembly should never be underestimated.

The formal role of a Family Assembly is often to formulate and comment on family policies that affect current and future generations of the family and not just the existing owners. This could apply to the family’s philanthropic activities or aspects of their relationship with the enterprise, for example, in relation to employment and remuneration of family members or the exploitation of the family’s reputation in marketing and PR.

Another Family Assembly policy may be an agreed procedure on how conflict among family members or between the family and the enterprise should be resolved. When there are many interests (individuals, family branches, various business and other interests etc) interacting and competing for the finite resources that a family enterprise can provide, there inevitably will be moments when the anxiety that this competition causes spills over into conflict.

That’s just part of the reality of a family enterprise, so it is pragmatic and wise to

ensure that the Family Constitution includes an agreed procedure to help resolve these conflicts and keep the family enterprise as healthy as possible.

A Family Assembly can play an important role in educating and informing the wider family, including the next generation, about the structures that affect their lives, for example, technical structures such as family trusts, which will outlive their creators. On a broader educational front, the Family Assembly often helps to increase the family’s awareness of business practices, which can be useful to family members whether or not they pursue a career in the family enterprise.

### **Family Council**

The constitution of the Family Assembly will also need to specify how it will be administered, how often the Assembly will meet, what formality is required to convene and run the meetings and how any formal decisions are to be taken.

Sometimes it is helpful to appoint or elect a separate group with responsibility for running the Assembly and being the main governance link between the wider family and other parts of the enterprise, such as the board of directors. This separate group is called the Family Council and the illustration shows how important a role it can perform in overall governance



Family Assembly

Appoints/  
Elects

Information/  
Communication

Family Council

Family Business  
Policies

Family Business  
Education

Annual Family  
Meeting

## 5. YOUR FAMILY CONSTITUTION

In this edition of Business and Life we've highlighted the following sections of your Family Constitution.

### Section 1: Our Shared Purpose

- A statement of why we are in business together.

### Section 2: Ownership Governance

- The role of owners – Value-Out or Custodians.
- Bloodline or spouses.
- Working or non-working owners.
- Return on investment/dividend policy.
- Transferring ownership.
- Decisions reserved for owners (including how these are made).

### Section 3: Family Governance

- The role of family members.
- Family Assembly and Family Council.
- Family policies (e.g. employment and remuneration of family members; philanthropy; education of next generation; PR).

The other parts of the Family Constitution will depend on the type of assets that are part of the family enterprise. For example, if the family owns a business then the constitution should cover things like:

- Role of the board.
- Composition of the board.
- Selecting and appraising board members.
- The role of non-executive directors.
- Communication between the board and the owners and wider family.
- Remuneration and incentives.
- Decisions reserved for the board.
- The responsibilities of any board committees.

If the family enterprise involves different assets and activities (property, investments, philanthropy etc.), the Constitution should clarify the relationship between the family and each of these activities. If the family invests the time and effort in clarifying the balance of power between the owners, the wider family and the company, partnership, charitable trust or whatever, there is far less scope for the type of conflict that can otherwise afflict a family.

### The Final Words

We were recently asked by a client to sum up in a few words what an enterprising family should do if they wanted to continue to build wealth across generations. We weren't even being offered the opportunity of getting everything onto one side of A4 paper but, responding to the challenge, we repeated what was said at the beginning; "get organised". Two words that progressive family enterprises interpret by creating their own Family Constitution.



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