Laying down boundaries

IT IS NOT ENOUGH TO JUST SET UP A TRUST OR OTHER LEGAL STRUCTURE TO OWN AND SECURE A FAMILY BUSINESS, SAYS CHRISTIAN STEWART

Advisors can help clients better secure their family business by asking them to address four key areas: legal structure, governance structure, policies and processes. Many traditional professional advisors and trustees are familiar with legal structure, but it is critical to address all four areas to help clients build a solid business foundation for the future.

LEGAL STRUCTURE

The first question to ask is: what is the right kind of legal structure to secure the long-term protection of the family business? Should it be owned by a trust, a charity, a foundation or a holding company? Should there be a mechanism, such as voting and non-voting shares or a partnership structure, to separate control from the economic interest in the business? If it is going to be a trust structure, what kind of trust and what kind of trustee?

In Asia, for example, trust ownership is not uncommon, but where the asset is the shares in a family business, an institutional trustee will want a trust structure that completely carves out and allocates responsibility for control of the shares in the family business to the settlor of the trust and their family. Alternatively, an institutional trustee may recommend a private trust company structure to be run by the settlor and their family, with the institutional trustee providing only administrative support.

One reason for needing a legal structure to own the business is to consolidate ownership and prevent fragmentation of the shares. A legal structure is about allocating the benefits of ownership, and control. It should provide an ownership transition plan for the business, and the right one can also help to protect shares from creditor, divorce and illegitimate heir claims. A legal structure such as a trust can potentially allow the shares in the business to be owned by the family for multiple generations. Family meetings to explain the terms of the family trust or other legal structures will ensure there are no surprises in store.

GOVERNANCE STRUCTURE

The legal structure is not sufficient by itself, so the next point to address is what governance structure would best suit the goals and objectives of the founder and their family. As a minimum, periodic family meetings between the business owners enable them to talk about the relationship between the family and the business. Family meetings should follow an agenda and rules, with someone chairing and another facilitating. These key roles can be rotated among family members, but a family new to formal meetings is likely to use a non-family facilitator. These meetings are not necessarily about decision-making but about ensuring that the family has a voice and creates a fair process.

More formal governance structures are a family assembly comprising all family members; a family council, a smaller group that represents the family assembly; and possibly one or more committees of the family council, for example education and development, or career planning.

If there's a family office that manages the liquidity the business generates, it should be a structure separate from the family business, with its own organisation, officers and staff. The family office can help organise the governance structure, and support the activities and initiatives of the family council, which is responsible for ensuring control and overseeing the office.

Part of planning the governance structure is reviewing the manner in which the family business has been governed: looking at the composition and the role of the board of directors of the business. There is often a link between the governance structure for the family and the board of directors. In practice, this may be achieved by having overlapping memberships or through arranging occasional meetings between the board and family council.

Governance structures provide leadership and direction for the family and its business. They help ensure continued support and commitment to the business, and enable harmony because family members have worked out their differences behind closed doors. And if the founder or family's goal is to continue the business for generations, there needs to be an organised structure and processes for the owners to make decisions together.

CHOOSING POLICIES

Policies regulate the relationship between the family and the business, but what kind do you need? A family employment policy, a dividend policy or a policy for compensating family members who work in the business? And do you need policies relating to the qualifications for acting as a director? Is there an exit policy governing how shares can be sold?

Having the right policies helps avoid predictable conflicts and establishes boundaries between family issues and business matters. Policies make things clear, so everyone is on the same page.

It's common for the family council to develop the terms of the policies, but it cannot make policies or decisions about the management or operation of the business.

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In these cases, it can develop and propose the policy to the board of directors, which approves it as necessary.

PROCESS OPTIONS

Finally, there are processes, and which ones are needed to bring the family and business governance system to life. Consider the following example: a business founder sets up a family trust to own the shares in the family business. The trust is structured so the founder controls all the voting rights on the shares. It provides that if the founder dies or becomes incapacitated, control of the voting rights on the shares will pass to their surviving spouse. But what if the spouse does not know anything about being a controlling shareholder in the business? What if the spouse does not understand the trust structure and their potential role in it? What if there is a board but the spouse does not understand its role – that the members of the board could be their representatives in the future and that they have the power to change them? What if the spouse does not understand the strategy of the business or the risk profile of the business? In practice, this is a common scenario.

The trust structure in this example may be a good legal structure and it may help the founder keep control and pass legal control to their spouse. It provides an ownership succession plan, but you can see this trust structure is not by itself going to teach the spouse how to be a good owner and business steward. You cannot rely on structure alone to guarantee future success.

The types of ongoing processes that business-owning families implement can include education and development of shareholders and owners (whether that ownership is direct, or indirect through a trust), career planning and developing the next generation of family managers and leaders. As the future business will be a more complex environment than the business of today, the next generation need skills in important areas such as communication and conflict resolution, strategic planning and leadership.

DIFFERENT APPROACHES

The traditional approach to selecting and setting up a legal structure for the family business has been to work only with the business founder. In Asia, for example, it is not uncommon to find cases where the legal structure is not fully revealed to the rest of the family members until the founder has died or become incapacitated.

In practice, a different kind of approach is taken to design the right governance structures, policies and processes. The most common is either to form a family task force, which may consider options and give proposals to the founder, or to install a series of family meetings, which include the founder, their spouse and adult children, to discuss and design their own governance structure, etc. The founder can control these meetings, but by involving their spouse and children, the rest of the family can get a clear understanding of their goals, wishes and thoughts and they can all work together to develop an approach that has family buy-in and support.

The most common approach is to combine the agreed governance structure, policies and processes into a written document known as a family constitution or a family charter. These agreements can be made legally binding but often they are not. The family constitution's value and effectiveness come from the process of the family members working on it together, considering alternatives, and coming up with their shared understandings of how things should be done.

If the legal structure is handled in the same way as the family constitution, the same benefits will be achieved: increased family buy-in, understanding and the ability to get feedback on the basic question of whether or not the proposed legal structure will be workable when the founder is no longer around.

Christian Stewart TEP is Managing Director of Family Legacy Asia (HK) Limited, in Kowloon, Hong Kong