



# The good constitution

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*“The palest ink is better than the best memory”*  
A Chinese Proverb

**A successful family can be compared to a small country that needs its own written “family constitution” that articulates the governance system for that family and the business or financial wealth that the family jointly own together, thereby establishing the “rule of law” for that family.** To have a family constitution is also becoming regarded as one of the essential best practices for business owning families as well as for “financial families” especially by the time the family starts to see a split between family members who are in ownership roles, and family members who are also in management roles.

### To bind or not to bind?

The intention of this article is to explore some of the questions that are emerging as the concept of creating a formalised family constitution for an enterprising family becomes more and more popular. One fundamental question that will often be asked by a family is whether a family constitution will really be effective if it is not legally binding in nature?

As many successful families are likely to have the ownership of the family enterprise structured through one or more family trusts, if such a family also have a family constitution, then there will also be questions about how the constitution and trust(s) will interface or relate to each other. Perhaps the more fundamental question concerning trusts is

whether it would be wise to make use of a family trust structure to provide a mechanism for enforcing compliance with the terms of a family constitution?

### A working definition

There is no universal definition of a “family constitution” or “family charter”. As will be explained below the approach taken by every family can be different and unique. It is not the intention of this article to attempt to be either prescriptive or comprehensive in providing a definition of a family constitution. Instead the term “family constitution” when used in this article is intended to refer to a range of - or a combination of - different kinds of family written “agreements” and policies such as a family employment policy, a code of conduct, family meeting rules, an agreement as to the process for making joint decisions about management issues, a board charter, or a set of family principles for doing business together. For simplicity, no distinction will be made between a family constitution and having separate “family policies”.

### How does a family create a constitution?

The process for creating a family trust structure usually involves an advisor who is an expert in trust and related tax issues working directly with the settlor, and possibly the spouse of the settlor. There is typically a single client (or a couple) and the advisory role is primarily the role of being an “expert advisor”. The advisor will also draft the trust instrument as well as any related letter of wishes.

The process for creating a family constitution is different. The advisory role involved should also be different.

First, the process involves working with either all of the adult family members, if that is a small group, or working with a smaller task force of family members, in the case of a larger family group. This small group or task force should be a collaborative group in their approach.

Second, it should be the family's constitution made by the family and not made by the advisors. It should be tailored to the specific needs and issues of that family at that point of time. It should also be tailored to accommodate their own family culture. Ideally the drafting work is also done by the family members. When making a family constitution the family should own the process and the process will be more important for the family than the product.

The vehicle for designing the family constitution should be a series of facilitated family meetings where an effort is made to pay careful attention to ensuring that there is a safe environment and an honest level of communication amongst the family members.

The family should start with a blank sheet of paper when designing their own family governance system and the family members need to be able to suspend their own natural decision making processes<sup>1</sup>. Most families find this difficult to do by themselves. This means that most families will need to work with an experienced family meeting facilitator – or “process consultant” – to facilitate the family meetings. While the advisor should have relevant content knowledge concerning family owned firms or “financial families”, apart from being required to facilitate, the key aspect of the role will be to advise the family on process issues.

The family should develop their own solutions. This means the advisor should not rush in to solve issues for the family. The solutions

the family members hammer out for themselves will be the solutions that last. The solutions the advisor gives them might not be integrated into how the family work together.

### Can the family members work together?

A family constitution involves forming a voluntary social compact<sup>2</sup>. A voluntary social compact means that individual family members are willing to put aside their personal interests (at least in those areas where they agree to be jointly governed together) in favour of doing what is best for the group. Arriving at the decision to commit to a voluntary social compact with your other family members can involve going through an emotional process that the facilitator has to guide the family members through.

There can be a difference between a group of co-owners who happen to be all from the same family; and a group of family member co-owners who have voluntarily agreed to collaborate together as equal adults to further their shared interests and shared values. In the latter case there is an emotional connection, an “energy”, between the family members that will be missing in the former case.

There are the questions of “can we work together” and “do we want to work together?” In this context, “work together” means to be the co-owners of joint family financial wealth together; it is not referring to working in management roles together (although that might be part of it).

Not every family will have the desire to work together as the joint owners of a family enterprise. Not every family will have the skills required to be able to work as effective co-owners together. These issues are important as a family constitution is fundamentally dealing with the qualitative nature of the relationships amongst family members who are the co-owners of a business or other financial capital together.

There will be cases where it is obvious that the basic skills to be able

to work together are missing, or where there is no shared dream for the future and there is no desire to stay together as a family. There will also be many cases where some of the family members are committed to working together as co-owners while one or two other family members do not want to be a part of it.

If the family members do have the desire to work together, it's always possible to improve on relationship skills. Part of the agreement to form a family constitution together would typically involve a commitment to learning new relationship skills. An experienced facilitator can also help to improve relationships amongst family members.

### Knowing where the boundary is

In working through the questions of “can we and do we want to work together?” the family members need to know where the boundaries to this will be. In designing a family governance system thought needs to be given to the question of what things will the family members do jointly together, and what things will be left to individual family members, or different family branches, to decide on their own.

Maybe the family constitution that is being developed only applies to a single asset, such as the shares in the family business. Maybe the family constitution is being designed simply to regulate the family office or family foundation and nothing more. Alternatively, maybe the family constitution is intended to provide an overarching framework for a variety of different aspects of the affairs of the family. This is another decision the family members have to make.

### A process of education

The process of creating a family constitution will typically also involve the need to educate the family members on various issues. Therefore it can also be considered to be an education process.

The educational component should include learning about relevant models and theories concerning family

enterprises and their evolution and continuity.

The family members involved in the process should learn about the different roles that are present in their family enterprise system. For example, what is the typical role of a shareholder, or a director, or the chairman of a board, or the protector on a trust?

The most important thing that they may learn about, through the guidance of the facilitator, is about themselves and about the other family members involved in the process. For example, they may learn about their own personality types and the personality types of the other family members. They may learn about the personal values of each of the other family members. They may receive feedback on how they are perceived by the other members of the group. It should be expected that the process will involve having to learn some new relationship skills, with the primary one being the ability to listen with empathy.

### Implementation and support

Making the constitution is one thing, implementing it is another. If you think of a constitution as including structures, policies and processes, it is the ongoing processes that will bring it to life. Examples of ongoing processes will include things like holding quarterly family meetings throughout the year; planning and running educational events; reporting to the family shareholders and holding an annual family assembly meeting.

It is also important to think about the sources of support for the constitution. If there is a family office it can provide ongoing administrative support. Independent directors are another source of support for the constitution. The question also arises whether the Independent trustees of the family trust(s) can also be relied on to help ensure compliance with the terms of the constitution.

### Enforcing the family constitution

As part of the ongoing processes that bring a family constitution to life,

from time to time the question of enforcing compliance with the terms of the family constitution is going to come up. Accordingly, as part of the process of developing the family constitution, the family members will likely also address the question of enforcement.

### The model of the sole decision maker

The original governance model for Asian families is that it all starts with a sole decision maker. The first generation wealth creator in Asian families will be a Confucian authority figure who believes in the importance of “top down” decision making.

Accordingly the “family governance model” that the business founder often has in his mind is one of leadership based on hierarchy or leadership based on competency, with limited scope for participation in decision making by other stakeholders such as family members who are “outside shareholders”. However the problem with concentrating decision making authority in the hands of just one or a few “inside” family members, even if they are talented at business is best seen over the long term.

If there is a sole decision maker in the family who makes all of the management decisions for the family enterprise, it is natural to predict that family members who have an interest in ownership but who do not get to participate in management decisions will have a different perspective from those in management and that over time conflicts will arise between these outside shareholders and the inside manager(s). Emotional commitment for the family enterprise will also break down.

You can also eventually see the family enterprise become the “personal kingdom” of the family branch that has the management control. This “silo effect” can deprive the family enterprise of the benefit of talent from other branches of the family and puts a strain on trust and communication and family

relationships.

The reality is that the “patriarchal governance model” will not help to sustain the family enterprise beyond the first generation and it will not help preserve family harmony and positive family relationships and avoid destructive family conflicts. The family governance model for the family has to change in the second generation.

### Fair Process in decision making

Related to the concept of emotional commitment is the concept of ensuring that there is “fair process” in decision making. Where fair process is present, it leads to voluntary commitment to the decision, even if the decision is perhaps not regarded as a fair decision either in terms of the family system or in terms of the business system<sup>3</sup>. On the other hand, where fair process is absent non-compliance with the decision is to be expected.

### Decision making bodies and communication forums

When a family develop their own governance system it can be expected that the family constitution may distinguish between (i) some bodies that are decision making bodies (“DMB”) in relation to the family enterprise, and (ii) one or more different kinds of family communication forums (“FCF”).

Membership of the DMBs can be based on principles of competence and merit. On the other hand FCFs are concerned with ensuring fair process in decision making and giving the stakeholders a voice and a forum to raise issues of concern to them. A comprehensive family constitution should define the powers purpose and function of these different DMBs and FCFs. It should also talk about how they interact with each other.

### The legally binding family constitution

As a starting point the term “family constitution” can be assumed to refer to a document or collection of documents that are intended to be “normative” in nature or “morally binding”. Families will often ask whether it is possible to create a family constitution that is legally binding.

### The question of “can it be done?”

An agreement that is legally binding is one that will deal with legal rights and obligations and which can be enforced through legal remedies. By and large the law can only deal with rights and obligations. In the event of a breach the court can order the transfer of property or the payment of money. In very limited circumstances it can give injunctions. If those remedies are not appropriate and proportionate in the context, they are not effective remedies. Some of the component parts of a family constitution will not easily lend themselves to enforcement through legal remedies.

First, there will often be some elements of a family constitution which are emotional or aspirational in nature. For example, it might contain a family mission statement or vision statement which are intended to unite the family members and give them direction; or it might contain a statement of shared family values. Second, there will also be some elements of a family constitution that are directed towards the quality of the relationships between family members or that are intended to encourage better communication amongst family members. Examples here would include a “family code of conduct” and “family meeting rules”.

Nevertheless there may be other component parts included in a family constitution that do lend themselves to enforcement through legal remedies. The classic example would be the area of dealing in shares in the family enterprise, including the process for exiting from the family enterprise. In practice this topic would typically be covered in a legally binding shareholders agreement. This leads to the practical answer that there is scope to have both a family constitution as well as some of the terms of the constitution supported or reinforced by appropriate legally binding agreements. The legal agreements should however be in alignment with the terms of the family constitution.

### The benefits of a non-binding constitution

Aside from the technical question of “can it be done”, there is the more fundamental question of “does a constitution need to be legally binding in order to be effective?” Provided that (i) there was a fair process in the development of the family constitution;(ii) the family members have been able to integrate the constitution into their decision making processes<sup>4</sup>; and (iii) the family members are emotionally committed to the terms of the constitution, the constitution will have the following benefits, even if it is not supported by legally binding agreements:

First there is value in going through the process of making a family constitution even if it is not a legally binding if the process helps to provide clarity (i.e. to get every family member onto the same page) on roles and agreement on processes; if as a result trust and communication are improved within the family; if as a result there is greater transparency; and if the family members become united behind a shared vision or dream.

Second, the more that roles and boundaries can be clarified and agreed on by the family members, the lower the chances of role confusion occurring and the lower the chances of a family conflict arising.

Third, there is value in going through the process if as a result the family make a joint decision on how to best organise themselves going forward; and even if the family decide that they do not want to work together going forward. In other words the process can result in the family deciding what is the best direction for themselves to take.

Fourth, part of the idea of having a family constitution and family policies is that it gives the family members the opportunity to plan together for how they will deal with predictable problems before those problems arise.

### The benefits of having appropriate legal supporting documentation

However, just because a family constitution that was developed through a fair process can have benefits even if it is not legally binding, there is still a proper place for appropriate supporting legal agreements, provided that they are

in alignment with the terms of the family constitution.

First, the family constitution might not contain the same level of detail as a formal legal agreement would. Second, the constitution might fail to address all of the right legal issues. Third, it might be important to have legal agreements in case you want protection from third parties who are not members of the family constitution (e.g. third party creditors or in the event of a matrimonial property division). Fourth, it might be important to have a legal agreement in case a family member decides not to join the family constitution or who later decides to opt out of the family constitution or in case all of the family members later decide that the family constitution is not working and needs to be unwound.

### The disadvantages of relying on a legally binding constitution

Apart from the enforcement problems mentioned above, there are potential dangers with relying too heavily on the concept of being able to create a legally binding family constitution, which families making a constitution should carefully reflect on.

Ian Marsh, an expert in family dynamics and communication, and a former litigator, notes that: “The law deals in rights and obligations, whereas families are cultural and emotional. Invoking the law will impact the dynamic. It will change the family. It is for each family, for each family member, to weigh the pros and cons of that.” Marsh also recommends that legal agreements made between family members should contain conflict management protocols, which would include steps for facilitation and mediation of family disputes.

There can also be the danger that the family patriarch imposes the family constitution top down on the family members in the belief that it’s legally binding status will require compliance when in fact some of the parties would not agree to join the constitution, or not agree to all of its terms, if they had a voluntary choice. i.e. there is a risk that the voluntary element can be taken away. If the family constitution is forced onto the family members then emotional commitment to support the family enterprise will suffer. In fact if there is no voluntary social compact then the document that is forced on the family members should

not be called a “family constitution”.

Technically, you do not need fair process to create a legally binding agreement. However in the absence of a fair process in the development of the agreement, there is no guarantee that the family members will voluntarily comply with the terms of that agreement, which means that forcing compliance requires using legal mechanisms; which can then lead to a family war. This would be a sad result when the original business founder was really looking for a way to ensure family harmony. In terms of the concept of fair process, the lesson is that when dealing with family members, even the process for creating legal agreements should be based on a process that is regarded by those family members as a fair one; which brings you back to the need to have a series of facilitated family meetings, in a safe environment, to develop those agreements.

### The family constitution and the family trust

Family trust structures are a common tool for the ownership of the shares in a family enterprise. Therefore there will be questions as to the relationship between the “trust structure” and the family constitution. There is also the question of whether a trust structure represents a wise mechanism to ensure compliance with the terms of the family constitution. It also needs to be remembered that trust structures are themselves a form of governance mechanism. This leads to the question of whether, in terms of what is the “best way” for the family to be governed, the governance structure for the family trust matches, or is at least in alignment with, the ideal governance structure for the family.

### The benefits of family trust structures

Clearly trust structures offer certain legal and administrative benefits which need not be reviewed here. However in terms of the role they can play in a family governance system:

First, one of the key features of a trust is that it offers a way to consolidate voting control; it can be used to concentrate power to decide how to exercise the voting rights on the shares in the family enterprise in the hands of a small number of family members or their representatives. Therefore a trust structure is a way to create a DMB.

Second, setting up a trust also provides a very useful opportunity to talk to the business founder about his/her dreams and their vision for the future which can then be incorporated into the non-legally binding letter of wishes for the trust.

Third, possibly if there is a professional trustee of the family trust they may be able to play a role in helping to ensure that the rules of the family constitution are applied in practice; especially at the level of the board of directors of the holding company for the underlying family enterprise.

Fourth, the family trust can be drafted so as to authorise distributions to beneficiaries for the purposes of supporting the participation by those beneficiaries in family meetings, or otherwise to support the costs of the ongoing family governance processes of the family.

### More attention needs to be given to the governance of family trusts

In practice, what can often be missing from family trust structures, especially those intended to the major owner of the shares in a family enterprise, is enough careful thought given to the governance of that trust structure. This includes giving more thought as to the “governance triangle” made up of (i) the board of the family enterprise; (ii) the trustee as shareholder and (iii) the beneficiaries of the trust as the economic owners of the family enterprise. In practice, more attention needs to be given to the effective governance of family trusts.

### DMBs and FCFs and family trusts

As mentioned, a comprehensive family governance structure will typically include both DMBs as well as FCFs. If there is an investment or a management committee created under the terms of the family trust that exercises the voting or investment control over the assets held by the trustee, then this committee is a form of DMB (as is the protector).

Where then is the FCF for the trust? Especially if you have several branches of a family represented under a single “pot” trust, it will be especially important to make provision for a separate FCF for the beneficiaries of the trust. You could call this a “family council” or a “family meeting” for the beneficiaries and it would not need

to be a DMB. However to have a “good” governance mechanism, the members of the investment committee for the trust would have to establish the practice of making sure that they take into account the opinions of the beneficiaries raised through this family council or family meeting of the beneficiaries. This is not to say that they should be directed by the beneficiaries. Members of the DMB would have to be able to practice “fair process” in their decision making.

### The “dark side” of family trusts

Having said that in practice, the governance mechanism for many family trusts could usually be better articulated, on the other side of the coin, extreme caution is needed when considering the proposal that a family trust can be used as a mechanism to ensure compliance with the terms of a family constitution. The list of issues here is similar to the potential dangers identified above that could come from a patriarch forcing his family members to sign a legally binding “family constitution” in the absence of a fair and voluntary process.

First, you cannot use a trust to bottle up family emotions, and you cannot ignore the emotional side of working with family enterprises.

Second, throughout this article the importance of a voluntary social compact, of preserving family emotional commitment, and of having a fair process in decision making, has been emphasised. The risk with a trust structure being used to enforce the terms of the family constitution is that there could be beneficiaries of the trust who find themselves being forced to comply with the terms of the family constitution who have never been given a voice in the creation of that constitution, or who would not have participated if they had been given a choice, or who find they do not have any real voice in the decisions that are being made by the DMBs for the trust. A top down approach of decision-making might work in the first generation of an Asian family, but it is not a sustainable model.

Third, a challenge with single trusts that have beneficiaries from many different family branches is there is no easy mechanism to exit from the trust with any kind of fair compensation. You can always renounce being a beneficiary under a discretionary trust but that is very different from the scenario where



you have the right to sell the shares you own in the family enterprise even if at a discounted price. Lack of a fair exit mechanism will erode emotional commitment and create disgruntled beneficiaries.

### A more sustainable approach

As long as the possible “dark side” of the use of a family trust is acknowledged and carefully avoided, it will still be possible to marry a “good constitution” with a family trust structure. The key lies in permitting the family members (not just the business founder) to explore whether they have the relationship skills necessary and have a shared dream that would form the basis for creating their own voluntary social compact together. If the answer to those two questions is in the affirmative, the trust structure can be designed to support their voluntary social compact. However if the dream is multigenerational success, then each new generation needs the freedom to make their own social compact. Therefore such a trust would need to have a mechanism built into it so that the terms of the constitution and trust can be completely revamped with each new generation of the family.

### Expert advice versus process advice

Trust structures will frequently involve taxation issues, in which case appropriate expert tax advice will be required. Trust structures have to be established and then operated in a manner intended to maintain the proper legal integrity of the trust, and trustees and other fiduciaries involved in the structure will need to ensure they are properly complying with their duties. These are all issues that require expert legal advice. These are roles for “expert advisors”.

When it comes to the creation of a family constitution, the key questions are whether the family members are able to form their own voluntary social compact and articulate a shared dream together. The practical goal of a constitution will often include improving the qualitative aspects of the relationships amongst family members, and as between the family and its enterprise, and ensuring that emotional commitment is going to be preserved. Family constitutions are ultimately concerned with the emotional and relational aspects of the family. Often the context for making a

family constitution is that the family are facing a transition and there is a time of change coming. For these reasons, when creating a family constitution a family will need a safe environment, help with facilitation, and help with exploring a change together. They will need “process advice” (or a “helping relationship”) and not “expert advice”, at least not at that time. Once a family have gone through the necessary processes of developing their own system of how they will best be voluntarily governed together then that family governance system can be supported by appropriate legal agreements and/or a trust structure. “Form should follow function”.

#### END NOTES

- 1 Barbara R. Hauser
- 2 *Family, The Compact Among Generations*, by James E. Hughes Jr
- 3 Randel S. Carlock
- 4 Hughes