



HANDBOOK

# IFC Family Business Governance



*Creating Markets, Creating Opportunities*

# **IFC Family Business Governance Handbook**

Fourth Edition: Available in Albanian, Arabic, Azeri, Chinese, English, French, Georgian, Khmer, Macedonian, Mongolian, Montenegrin, Myanmar language, Portuguese, Russian, Serbian, Spanish, Turkish, Ukrainian, Urdu, and Vietnamese.

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## Foreword

The purpose of the IFC Family Business Governance Handbook is to help IFC investment and advisory services staff to identify and address basic family business governance issues with their family business clients. The Handbook may also serve as a guidance tool for IFC clients that are looking to strengthen their family governance practices. The Handbook complements the IFC Corporate Governance Methodology tools for family companies that are currently used within IFC to assess the governance of family business clients.

This Handbook is not intended as a comprehensive reference work on family business governance. Nor is it a substitute for the individualized advice that may be provided by qualified family business consultants and legal and accounting professionals. Rather, we intend it to be a concise and practical description of essential family business corporate governance components together with suggested approaches to common family business governance dilemmas. Further details on the topics covered by this Handbook can be found in the extensive literature that exists on this subject as provided in the footnotes and the bibliography at the end of the Handbook.

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## Acknowledgements

The author would like to express her appreciation to all the individuals who participated in the development of this Handbook.

Included among those who contributed to the Handbook are: Natalya Arabova, First Freight Company (Russia); Ayman Eltarabishy, The George Washington University (United States); Leo Goldschmidt, Bank Degroof (Belgium); Darrin Hartzler, Davit Karapetyan, Sebastian Molineus, and Cecilia Rabassa, IFC/World Bank; Herbert Steinberg, Mesa Corporate Governance (Brazil); and John Ward, Kellogg School of Management (United States). Each provided invaluable input in developing and reviewing the content of the Handbook.

The author would also like to thank Joe Achkar, SABIS (Lebanon); and Alfredo Carvajal Sinisterra, Carvajal Group (Colombia), for sharing some examples of their family governance practices in the Handbook.

Special thanks go to Sandra Guerra, Better Governance (Brazil); Kiril Nejkov, Fabio Isay Saad, Enrique Sanchez-Armass, Anderson Caputo Silva, and Medhat Bassily, IFC/World Bank, for their review of the translated versions of the Handbook.

Our appreciation also goes to Jewel Caguiat and Maya Polishchuk, IFC, who were instrumental in supervising the design, printing, and distribution of the Handbook.

Finally, the author would like to extend a special acknowledgment to Mike Lubrano, Cartica Capital (United States), for his essential role in orienting and reviewing the development process of the Handbook.





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## Introduction

Family businesses constitute the world's oldest and most dominant form of business organizations. In many countries, family businesses represent more than 70 percent of the overall businesses and play a key role in the economy growth and workforce employment. In Spain, for example, about 75 percent of the businesses are family-owned and contribute to 65 percent of the country's GNP on average.<sup>1</sup> Similarly, family businesses contribute to about 60 percent of the aggregate GNP in Latin America.<sup>2</sup>

Family businesses range from small and medium-sized companies to large conglomerates that operate in multiple industries and countries. Some of the well-known family businesses include: Salvatore Ferragamo, Benetton, and Fiat Group in Italy; L'Oreal, Carrefour Group, LVMH, and Michelin in France; Samsung, Hyundai Motor, and LG Group in South Korea; BMW, and Siemens in Germany; Kikkoman, and Ito-Yokado in Japan; and finally Ford Motors Co, and Wal-Mart Stores in the United States.

It is also a fact that most family businesses have a very short life span beyond their founder's stage and that some 95 percent of family businesses do not survive the third generation of ownership.<sup>3</sup> This is often the consequence of a lack of preparation of the subsequent generations to handle the demands of a growing business and a much larger family. Family businesses can improve their odds of survival by setting the right governance structures in place and by starting the educational process of the subsequent generations in this area as soon as possible.

This Handbook will focus on the unique corporate governance challenges that family businesses face and propose structures and practices that can mitigate these challenges and ensure the viability of the business. The Handbook gives an international perspective since it focuses on characteristics of family businesses that can be observed across countries. The suggested governance structures of the Handbook will need to be adapted to the local requirements and regulations of family businesses before being applied in a specific country.

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<sup>1</sup> The Family Business Network, [www.fbn-i.org/fbn/main.nsf/doclu/facts](http://www.fbn-i.org/fbn/main.nsf/doclu/facts).

<sup>2</sup> The Family Business Network, [www.fbn-i.org/fbn/main.nsf/doclu/facts](http://www.fbn-i.org/fbn/main.nsf/doclu/facts).

<sup>3</sup> The Family Business Network, [www.fbn-i.org/fbn/main.nsf/doclu/facts](http://www.fbn-i.org/fbn/main.nsf/doclu/facts).

## 1- Family Business Definition and Characteristics— Strengths and Weaknesses

**Definition:** In this Handbook, a family business refers to a company where the voting majority is in the hands of the controlling family; including the founder(s) who intend to pass the business on to their descendants. The terms “family business”, “family firm”, “family company”, “family-owned business”, “family-owned company”, and “family-controlled company” will be used interchangeably throughout the Handbook to refer to family businesses.

**Strengths:** Several studies have shown that family-owned companies outperform their non-family counterparts in terms of sales, profits, and other growth measures.<sup>4</sup> A Thomson Financial study for Newsweek compared family firms to rivals on the six major indexes in Europe and showed that family companies outperformed their rivals on all of these indexes, from London’s FTSE to Madrid’s IBEX. Thomson Financial created a unique index for both family and non-family firms in each country, and tracked them over 10 years through December 2003. In Germany, the family index climbed 206 percent, while the non-family stocks increased just 47 percent. In France, the family index surged 203 percent, while its counterpart rose only 76 percent. Family businesses also outperformed their counterparts in Switzerland, Spain, Britain and Italy.<sup>5</sup>

This high performance is the result of the inherent strengths that family businesses have compared to their counterparts. Some of these strengths include:<sup>6</sup>

- **Commitment.** The family—as the business owner—shows the highest dedication in seeing its business grow, prosper, and get passed on to the next generations. As a result, many family members identify with the company and are usually willing to work harder and reinvest part of their profits into the business to allow it to grow in the long term. In dealing with its family business clients, IFC highly values having a committed set of shareholders at the core of the company.

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<sup>4</sup> Denis Leach and John Leahy, “Ownership Structures, Control and the Performance of Large British Companies”, *Economic Journal*, 1991.

<sup>5</sup> Newsweek, [www.msnbc.msn.com/id/4660477/site/newsweek](http://www.msnbc.msn.com/id/4660477/site/newsweek).

<sup>6</sup> Sir Adrian Cadbury, *Family Firms and Their Governance: Creating Tomorrow’s Company from Today’s* (Egon Zehnder International, 2000); John Ward, “The Family Business Advantage: Unconventional Strategy”, *Families in Business*, 2002.

- *Knowledge Continuity.* Families in business make it a priority to pass their accumulated knowledge, experience, and skills to the next generations. Many family members get immersed into their family business from a very young age. This increases their level of commitment and provides them with the necessary tools to run their family business.
- *Reliability and Pride.* Because family businesses have their name and reputation associated with their products and/or services, they strive to increase the quality of their output and to maintain a good relationship with their partners (customers, suppliers, employees, community, etc.).

**Weaknesses:** Perhaps the most often cited characteristic of family businesses is that many of them fail to be sustainable in the long term. Indeed about two-thirds to three-quarters of family businesses either collapse or are sold by the founder(s) during their own tenure. Only 5 to 15 percent continue into the third generation in the hands of the descendents of the founder(s).<sup>7</sup>

This high rate of failure among family businesses is attributed to a multitude of reasons. Some of these reasons are the same ones that could make any other business fail such as poor management, insufficient cash to fund growth, inadequate control of costs, industry and other macro conditions. However, family businesses also show some weaknesses that are especially relevant to their nature. Some of these weaknesses are:

- *Complexity.* Family businesses are usually more complex in terms of governance than their counterparts due to the addition of a new variable: the family. Adding the family emotions and issues to the business increases the complexity of issues that these businesses have to deal with. Unlike in other types of businesses, family members play different roles within their business, which can sometimes lead to a non-alignment of incentives among all family members. This point will be discussed in more detail in Section I of the Handbook.

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<sup>7</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

- *Informality*. Because most families run their businesses themselves (at least during the first and second generations), there is usually very little interest in setting clearly articulated business practices and procedures. As the family and its business grow larger, this situation can lead to many inefficiencies and internal conflicts that could threaten the continuity of the business.
- *Lack of Discipline*. Many family businesses do not pay sufficient attention to key strategic areas such as: CEO and other key management positions' succession planning, family member employment in the company, and attracting and retaining skilled outside managers. Delaying or ignoring such important strategic decisions could lead to business failure in any family business.

## 2- Stages of Growth in a Family Business

Several models have been developed to describe and analyze the different stages that family businesses go through during their existence. In this Handbook, we will use the basic three-stage model that summarizes the family business lifecycle as: (i) the Founder(s) Stage; (ii) the Sibling Partnership Stage; and (iii) the Cousin Confederation Stage.<sup>8</sup> Although this model allows for a good analysis of the three basic steps of evolution of the family business, it does not mandate that all family-owned companies will necessarily go through all three stages of development. For example, some companies will disappear during the early stages of their lifecycle because of bankruptcy or getting acquired by another firm.

The evolution of ownership and management within most family businesses goes through the following stages:

### 2.1. Stage 1: The Founder(s) (Controlling Owner(s))

This is the initial step of the family business' existence. The business is entirely owned and managed by the founder(s). Most founders might seek advice from a small number of outside advisors and/or business associates but they will make

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<sup>8</sup> John Ward, *Creating Effective Boards for Private Enterprises* (Family Enterprise Publishers, 1991); Kelin E. Gersick, John A. Davis, Marion McCollom Hampton, Ivan Lansberg, *Generation to Generation: Life Cycles of the Family Business* (Harvard University Press, 1997).

the majority of the key decisions themselves. This stage is usually characterized by a strong commitment of the founder(s) to the success of their company and a relatively simple governance structure. Overall, this stage contains limited corporate governance issues compared to the next two stages since both the control and ownership of the company are still in the hands of the same person(s): the founder(s). Perhaps the most important issue that will need to be addressed during the life of the founder(s) is succession planning. For the family business to survive into its next stage, the founder(s) should make the necessary efforts to plan for their succession and start grooming the next leader(s) of the company.

## 2.2. Stage 2: The Sibling Partnership

This is the stage where management and ownership have been transferred to the children of the founder(s). As more family members are now involved in the company, governance issues tend to become relatively more complex than those observed during the initial stage of the business' existence. Some of the common challenges of the sibling partnership stage are: maintaining siblings' harmony, formalizing business processes and procedures, establishing efficient communication channels between family members, and ensuring succession planning for key management positions.

## 2.3. Stage 3: The Cousin Confederation (Cousin Consortium or Family Dynasty)

At this stage, the business' governance becomes more complex as more family members are directly or indirectly involved in the business, including children of the siblings, cousins, and in-laws. Since many of these members belong to different generations and different branches of the family, they might have diverse ideas on how the company should be run and how the overall strategy should be set. In addition, any conflicts that existed among the siblings in the previous stage would most likely be carried to the cousin generation as well. As a consequence, this stage involves most family governance issues. Some of the most common issues that family businesses face at this stage are: family member employment; family shareholding rights; shareholding liquidity; dividend policy; family member role in the business; family conflict resolution; and family vision and mission.



The following table summarizes the key family governance issues faced by family businesses during their development cycle:<sup>9</sup>

Ownership Stage	Dominant Shareholder Issues
<b>Stage 1: The Founder(s)</b>	<ul style="list-style-type: none"> <li>• Leadership transition</li> <li>• Succession</li> <li>• Estate planning</li> </ul>
<b>Stage 2: The Sibling Partnership</b>	<ul style="list-style-type: none"> <li>• Maintaining teamwork and harmony</li> <li>• Sustaining family ownership</li> <li>• Succession</li> </ul>
<b>Stage 3: The Cousin Confederation</b>	<ul style="list-style-type: none"> <li>• Allocation of corporate capital: dividends, debt, and profit levels</li> <li>• Shareholder liquidity</li> <li>• Family conflict resolution</li> <li>• Family participation and role</li> <li>• Family vision and mission</li> <li>• Family linkage with the business</li> </ul>

Each stage presents different challenges and issues that if properly managed can ensure the continuity of the family business. Most family-owned companies are successful during their infancy stage thanks to the tremendous efforts made by the founder(s) as they are implicated in all aspects of the business. In the longer term though, it becomes necessary to set up the right governance structures and mechanisms that will allow for efficient communication channels and a clear definition of the roles and expectations of every person involved in the family business.

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<sup>9</sup> John Ward, *Creating Effective Boards for Private Enterprises* (Family Enterprise Publishers, 1991).

# SECTION I

## FAMILY MEMBER ROLES IN THE GOVERNANCE OF THEIR BUSINESS

In a typical non-family business, any involved individual can be an employee, a manager, an owner, a director, or some combination of these roles. In a family-owned business however, matters become more complex as an individual can have multiple roles and responsibilities. These multiple roles are usually associated with different incentives, which increases the challenges that family businesses face as opposed to their non-family counterparts.<sup>10</sup>

### 1- Owners (Shareholders)

Owners in a family business have several roles and motivations that can sometimes lead to conflicting opinions. For example, a decision to reinvest profits in the company instead of distributing them as dividends can be differently seen by the various owners depending on their other roles in the business. An owner who works in the family business might not object to such a decision since he/she is already receiving a salary from the company. On the other hand, this situation would look different from the perspective of an owner who does not work in the business and relies on dividends as a main source of income. This owner would actually be interested in receiving higher and more frequent dividends.

Matters usually get more complex as the family business grows and its owners hold different roles, with different incentives. Some of the roles that an owner in a family business can have are:

- Owner only.
- Owner/manager.
- Owner/family member.
- Owner/family member/manager.
- Owner/director.
- Owner/family member/director.
- Owner/family member/director/manager.

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<sup>10</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

## 2- Managers (Senior Management)

Managers in a family business will also have different motivations depending on their other roles within the business. A common issue in this area is the unequal treatment of family and non-family managers. In many family businesses, part or all of the senior management positions are strictly reserved for family members. This could negatively impact the motivation and performance of non-family managers who know for a fact that no matter how hard they work, they will never be part of the senior management of the company. As a consequence, many family businesses find it very hard to attract and retain talented non-family managers. Setting up a clear and fair employment policy (for both family and non-family employees) will make it easier for family businesses to keep their very best employees motivated and interested in the growth of the company. Such policy would align the employees' incentives to their performance regardless of whether they are part of the family or not.

## 3- Directors (Board of Directors)

When it comes to board membership, most family businesses reserve this right to members of the family and in a few cases to some well trusted non-family managers. This practice is generally used as a way of keeping the family control over the direction of its business. Indeed, most decisions are usually taken by the family-member directors. In the previous example of dividend distribution, family directors who are also managers in the business would naturally encourage reinvesting profits in the company so as to increase its growth potential. On the contrary, family directors who do not work in the business would rather make the decision of distributing the profits as dividends to family shareholders. These contradicting views can lead to major conflicts in the board and negatively impact its way of functioning.

## 4- Family Members (the Family and its Institutions)

As previously mentioned, family members can have different responsibilities, rights, and expectations from their business. This situation can sometimes lead to conflicts and issues that might jeopardize the continuity of the family business. One issue that can increase conflicts among family members is the level of access to infor-

mation about the company and its activities. This can be problematic as the members who work in the business usually have access to such information in a timely manner while those outside of the business can't access it in the same way.<sup>11</sup> Family businesses should establish the necessary communication channels and institutions to keep all family members informed about the business, strategy, challenges, and the overall direction where the company is heading.

### Corporate Governance Definition

"Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital."<sup>12</sup>

This definition focuses on three key elements:

- Direction refers to all the decisions that relate to setting the overall strategic direction of the company such as: (i) long-term strategic decisions; (ii) large-scale investment decisions; (iii) mergers and acquisitions; and (iv) succession planning and appointment of key senior managers, such as the CEO of the company.
- Control refers to all the actions necessary to oversee the management's performance and follow up on the implementation of the strategic decisions set above.
- Relationship among the main governing bodies of the firm refers to the interactions among the shareholders, the directors of the board, and the managers. An important element of any good corporate governance structure is the clear definition of the role, duties, rights, and expectations of each of these governing bodies.

The next three sections of this Handbook will focus on the governance bodies of a family business by defining the roles, rights, and responsibilities of the shareholders/family members, the directors of the board, and the managers.

<sup>11</sup> Fred Neubauber and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998); Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999).

<sup>12</sup> International Finance Corporation, <http://ifcln1.ifc.org/ifcext/corporategovernance.nsf/Content/WhyCG>.

This section described how several issues that family businesses face arise from the numerous roles that their members can have. These issues, added to the constant challenges that any business faces, make it harder for family businesses to survive. This is probably one of the reasons for the high failure rate observed among family businesses. Family businesses can of course increase their survival chances by paying particular attention to their governance and establishing the necessary mechanisms that are needed in this area. Some of these mechanisms are discussed in the next section of this Handbook.

# SECTION II

## FAMILY GOVERNANCE

The family aspect is what differentiates family companies from their counterparts. As a consequence, the family plays a crucial role in the governance of its business. When the family is still at its initial founder(s) stage, very few family governance issues may be apparent as most decisions are taken by the founder(s) and the family voice is still unified. Overtime, as the family goes through the next stages of its lifecycle, newer generations and more members join the family business. This implies different ideas and opinions on how the business should be run and its strategy set. It becomes mandatory then to establish a clear family governance structure that will bring discipline among family members, prevent potential conflicts, and ensure the continuity of the business. A well functioning family governance structure will mainly aim at:

- Communicating the family values, mission, and long term vision to all family members.
- Keeping family members (especially those who are not involved in the business) informed about major business accomplishments, challenges, and strategic directions.
- Communicating the rules and decisions that might affect family members' employment, dividends, and other benefits they usually get from the business.
- Establishing formal communication channels that allow family members to share their ideas, aspirations and issues.
- Allowing the family to come together and make any necessary decisions.

Developing such a governance structure will help build trust among family members (especially between those inside and outside of the business), and unify the family thus increasing the viability chances of the business. The major constituents of a family governance structure are:

- **A family constitution** that clearly states the family vision, mission, values, and policies regulating family members' relationship with the business.

- **Family institutions**, which can have different forms and purposes, e.g. family assembly, family council, and other family committees.

## 1- Family Constitution

**Definition:** The family constitution is also referred to as “Family Creed”, “Family Protocol”, “Statement of Family Principles”, “Family Rules and Values”, “Family Rules and Regulations”, and “Family Strategic Plan”. The family constitution is a statement of the principles that outline the family commitment to core values, vision, and mission of the business.<sup>13</sup> The constitution also defines the roles, compositions, and powers of key governance bodies of the business: family members/shareholders, management, and board of directors. In addition, the family constitution defines the relationships among the governance bodies and how family members can meaningfully participate in the governance of their business.<sup>14</sup>

The family constitution is a living document that evolves as the family and its business continue to evolve. As a consequence, it is necessary to regularly update the constitution in order to reflect any changes in the family and/or the business.

**Components:** The form and content of family constitutions differ from one family business to another depending on the size of the family, its stage of development, and the degree of involvement of family members in the business. However, a typical family constitution will cover the following elements:

- Family values, mission statement, and vision.
- Family institutions, including the family assembly, the family council, the education committee, the family office, etc.
- Board of directors (and board of advisors if one exists).
- Senior management.
- Authority, responsibility, and relationship among the family, the board, and the senior management.
- Policies regarding important family issues such as family members' employment, transfer of shares, CEO succession, etc.

<sup>13</sup> These principles can range from basic (when the family is still at its founder(s) stage) to detailed and more specific as the family size gets larger.

<sup>14</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998); Daniela Montemerlo and John Ward, *The Family Constitution: Agreements to Secure and Perpetuate Your Family and Your Business* (Family Enterprise Publishers, 2005); Craig Aronoff, Joseph Astrachan, and John Ward, *Developing Family Business Policies: Your Guide to the Future* (Family Enterprise Publishers, 1998).

Although most family companies don't have a formal constitution, they usually have an informal set of rules and customs that determine the rights, obligations, and expectations of family members and other governance bodies of the business. As the family increases in size, it becomes crucial to develop a written and formal constitution that is shared among all family members.

### 1.1. Family Member Employment Policies

One very important area of the family constitution is the definition of family member employment policies. Many family businesses that didn't set up clear employment policies for their members end up with more employees from the family than the company needs. Some of these employees might not even be suitable for the jobs that they are given within the business. Even worse, some family businesses find themselves acquiring businesses that have no relationship with their original business or keeping some unprofitable business lines just to make sure that everybody in the family gets a job within the company.

Once at the sibling partnership stage, families in business should formalize their family members' employment policies. This would require setting up clear rules about the terms and conditions of family employment within the firm. Some of these rules would clearly state the conditions of entry, staying, and exit from the business. The policy should also cover the treatment of family member employees in comparison with non-family employees.

The content of family employment policies differs from one family business to another. There is no right set of rules that all family businesses have to follow in this area. For example, some families completely forbid any of their members from working in the family business. Other families allow their members to work in the business but impose certain conditions on them such as the minimum required level of education, prior work experience, and age limits. In developing its family employment policy, the family should focus on the rules, conditions, and processes that allow it to attract and motivate the best competence available (whether from within the family or outside of it). It is also very important to set employment conditions that do not discriminate against or favor family members. This would help establish an atmosphere of fairness and motivation for all employees of the family business.



Finally, once developed and agreed upon by the family, the written employment policy should be made available to all family members. This will help set the right expectations about family employment among all family members.

## CASE STUDY 1

### SABIS®—Family Employment Policy

SABIS® is an international, college-preparatory education system with roots in the 19th century. Schools in the SABIS® School Network provide Pre-K and K-12 students with a distinctively rigorous, college-preparatory education. SABIS®' unique educational system is currently being successfully implemented in 50 schools in 14 countries with 40,000 students around the world. SABIS® and its team of experienced professionals are dedicated to offering educational management products and services to a membership network of private and public schools.

The first school in the SABIS® School Network was founded in 1886 in the suburbs of Beirut, Lebanon. The name SABIS® is actually derived from the first letters of the last names of the founders: the Saad and the Bistany families. As of August 2007, there were 25 family members, 10 of them were working at SABIS®.

IFC's investment in SABIS® in 2005 was related to the new SABIS® International School in Adma, Lebanon. SIS-Adma was a greenfield elementary and secondary school designed to accommodate 1,700 students. IFC invested \$8 million towards the new facilities which have become both the flagship school and international headquarters of SABIS®. IFC has also provided advice to SABIS® in its efforts to build a sound family business governance structure.

#### Family Employment Policy of SABIS®<sup>15</sup>

##### A. Employment Philosophy

The driving force behind our decisions should be the best interest of the organization and not that of individual family members.

1. We would like to attract the most qualified people to SABIS®, both family and non-family.
2. A job at SABIS® is neither a birthright nor an obligation for family members.
3. Once hired, family members will be treated as all other non-family employees.

<sup>15</sup> Adapted and summarized from the 2006 Family Employment Policy of SABIS®.

4. There is no guarantee that family employees will be promoted to top management positions, simply because they are part of the family.
5. Family employees are expected to set the example in as far as dedication, performance, and conduct.
6. We cannot afford to carry individuals, whether family members or not, who do not make a full contribution.

## **B. Existence of an Open Position**

SABIS® must have a position available for which the applying family member is qualified. SABIS® will not create a position for a family member unless the growth of the business justifies it, which is to be decided by the Board. Furthermore, non-family employees will not be dismissed to make room for family members.

## **C. Prerequisite Qualifications**

### **1. Educational Requirements:**

A university degree (bachelor or higher, from a reputable university approved by SABIS®) is required for employment in any position within the company.

### **2. Outside Working Experience:**

A successful working experience (of 3 to 5 years) outside of SABIS® is strongly recommended, although not always required. The final decision would be taken by the Board, based on the assessment and recommendation of the Group VP of Organization Development (VP-OD) and the President/CEO.

Family employees joining with no outside experience will go through an "initial training" of about 6 to 12 months, with the following objectives:

- a. To introduce and expose them to SABIS®.
- b. To help them uncover, or validate, their professional interests.
- c. To help the company assess them.

### **3. Age Limit:**

In line with our employment philosophy, the company should not be considered a "shelter" for family members in search of a job. Hence, in the case of family members seeking employment with SABIS® after the age of 40, the Board will examine their professional career path and the reasons they did not join earlier before making a decision about their application.

*(continued)*

#### **D. Family Employment—Specifics**

1. Family members who wish to join SABIS® should inform the President/CEO of their desire to join. They would then be asked to complete the standard application form.
2. Family members will then go through the standard interviewing, assessment and selection process.
3. The final decision for hiring, or rejecting, a family candidate rests with the Board.
4. Once a family member becomes an employee, he/she will be treated as any other non-family employee. Family employees will be trained, supervised, evaluated, and promoted like other employees.
5. Family employees will have regular performance reviews (through the standard channels) and will be given feedback on how they are doing, and guidance on how to improve their performance. Additionally, the Group VP–OD will also review their performance for possible guidance or action in view of their prospective career plans within the company.
6. In order to contribute to the development and advancement of family members, a “Development Plan” will be elaborated for every family member working at SABIS®. This plan would encompass training, continuing education, coaching, mentoring, special projects and assignments, job rotations, etc.
7. As part of their performance management and self-development, family employees will be asked to provide a yearly self-assessment, including personal development objectives for the following year.
8. In the area of promotion and advancement of family employees, a recommendation will be made by their supervisor or by the company's management, with the final decision being taken by the Board.
9. The grounds for dismissing a family member include continued poor performance, unacceptable personal conduct, and any other grounds on which a non-family employee may be dismissed.
10. If a family member has been dismissed by the company, he/she will not be reconsidered for employment.
11. If a family member has left SABIS® voluntarily, he/she may return to work at SABIS® subject to the approval of the Board, if an appropriate position is vacant. This would generally be limited to one time only.

## **E. Compensation**

Compensation and benefits of family employees will be based on their position, responsibilities, qualifications and performance, and will be comparable to that of non-family employees in the same position and with similar qualifications. They will receive compensation and benefits based on being employees, and not on the shares they own. As owners, they will be compensated through the return on their shares.

## **F. Other Family Employment Policies**

### **1. In-laws Employment:**

Family member spouses who wish to join SABIS® will go through the standard interviewing, assessment, and selection process. The final decision for hiring, or rejecting, a family member spouse will rest with the Board, which would meet without the family member in question and vote confidentially.

### **2. Supervision and Reporting Relationships:**

Wherever possible, family members will not be supervised by other family members. This may sometimes be unavoidable, especially in the case of senior leadership roles; however, such situations should be approved and monitored by the Board. In addition, if both members of a couple are working at SABIS®, they cannot work in the same department.

### **3. Short-term Internships and Summer Employment:**

Younger family members who show a desire of working at SABIS® will be encouraged to go through short-term internships with the organization (generally ranging from a few weeks to a couple of months). Such an internship shall not replace the required "initial training" that they may have to go through if they join the company at a later stage.

### **4. Continuing Education:**

Standard company policy will apply both to continuing education (towards a degree), and to professional development (e.g. training, seminars, and conferences). In the case of continuing education, if the family employee would like additional financial contribution from the SABIS® Family Council, above what the company may provide employees, a request to this end will be put forward to the Family Council by the President/CEO. The Family Council will then study the request and take a decision accordingly.

## 1.2. Family Member Shareholding Policies

For some families it is crucial to clearly define shareholding policies at the earliest stages of the family's existence. This usually helps set the right expectations among family members regarding shares' ownership rights, e.g., whether in-laws and other related family members are allowed to own shares or not. A good shareholding policy would also define the mechanisms that allow family members to sell their shares if they prefer cash instead. Indeed, as the shareholders' pool grows larger, most shareholders will end up with a smaller percentage of the company's shares that would yield lower dividends (if the company is paying dividends at all). This situation can create frustration among these minority shareholders and lead to conflicts with salary receiving family members.

Providing the shareholders with a liquidity option for their shares could help avoid many conflicts and increase the business' chances of survival. Some family businesses establish a Shares Redemption Fund in order to buy back any shares that family members would like to liquidate. The Fund is usually financed by contributing a small percentage of profits to it every year.

## 2- Family Governance Institutions

Family governance institutions help strengthen the family harmony and relationship with its business. By allowing family members to get together under one or more organized structures, family institutions increase the communication links between the family and its business as well as provide opportunities for family members to network and discuss aspects that can be related to the business or the family. These organized activities help increase understanding and build consensus among family members.

Family members should be well informed about the purpose and activities of any established family governance institutions. It is also very important to make sure that family members distinguish between the role of these institutions and the governing bodies of the business such as the board of directors and senior management. This can be achieved by developing written procedures for these institutions and sharing them with all family members.

Below is a description of some family governance institutions that a family business might have. Of course, not all family businesses need or must establish all of these institutions. Deciding what type of institution to establish will depend on the size of the business, the family's stage of development, the number of existing family members, and the degree of involvement of family members in their business.

## 2.1. Family Assembly

**Definition:** Also called "Family Forum", the family assembly is a formal forum for discussion for all family members about business and family issues. During the founder(s) stage of the business, the family assembly is replaced by a more frequent and informal "Family Meeting". These informal meetings allow the founder(s) to communicate family values, generate new business ideas, and prepare the next generation of the family business' leaders. As the family and the business get more complex (sibling and cousin stages), it becomes crucial to establish a formal family assembly.

**Purpose:** To bring family members together so as to reflect on areas of common interest (family and family business issues). The family assembly allows all family members to stay informed about business issues and gives them the opportunity to voice their opinions about business development and other family issues. These assemblies help avoid potential conflicts that might arise among family members because of an unequal access to information and other resources. Family assemblies are usually held about once or twice a year in order to discuss and manage issues of interest to the family. Some of the issues handled during family assemblies include:

- Approval of any change in the family values and vision.
- Education of family members about their rights and responsibilities.
- Approval of family employment and compensation policies.
- Election of family council members (if the council exists).
- Election of other family committees' members.
- Other important family matters.

**Membership:** As a general rule, family assemblies are open to all family members. However, some families prefer to set certain membership restrictions such as minimum age limits, participation of in-laws, and voting rights during the

assembly. The scheduling and chairing of the family assembly is usually handled by the family patriarch or some other respected family figure. In larger families, this task is usually given to the family council.

### 2.2. Family Council

**Definition:** Also called “Family Supervisory Board”, “Inner Council” and “Family Executive Committee”, the family council is a working governing body that is elected by the Family Assembly among its members to deliberate on family business issues. The council is usually established once the family reaches a critical size, i.e. more than 30 members. In this situation, it becomes very difficult for the family assembly to have meaningful discussions and make prompt and qualified decisions. The family council is established at this point as a representative governance body for the family assembly in coordinating the interests of the family members in their business.

**Purpose:** The composition, structure and functioning of family councils differ from one family business to another. However, the duties of a typical family council would include:<sup>16</sup>

- Being the primary link between the family, the board, and senior management.
- Suggesting and discussing names of candidates for board membership.
- Drafting and revising family position papers on its vision, mission, and values.
- Drafting and revising family policies such as family employment, compensation, and family shareholding policies.
- Dealing with other important matters to the family.

**Membership:** Just like any well-functioning committee, the family council should have a manageable size, i.e. from 5 to 9 members. These members are usually elected by the family assembly by taking into consideration their qualifications and availability to perform the council's duties. Some families prefer

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<sup>16</sup> Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999); Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

to impose certain restrictions regarding membership in the council such as age limits and experience requirements; and non-participation of in-laws and family members that also serve on the board or are part of the company's senior management. One good practice is to set limited terms for the council's membership so as to allow more family members to be part of the council and create a feeling of fairness and equal opportunities within the family.

The family council should have a chairman, who is also appointed by the family assembly. The chairman leads the work of the council and is the main contact person for the family. It is also a good practice to appoint a secretary of the council that keeps minutes of meetings and makes them available to the family. Depending on the complexity of issues facing the family, the council would meet from 2 to 6 times per year. Decisions are usually approved by majority votes of the council's members.

The following table outlines the major differences between the family meeting, family assembly, and family council:

	<b>Family Meeting</b>	<b>Family Assembly</b>	<b>Family Council</b>
<b>Stage</b>	Founder(s)	Sibling Partnership/ Cousin Confederation	Sibling Partnership/ Cousin Confederation
<b>Status</b>	Usually informal	Formal	Formal
<b>Membership</b>	Usually open to all family members. Additional membership criteria might be set by the founder(s).	Usually open to all family members. Additional membership criteria might be set by the family.	Family members elected by the family assembly. Selection criteria defined by the family.
<b>Size</b>	Small size since family still at founder(s) stage. Usually 6- 12 family members.	Depends on the size of the family and membership criteria.	Depends on criteria set up for the membership. Ideally 5-9 members.



(continued)

	Family Meeting	Family Assembly	Family Council
<b>Number of Meetings</b>	Depends on the stage of the business' development. When the business is growing fast, can be as frequent as once a week.	1-2 times a year.	2-6 times a year.
<b>Main Activities</b>	<ul style="list-style-type: none"> <li>• Communication of family values and vision.</li> <li>• Discussion and generation of new business ideas.</li> <li>• Preparation of the next business leader(s).</li> </ul>	<ul style="list-style-type: none"> <li>• Discussion and communication of ideas, disagreements, and vision.</li> <li>• Approval of major family related policies and procedures.</li> <li>• Education of family members on business issues.</li> <li>• Election of family council and other committees' members.</li> </ul>	<ul style="list-style-type: none"> <li>• Conflict resolution.</li> <li>• Development of the major family related policies and procedures.</li> <li>• Planning.</li> <li>• Education.</li> <li>• Coordination of the work with the management and the board and balancing the business and the family.</li> </ul>

### 2.3. Family Office

**Definition:** The family office is an investment and administrative center that is organized and overseen by the family council. Family offices are usually very common within large and wealthy families in business, whose members express a need for getting personal financial, banking, accounting, and other advice.

**Purpose:** To provide advice on personal investment planning, taxes, insurance coverage, estate planning, career counseling and other topics of interest to individual family members.

**Membership:** The family office is a quite separate operation from the business, although a few of its members may work in the business as well. The office is usually populated by professional managers who monitor the investments, tax compliance, insurance, financial planning, and intra-family transactions such as gifts of stocks and estate plans.<sup>17</sup>

## 2.4. Other Family Institutions

Families in business might find it useful to develop other types of institutions that cover areas of particular interest to them. Some of these institutions are:<sup>18</sup>

**Education Committee:** This committee is responsible for nurturing the family's human capital and its capacity to effectively collaborate in the tasks of governance. The education committee anticipates developmental needs of family members and organizes educational events and activities for them. For example, this committee could organize an accounting seminar for family members to help them read and understand the financial statements of their company.

**Shares Redemption Committee:** This committee is overseen by the family council, and manages an established fund for shareholders who wish to cash in their stock at a fair price in order to pursue other activities with this money. The fund is usually built by contributing a percentage of the company's profits to it each year.

**Career Planning Committee:** Serves to establish and oversee entry policies for family members interested in joining the family business. This committee also helps monitor the careers of family members, offers career mentoring and keeps shareholders and the family council informed on their development. The career planning committee can also be very useful in advising family members who choose not to work in the family business on their external careers.

**Family Reunion and Recreational Committee:** The purpose of this committee is to plan fun and other events in order to get family members together around recreational activities. The committee also organizes yearly family reunions designed to nurture relationships among family relatives by providing opportunities to get together and enjoy each other's company.

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<sup>17</sup> Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999).

<sup>18</sup> Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999); Fred Neubauer and Alden G. Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

## CASE STUDY 2

### The Carvajal Group

#### Family Protocol–Table of Contents

The Carvajal Group is a leading privately-owned Colombian multinational company with businesses in 19 countries, primarily in Latin America. The Carvajal Group operates in 12 different sectors, the largest of which are: paper manufacturing and conversion; school and office supplies; telephone directories; publishing and editing; and plastic and paper packaging.

The Carvajal Group was founded in 1904 in Cali, Colombia, by Manuel Carvajal Valencia who established a printing company called La Imprenta Comercial. Over time, the company expanded into other businesses and regions to become one of Latin America's most respected multinational firms.

IFC's two investments in the Carvajal Group, in 2004 and 2006, had a purpose of supporting the Group in its strategic and modernization plans. The most recent IFC investment in the Carvajal Group is related to the revamping and modernization of the Group's information systems. IFC has also provided advice to the Carvajal Group in the area of corporate governance.

#### **Table of Contents of the Family Protocol of The Carvajal Group<sup>19</sup>**

##### **A. Objective of the Family Protocol**

1. Integrity of the Carvajal Company
2. Unity of the Carvajal Family

##### **B. Family Institutions**

1. Family Assembly
  - a. Objective of the Family Assembly
  - b. Functions of the Family Assembly
2. Family Council
  - a. Objective of the Family Council
  - b. Composition of the Family Council
  - c. Functions of the Family Council
  - d. Decisions of the Family Council
  - e. Frequency of Meetings of the Family Council

<sup>19</sup> Adapted and summarized from the 2002 version of the Family Protocol of The Carvajal Group.

3. Council for the Development of Family Members Working in the Company
  - a. Objective of the Development Council
  - b. Composition of the Development Council
  - c. Functions of the Development Council

#### **C. The Carvajal Family Foundation (Charity Institution)**

1. Objective of the Family Foundation
2. Board of the Family Foundation
3. President of the Family Foundation

#### **D. Institutions of the Company**

1. Shareholders Meeting
  - a. Objective of the Shareholders Meeting
  - b. Decisions of the Shareholders Meeting
2. Board of Directors
  - a. Objective of the Board of Directors
  - b. Composition of the Board of Directors
  - c. Chairman of the Board of Directors

#### **E. Management of the Company**

1. CEO of the Company
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  - a. Right of First Refusal
  - b. Conditions of Sale
2. Liens on Shares
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4. Reserve Fund
  - a. Objective of the Reserve Fund
  - b. Board of Directors of the Reserve Fund
5. Conflicts of Interest
  - a. Investment in Other Companies
  - b. Transactions with the Company
  - c. Other Activities

*(continued)*

**G. Employment of Family Members**

1. Entrance
2. Responsibilities
3. Remuneration
4. Evaluation for Development
5. Retirement

**H. Social Dividend (Subsidies for Family Members)**

1. Objective of the Social Dividend
2. Components of the Social Dividend
3. Regulation of the Social Dividend

**I. Family Activities**

1. Social Meetings
2. Informative Meetings
3. Communication
4. History of the Company

**J. Relations with the Public**

**K. Overseer of the Family Protocol**

1. Objective of the Overseer
2. Appointment of the Overseer
3. Functions of the Overseer

**L. Secretary of the Family Council**

1. Objective of the Secretary of the Family Council
2. Appointment of the Secretary of the Family Council
3. Functions of the Secretary of the Family Council

**M. Resolution of Conflicts**

**N. Updating of the Family Protocol**

**O. Definitions**

# SECTION III

## BOARD OF DIRECTORS IN A FAMILY BUSINESS

The board of directors is a central institution in the governance of most companies, including family-owned ones. The role, structure, and composition of the board of directors vary from one family business to another. These are usually determined by the size and complexity of the business and the maturity of the owning family.

During the first years of their existence, most family businesses create a board of directors in order to comply with legal requirements. Known as a “paper board”, its purpose is usually limited to approving the company's financials, dividends, and other procedures that require board approval by law. These boards usually meet about once or twice a year (depending on the local regulation) and their sessions last for a very short period of time. The board in this case is generally composed exclusively of family members and –in some cases- a few well trusted non-family senior managers. It is also very common to see the same individuals serve as managers and board directors, while being the company's owners. Such a governance structure adds little value to the family business as each element of this structure (board, management, and family) could separately play a more active and constructive role within the governance of the company. As a consequence, roles are mixed, possibly leading to conflicts and inefficiencies in overseeing the company and its strategic decision.

As the family business gets more complex, it becomes necessary to rely on the board to play an active role in more important matters such as setting the company's strategy and reviewing its management performance. These tasks require the board to meet more often and to have the necessary expertise and independence to challenge the company's management. This is when the family business board becomes more organized, well focused, and open to outside independent directors.

Before moving to a fully professional board that has the ability to act in the best interest of the business, independently from the management and controlling shareholders, many family businesses set up an advisory board that complements the skills and qualifications of their current directors. In this case, the advisory board closely works with the company's board of directors and senior management to address any key strategic issues that the business is facing.

## 1- Advisory Boards

### 1.1. Definition and Role of the Advisory Board

The advisory board is a group of experienced and respected individuals that many family businesses form when their own boards of directors remain only composed of family members and company senior managers. In this case, the board might lack expertise and outside perspective in certain strategic areas such as marketing, finance, human resources management, and international markets. Accordingly, the advisory board is then created to compensate for shortcomings of the board of directors without the family diluting any control over decision-making or being required to share information with outsiders. The advisory board can also add value to the family business through the business connections that its members might have.<sup>20</sup>

The advisory board is often considered a "compromise solution" between a family dominated and a more independent board. Many family businesses recognize the need for an independent board, but are also uncomfortable sharing sensitive company information and decision-making power with a group of outsiders. These family businesses usually opt for the creation of advisory boards as a way of getting outside advice and expertise while keeping control over the company's real board. Over time and once the family sees the added value of the advisory board, some of its members are often invited to join the company's board of directors.

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<sup>20</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

## 1.2. Composition of the Advisory Board

The most practical size for an advisory board is from 3 to 7 members. Keeping the size of this board small will help maintain its effectiveness and make it possible for its members to clearly communicate their ideas to the rest of the group. Members of the advisory board are usually experts in the family business' industry and market, or in other areas such as finance, marketing, and international markets. They also provide expertise and experience when the family business moves into new activities or countries. The advisory board usually meets 3 to 4 times a year, depending on the family business' size and complexity of operations. The CEO and a few senior managers from the family business can also be part of the advisory board in order to coordinate and orient the meetings' discussions towards the company's needs.

In order to ensure the objectivity of the advisory board members, the following individuals should not be part of this board:<sup>21</sup>

- Suppliers or vendors to the company.
- Friends of the owners with no relevant expertise to offer.
- Existing providers of service to the company (e.g., bankers, lawyers, external auditors, consultants), since their advice is already provided in other forms and their objectivity and independence might be questionable because they are working for and being paid by the company.
- Individuals who have a conflict of interest in being advisors to the company.
- Individuals who are already overcommitted and would not be able to correctly perform their roles as members of the advisory board.

## 1.3. Advantages and Disadvantages of Advisory Boards

The following table summarizes some key advantages and disadvantages of advisory boards:<sup>22</sup>

<sup>21</sup> Richard Narva and Beth Silver, "How to Create Effective Governance in a Family Controlled Enterprise", *NACD Directors Monthly*, August 2003.

<sup>22</sup> Adapted from: Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).



<b>Advisory Board</b>	
<b>Advantages</b>	<ul style="list-style-type: none"> <li>• Its members have no legal responsibilities; this reduces the company's cost (insurance is not necessary) and makes it easier to recruit members (since membership is not as risky as being part of the company's board of directors).</li> <li>• Can provide the company with additional skills, technical expertise, and knowledge that are not available at the current management and board levels.</li> <li>• Its advice is usually unbiased.</li> <li>• Its members may offer new contacts that can lead to additional sales or sources of capital.</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>• The advisory board functions like a group of experts whose advice is not systematically followed by the company. As a consequence, the advisory board might not be taken as seriously as a real board of directors.</li> <li>• The advisory board has no authority to request information from the management, so its recommendations can only be based on what management is willing to share with its members.</li> <li>• Advisory board members have little or no influence on the strategy and performance oversight of the management.</li> <li>• The lack of legal responsibility makes it difficult to hold members of the advisory board accountable for their advice.</li> <li>• Some advisory board members might not take their role seriously and put in the necessary preparation and contribution as they would as real board members.</li> </ul>

## 2- Board of Directors

### 2.1. Role of the Board of Directors

The core roles of a well performing board of directors are to *set the overall strategy* of the firm; *oversee the management performance*; and *ensure that an appropriate corporate governance structure is in place*, including a robust

control environment, sufficient disclosure levels, and an adequate minority shareholders' protection mechanism. The amount of time and effort allocated by the board to each of these areas will depend on the size and complexity of the family business. For example, a company with a few shareholders, simple business processes, efficient internal controls, and a high level of involvement of its owners in the operations, would need its board to focus more on strategy and long-term planning issues.

The board of a family-owned company should add value to the business, and not replicate activities already handled by other bodies of the company. For example, the board should guide, but not get involved in the day-to-day management of the company as this is fundamentally the task of the company's management. Moreover, directors should have the necessary resources and freedom to oversee and challenge the decisions and other actions performed by the management and/or family members.

In addition to strategy and oversight, some of the main tasks assigned to the board of directors include:<sup>23</sup>

- Securing senior management succession.
- Ensuring the availability of financial resources.
- Ensuring the adequacy of the company's internal controls and risk management systems.
- Reporting to the owners and other interested parties.

### 2.2. Composition of the Board of Directors

The composition and size of the board of directors will depend on the size and complexity of the company's operations. Although there is no simple formula for determining the proper number of directors for all family businesses, best practice recommends having a manageable board size, i.e. 5 to 9 members. The advantages of a smaller board size include an increased efficiency as directors will have better chances for communicating, listening to each other, and keeping the discussions on track. In addition, it is easier to organize board meetings and to reach the quorum for a smaller group than a larger one.

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<sup>23</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

In selecting their directors, family-owned companies should focus on individuals who will add value to the business and supply any necessary skills in the areas of strategy and/or management and operations' oversight. Furthermore, a successful selection of directors focuses on their potential contribution to the company rather than whether they belong to the family or not. In reality however, family businesses tend to have boards that are almost entirely populated by family members. The benefits of having a board that acts independently from the management and controlling shareholders will be discussed in section III-3 further below.

The following table summarizes some of the criteria that good directors should possess:

Personal Traits	Professional Qualifications
<ul style="list-style-type: none"> <li>• Personal integrity and accountability</li> <li>• Team work ability</li> <li>• Good communication skills</li> <li>• Leadership skills</li> <li>• Strong analytical skills</li> <li>• Courage, self confidence and ability to challenge other directors, family members, and senior managers</li> </ul>	<ul style="list-style-type: none"> <li>• Industry experience</li> <li>• Proper business judgment</li> <li>• Expertise and skills in relevant areas (to be defined by the company). These could include: Strategy; Marketing; Law; Finance and Accounting; Risk Management and Internal Control; Human Resources; and Corporate Governance</li> <li>• Useful ties and connections</li> </ul>

### 2.3. Duties of Directors

Directors are elected by the company shareholders and are supposed to act in the best interest of the company and to exercise care in doing so. The following are the main duties of directors:<sup>24</sup>

**Duty of Care:** Before making a decision, directors must act in a reasonable manner and make a good faith effort to analyze and consider all relevant and material information available for their consideration. Under the duty of care, directors must:

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<sup>24</sup> NACD, "The Board of Directors in a Family-Owned Business", *Director's Handbook Series*, 2004.

- Carefully study any material information available to them before taking any decisions.
- Act with diligence and competence.
- Make decisions on an informed and deliberative basis.
- Regularly attend the board's meetings, come prepared to these meetings, and actively participate in them (this part of the duty of care is also referred to as the "duty of attention" or "duty of obedience").

**Duty of Loyalty:** In performing their duties, directors must be loyal to the company, putting this loyalty ahead of any other interests. Directors cannot personally benefit from any action taken on behalf of the company. Under the duty of loyalty, directors must:

- Put the interests of the company above any personal or other interests.
- Immediately disclose any conflicts of interest to the rest of the board.
- Abstain from voting on matters that could involve a personal conflict of interest.

### 3- Independent Directors

#### 3.1. Importance of Independent Directors

Establishing a strong and independent board is a wise decision that most families in business take once their company's operations reach a critical size and complexity. A study conducted in the United States of more than 80 family-owned companies run by the third or later generation, showed that the existence of an active and outside (non-family-controlled) board was the most critical element in the survival and success of these companies.<sup>25</sup>

In reality however, when it comes to board membership, most family businesses reserve this right to members of the family and in a few cases to some well trusted non-family managers. This practice is generally used as a way of keeping the family control over the direction of its business. Unfortunately, the absence of outside independent directors might make it difficult for a family

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<sup>25</sup> John Ward, *Creating Effective Boards for Private Enterprises* (Family Enterprise Publishers, 1991).

business board to gain the knowledge and expertise that it is missing. Truly independent directors will also challenge the family thinking and add more discipline to the board meetings. In addition, the presence of independent directors during board meetings will discourage family members from wasting valuable time on family issues and concentrate on the business strategy and oversight instead. Finally, independent directors can also play the “buffer” role among different family members in case these have contradictory views on business issues.

Some of the advantages of having independent directors include:<sup>26</sup>

- Bringing an outside perspective on strategy and control.
- Adding new skills and knowledge that might not be available within the firm.
- Bringing an independent and objective view from the family.
- Making hiring and promotion decisions independent of the family ties.
- Acting as a balancing element between the different members of the family and, in some cases, serving as objective judges of disagreements among family-member managers.
- Benefiting from their business and other contacts and connections.

### 3.2. Definition of Director Independence

The definition of director independence differs from one market to another; however, its main components remain the same. The general principle is that an independent director should be free of links to management, controllers (family), and others that could influence his/her judgment. The following is the IFC definition of independent directors:

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<sup>26</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

## Indicative Independent Director Definition<sup>27</sup>

**“Independent Director” means a director who is a person who:**

1. has not been employed by the Company or its Related Parties in the past five years;
2. is not, and is not affiliated with a company that is an advisor or consultant to the Company or its Related Parties;
3. is not affiliated with a significant customer or supplier of the Company or its Related Parties;
4. has no personal service contracts with the Company, its Related Parties, or its senior management;
5. is not affiliated with a non-profit organization that receives significant funding from the Company or its Related Parties;
6. is not employed as an executive of another company where any of the Company's executives serve on that company's board of directors;
7. is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the Company or its Related Parties as an executive officer;
8. is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the Company or of a Related Party; or
9. is not a controlling person of the Company (or member of a group of individuals and/or entities that collectively exercise effective control over the Company) or such person's brother, sister, parent, grandparent, child, cousin, aunt, uncle, nephew or niece or a spouse, widow, in-law, heir, legatee and successor of any of the foregoing (or any trust or similar arrangement of which any such persons or a combination thereof are the sole beneficiaries) or the executor, administrator or personal representative of any Person described in this sub-paragraph who is deceased or legally incompetent,

and for the purposes of this definition, a person shall be deemed to be "affiliated" with a party if such person: (i) has a direct or indirect ownership interest in; or (ii) is employed by such party; "Related Party" shall mean, with respect to the Company, any person or entity that controls, is controlled by or is under common control with the Company.

<sup>27</sup> International Finance Corporation, <http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CGTools-FamilyFounderUnlisted>.

# SECTION IV

## SENIOR MANAGEMENT IN A FAMILY BUSINESS

Senior managers are an essential part of the family business governance structure and their quality directly affects the company performance and family wealth. The senior managers are in charge of implementing the strategic direction set out by the board of directors and managing the daily operations of the company. Having the right managers at the head of the company is a key element of family business success.

### 1- Family vs. Non-Family Managers

During the first years of their existence, family businesses are usually directed and managed by the founder(s). Their management structure may remain quite informal and the decision-making power is concentrated in the hands of the founder(s) and a few close relatives. This management structure usually works well during the early stage of development of the company. A driven and hard-working founder(s) is usually the main reason for the success of a family business at this stage.

As the company grows in size and its business operations become more complex, a more formal management structure, a decentralized decision making process, and a qualified management body become necessary to deal with the complexity of the business and the more challenging day-to-day operations. Unfortunately, many family businesses ignore the need for professionalizing their businesses and keep senior management positions exclusively for family members. Although many of these family members are skilled managers that add value to their business, often they are not qualified to perform such duties. Even in the cases where all family members are good managers, they may not have the specialized skills and expertise that the growing and more complex company requires. Successful families in business understand that in the longer term, some family members should step down and be replaced by more professional and skilled outsiders.

Ensuring that the family-owned company has the right senior managers is a process that should start early, even as early as during the founder(s) stage of the family business. Some of the steps of this process are:

- Analyzing the organizational structure and contrasting the current and optimal roles and responsibilities (compared to peer companies) of each senior manager.
- Designing a formal organizational structure that clearly defines the roles and responsibilities of all senior managers. This should be based on the company's current and future business operations' needs.
- Evaluating the skills and qualifications of the current senior management based on the new organizational structure.
- Replacing and/or hiring senior managers.
- Decentralizing the decision-making process and approval levels as necessary. Decision-making powers should be linked to the roles/responsibilities of managers and not to their ties to the family.
- Establishing a clear family employment policy and making its content available to all family members (see section II-1-1 of this Handbook for more details on family employment policies).
- Developing an internal training program that allows skilled employees to be prepared for taking on senior assignments in the future.
- Establishing a remuneration system that provides the right incentives to all managers depending on their performance and not their ties to the family.

The following table summarizes how family businesses address some employment issues depending on whether they are prioritizing the family or the business:<sup>28</sup>

Issue	Family First Companies	Business First Companies
<b>Employment Policy</b>	<i>Open door policy for all family members. The family-owned company often becomes a safety net for those who can not succeed outside the business.</i>	<i>Only qualified family members join the company. Conditions for family employment are clearly set and contain requirements concerning education and prior work experience outside of the family business.</i>

<sup>28</sup> Mike Cohn, "Does your Company Put Family or Business First?", *The Business Journal of Phoenix*, January 2005.



(continued)

Issue	Family First Companies	Business First Companies
<b>Compensation</b>	<i>Equal pay for all. Everyone is paid the same, regardless of their experience and contribution to the business. Competent family members are expected to care for (via compensation, benefits, etc.) their less-than-competent siblings or cousins.</i>	<i>Compensation is based on performance and responsibility. Compensation is based on market and industry measures, not on family needs. Accountabilities and reporting relationships are clearly communicated and understood. High performers are highly paid. Family members may be terminated for poor performance.</i>
<b>Leadership</b>	<i>Leadership is based on seniority, rather than demonstrated competences or successes. Longevity in the family business may be more highly valued than working and succeeding outside the business.</i>	<i>Making sure leadership is earned. The family mantra is to have “the best and the brightest” running the business: family or non-family. Non-family senior executives may be recruited from within the industry although some companies successfully grow their own top managers.</i>
<b>Business Resources Allocation</b>	<i>Business resources are used for family members’ personal needs (housing, cars, personal purchases, etc.)</i>	<i>Business resources are used strategically. There is a clear separation of business and family assets. Budgeting and planning are important; earnings are used for growth initiatives or paid out as dividends.</i>
<b>Training</b>	<i>No formal training programs. Family members are expected to intuitively learn business practices.</i>	<i>Need for formal training is timely recognized. Trainings are scheduled and delivered to teach family members necessary business practices.</i>

## 2- CEO and Senior Management Succession

CEO and senior management succession is probably the most important issue that confronts companies, including family-owned ones. This is because a company's top managers are usually the drivers of its performance, growth, and survival. The issue of management succession is even more important for family businesses as it becomes particularly thorny as the family grows larger and several potential senior management candidates from different branches of the family become available. Many family businesses put off the succession planning of their senior managers until the last minute, which leads to crises that sometimes can cause the death of the family business. Poor senior management succession planning could indeed be one of the reasons most family businesses disappear before they reach their third generation.<sup>29</sup>

This section of the Handbook will mainly provide some basic advice on establishing a sound CEO succession planning process within the family business. Most of this advice can also be used for ensuring a smooth succession for the other senior managers of the family business.

Families in business might ignore the necessity of planning for the succession of their CEO for a multitude of reasons. Some of these reasons include:<sup>30</sup>

- Family members delaying the decision in order not to create potential frictions among family members in case several potential CEOs are available within the family.
- Family members delaying the decision because no current family member or outsider is deemed capable of replacing the current CEO.
- Family members avoiding to address this issue in order not to discuss the topic of the eventual loss of a family leader (the current CEO).
- Current CEO refusing to admit that the company can survive without him/her and/or is afraid of retirement and refusing to address succession issues.

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<sup>29</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

<sup>30</sup> Ivan Lansberg, "The Succession Conspiracy", *Family Business Review*, June 1988; Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

## 2.1. Importance of a Formal Senior Management Succession Plan

Senior management succession is a process that follows several steps in order to ensure proper succession to key management positions including the CEO one. A formal succession plan ensures business continuity and thus increases the chances of survival of a family business as it is handed over from one generation to the next. The purpose of this plan is to ensure the skills and leadership necessary to replace any outgoing senior manager are available when needed. An effective CEO succession plan should allow for the selection of the most competent person (whether it is a family member or not) as the next CEO. In addition, it is crucial to involve all family members, the board, key senior managers, and other important external stakeholders in the selection process and make sure they agree on the next CEO choice.

## 2.2. Steps of a Formal CEO Succession Plan

The CEO succession planning process usually differs from one family business to another depending on the complexity of the business, the degree of involvement of the family in it, and the availability of competent CEO candidates from within the family. The following is a step-by-step process that can help family businesses get better prepared for their CEO succession:<sup>31</sup>

**Starting Early:** Many family business advisors recommend starting the selection process of the next CEO as early as when the current CEO is appointed. This will ensure the continuity of the business and provide the company with a new CEO that was carefully chosen and well-prepared to succeed to the current one. The early start of the CEO selection process is particularly important if the next CEO is expected to be chosen from within the family. In this case, the process of selecting and grooming the next CEO from the younger generation would take longer than if the CEO is to be chosen from outside the family.

In most family businesses, it is the current CEO who initiates the succession planning process. An active board can also play an important role by insisting on the establishment of a succession plan in case the current CEO is not taking this on early enough.

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<sup>31</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

**Creating Career Development Systems:** A successful succession plan is one that selects the best possible candidate for the job, regardless of whether this candidate is related to the family or not. If the next CEO will be chosen from the family or its current employees, a rigorous career development system should be developed to prepare the potential CEOs. Such a system would enhance the competence of the CEO candidates by offering them any necessary education, training, and by giving them periodic feedback on their performance within the company.

Some family businesses decide to hire an external CEO if no good CEO candidates are available from within the family or its employees. In this case, a committee of the board (Nomination Committee for example) should lead the succession planning of the CEO. The committee would start by setting the selection criteria for the next CEO before searching for suitable candidates. In addition, many family-owned businesses find it useful to employ professional headhunters to get access to a wider pool of candidates.

**Seeking Advice:** Particularly while narrowing the list of potential successors, the CEO should get advice from the external independent directors of the board. If these don't exist, trusted senior non-family managers should be consulted. Some families also find it useful to get the opinion of the family council in the selection process, especially if the CEO candidate is from the family.

**Building Consensus:** The success of the future CEO is largely dependent on his/her acceptance by the key stakeholders involved in the company. It becomes then mandatory to involve all key stakeholders in the CEO selection process including the board of directors, senior non-family managers, and family members.

**Clarifying the Transition Process:** Once an adequate succeeding CEO has been selected, a clear transition process for both the current CEO and the successor should be developed. This transition process would specify the transition date and also define the levels of involvement of the current CEO after retirement (advice to the successor, board membership, additional activities, etc.).

# SECTION V

## FAMILY BUSINESS GOING PUBLIC

### 1- Why Go Public? Why Not?

Many family businesses take the decision of going public at some stage in their life to be able to secure financial resources for the business expansion or to give its shareholders a way of selling their shares in case they prefer to cash them in. Going public is a complex process that requires careful consideration of the alternatives, plenty of preparation from the board and the management, and extensive outside specialists' advice. Going public is also a decision that presents many advantages and disadvantages to the family business.

#### 1.1. Advantages of Going Public for a Family Business<sup>32</sup>

Going public may offer several advantages to family businesses and their shareholders, including:

**Improved Marketability of Shares:** This makes it possible for family shareholders to sell their shares at the prevailing stock price in the open market. It also makes it easier for shareholders to use their shares as collateral to obtain loans. As a result, the improved marketability of the company's shares helps reduce family issues as it solves the liquidity needs for shareholders who prefer to hold their wealth in assets other than their interest in the company.

**Improvement of the Company's Financial Position:** This is a direct result from selling the company's shares to the public. The stronger financial position makes it easier for the company to seek loans and to negotiate the terms of these loans.

**Potential Increase in the Value of the Shares:** Many family-owned companies that went public saw their stock price rise above the initial estimation made by the investment banking firm. This increase in value is partly due to the willingness of investors to pay a higher price for the company's stock

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<sup>32</sup> Monica Wagen, "Perspectives on Going Public", *Family Business*, Spring 1996; Fred Neubauer and Alden G. Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

because of its greater credibility as a public company, the improved marketability of the shares, and the increased transparency of accounts.

**Greater Visibility:** Going public gives family businesses increased prestige and visibility in the market. Markets tend to perceive public companies as professionally managed and more transparent (audited accounts and periodic publication of financial statements and performance data). As a result, a family business that goes public might increase its visibility in the market.

## 1.2. Disadvantages of Going Public for a Family Business<sup>33</sup>

Going public may also present potential disadvantages to family businesses. Some of these disadvantages are:

**Loss of Privacy:** This is probably the most unwelcome outcome of going public for family businesses. Indeed, once public, the family business will have to reveal more information than before, including: detailed financial statements and other performance measures, and any advantages given to family members.

**Loss of Autonomy:** This is a consequence of the arrival of new shareholders after the family business goes public. Even in cases where the family remains a controlling shareholder, minority shareholders have rights that will make it difficult for the original family members to operate unfettered.

**Increased Liability:** Public companies have a higher liability than their counterparts. For example, public companies have to make sure that all the information that they provide to their shareholders and to the market is accurate.

**Possibility of a Takeover:** If enough shares have been issued to outsiders during the process of going public, it could be possible for competitors or other investors to gain control over the family business.

**Additional Costs:** The initial cost of going public can be quite substantial. Some of the potential components of this cost are: underwriter's commission, auditing fees, legal fees, and any registration costs. In addition, once public, the company will

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<sup>33</sup> Fred Neubauer and Alden G.Lank, *The Family Business: its Governance for Sustainability* (Routledge New York, 1998).

incur additional costs such as audit fees, periodic disclosure of financial information costs, and any other compliance requirements' fees for public companies.

## 2- Getting Ready for an IPO

Going public is a long and complicated process that does not take place overnight. Family businesses that are planning to go public have to get professional advice and help in many legal, technical, financial, and marketing areas. In addition, many investors are now requiring the companies that are going public to show a long-term track-record of good corporate governance practices before the actual IPO. In particular, investors and the market highly value the company's practices in the areas of the board of directors, shareholder rights, and transparency and disclosure.

The following table provides a summary of key corporate governance practices that would help convey a positive image to the market about companies that are preparing to go public. Of course, most of these practices need to be put in place a few years before the IPO in order to show a good track-record of adequate governance to the market and potential investors.<sup>34</sup>

Governance Attributes	Examples of Best Practices
<p><b>Shareholder Rights</b></p>	<ul style="list-style-type: none"> <li>• Clear protection of minority shareholders in charter, by-laws, and company governance code.</li> <li>• Adequate notice and shared agenda of all shareholders' meetings.</li> <li>• Ability to participate and vote meaningfully at shareholders' meetings (e.g., cumulative voting for directors).</li> <li>• Fair treatment regarding information disclosure (material shareholder agreements, conflicts of interest, etc.)</li> <li>• Clarity in rights of different classes of shares – voting rights vs. economic rights.</li> <li>• Equitable treatment in changes of control (e.g., tag-along rights).</li> </ul>

<sup>34</sup> International Finance Corporation, [www.ifc.org/corporategovernance](http://www.ifc.org/corporategovernance).

Governance Attributes	Examples of Best Practices
<p><b>Board of Directors</b></p>	<ul style="list-style-type: none"> <li>• Right mix of professional skills (e.g., marketing, strategy, international financial markets, and audit committee expertise).</li> <li>• Strong independence component.</li> <li>• Separate chairman and CEO roles.</li> <li>• Regular schedule and agenda of meetings.</li> <li>• Existence of board committees responsible for oversight in key areas (Audit, Governance and Nomination, and Remuneration).</li> <li>• Initial and continuous director education.</li> <li>• Periodic evaluation of directors.</li> </ul>
<p><b>Transparency and Disclosure</b></p>	<ul style="list-style-type: none"> <li>• Information prepared and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure.</li> <li>• Annual audit conducted by an independent, competent, and qualified auditor in accordance with the International Standards on Auditing.</li> <li>• External auditors accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of their audit.</li> <li>• Channels for disseminating information should provide for equal, timely, and cost-efficient access to relevant information by users.</li> </ul>



## Conclusion

Family businesses are the backbone and the main driver of growth in many, if not most economies. Because of their nature, family businesses face many additional challenges to those that their counterparts have to deal with. Some of these challenges can be addressed by adopting a sound corporate governance structure within the company. This governance structure should clearly define the roles, responsibilities, rights, and interaction among the company's main governing bodies.

The responsibility for corporate governance tasks in a family business is generally shared among the owners, the board of directors and the senior management. However, family members probably have more responsibility in ensuring that their business is governed in a way that will make it viable and sustainable in the long term. In addition, family members' duty is not only limited to the governance of their company, they are also responsible for the governance of their family and its relationship with the business. Setting up a solid family governance system early in the lifecycle of the family will help anticipate and resolve potential conflicts among family members about business issues. This will make it possible for family members to concentrate on other key issues such as growing the business.

In addition to their own governance, family members have to set up an adequate structure for their company's board of directors and senior management. A skilled, predominantly independent, and well organized board of directors would make it possible to set the right strategy of the company and properly oversee its management's performance. Also, a professional and well-driven management is essential to running the day-to-day activities of the company. The choice of directors and senior managers should be based on their qualifications and performance and not on their ties to the family.

Finally, it is very important that families in business become aware of the importance of these issues and start building an adequate corporate governance structure as soon as possible. Waiting until the size of the family is very large, and its business operations more complex would make it very difficult to address the already existing conflicts between family members. A timely and clear governance structure would make it easier to maintain family cohesion and its members' interest in the family and its business.

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