Corporate rules and regulations for family businesses

By Luanna McGowan

Family businesses can learn from larger public corporations and adapt the new governance trend of independence to suit their own business needs

THE DOWNFALL of companies like Enron and WorldCom has shaken the foundations of corporate governance. The consequences of these scandals are not limited to large public companies in the US – they have a much more far-reaching effect. In virtually all developed nations, investor confidence has been eroded. The US has responded by enacting the Sarbanes-Oxley Act in hopes of eliminating corporate abuses of public trust. While the Sarbanes-Oxley Act applies to publicly traded companies listed on US exchanges, privately held companies from around the world could also benefit from modelling some of the changes legislated by the Act.

The Sarbanes-Oxley Act (the 'Act') provides for greater independence on the board of directors and enhances the standards for accountability of the CEO. For companies to be listed by the Securities and Exchange Commission (SEC), they must follow the rules set out by the Act including creating a completely independent Audit Committee, providing enhanced disclosures to stockholders and requiring the CEO and CFO to certify quarterly and annual reports to the SEC, including making representations about the effectiveness of specified controls. The Act also lays out stricter penalties for fraud and so-called 'white-collar' crimes, including larger fines (some offences up to US$25,000,000) and longer prison terms (up to 20 years).

The Sarbanes-Oxley impact on private companies

Although this Act is aimed at publicly traded companies, what does this mean for privately-held companies and family-owned businesses? Privately-held companies need to take into consideration the consequences of the Act in a number of situations. For example, if a private company intends to go public on a US exchange at some time in the future, that company would have to be compliant with some provisions of the Act upon its initial filing with the SEC and with other provisions upon its registration statement being declared effective. Also, if a privately-held company merges with, or acquires a public company listed on a US exchange, it also should have the measures and controls in place prior to the transaction.

But, what implications does the Act have on privately-held firms not considering an IPO or merger? Public trust in any organisation has been shaken by recent stories of gross misconduct by large corporations. Potential investors, business partners, employees and other entities with whom a private company needs to do business are likely to be influenced by how they see public companies operating, not to mention what they see on the news. So, what can private companies and family-owned businesses do to ensure that their businesses do not succumb to the mistrust of others? The answer may lie in the principles in which the Sarbanes-Oxley Act is grounded – implementing and maintaining good governance structures.

Public trust in any organisation has been shaken by recent stories of gross misconduct by large corporations

Governance

The board of directors is a powerful body in the structure of a large corporation. Board members are elected by the shareholders of the company and are required by law in virtually all countries to protect their interests and monitor operations on their behalf. Typical functions of a board include selecting and evaluating the CEO, approving strategic plans, planning for management succession and monitoring business operations.

Governance for family-owned companies typically differs from non-family companies given the unique structure of a family business. Each system in a family business has its own distinct governing body. The family system, for example, is governed by a

Fmaily businesses need to create a more formal structure around their governance processes

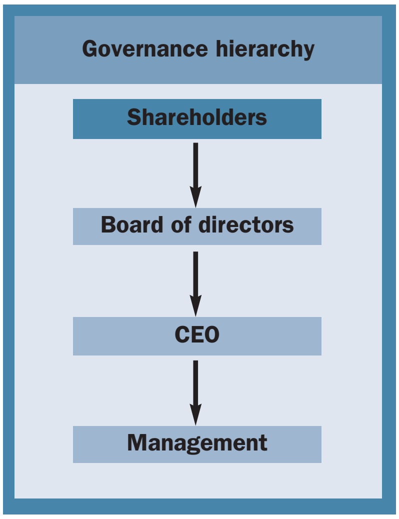
family council. A family council is made up of a group of family members who represent the entire family and addresses issues pertaining specifically to the family and the family's involvement in the business. Typical functions of a family council include creating policies (eg family participation plan, code of conduct), and educating other family members about the business.

The ownership and management systems, as with non-family businesses, are governed by the board of directors. Many family firms, however, do not have a formalised board of directors or do not use their existing board to its fullest potential. Laws governing incorporation generally require the business to form a board of directors. Typically in a family business, the owner and his or her spouse are the only directors of the corporation and informal annual board meetings take place (or are deemed to have taken place) for the sole purpose of satisfying legal requirements. As the family business grows, the board generally grows to include family members, friends of the family and advisors. While seemingly logical choices, these members typically bring in an inherent conflict of interest to the boardroom. One of the legal functions of a board is to oversee the management of the corporation. In its truest sense, this can mean challenging the CEO on business decisions. For 'insiders' such as family members, friends and advisors, this can be extremely difficult.

Occasionally, family members who are not working in the business but who own shares are given a seat on the board. Non-active shareholders, however, typically have different interests than active shareholders. For example, non-active shareholders may be more interested in receiving dividends instead of re-investing the profits back into the business. Non-active shareholders may also have little or no knowledge of the business and its operations. These situations may create tension with active members (and therefore in the family) given the divergent needs, interests and knowledge of active and inactive shareholders. Family members should consider carefully the benefits and challenges of having non-active shareholders on the board.

Improving governance in the family business

To avoid potential distrust from external stakeholders and partners, family businesses need to create a more formal structure around their governance processes – primarily with respect to the board of directors. The potential negative influence of the family dynamic on the



business can be neutralised by having outside directors sit on the board. This is somewhat similar to the independence requirement of public corporations under the Sarbanes-Oxley Act. Outsiders can be defined as someone who is not a family member, employee, friend of the family or advisor to the family or company. The purpose of having an outside director, however, is not to suggest that there is any misconduct or suspicion of misconduct on the part of the CEO in the operation of the business, nor is it to act as a mediator for family disputes – an outside director makes a statement to the community about a family business's commitment to 'professionalising' the company and also can strengthen the confidence of outside advisors, customers, suppliers and any business partners or investors.

Finding outside directors, however, can be a difficult task. Shareholders should begin with determining the attributes of an outside director that best complement their current board composition – whether it be industry expertise, strategic planning expertise or strong business acumen. The search for board members can begin by canvassing existing advisors for referrals or approaching peers in the business community. Candidates should have several years of business experience, at least a general knowledge of the industry and strong interpersonal skills. Someone with knowledge of, or sensitivity to, family business issues also could be invaluable to a family business.

Although many advisors recommend refraining from having family members sit on the board, the reality is – many family businesses do. So, what can be done to improve the functionality of the family board? According to Paul Lapides of Kennesaw State University, "My experience is that 80–90% of people who sit on boards do not know the purpose of the board, understand their duties, or how to execute them. Part of this issue is about just plain education" (*Emerging Trends in Corporate Governance*, 2002). As directors, family members should know how to read financial statements, be aware of their legal duties as a director, and have an understanding of the operations of the business and the environment in which it functions. Executive education and internal seminars can help educate family members on such matters.

In the wake of recent scandals such as Enron and legislation such as the Sarbanes-Oxley Act, corporate governance is going through a reformation period. The basis for much of the reform, largely due to the requirements outlined in the Sarbanes-Oxley Act, revolves around strengthening governance structures and increasing board independence. Family businesses can learn from the larger corporations and adapt the new governance trend of independence to suit their own business needs. Greater independence on family business boards can fortify the level of confidence outsiders such as customers, suppliers, bankers and partners have in the business and reaffirm to the community at large the family's commitment to the long-term success of the company. ■

Luanna McGowan *is the Canadian National Partner of PricewaterhouseCoopers' Centre for Entrepreneurs and Family Business. She is a lawyer and facilitator and has worked with entrepreneurs and family businesses from several industry sectors to develop succession and strategic plans.*