Chapter 10

The Family Constitution as an Instrument of Corporate Governance in Family-Owned Companies*

Patrick Ulrich and Sarah Speidel

Aalen University, Aalen, Germany

Abstract

In recent years, the corporate governance structures of family businesses have become increasingly important to the public. This is due not only to the increasing number of corporate successions but also to the (still) lower degree of formalization of corporate governance in family-owned companies. In this chapter, the authors analyze theoretical and empirical findings on family governance with a focus on family constitution and present the results of their own exploratory empirical survey conducted in 2017.

Keywords: Family constitution; motives for introducing the family constitution; motives for not introducing the family constitution preparation process of the family constitution; survey data; Germany

*This chapter is based on an article by Ulrich and Speidel, which was published in Zeitschrift für Corporate Governance 5/2017.

Family Firms and Family Constitution, 165–173

doi:10.1108/978-1-83797-200-520231010

10.1. Introduction

In recent years, research and practice in business administration have increasingly been devoted to family businesses, as these have been neglected by business administration in the past decades (Priem & Alfano, 2016). In addition to the special economic and business management features, i.e., corporate management in general, financing, company succession, external management and other business management functions, work on the special features of corporate governance in family-owned companies is also increasingly being published. This is of increasing interest not only in Germany, but also in the international environment (Daspit et al., 2017).

For the German situation of family-owned companies, there is an interesting area of conflict: On the one hand, family-owned companies are regarded by the general public as particularly successful, good employers who operate successfully on a sustainable basis. On the other hand, recent cases such as Aldi, Oetker, and Tönnies have also become known in which disputes within the family have had a negative impact on the respective companies.

In this area, both classic instruments of corporate governance and special instruments of family governance can contribute to the reduction of information asymmetries. One of these mechanisms is the family constitution. This term is used in this chapter as a collective term for documents that can be referred to in practice as a family code or family mission statement, for example, and which can be used as a basis for discussing structures and strategies in the family context. Several studies have already been carried out here on family businesses (Fleischer, 2016; Mengers & Prigge, 2017).

This chapter examines the theoretical and empirical findings about the family constitution. The further progress of the contribution is as follows. First, the mechanisms of corporate governance in family-owned companies are briefly described before an introduction to the family constitution is given. Section 4 contains the empirical findings. The chapter concludes in Section 5 with a summary.

10.2. Mechanisms of Corporate Governance in Family Businesses

In principle, corporate governance functions differently in family-owned companies than in non-family businesses, as the additional "family" system joins the established "company" and "management" systems. As a result, this leads to changed principal-agent-constellations, which depend on the number of persons, but also on the number of generations, family relationships, and the distribution of rights of disposal. In principle, three interest situations can be distinguished (Becker & Ulrich, 2008):

- The owner-managed company, which is managed by a person who holds all shares in the company, does not have any principal-agent conflicts;
- In the family business, in which $n > 1$ persons from the family/several family tribes are involved in ownership and management, there are multiple conflicts of interest between persons within and outside the family;

- In an externally managed company in which the family has withdrawn from operational management, there are not only the "typical" principal-agent conflicts, such as the monitoring of external management, but also the question of which persons from the family or the participating tribes may be represented in the company.

As a result, asymmetries appear in the three configurations mentioned above, which are negative for the company's added value and therefore have to be "managed." This can be done by means of a catalogue of governance instruments, which are themselves liable to pay costs but can reduce agency costs.

In general, corporate governance is less formalized in family businesses than in non-family businesses (Klein, 2009). Written or formal mechanisms are partly or completely replaced by the corporate culture and the cohesion of the actors in the company, so that the lower degree of formalization of corporate governance does not pose a major problem for quite simply structured family-owned companies. However, given the increasing complexity caused by the size of the company, the product portfolio, internationalization processes or, above all, the increasing number of, or conflicts of interest between, family members, these informal mechanisms may reach their limits, which is why special instruments such as an advisory board, a shareholders' committee or other family-related measures (e.g., family office, family activity, and family philanthropy) can be supplemented. These instruments also include the family constitution, which is briefly discussed below.

10.3. Effects of the Family Constitution in Business Practice

The family constitution is a written document that contains the fundamental convictions and principles of the entrepreneurial family. It is an identity-forming model and its principles of action are intended to regulate the relationships between family members and the interaction between family and company. This instrument has its origin in the Anglo-American legal system, where the term "Family Business Protocol" has become established (Brenes et al., 2011). In Germany, the family constitution is often referred to as the "Family Charter," "Family Protocol," or "Owner's or Family Strategy" (Kirchdörfer & Lorz, 2011).

The family constitution is informal. In the first step, it is not legally binding or enforceable and is not formulated in a legally precise manner. It is written in a generally understandable way and can rather be declared as a declaration of intent, with a moral binding effect at most. In its nature and function, it is to be distinguished from the social contract. It precedes other treaties. Thus, many of their rules result in contracts of association, inheritance or marriage, making them legally binding and enforceable. In order to avoid problems with the legal interplay of the rules and regulations with different legal status, the contents of the family constitution should be clearly formulated and, if possible, should appear in identical terms in contractual agreements. In the event of deviations, the family constitution clearly has no legal provisions. However, it often has an indirect influence on the interpretation of other treaties and can thus possibly affect their regulations.

The family constitution is an opportunity for the entrepreneurial family to reach a consensus (Zellweger & Kammerlander, 2015). Raising awareness of matching goals strengthens the family. But also the understanding of conflicting goals can be used to counteract conflicts in a clarifying way and to preventively counteract disputes. All family members are included. Decision autonomies are removed, arbitrariness and abuse of power are reduced (Baus, 2013).

The road to a family constitution entails further risks. There is a danger that the family constitution will be filled in with complex topics that should be reserved for the articles of association and that they will be regarded as a substitute for it. The regulations of the family constitution then run into a void due to their legal non-binding nature and are not necessarily effective. Furthermore, differences between the family constitution and the articles of association may also give rise to legal problems. A further danger lies in the fact that goals are set without reference to the entrepreneurial reality or regulations overshoot goals. As positive as the dismantling of the information asymmetries is, individuals can lose in this process. They may have less power, a different position or less financial support as a result of new regulations.

According to the results of an empirical study by the INTES Institute, older and larger family-owned companies with a diversified shareholder structure and external management as well as supervisory bodies dispose more often of a family constitution (Schween et al., 2011).

10.4. Own Empirical Findings

10.4.1. Characterization of Survey and Sample

The quantitative-empirical survey conducted in January 2017 is based on the data of 65 family-owned companies in Germany. In order to obtain the data, a computer-assisted questionnaire was provided in the form of an online survey, enabling a large number of potential participants to be reached. The information on the companies and respondents was completely anonymous, and the standardization of the questionnaire ensures the comparability of the results. The survey was based on the 1,000 largest family-owned companies in Germany according to “DIE DEUTSCHE WIRTSCHAFT.” Here, the addresses of 986 companies could be identified (http://die-deutsche-wirtschaft.de/die-liste-der-1000-groessten-familienunternehmen-in-deutschland; last accessed December 7, 2021). The return of 65 completed questionnaires corresponds to a response rate of 6.59%.

For the present study, a family business was defined as follows: The company has more than 20 employees and the founder or a member of the founding family leads the company or has a dominating influence in the supervisory or advisory board.

The economic sector, legal form or turnover do not constitute sound selection criteria within the scope of this survey, as no representativeness was sought. The various structural features of the survey show the diversity and individuality of family businesses. The arithmetic mean of the number of employees and turnover is 3,329 and €730 million, respectively. The majority (57%) of the participating companies are attributable to the manufacturing industry. Most companies are incorporated as a GmbH (35%) or as GmbH & Co. KG (30%). The youngest companies are run by the first generation whereas the oldest companies are in the hands of the ninth generation. The ownership structure ranges from sole proprietor to stock exchange listing. However, all participating companies have strong family ties, 90% of the companies are wholly owned by a family or an individual and at the same time completely controlled by a family or an individual. For approximately 30% of the companies surveyed, ownership and management are identical (owner-managed), for 45%, at least a part of the owner family represents the management level (family-managed) and for a quarter of the respondents, the family controls the outside management via a supervisory board (family-controlled).

The results of the investigation were evaluated narratively in the sense of Alvesson (2003). This means that in the following important statements of respondents by highlighting the citations in double quotation marks.

10.4.2. Characteristics and Management of Family Businesses

The family-owned companies surveyed are characterized by "flat hierarchies" and the associated "short decision-making paths." A specific behavior is their "long-term orientation" and "thinking in generations." In addition to the "awareness of tradition," a "good working atmosphere" and "employee friendliness," the companies generally perceive themselves as "innovative" and, with regard to the workplace, as "safe."

The companies have a "reserved, self-confident appearance," with a "healthy distance to fashion trends." They are "down-to-earth in their thinking and acting" and they are guided by "strong values," an "appreciation" and a "focus on the essentials," "products and customers are at the centre" and "high quality of products and services" come before "return" in their companies. For the employees, there would be a "variety of tasks through broad diversification" with "plenty of scope for new projects." The family-owned companies frequently have a "strong regional link," operate "regionally" and "consolidate Germany as a business location." In this way, they assume a "high level of social responsibility for the people in the region." All of the above-mentioned characteristics can be described as characteristic for family-owned companies, but they are not unique to them.

The management structure of family-owned companies is often oriented toward the managing (family) partners. The respondents are also characterized by strong personal ties. People talk about a "personal bond," "close contact with the workforce," "appreciation," and "strong values." The "executives are close to the employees," the management is "visible and responsive." There is a "high level of delegation" and a "leadership through trust." "Humanity in dealing with each other" is also often mentioned. Employees often perceive themselves as "part of the family" who bring in their "skills for the benefit of the company." However, it also points out possible weaknesses in companies, such as "excessively high fluctuation among managers" or "a fairly high workload because resources are being kept scarce." Sometimes "decisions in difficult, painful structural decisions are delayed too long, which often discourages top performers."

10.4.3. Corporate Governance and Family Governance in Family Businesses

For the companies surveyed, the term corporate governance is more commonly used overall and there are more instruments in existence. About 97% are familiar with the term corporate governance in the corporate context and almost three quarters of the companies have professionalized their management and monitoring structures in the form of corporate governance. In concrete terms, this means that bodies such as a shareholders' meeting, an advisory board or a supervisory board are established within the company. On average, the companies surveyed have set up two bodies, with 38% of the respondents representing a combination of shareholders' meeting and advisory board.

Only around 70% are familiar with the concept of family governance, while just under a quarter professionalized organization of the owner's family. A quarter of the companies surveyed with a family governance structure have fixed family values, a partnership agreement or a family meeting. Half of them have further education programmes (family education), common non-profit activities, such as a foundation, or conflict resolution mechanisms. One-third of the respondents have established a Family Council or Family Office. Approximately one-sixth uses a communication platform within the company, such as an app or a newsletter. On average, respondents have established five family governance mechanisms.

10.4.4. Family Constitution as an Element of Family Governance

Within the framework of family governance, many companies adhere to informal rules. They see themselves as a "community of values where the unwritten word counts." Other companies document their values, goals, and rules in a written family constitution.

More than half (57%) of all companies surveyed have drawn up a family constitution. Although this topic is still relatively new in the scientific literature, 72% of companies with a family constitution already have regulations in place for between 1 and 10 years. Companies with a family constitution are not significantly larger or older than those without this set of rules. It is also not possible to establish a correlation with the generation, the age of the company or the number of employees.

The most important motives for the introduction of a family constitution include safeguarding the company's future (28%), conflict prevention (17%), the question of filling positions in the company (17%), and succession planning (14%). Otherwise, determining who is a member of the entrepreneurial family (11%), the qualifications required to fill positions with family members (8%), the withdrawal of (family) shareholders (3%), and the financing (3%) are motivations for drawing up a family constitution. Overall, 97% of the entrepreneurial families hope for an emotional added value through the family constitution. Only 3% of the entrepreneurial families primarily aim for an economic increase in the value of the company. The expectations of the family constitution were fulfilled in all participating companies with a gradation of "rather yes" (50%) and "yes, totally" (50%).

The preparation process itself is important for the family of entrepreneurs. During the preparation of the family constitution, the owners get to know each other better with their interests, expectations, strengths, and weaknesses and have the opportunity to take preventive action against conflicts. Two-thirds (67%) of the participating companies received the impetus for the elaboration from the shareholders themselves. Otherwise, family members on the board of directors (11%), the family tradition (11%), or the advisory board (11%) were decisive for drawing up a family constitution. The process of drafting a family constitution took between six and twelve months for two-thirds of those surveyed (67%).

A family constitution must be filled with life, so that it brings strategic benefits and emotional added value. It is also advisable to adapt it regularly to the individual and constantly changing situation of the entrepreneurial family. In 89% of the companies surveyed who have a family constitution, the values, goals, and regulations of the family constitution are actively exemplified. 11% would like to see even greater compliance. Three-quarters of those surveyed have already reviewed their family constitution and adjusted it if necessary. The first adjustment takes place on average after three to four years.

Less than half (45%) of companies that do not have a family constitution still want to introduce such a set of rules. The instrument of family constitution is also generally considered beneficial for family businesses that do not have such an instrument. As a reason why no regulatory framework has been developed, half of them state a lack of information, with 36% having too little information about the family constitution as an instrument of family governance and 14% having too little information about the preparation process. 21% do not see any relevance for their company, for example "because the company is under patriarchal management in the first generation and the family constitution is not planned until the next generation," because "the company itself is too small for such an instrument," or the potential contents of the family constitution are "regulated by the supervisory board." No relevance is also mentioned because, for example, a "small family" leads and therefore "little potential for conflict" is seen. One participant says: "Paper is patient. Life is always more colourful than you think…." In each case, 7% point to a lack of expertise in drawing up, lack of time or an extensive partnership agreement. For no company surveyed, a high level of effort or the costs associated with the preparation of the survey is a reason against the family constitution.

10.5. Recommendations for Action and Conclusion

This section links this chapter with extant theoretical and empirical findings on family governance and family constitution. The empirical study on which the chapter is based shows that, in contrast to the study conducted by Schween et al. (2011) for example, there are no effects of contextual factors such as company size, industry sector, or the existence of a supervisory board. The family constitution seems to have prevailed at least in the sample.

At the same time, respondents to the study still list the disadvantages of an additional set of rules that may conflict with the existing company agreement.

Certainly, the family constitution is not a panacea, it must always be adapted to the situation and supplemented by other mechanisms such as mediation.

From a theoretical point of view, this contribution shows that the assumption often mentioned in the literature, that stewardship theory prevails over principal-agent theory in family businesses, does not necessarily have to be correct, because the family constitution can also be interpreted as a reaction to an increase in principal-agent conflicts within the family (Siebels & zu Knyphausen-Aufseß, 2012).

The empirical study outlined in this chapter is itself subject to several restrictions: On the one hand, it was only carried out for larger family-owned companies at one time and only one respondent was interviewed for each company. Since the family constitution is an individual issue, a qualitative, long-term field study approach for the assessment of mechanisms of action for the future would also be a promising approach to the further development of theory and empiricism.

In practice, several conclusions can be drawn from the remarks in this chapter: The family constitution has become an established tool for the larger family-owned companies. The participants in the study questioned whether this is also always the case for smaller family-owned companies, since they indicated a high degree of complexity and the existence of several generations as a basic prerequisite for meaningfulness.

Nevertheless, however, the question arises as to whether and to what extent the informal mechanisms of trust in family businesses are affected by the family constitution. In addition to the new theoretical approach of Socioemotional Wealth, this problem area should be one of the focal points for further research work on family governance and family constitution.

References

Alvesson, M. (2003). Beyond neopositivists, romantics, and localists: A reflexive approach to interviews in organizational research. *Academy of Management Review*, *28*(1), 13–33.

Baus, K. (2013). *Die Familienstrategie* (4th ed.). Springer Gabler.

Becker, W., & Ulrich, P. (2008). Corporate Governance in mittelständischen Unternehmen. *Ein Bezugsrahmen. Zeitschrift für Corporate Governance*, *3*(6), 261–267.

Brenes, E. R., Madrigal, K., & Requena, B. (2011). Corporate governance and family business performance. *Journal of Business Research*, *64*(3), 280–285.

Daspit, J. J., Chrisman, J. J., Sharma, P., Pearson, A. W., & Long, R. G. (2017). A strategic management perspective of the family firm: Past trends, new insights, and future directions. *Journal of Managerial Issues*, *29*(1), 6–29.

Fleischer, H. (2016). Das Rätsel Familienverfassung: Realbefund–Regelungsnatur–Rechtswirkungen. *ZIP: Zeitschrift für Wirtschaftsrecht*, *37*(32), 1509–1519.

Kirchdörfer, R., & Lorz, R. (2011). Corporate Governance in Familienunternehmen, Familienverfassungen und Schnittstellen zum Gesellschaftsvertrag. *Zeitschrift für Familienunternehmen und Stiftungen*, *1*(3), 97–106.

Klein, S. B. (2009). Komplexitätstheorem der Corporate Governance in Familienunternehmen. *ZfB Zeitschrift für Betriebswirtschaft Special Issue*, (2), 63–82.

Mengers, K., & Prigge, S. (2017). Die Familienverfassung aus betriebswirtschaftlicher Perspektive. In H. Fleischer, S. Kalss, & H. U. Vogt (Eds.), *Recht der Familiengesellschaften,* (pp. 71–98). Mohr Siebeck.

Priem, R. L., & Alfano, F. (2016). Setting new directions for the management discipline through family business research. *Journal of Family Business Strategy*, *7*(1), 58–62.

Schween, K., Koeberle-Schmid, A., Bartels, P., & Hack, A. (2011). Die Familienverfassung–Zukunftssicherung für Familienunternehmen. *INTES Akademie für Familienunternehmen*, Bonn.

Siebels, J. F., & zu Knyphausen-Aufseß, D. (2012). A review of theory in family business research: The implications for corporate governance. *International Journal of Management Reviews*, *14*(3), 280–304.

Zellweger, T., & Kammerlander, N. (2015). Family, wealth, and governance: An agency account. *Entrepreneurship Theory and Practice*, *39*(6), 1281–1303.