Forschungsstelle für
Familienunternehmen
der Universität Bayreuth

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Corporate Governance in Familiy Enterprises

Keynote Speech

Turkish-German Family Entrepreneur Summit
Istanbul, 6th June 2013

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Contents

Thank you Mr. Mach for the friendly introduction. Good evening ladies and gentlemen, it is a pleasure for me to hold the keynote speech on the topic "corporate governance in family enterprises".

I. Introduction

Corporate governance is a broad field. When we start to explore it, we may face the fate of Odysseus. This is especially true, if we do not look at the situation in Germany separately, but compare it with the situation in Turkey. I would like to start this journey now, and invite you to join me. Our goal is to investigate similarities and differences of corporate governance for family enterprises in both countries. On this basis, we can learn from each other – positively and negatively. However, such a comparing view involves the danger of loosing sight of our goal. Our journey of exploration becomes then an odyssey. To prevent this, I have defined five criteria, which shall guide my considerations as lighthouses.

They are

- the term and the rules of corporate governance
- their aims
- the specific effects of corporate governance on family enterprises and opportunities to manage conflicts which were caused by them.

II. Term "Corporate Governance"

The term "corporate governance" provides a first orientation. In this respect, a largely consistent meaning of the term has been developed on a supranational level, but also in Germany and in Turkey. Hence, corporate governance is "the legal and factual framework for directing and controlling an enterprise". It focuses on the structure, which is the organization of the enterprises, and their management.

III. Regulation of Corporate Governance

Legal rules of corporate governance narrow down this broad term in different aspects on different levels.

1. National Law

The relevant Turkish and German laws contain, for example, general rules for commerce. Both the German Commercial Code (HGB) and the new Commercial Code of Turkey demand "due diligence" of a "prudent businessman" respectively of a "prudent business executive" in business conduct. Furthermore, there are in both countries specific governance rules for the different types of enterprises. That concerns, for example, the qualification of members of the supervisory board in Germany respectively the board of directors of banks and insurances in Turkey. According to the German Stock Corporation Act, an independent member of the supervisory board has to have expert knowledge in the field of accounting and auditing. According to the new Turkish Commercial Code, board members of banks and insurances must have special education and experience in their respective fields.

2. European Law

Also, the relevant Turkish and German laws are increasingly influenced and complemented by standards of the European Union. The process of European regulation on corporate governance starts with broadly conceived studies, so-called Green Books. It usually ends either with non-binding recommendations or binding standards, mostly in the form of EU directives. These mandatory or optional legal rules address stock market-listed enterprises. Currently, the European Commission develops a new action plan concerning European corporate law and corporate governance. It contains extensive considerations on developing rules of governance. This includes more transparency and stronger involvement of shareholders. Besides, the framework for cross-border business activities of European enterprises shall be improved. Though this attempt is in an early stage yet, we know from experience that this course of action mostly leads to binding European rules, especially in the form of directives. Germany, as a member of the legal community "European Union", then has to transform these standards into national law within a given period of time. Turkey is affected by these European regulations at least through a factual binding effect, because since the year 2000 in the course of requesting for European Union membership, Turkish law has adopted many European standards. Ladies and Gentleman, meanwhile, from a German point-of-view, the increasing regulative power of the European Union is seen quite skeptical. Concerns are especially raised against an overexpansion of competences of the European Union to the disadvantage of the member states. In reaction to this, the Treaty of Lisbon has sharpened the two instruments to protect national autonomy: Firstly, the European Union may take action only insofar, as it is authorized to do so by the founding treaties. The Treaty on the Functioning of the European Union therefor contains a detailed and enumerative catalogue of competences. In addition to this, according to the principle of subsidiarity, the Union may make use of a competence only in such cases, when the goal cannot be reached by the member states in an equally effective manner. As a professor for German law, it is difficult for me to estimate the future influence of European law on the legal situation in Turkey. In any case, a close link with the progress of the membership application is obvious.

3. Soft Law

I now want to discuss a very important part of corporate governance regulations, which can be found beneath the national statutes and are described as "soft law". Characteristic for these regulations is the fact that they do not have the binding effect which statutes do. Thus, they do not have to be obeyed mandatorily, but rather often only have the character of a recommendation. Besides, deviation is permitted, as far as the exception is sufficiently justified. Hence, the principle "comply or explain" applies. Another attribute of this soft law is the fact, that it is enacted by committees. In these committees not only governmental representatives, but also managers and independent experts have a chair. On a supranational level the Corporate Governance Principles of the OECD are an example of this so-called soft law. Referring to Germany, the German Corporate Governance Code exists since 2002. It is enacted and continuously developed by a governmental committee, which consists of executive and non-executive members of boards of large enterprises, financial auditors and scientists. The Code addresses first and foremost market-listed stock corporations. Beyond that, the observation of the code is also recommended to unlisted incorporated enterprises. There are certain similarities between the German Corporate Governance Code and the Corporate Governance Principles, which were enacted by the Capital Markets Board of Turkey, the CMB. These principles also address publicly traded companies. Their regulations are partially mandatory, partially optional. Unlike the German Corporate Governance Code, the Turkish set of regulations distinguishes between different categories of enterprises based on their market capitalization and their value of floating shares. Nevertheless, both frameworks agree on the principal validity of the rule "comply or explain". This justifies their qualification as "soft law", even though there is recently a process of transformation to hard law.

The German Corporate Governance Code has met partly approval, partly criticism. Insofar as its regulations are considered as reasonable, the legislator occasionally adopts them in formal laws and thereby gives them a stronger validity. Problems arise in cases, where legal rules and rules of the code diverge. A current example is the discussion in Germany about limiting salaries for managers in publicly traded companies. While legislation doesn not impose limits on salary, the Committee German Corporate Governance Code proposes such a salary cap. To avoid a conflict between hard law and soft law, the government proposes that the code rule is only an addition to the Stock Corporation Act. But this explanation raises fundamental questions. They concern the democratic legitimacy of the Corporate Governance Code Committee, as its members are not elected by the people. This deficit is partially compensated, because the state is involved in creating the committee. Nevertheless, regarding its competences, there are higher requirements for pluralism in the composition of this committee. This means, the subjects affected by the rules of the committee should be appropriately represented in this body. Regarding family enterprises, this requirement is not met, though this type of enterprises represents a major part of all addressees of the Code. Another fundamental problem, which became virulent in the discussion about salary caps, is the binding effect of the Corporate Governance Code. There are two contrary positions. One opinion claims, that those rules only have a factual relevance. The other opinion assumes a legal binding effect similar to statute law. The following dictum of a German lawyer illustrates the practical importance of this theoretical dispute: “The effect of rules of the governance code depends on wether they are advantageous or disadvantageous to my client. If they are advantageous, I treat them as binding law, of course. If they are disadvantageous, then they are non-binding recommendations, which one can deviate from without sanction.” Though this surely is an exaggeration, it shows the scope of the problem. It is difficult to find a solution, because the factual binding effect depends on another factor, which influence is hard to forecast or to measure: the public opinion, especially the press. They take action, when enterprises violate principles of good governance.

IV. Goals of Corporate Governance

What does “good corporate governance” mean? That is a very difficult question to answer. To find the solution, I ask you to reconsider the reasons for these corporate governance rules. The main reason is the separation between ownership and management. This divergence typically appears in stock market listed corporate enterprises. From an economic point of view we describe this constellation as a “principal-agent-conflict”. I agree to this approach, but it is not the focus of my keynote. At this point it is sufficient to state, that this conflict typically arises for incorporated enterprises, which are listed at the stock market and where therefore their shares are traded publicly. As a reaction to this divergence between ownership and management of an enterprise, the following basic policies are regarded as guiding principles of "good governance": equality, transparency, accountability, responsibility and legitimacy.

V. Impact of Corporate Governance on Family Enterprises

This leads me to the key issue of my consideration: How do governance principles impact on family enterprises?

1. Term and Meaning of "family enterprise"

For this purpose I want to clarify the term "family enterprise". There is still no generally accepted, uniform definition of these enterprises. Considering the heterogeneity of family enterprises, developing such a definition is hardly possible and not truly necessary. It is sufficient for my explanations to require two main attributes for family enterprises: On the one hand, the family must be the majority owner. On the other hand, the family must have a dominating influence on the management. Such influence can be accomplished either through the executive board members, or through the non-executive board members. In contrast to this, neither the size of the company, especially its number of employees or its revenue, nor the fact whether it is listed on the stock exchange, does matter for the categorization as a family enterprise.

Nevertheless, stock market listing is important for the application of the rules of the German Corporate Governance Code. The assumption that these rules are irrelevant to family enterprises because they are typically not listed on the stock exchange, is legally und factual incorrect. German family enterprises are often organized as incorporations, either as "Aktiengesellschaft" (public company) or as "GmbH" (limited liability company).

At least, big family enterprises tend to finance themselves on the capital market, so governance rules of the code are applicable in principal. This is objectively justified, insofar the regulation correlates with stock market listing. Apart from that I would like you to consider that the "principal-agent-conflict", which is the reason for good governance rules, applies to family enterprises in a different way.

The reason for this different effect is the special structure of these enterprises.

2. Structure of Family Enterprises

Family enterprises are characterized by the interaction of three determinants: the family, the ownership and the management. This "magic triangle" causes specific interests. For the entrepreneurial family, a sustainable increase of the enterprise value is more important than a short-term profits maximization. Furthermore, family enterprises accept a specific responsibility for their employees, who are traditionally closely connected to the enterprise.

Aside to these positive impacts, family enterprises face special conflict situations, which are inherent to the triangle constellation between family, ownership and management. Should the interests of the owners or the interests of the enterprise have priority? This conflict accumulates in the discussion concerning the height of the dividend and the sale of shares. The decision-making process in the family on entrepreneurial issues is also prone to conflict. Empirical studies show, that such conflicts occur between siblings, between different generations or between different branches of the family. Furthermore, soft facts like family ties and emotional bindings often conflict with management decision based on hard facts like revenue. These conflicts are difficult to resolve. The regulations of the Corporate Governance Code do not provide help in these cases, because they are not tailored for family enterprises. Quite the contrary, they can raise further problems. For example, the obligation to confidentiality of board members increases the asymmetry of information between family shareholders. This can lead to conflicts between those family shareholders, who are involved in the management, and those, who are not.

3. Special Problems of Corporate Governance in Family Enterprises

Now I want to discuss two up-to-date problems, which arise from the uncoordinated clash of governance rules with structures and traditions of family enterprises. The first problem relates to the independence of the members of the supervisory board, which are in the Turkish legal system the non-executive members of the board. According to the German Corporate Governance Code, the supervisory board shall comprise a certain number of independent members. At the same time, the Code states a member cannot be seen as independent, when it is in a personal or business relation to the company, its institutions or a controlling shareholder that can cause an essential and not only temporary conflict of interest.

The recommendation of the European Union goes even further. Hereafter, a member of the board should be considered to be independent only if he is free of any business, family or other relationship with the company, its controlling shareholder or the management of either, which creates a conflict of interest such as to impair his judgement . For a family enterprise this means a substantial restriction of the family's influence on the management through the executive and non-executive members of the board. In some cases this may even lead to a situation, where the controlling influence of the family cannot be guaranteed anymore. In such a case, the company loses its status as a family enterprise. For sure, such effects are not intended by the governance rules, maybe not even recognized. But this does not change the fact that the application of these rules may lead to a disproportional and thus unconstitutional intrusion into the property rights of the entrepreneurial family.

The question of a violation of property rights by governance rules also comes up at the proposal to implement a binding women's quota. Such a quota could apply for stock listed companies and companies with workers' participation. I do not want to go into details of this complex and emotional discussion. But please allow me the following remark: According to German law, public or limited liability companies are subjected to workers' participation, if they employ an average of more than 2000 employees. That applies to a great number of family enterprises. If the family owner decides in favor of an external management, which can be seen in more and more cases, the family as owner of the corporation can only exercise its influence through the supervisory board. In this committee, shareholders and employees must be represented in equal numbers. A binding women's quota for family enterprises subject to workers' participation may require the family to nominate external members for the supervisory board, when there are no suitable female family members available – a result hardly acceptable.

4. Approach to a Solution

The importance and the benefit of governance rules are not generally questioned by these critical comments. Nevertheless, these rules have to be modified as far as they affect family enterprises unappropriatly or even unconstitutionally. Last but not least, I would like to point out some approaches to manage these difficulties.

First we have to distinguish three categories of governance rules: First of all, there are rules that affect only the domain of family shareholders. Examples are the organization of decision-making and conflict management in the family. I call this area the field of family governance. It generally has to be developed by the entrepreneurial family independently and free of state influence. This can be achieved through a so-called "family constitution". In Germany, the family Henkel, for example, has such a constitution. The advantages and disadvantages of a family constitution are disputed controversially. Such a formal framework, however, seems only to be reasonable if a certain number of family members is reached. Irrespective of that, there should be an increased communication about best practice in these questions also between Turkish and German family enterprises. I hope that this evening contributes to this dialogue.

The second category of governance rules is characterized by the fact that they affect family enterprises as well as any other enterprise. That concerns especially the rules and regulations about compliance and risk management. Insofar, the general regulation by the state or the European Union is justified by the importance of these issues for the capital market. As national borders are irrelevant for financial products, a harmonization through consistent regulations is required. This is also true for investors, who are in particular in need of protection.

The third category of governance rules marks the most controversial area. These rules refer to particular characteristics of the enterprise, for example the stock market listing or the workers' participation. But they do not just influence the management; rather they also have an effect on the ownership of the entrepreneurial family. I have pointed at this fact, when I mentioned examples concerning independence of board members or the women's quota. In these cases, different interests clash unrestrained into each other: Interests of the family, the rights of family shareholders, management interests and sociopolitical aims of the state. This leads to a conflict of interests, which can hardly be handled adequately. There is no ideal solution to resolve that conflict of interest. But in my opinion, it is a reasonable approach to solve that problem by governance rules providing so-called opening clauses for family enterprises. They allow deviation, when the family enterprise or the entrepreneurial family is disproportional burdened.

Dear ladies and gentlemen, it remains to be seen, if it is possible to build a safe haven facing the storm of governance regulation. Anyway, our joint expedition through the sea of corporate governance in family enterprises has now reached the harbor. Thank you for your attention.

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- National and international law of economics, especially issues of liberalization and regulation, e.g. of telecommunication, of air traffic, of the energy industry, of the financial sector and of the health care system
- Legal and economical framework for family enterprises it Legitimacy of standardization by private entities, e.g. by the IFRS; binding effect and content of so-called "soft law", e.g. governance rules.

VII. Contact

    

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