

## Family Business: The Need for a General Framework

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### I. Introduction

Family owned businesses are of a special nature. In many cases, corporate and family relations intertwine, and the operation of these businesses is often directly affected by personal and family affairs.<sup>2</sup> These businesses thus merit particular consideration.

The study of family business as a special kind of business began in the 1960's and 1970's,<sup>3</sup> but there is still no unique definition of family business. Sometimes, the concept of family business overlaps with the definition or characteristics of small or medium enterprises. However, family businesses are not all small or medium businesses, and all small or medium businesses are not family businesses.<sup>4</sup> Family businesses are very diverse in size,<sup>5</sup> and they take on a wide variety of corporate structures, from partnerships to closely-held corporations to limited liability companies or corporations. Furthermore, some are publicly traded on stock markets while others are closely-held by their shareholders.

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2 Kelin E. GERSICK, Joahn A. DAVIS, Marion MCCOLLOM HAMPTON, Ivan LANGSBERG (1997), *Generation to Generation: Life Cycles of the Family Business*, Harvard Business School Press, Boston, p. 4 (discussing nepotism, sibling rivalry, and unprofessional management).

3 Tagiuri and Davis developed a three-circle model to represent the interactions between family and businesses. The three-circle model describes the family business system as three independent but overlapping subsystems: business, ownership, and family. See Tagiuri, R., Davis, J.A. (1982). Bivalent attributes of the family firm. Working Paper, Harvard Business School, Cambridge, Massachusetts. Reprinted 1996, *Family Business Review* IX (2) 199–208.

4 José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 18.

5 For example, Spanish family businesses are typically smaller than the average size of European family owned business. See Ramón ADELL RAMÓN (1998), «El acceso de la empresa familiar a los mercados de valores», *Alta Dirección*, núm 202, pp. 49–55. At 49.

This diversity of characteristics makes it difficult to provide a uniform concept, definition or description of what family businesses are<sup>6</sup> and therefore to conceptualize the general challenges they face. The problems presented by a sole person business working with a family member are not the same as the ones presented by a publicly traded corporation with a majority of stock owned by a few family members. And the challenges presented by a closely-held company with shareholders who are family members are significantly different than the ones faced by a publicly listed corporation the stock of which is traded on a stock market. Further, businesses are not subject to the same incorporation requirements and regulations when incorporated in the U.S., in Europe or in Japan; neither are individuals. Therefore, family businesses do not fit into a corporate structure, corporate size, ownership and management structure or specific industry.

Despite the difficulty of tracing a concept that could help explain and define what family businesses are, the literature has highlighted some characteristics commonly shared by family businesses irrespective of their diversity.<sup>7</sup>

First, the ownership of family businesses is generally structured around individuals who are related by a family relationship. This does not necessarily mean that family businesses are owned solely or completely by family members. There could be other shareholders, but family businesses are generally owned, or the majority of stock is owned, by individuals belonging to a certain family.<sup>8</sup>

Second, the management of family businesses is generally held by family members who own the majority of the company's stock.<sup>9</sup>

Finally, family businesses generally have a long-term intent to participate in the market if possible, in the hands of the founding family. Family businesses do not generally have short-term goals of incorporating the

6 FRANCISCO VICENT CHULIÀ (2000), «Organización jurídica de la sociedad familiar», *Revista de Derecho Patrimonial* 5/2000, pp. 21–48. At 21.

7 Some have described family business as business where ownership, management and intent of permanence overlap. See FRANCISCO VICENT CHULIÀ (2000), «Organización jurídica de la sociedad familiar», *Revista de Derecho Patrimonial* 5/2000, pp. 21–48. At 29. See also JOSÉ JAVIER PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 18.

8 JOSÉ JAVIER PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 18.

9 This management structure should not be understood as a ban on external members to participate in the business board but the majority of the board members belong to the family who at the same time owns the business.

business in order to sell it for profit or to obtain a high short-term return on the investment. For the most part, family businesses intend to remain in the market and be able to capture a share of the market of their industry and to continue under the control of the family members.

However, family businesses face specific challenges that condition their structure and possibilities of success. This article provides a study of the specific challenges faced by family businesses from a corporate, family and inheritance law perspective. In light of the major importance of family business in European and in U.S. economies,<sup>10</sup> the absence of a global framework for family owned businesses is surprising. The definition of family business that will be used in this paper will be based on the above-mentioned characteristics of ownership, management and long-term business goals that will allow us to lay out the specific family business challenges that can be addressed through a regulatory framework.

The next three sections of this paper develop the three major challenges presented by family business: Section 2 focuses on corporate law questions, Section 3 presents the effects on family business of the interaction between family law and corporate law, and Section 4 discusses the effect of inheritance law on the transfer of family businesses to the next generation. As mentioned above, these issues have not been addressed globally by legislators. As will be presented below, corporate managers have tried to create mechanisms to overcome such problems, but they have been largely unsuccessful because most of the problems derive from the imperatives of family and inheritance law. Section 5 develops a response to the lack of general framework for family businesses provided by private practitioners: the family law protocol. The last section of the paper includes brief conclusions.

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10 Numbers vary because the lack of a commonly shared definition of what family businesses are makes calculations difficult. In countries such as Spain 65 to 80% of total of business are family business and their output amounts to 15% of the Gross Domestic Product (GDP) while they create between 65 to 70% of the total employment, employing more than 700.000 people. Further, 22% of the Spanish biggest thousand corporations may be considered family businesses. The U.S. shows similar figures: 35% of the biggest 500 U.S. corporations are family businesses that generate 42% of the employment of the U.S. economy. This information is available at the website of the Instituto de la Empresa Familiar – the Spanish Family Business Institute (<http://www.iefamiliar.com/organizacion/datos.asp>).

## II. Fitting into Corporate Law: Corporate Challenges of Family Businesses

Family businesses are companies incorporated and structured as any other corporation. They generally share with other types of businesses such goals as maximizing profits, ensuring viability, and growing and consolidating positions within a given industry. So the fact that businesses are owned and managed primarily by family members does not make them particularly different from other businesses in these respects. For that reason, corporate law does not consider family businesses as a special kind of business needing special regulation.

However, corporate structure, management, and the availability of external financing are especially sensitive issues for family businesses. In fact, these issues may explain why it is often so difficult for family businesses to survive beyond the first generation, unlikely to survive beyond the second, and almost impossible to survive beyond the third.<sup>11</sup>

### 1. *Finding the optimal corporate structure of family businesses.*

Family businesses may be formed under any of the company or corporate structures available under corporate law: They may be individual or single-person companies or adopt a corporate form that enables corporate founders to enjoy limited liability.<sup>12</sup> Deciding the optimal structure and legal form of a family business will have important consequences, both legal and economical, on the creation of the business, its development, management, transfer, and its prospect of success.<sup>13</sup>

In the past, small family businesses were generally formed as individual or single-person companies. While this form is still used, the uncertainties of the market and the difficulties of success have tended to push even small family businesses toward limited liability structures that protect private assets. Most businesses nowadays – including family business

11 The Spanish Instituto de la Empresa Familiar – the Spanish Family Business Institute – quantifies this information stating that 11 % of the family businesses who are members of the Spanish Family Business Institute are in the first generation, 36 % of them make it to the second, 25 % to the third, 21 % to the fourth, 4 % to the fifth, 2 % to the sixth and 1 % to the seventh generation. This information is available at <http://www.iefamiliar.com/organizacion/datos.asp>.

12 José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 23.

13 José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 23.

– are structured as either limited liability companies or as corporations.<sup>14</sup> Furthermore, family businesses tend to be closely-held.<sup>15</sup>

The differences between limited liability companies and corporations are significant. Limited liability companies are closed companies, which means that their stock is not traded in a stock market. They are therefore less liquid, as shareholders are allowed to sell their shares only to other shareholders or to third parties that the other shareholders agree on. Further, personal characteristics of shareholders are relevant because the corporate charter may place restrictions on who may own the company's stock, limiting ownership, for instance, to individuals as opposed to other companies or corporations. Corporations, on the other hand, have shareholders that receive stock certificates and elect board directors that adopt the major corporate decisions but do not engage in the day-to-day management of the corporation, which is the responsibility of corporate officers.<sup>16</sup> Corporations may be closely-held, in cases where stock is not publicly traded, or they may be public corporations, where stock is traded on a stock market and therefore freely transferable between shareholders, who do not necessarily have to be family members.

## 2. *The Management of the Family Business:*

### *The Difficult Balance between Family and Business*

Finding an equilibrium between business managers and stock owners, who are at the same time family members, is especially relevant in the case of family businesses. Deadlock situations resulting from disagreements among family members<sup>17</sup> present a serious threat to management and can result in complete collapse, with obvious consequences for the position of the business in the market.

Family businesses generally have three major kinds of management options available:<sup>18</sup> First, managers and directors may themselves be family members and simultaneously shareholders. A second design is one where

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14 Frank H. EASTERBOOK & Daniel R. FISCHER, *The Economic Structure of Corporate Law*, 228–252, Harvard University Press, Cambridge (1991).

15 José Manuel CALAVIA MOLINERO (1998), «Aspectos societarios de la empresa familiar: raíces históricas y nuevas opciones», *Alta Dirección*, núm 202, pp. 409–16. At 410.

16 Frank H. EASTERBOOK & Daniel R. FISCHER, *The Economic Structure of Corporate Law*, 228–252, Harvard University Press, Cambridge (1991).

17 José Manuel CALAVIA MOLINERO (1998), «Aspectos societarios de la empresa familiar: raíces históricas y nuevas opciones», *Alta Dirección*, núm 202, pp. 409–16. At 412.

18 José Manuel CALAVIA MOLINERO (1998), «Aspectos societarios de la empresa familiar: raíces históricas y nuevas opciones», *Alta Dirección*, núm 202, pp. 409–16. At 414.

both management and directors are individuals external to the family. Finally, management may be a mixed system under which certain managers are members of the family and others are external to the family. Needless to say, regardless of the chosen corporate structure, whenever family members can serve as business managers, it is important to establish minimum standards and requirements for these positions in order to avoid having them filled by non-professional or non-qualified family members.<sup>19</sup>

It is beyond the scope of this paper to present the advantages of one management structure over another. However, management structures that favor the inclusion of non-family members either exclusively or jointly with family members would seem the best way to preserve some separation of the two often conflicting institutions in play here: on one side, the family and the personal and emotional conflicts it entails, and on the other side, the business, where certainty, efficient decision-making processes and serious management decisions are generally the formula for success. Markets seem to perceive positively the introduction of mechanisms by which family and business are as separated as possible.<sup>20</sup>

### 3. *The Access to Capital Markets:*

#### *A 21<sup>st</sup> Century Challenge for Family Businesses*

In today's corporate world, finding financial sources and attracting external investors is key for the success of a company. Capital stock, necessary for starting the business, is not enough for financing the often valuable investments businesses need to make and profits or corporate assets are not generally totally re-invested in the business. Shareholders claim their dividend and systematic re-investment is not a long-term option. Therefore, it is part of the daily life of a business to go to investors, financial institutions or the stock market to obtain additional financing.

Family businesses are not excluded from this phenomenon: they need external financing, obtain financial sources beyond family members and, sometimes, even go public in a stock market for this purpose.

Obtaining external financing is not easy for family business for several reasons. First, as mentioned above, even though it is not possible to talk about a unique corporate structure of a family business, the corporate

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19 INFORME DE LA PONENCIA DE ESTUDIO PARA LA PROBLEMÁTICA DE LA EMPRESA FAMILIAR (543/000005), Boletín Oficial de las Cortes Generales – Senado VII Legislatura. Serie I: Boletín General, núm. 312 de 23 de noviembre de 2001, pp. 1–40. At 39.

20 José Manuel CALAVIA MOLINERO (1998), «Aspectos societarios de la empresa familiar: raíces históricas y nuevas opciones», *Alta Dirección*, núm 202, pp. 409–16. At 414.

form mostly used by family business is the limited liability company.<sup>21</sup> This structure implies that the company is closely held and that the personal conditions and qualities of shareholders are important. Further, there is generally no market for the shares that are sold to either other shareholders or to approved third parties (often other family members). Additionally, because of the illiquid condition of the shares, it is difficult to determine a share value since they are not publicly traded and therefore there is no market price for them. All these factors discourage external investors from financing or from becoming shareholders of this kind of businesses.

Second, because of the family relationships generally inherent in the daily life of a family business, external investors may be dissuaded from investing and instead look for more flexible and open business structures.

Third, one of the goals of investors is generally short-term profits on their investment. As mentioned above, this strongly contradicts one of the essential elements of family businesses that aim at permanence and continuity of the shareholders and board members.

All these elements represent specific difficulties of family businesses for finding external finance sources. There have been proposals to improve the situation and create mechanisms to facilitate the access of family businesses to external investors. One proposal is to create investment funds that could commit to mid-term investments in exchange for tax benefits.<sup>22</sup> However, this has not yet been tried.

In order to avoid having to negotiate individually with each potential investor, one of the most common processes used to have access to external financing is listing the company on a public market.<sup>23</sup> Going public affects not only the way the company is financed but also the personality and often the character of the company given that there will have to be new management structures and new shareholders to whom it will be necessary to share information and control.<sup>24</sup>

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21 Frank H. EASTERBOOK & Daniel R. FISCHER, *The Economic Structure of Corporate Law*, 228–252, Harvard University Press, Cambridge (1991).

22 See Informe de la Ponencia de Estudio para la problemática de la empresa familiar. Ponencia del Sr. José Manuel Lara Bosch, President of Planeta Publishing Group. At 3.

23 **When a company lists its shares on a public exchange, it will almost always issue additional new share so that it can raise extra capital.** This new issuance is particularly important because the money paid by investors for these newly-issued shares is directly received by the company and not to the other shareholders, as it happens when shares are bought and sold in a public stock market.

24 Ramón ADELL RAMÓN (1998), «El acceso de la empresa familiar a los mercados de valores», *Alta Dirección*, núm 202, pp. 49–55. At 52.

The process of going public is not easy for any company because it entails a determination of the price at which shares will be offered, involves a potential change in the corporate management, and eventually entails a decrease of control by company owners, which in the case of family businesses are generally family members. However, public offering can be a step toward achieving higher corporate growth, increasing corporate transparency, providing liquidity to shareholders, facilitating access to information about the companies' market value, diminishing control and ownership of the company's founding members, giving a better image to the company, and representing that the company is increasing its activities or volume level.

It does not seem possible to establish a moment or situation when issuing a public offering will be attractive for all family businesses. It is often said, however, that this moment tends to come when a family business moves toward ownership by different branches of the family.<sup>25</sup>

As mentioned above, corporate law issues are not specifically problematic for family businesses. Given the interaction, and often overlap between family and business, the personal law of the different family members will be of crucial importance especially in two areas of special relevance for the viability, success and potential transfer of the family business to the next generation: family law, which will be the topic of the next section and inheritance law, which will follow.

### **III. The Effect of Family Law on Family Businesses: A Difficult Overlap**

When talking about businesses and the challenges they face, it is generally only necessary to look at corporate law requirements – together with tax law – to determine what are the steps needed to be taken in order to create, manage and develop a business. However, family businesses entail an additional requirement given that the personal laws of family business owners may directly impact the ownership structure of the family business. This becomes particularly apparent in a family crisis.

As mentioned earlier, family businesses are generally structured as separate legal entities with ownership divided between shares owned by

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25 Ramón ADELL RAMÓN (1998), »El acceso de la empresa familiar a los mercados de valores«, *Alta Dirección*, núm 202, pp. 49-55. At 55.



family members.<sup>26</sup> In the moment of a family divorce, depending on the marital regime in force, shares, returns, dividends or profits could be subject to division. Thus, legislation affecting the economic marital relations and the content of separation agreements may have a direct impact on the ownership structure, management, and potential success of family businesses. In some states, such as Spain and the United States, pluri-legislative systems mean that family businesses may need to consider a variety of marital property regimes to which they might be subject. An important division in these systems is between separate property and community property regimes.

Under a separate property regime, there is a legal presumption that individual assets and income generated by such assets belong to whichever spouse paid for them, earned them or has title to them. Therefore, these assets are not subject to division with the other spouse. Despite the separation of property and the presumption of property title, this does not necessarily mean a complete separation of property between spouses given that there are certain payments or compensations, such as equitable distribution of property, alimony and spousal support payments, that need to be made in order to avoid inequitable results. In contrast, community property regimes create a legal presumption that all income and assets acquired by either spouse during marriage belongs to both of them in equal shares. Therefore, whenever there is a marital crisis, property will be divided equally between spouses.

The effects of marital economic regimes have been significantly mitigated with the possibility of premarital agreements and separation agreements. But even in cases where these kinds of agreements are adopted, economic disputes between spouses may arise with respect of the share to which they are entitled or the value attributed to a certain asset.

Family businesses, as any other economic asset, may be a private good – if created before marriage – or a marital good – if business was created during marriage.<sup>27</sup> This qualification is crucial for the prospect of the family business because that will determine whether family businesses may be subject to distribution between spouses or may generate compensation rights from one spouse to the other. Further, there may be problems regarding the economic value of the family business or regard-

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26 Law 7/2003, of April 1st, of Limited liability company »Nueva Empresa«. See Fernando CURIEL LORENTE (2001), »La sucesión de la empresa familiar en el derecho civil aragonés«, XI Encuentros del Foro de Derecho Aragonés, pp. 86–139, 96.

27 See Informe de la Ponencia de Estudio para la problemática de la empresa familiar at 28.

ing the increase of value and the form of payment of the compensation to the non-business spouse.<sup>28</sup> When all these issues collide, family businesses may become non-manageable.

#### **IV. Organizing the Transfer and Future of the Family Business: The Effect of Inheritance Law on the Succession of Family Businesses**

The third and last key issue that differentiates family businesses from other businesses is the impact of inheritance law on them. Inheritance law is of special importance for family businesses for two major reasons: First, organizing the succession of family businesses is key to the future of the company given that the lack of planning can result in the business disappearing. Second, inheritance law imposes rigid and burdensome limitations to the scope of decision of individuals when organizing their succession that inherently affect the organization of the succession of the business.

The organization of the succession of family businesses is crucial so that the continuity, stability and therefore future prospect of the business is granted.<sup>29</sup> Companies need continuity and stability and interruptions can be very harmful. It is well settled in the literature that in order to minimize the risks presented by the transfer of the family business to the next generation, the succession should be as planned as possible. Business owners should work out succession plans that allow successors to take over immediately upon an owner's death or retirement.

A second issue of special relevance regarding the succession of the family business is that its stock and therefore its value is part of the decedent's estate. Inheritance laws generally establish mandatory shares in the form of a percentage of the estate that the law determines compulsory for the decedent's issue, if any; for the surviving spouse of the decedent, if any; or jointly, depending on the inheritance law applicable to the decedent. A family business is not contemplated as a unity and therefore is not especially protected by the legal system in that respect. Therefore, the family business is one of the assets that may be subject to the widow/widower's and to the decedent's issue inheritance rights.<sup>30</sup>

28 Ana FERNÁNDEZ-TRESGUERRAS GARCIA, *Esquema para la redacción de un protocolo familiar*, pp. 161, 164.

29 See Fernando CURIEL LORENTE (2001), «La sucesión de la empresa familiar en el derecho civil aragonés», XI Encuentros del Foro de Derecho Aragonés. 86–139. At 106.

30 See Fernando CURIEL LORENTE (2001), «La sucesión de la empresa familiar en el dere-

Mandatory shares or economic rights of the decedent's surviving spouse over a certain percentage of the estate is of major importance for the ownership structure and eventually for the success of family businesses for several reasons: first, because issues regarding the valuation of the stock in family businesses – that are generally closely held corporations – may arise; second, because heirs who are not awarded the family businesses will be entitled to compensation.<sup>31</sup> If the decedent's estate has not enough assets to effectively pay such compensation and the payment is done with stock of the family business, its ownership structure and potentially management structure will be affected. Third, inheritance law imposes liability for outstanding debts to the decedent's heirs who may not always be the business successors. One could consider whether such debts should be born by the heirs or by the business successors.<sup>32</sup>

Hence, the future of the family business, as an important asset of the decedent's estate may be seriously jeopardized when inheritance laws are applied.

## V. How to Overcome Such Problems Faced by Family Businesses?

As described above, family businesses present special challenges that are inherent to their personal structure and the legal context applicable to the individuals who at the same time are its owners. What is needed is a framework that would facilitate the foundation, development and transfer of family businesses. The current legislation, however, does not provide this.

Family business owners have sought such a framework and have suggested the creation of a statute of family business that would encompass all the characteristics and special needs a family business has in order to facilitate and enhance its performance. Even though legislatures have recognized of the importance of such businesses,<sup>33</sup> there are very few leg-

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cho civil aragonés», XI Encuentros del Foro de Derecho Aragonés.86-139. At 104.

31 The ownership structure of family business and the percentage of stock owned by the decedent will influence in the incentives to invest in the family firm. See A. ELLUL, M. PAGANO, F. PANUNZI, »Inheritance Law and Investment in Family Firms«, ECGI – Finance Working Paper No 222/2008.

32 See Fernando CURIEL LORENTE (2001), »La sucesión de la empresa familiar en el derecho civil aragonés«, XI Encuentros del Foro de Derecho Aragonés.86-139. At 101.

33 Ramon BLASI PUJOL, »El protocol familiar com a instrument apte per pactar la compensació econòmica per raó de treball de l'article 41 del Codi de Família«, *Revista Jurídica de Catalunya*, 2006 (3), 707-728, at 712. See also Family Business Institute.

islative initiatives, at either the European or the domestic level.<sup>34</sup> Up to today, legal systems have not generally incorporated specific measures to facilitate family businesses to address their specific challenges<sup>35</sup> beyond those facilitating and simplifying family business bureaucracy.<sup>36</sup> Hence, the rules applicable to family business are the general regulations applicable to any company.<sup>37</sup>

In light of the absence of legislative initiatives and the limitations of current corporate law to deal with such issues and provide solutions to these challenges, professionals – especially law firms – have created private law instruments in order to fill the void. These instruments are called Family Protocols and while they are not yet in general use, their adoption is growing significantly.<sup>38</sup>

The Family Protocol<sup>39</sup> is an agreement between family members used to coordinate their behavior and their relationship with the business it-

34 At the European level it is worth noting the Commission Recommendation 94/1069/EC, of 7 December 1994, on the transfer of small and medium-sized enterprises, O.J. L 385, 31/12/1994 P. 0014- 0017. The Recommendation may be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994H1069:EN:HTML>.

35 José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 41.

36 For example, in Spain, in 2003 Congress passed a new law regulating limited liability companies – and not specifically family businesses – whereby business were provided with new and simplified bureaucratic procedures regarding the companies' registration, administrative procedure requirements, accounting rules, relationship with public administrations, tax deferrals as well as introducing the possibility of conducting some of such procedures through email. See Law 7/2003 of April 1 (RCL 2003,903) de la sociedad limitada nueva empresa amending Law 2/1995 of March 23 (RCL 1995, 953) of Limited liability companies. Despite not being directly aimed for family businesses, such regulation will definitely have an impact on the requirements they will be subject to and the often too burdensome bureaucracy companies are faced, especially in continental Europe.

37 José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 15.

38 In fact, the Spanish Family Business institute states that only 25 % of the biggest Spanish family businesses that represent 8 % of the Spanish GDP, have a family protocol. See <http://www.iefamiliar.com/organizacion/index.asp>.

39 The origin of family protocols should be found in shareholder agreements of close companies in the United States. Family Protocols is a contract parallel to the articles of incorporation drafted in order to coordinate the decision making process of the company. The family protocol may include this kind of regulation (and it often does) but it has a broader scope. See Jorge Alberto RODRÍGUEZ APARICIO (2004), «El protocolo familiar», a VV. AA. *El buen gobierno de las empresas familiares*, Thomson-Aranzadi, Navarra. At. 295; FRANCISCO VICENT CHULIÀ (2000), «Organización jurídica de la sociedad familiar», *Revista de Derecho Patrimonial* 5/2000, p. 38; José Javier PÉREZ-FADÓN MARTÍNEZ (2005), *La empresa familiar: fiscalidad, organización y protocolo familiar*, CISS, Bilbao. At 43.

self.<sup>40</sup> It is a set of rules<sup>41</sup> that originally the founder and all other family members that own the business will sign, and, will consider whether and how to include new members in the future.<sup>42</sup>

There are authors that have suggested that a Family Protocol is a legal instrument that despite not being legally binding provides credibility and mutual trust to the parties entering into it.<sup>43</sup> Hence, its existence does not guarantee the intended coordination without the concurrence of the willingness of all family members to comply and enforce its provisions. For this reason, the Protocol is sometimes referred to as a »game of promises«. <sup>44</sup> Others, however, view the Protocol as no more than a management tool because it creates the idea of belonging to an entrepreneurial family while serving as a guide to anticipate potential problems and set out ways of solving them.<sup>45</sup>

We read Family Protocols as a non-enforceable instrument with a flexible content depending on the needs of each family and business.<sup>46</sup> Hence, its effectiveness will depend on the commitment of all parties of the protocol to comply with them and its content, form and nature of Family Protocols will vary from one business to the other or from one family to another: each family designs it to suit their own needs.<sup>47</sup> When drafting a Family Protocol, family members meet and decide the direction of the

40 José Javier RODRÍGUEZ ALCALDE y Maribel RODRÍGUEZ ZAPATERO (2006), »El protocolo familiar: un juego de promesas«, *La Notaría*, núm 33, p. 13.

41 Some authors (Ana FERNÁNDEZ-TRESGUERRES GARCÍA (2002), »Protocolo familiar: un instrumento para la autorregulación de la sociedad familiar«, *Revista de Derecho de Sociedades*, vol. 2, núm. 19, p. 90) refer to it as a »code of conduct« as it provides the guidelines that family members engaged in the business must follow in order for it to run smoothly.

42 Jorge Alberto RODRÍGUEZ APARICIO (2004), »El protocolo familiar«, a VV. AA. *El buen gobierno de las empresas familiares*, Thomson-Aranzadi, Navarra, p. 298.

43 See José Javier RODRÍGUEZ ALCALDE y Maribel RODRÍGUEZ ZAPATERO (2006), »El protocolo familiar: un juego de promesas«, *La Notaría*, núm 33, pp. 13-24, at 16.

44 José Javier RODRÍGUEZ ALCALDE y Maribel RODRÍGUEZ ZAPATERO (2006), »El protocolo familiar: un juego de promesas«, *La Notaría*, núm 33, p. 13.

45 Ana FERNÁNDEZ-TRESGUERRES GARCÍA (2002), »Protocolo familiar: un instrumento para la autorregulación de la sociedad familiar«, *Revista de Derecho de Sociedades*, vol. 2, núm. 19, pp. 90.

46 Ramon BLASI PUJOL, »El protocolo familiar com a instrument apte per pactar la compensació econòmica per raó de treball de l'article 41 del Codi de Família«, *Revista Jurídica de Catalunya*, 2006 (3), 707-728, at 714.

47 Ana FERNÁNDEZ-TRESGUERRES GARCÍA (2002), »Protocolo familiar: un instrumento para la autorregulación de la sociedad familiar«, *Revista de Derecho de Sociedades*, vol. 2, núm. 19, pp. 89-113. At 91.

business and the relationship between the family and the business.<sup>48</sup> The depth, content and rigidity of the Protocol will have two contradictory effects because while it will provide certainty to family members about the content of their agreement, it will also introduce difficulties in amending it and in being able to involve external non-family members to the management of the business.<sup>49</sup>

The substantive content of the Protocol can roughly be divided into two categories: personal and family law related provisions and corporate law provisions. Most Protocols will begin with the history and values of the family and the business<sup>50</sup> that will determine the goals and objectives of the business.

Personal and family related provisions refer basically to family law and inheritance law types of clauses and are used to ensure that the property of the shares stay within the family. With respect to family law clauses, protocols generally include the duty of all married business owners to enter into marital agreements in order to establish a separate property regime<sup>51</sup> or to alter the community property regime in order to avoid the business shares becoming part of the marital property subject to division. One of the major problems presented by this kind of clause is that the Protocol is *res inter alia*, that is, if the spouse who is not a business owner is not a signing party of the protocol, then he or she is not bound by it. The question that arises in these cases is whether a business owner could be held liable for breach of the provisions of the Protocol in cases where his or her spouse is not willing to enter into a marital agreement. Additionally, even in cases where the non-business spouse agrees to enter into a

48 Francisco VICENT CHULIÀ (2000), «Organización jurídica de la sociedad familiar», *Revista de Derecho Patrimonial* 5/2000, pp. 21–48. At 30.

49 This contradiction could result in a vicious circle in which it would lose liquidity in the market making it less attractive for external investors that, in turn, would make the company even less liquid. See A. ELLUL, M. PAGANO, F. PANUNZI, «Inheritance Law and Investment in Family Firms», 40, SSRN Working Paper.

50 Jorge Alberto RODRÍGUEZ APARICIO (2004), «El protocolo familiar», a VV. AA. *El buen gobierno de las empresas familiares*, Thomson-Aranzadi, Navarra, p. 299.

51 Ana FERNÁNDEZ-TRESGUERRAS GARCÍA (2002), «Protocolo familiar: un instrumento para la autorregulación de la sociedad familiar», *Revista de Derecho de Sociedades*, vol. 2, núm. 19, p. 92: When the default marital property regime is community property two major issues arise: 1) Liability of the community property for debts of one of the spouses: the community property is held liable for the debts of the spouses so the shares could be compromised, should the non-owner spouse become indebted. 2) Title of the shares: in case of divorce the spouses are entitled to half of the community property. This means that in cases where there were not sufficient assets, the shares could be transferred to the non-owner spouse.

marital agreement, the question will be whether specific performance of the clauses of the Family Protocol is available as a remedy for breach.

Regarding inheritance law clauses, Family Protocols often include clauses in which a business founder promises to appoint one of his or her children as heir so this child can continue with the business.<sup>52</sup> In most legal systems, however, this type of clause is unenforceable as against inheritance law principles of freedom of the testator until the end of his or her life.<sup>53</sup> Other legal systems do allow succession contracts in which the testator agrees on the heir **before** death. Because of their contractual nature, these succession contracts are irrevocable unilaterally and therefore will be binding both for the testator, who will not be able to appoint someone else as heir, and for the appointed heir, who will not be able to repudiate the decedent's estate.<sup>54</sup> As it can be easily foreseeable, the key to this kind of contracts is the game between appointing a son or daughter as heir or heiress while at the same time the rest of issue waive some of their inheritance rights.

The third type of clause usually included in the Protocol is a corporate law clause. This may be classified in two types:

- 1.) restrictions on share transfers in the form of personal conditions or minimum percentages of shares to transfer and
- 2.) management related clauses that may recommend the formation of management bodies such as a Family Council that may be composed by family members that do not necessarily need to be business owners.

Family Protocols are becoming more and more popular in Spain to organize the interaction between family and business. Their popularity appears to result from their private nature, which addresses the needs of entrepreneurial families. However, their short history and the lack of

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52 Ana FERNÁNDEZ-TRESGUERRES GARCÍA (2002), «Protocolo familiar: un instrumento para la autorregulación de la sociedad familiar», *Revista de Derecho de Sociedades*, vol. 2, núm. 19, p. 99.

53 For example, in some legal systems such as Spain and France) it is specifically forbidden any contracts whose object is a future inheritance right. Article 1271 of the Spanish Civil Code.

54 This is the case of Germany, and also Spain, a pluri-legislative state in which autonomous communities with historical civil law regimes allow this kind of contracts. In particular, the newest reform of the Catalan inheritance law is particularly permissive with inheritance contracts. See Joan EGEA FERNÁNDEZ (2007), «Protocol familiar i pactes successoris: la projectada reforma dels heretaments», *InDret* 3/2007.

judicial opinions interpreting them make their enforcement and effectiveness questionable. It remains to be seen how this will play out in the future, but there is clearly room for improvement, and when the protocols are challenged in court, judges will establish their nature, content and enforceability. This should help family members and business managers make future decisions about Protocols. Moreover, if the use of the protocol is spread to a majority of companies, it may be the case that the legislature finally sees a need to step in with comprehensive regulation.

## **VI. Conclusions**

Family businesses face specific challenges that significantly differentiate them from other kinds of business and that unequivocally determine their position in the market and influence their prospects and potential success. The overlap of corporate law, family law and inheritance law in the creation, evolution and transfer of family businesses makes it necessary to provide a general regulatory framework that would address the specific challenges that these businesses face. The private sector has already attempted to provide a solution to these issues through Family Protocols, but success has been limited because of the corporate, family and inheritance mandatory regulations that cause such Protocols to be of a non-binding nature.

The adoption of a general legislative framework that would help family businesses address these specific challenges is urgent in light of their weight in the industries of many economies.