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Committee Secretary  
Parliamentary Joint Committee on Corporations and Financial Services  
Department of the Senate  
PO Box 6100  
Parliament House  
Canberra ACT 2600  
Australia

## **Inquiry into shareholder engagement and participation**

### **Terms of Reference**

The Committee is to inquire and report on the engagement and participation of shareholders in the corporate governance of the companies in which they are part-owners, with particular reference to:

1. barriers to the effective engagement of all shareholders in the governance of companies;
2. whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies they invest in;
3. best practice in corporate governance mechanisms, including:
  - a. preselection and nomination of director candidates;
  - b. advertising of elections and providing information concerning director candidates, including direct interaction with institutional shareholders;
  - c. presentation of ballot papers;
  - d. voting arrangements (eg. direct, proxy); and
  - e. conduct of Annual General Meetings.
4. the effectiveness of existing mechanisms for communicating and getting feedback from shareholders;
5. the particular needs of shareholders who may have limited knowledge of corporate and financial matters; and
6. the need for any legislative or regulatory change.

## Submission to the Inquiry by Family Business Australia

### Introduction

Family Business Australia (FBA) is a national, member-based, not-for-profit organisation for family business owners and operators and their professional advisers. FBA recognises that family businesses have unique characteristics and they make a significant contribution to the life, culture and economy of Australia.

FBA's objectives are to:

- Improve the effectiveness of Australian families in business through the sharing of practical experience and knowledge;
- Promote the value and contribution that family businesses make to our society; and
- Represent Australian family businesses as a strong and united voice.

FBA seeks to enhance the contribution of its constituency to the Australian economy by, in part, educating its members in 'family business best practice'. FBA's 'best practice' models (FBA-FBBP) address certain issues of concern to this Inquiry.

### Constituency

Family and privately-owned businesses comprise about 97% of businesses in Australia and they employ more than half of the Australian workforce (MGI Australian Family & Private Business Survey 2006).

It is understood that the primary context of this Inquiry is the publicly listed corporate sector, however we respectfully contend that its scope should include unlisted companies, including unlisted family companies (UFCs), given their economic importance to Australia.

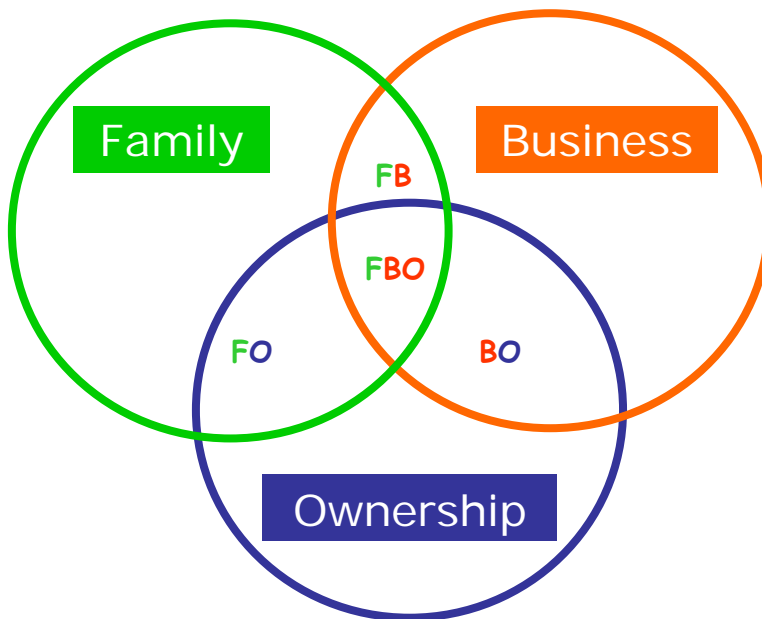
Definition: a family business is "a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families" (Chua et al, 1999).

Although numerous listed companies fit this description, this submission specifically relates to UFCs (both proprietary and public) with one or more – predominantly, three or more – non-employee (including non-director) family shareholders. These shareholders are categorised as FO in Figure 1 below; F indicates that they are members of the owning family and 'O' indicates they have some ownership (shares). It is recognised that there may also be non-family shareholders who are neither employees nor directors, but as with the BO category depicted in Figure 1 (ie employed in the business – 'B' – but also have some ownership – 'O'), they are much less common due to the pre-emptive right provisions of most UFC constitutions.

Family businesses are often mistakenly referred to as small businesses. In fact they vary in size from very small businesses to very large enterprises, such as Visy and Linfox. As stated, this submission relates to UFCs with at least some shareholders not working in the company, which is assumed to exclude most small UFCs. Paradoxically, it may also exclude some very large enterprises. We reiterate that the submission has primary regard for non-director and non-employee shareholders in UFCs.

Academics and professional practitioners have only recently (within the last 30-40 years) recognised the uniqueness and importance of that sector of enterprise owned and controlled by discrete families (or small groups of families) and their work continues to explore and communicate the way in which the three important sub-systems of family enterprise – the owning family/families, the business enterprise and the equity ownership group – can most effectively co-exist for their mutual benefit. Figure 1 provides an accepted diagrammatic representation of this relationship.

### The Three Circle Model



- FBO – family members who work in the business and own shares in it
- FB – family members who work in the business, but don't own a share in it
- FO – family members who own shares in the business, but don't work in it
- BO – non-family employees or directors who own shares in the business

From Davis and Taguri (1989)

Figure 1

## Characteristics of Unlisted Family Companies

Before addressing the Terms of Reference of the Inquiry it is considered worthwhile to outline some characteristics peculiar to UFCs.

1. UFCs are typically owned and controlled by people descended from a common ancestry.
  - a. Their owners usually seek to preserve this style of corporate ownership by limiting the transfer of shares to the descendants of the common ancestry.
    - i. UFCs typically adopt stringent pre-emptive rights in respect to the transfer of shares to protect this relationship. Such covenants possibly represent the strongest statement of differentiation between the 'private' UFC (whether proprietary or public company) and the listed public company: Pre-emptive rights clearly convey the message "our company is not open to membership by the general public".
    - ii. The common lineage of ownership in the UFC – often through multiple generations – creates specific implications for this Inquiry.
2. There is a growing body of evidence to suggest that family businesses often out-perform their non-family counterparts, supporting the contention that family ownership is an effective organizational form. Some of the reasons for this are:
  - a. Shares in the UFC are often inherited and are highly regarded as family heirlooms similar to tangible family assets such as furniture, jewellery, etc.
    - i. Such ownership contrasts with listed company shares which also are often inherited, but having a weaker family heritage link the attitude to their ownership is generally far more dispassionate and financially motivated.
  - b. Family members often take a custodial or steward-like attitude to ownership, which translates into 'patient capital' (de Visscher, Aronoff & Ward, 1995), wherein a long-term and broad view is taken in respect to financial return.
  - c. Shareholders in UFCs commonly hold their shares for their lifetime and pass them to their successors.
    - i. Such ownership stability contrasts with the listed public company wherein the owners typically comprise a diverse, ever-changing group.
  - d. Shareholders in UFCs often receive highly valued non-financial returns.
    - i. Among the non-financial returns is the often-expressed pride experienced by shareholders whose business bears their family name.
    - ii. The direct link between family, shareholder and business and various cultural attributes of the firm can create a sense of loyalty to the family firm beyond that generated by financial return.
      1. UFCs often adhere to and overtly espouse admirable family values; many adhere to strongly-held familial cultural or religious beliefs, which become embedded in the business culture; and many make strong

2. commitments to the local community or participate in other philanthropic endeavours.
- iii. Some UFCs invest in professional development, including family meetings and family business retreats, which are highly valued by shareholders and shareholder family members and create an informed ownership group.
3. Just as most families maintain a close and private family system, the owning families of UFCs commonly extend this privacy to their associated business system.
  - a. UFCs typically adopt structures and processes which preserve the privacy of their financial position and performance. This predilection has implications for:
    - i. Director appointments
    - ii. Proxy holders and representatives at shareholder meetings
    - iii. The treatment of company financial information

## Barriers to the effective engagement of all shareholders in the governance of companies

As noted, Figure 1 depicts three categories of shareholder typically found in an UFC. The effective engagement of shareholders in the governance of UFCs is often related to the category of shareholder, as follows. It is unusual for engagement barriers to exist for family shareholder executive, or non-executive directors (FBO), but barriers may exist for family shareholders who work in the business remote from the board or senior management roles; likewise, any non-family employee shareholders (BO). Barriers to effective engagement frequently exist for family shareholders who don't work in the business (FO).

For the purposes of this submission it is assumed that in the UFC context, the main barriers relate to family shareholders who don't work in the company and aren't non-executive directors (categorised as FO in Figure 1).

Category FO shareholders in UFCs might take a passive stance in respect to governance for a variety of reasons. They might:

- prefer to take a purely passive role as a shareholder.
- not be educated in the role of shareholder.
- not be prepared to learn how to be an effective shareholder.
- lack the confidence to communicate in the UFC environment.
- feel self-conscious about displaying a lack of knowledge about:
  - their role as a shareholder.
  - governance or corporate matters generally – especially in an environment comprising family peers.
- consider their shareholding is too small to warrant participation in company governance matters.
- be in conflict with one or more of the directors or senior company executives and prefer to avoid engagement in the governance process, especially if the conflict is with a family member, or members.

We consider that structures such as the Family Council (refer below), educational offerings promoted by FBA and readings such as Aronoff and Ward (2001) can help mitigate many of the barriers identified above. Family Councils and the other measures provide practical, cost-effective means to creating an appropriate culture and improved UFC shareholder engagement.

A less visible barrier to engagement is created by the "50 shareholder rule" (section 113 of the Corporations Act). This is one of the more unpopular provisions of the Australian corporate regulatory regime. UFCs are known to adopt a range of shareholding arrangements to avoid the requirement to convert from unlisted proprietary to unlisted public company status. These include: minimum shareholding limits and otherwise independent shareholdings being held jointly under various ownership, or beneficial ownership structures. Alternatively, strategies such as 'no dividend' or 'low dividend' policies are employed to create shareholder dissatisfaction and help

effect shareholder buy-outs. Such policies often cause family conflict and importantly, from an economic viewpoint, exiting shareholders are no longer available to contribute capital to the business and the funds committed to equity purchases are no longer available for investment in corporate growth.

These may not be regarded as barriers to engagement in the sense contemplated by this Inquiry, but section 113 of the Corporations Act has this effect, which is considered a form of shareholder oppression: oppression by exclusion.

### **Whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies in which they invest**

This submission does not contemplate institutional shareholders.

#### **Best practice in corporate governance mechanisms, including:**

##### **a. preselection and nomination of director candidates;**

It is not uncommon for UFC constitutions to provide that specific groups such as the holders of different share classes, or shareholders with common sub-family ancestry, have a right to specified representation on the board. Providing directors are appropriately qualified and are otherwise suited to the role, this arrangement can contribute to shareholder harmony.

However, FBA-FBBP encourages UFCs to consider the benefits of a non-representative style of corporate governance and certainly the inclusion of at least one independent non-executive director on the board. The pre-selection of directors should rest with the Family Council (refer below) and their nomination with a representative sub-committee of shareholders.

##### **b. advertising of elections and providing information concerning director candidates, including direct interaction with institutional shareholders;**

The Constitution and Shareholders' Agreement (refer below) or Shareholders' Manual generally provide adequate information about the election process, but we submit that adequate time should be allowed to enable the pre-selection and nomination processes to take place in a timely manner prior to formal notification of the Annual General Meeting.

Presuming UFCs adopt a process similar to that outlined in **a** (above), adequate information about the election process and prospective (and incumbent) directors should be provided to relevant stakeholders to allow objective decision-making.

As noted above, this submission does not contemplate institutional shareholders.

##### **c. presentation of ballot papers;**

FBA is unaware of any specific issues relating to ballot papers; however, we submit that shareholder education about their rights, including their right to call for a poll, should be part of the general shareholder education process.

**d. voting arrangements (eg. direct, proxy); and**

The importance of privacy to UFCs is mentioned elsewhere in this submission and the matter of privacy is relevant to proxies. Shareholders in UFCs often object to the admittance of non-shareholder proxy-holders to (private) family company meetings. While it is recognised that legal representatives or other professional advisers may have a legitimate role as a proxy-holder, we are aware of cases where persons have been appointed as proxies with mischievous intent.

**e. conduct of Annual General Meetings.**

FBA is unaware of any specific issues relating to the conduct of Annual General Meetings, other than the 'token' AGM which may or may not take place and may involve parties who have little understanding of the seriousness of the business being conducted.



## **The effectiveness of existing mechanisms for communicating and getting feedback from shareholders**

Communication between shareholders and the business – usually the board – in the UFC is one of the key issues addressed in FBA-FBBP. In addition to the statutory requirements, FBA-FBBP promotes Shareholders' Agreements and Family Councils as part of an effective suite of UFC governance structures which improve the clarity and effectiveness of the mechanisms which facilitate such communication.

Shareholders' Agreements typically expand upon the provisions of the company Constitution. Some UFCs incorporate those provisions within the Constitution, but more often they take the form of a supplementary governing agreement – often legally drafted and binding on all shareholders – which specifies how shares may be traded, the composition of the board, the decision-making authority of the board or board committees, the conditions under which family members may be employed, etc.

The Family Council facilitates effective communication between the ownership family and the UFC. 'Best practice' families in business create a Family Council which typically operates under a code of conduct-style Charter or Family Constitution as the means to providing an effective conduit between the ownership family and the business. The officers of the Family Council usually comprise people other than family members of the UFC board, however, shareholders and non-shareholder family members are typically involved in Family Council activities.

While these structures and processes are promoted by FBA, the extent to which they are adopted by Australian UFCs and the professionalism with which they are operated is not well known. We are aware of some UFCs which operate these structures and processes and they suggest that Family Councils provide an effective means of communication between the UFCs and shareholders – and the wider shareholder family – both of which are important to the corporation / ownership relationship and ultimately, growing the sector's contribution to the economy.

The widespread use of electronic means for communication between listed corporations and their shareholders is recognised. With the increasing use of the internet, this is an efficient means by which to communicate, however FBA contends that more personal means are more appropriate in the UFC context, especially for smaller family companies. FBA is also aware that a significant portion of the community either does not have internet access or doesn't use it regularly; therefore it is important to retain traditional communication methodologies which don't disadvantage those shareholders.

### **Financial Reports**

The Annual Financial Report is one of the most important means of transmitting financial information about the UFC to shareholders. Statutory reporting formats have changed significantly over the past decade or thereabouts to the extent that even qualified accountants concede that

they are difficult for the 'average' shareholder to comprehend and to extract information relevant to their needs.

We make the following points in respect to the contemporary formats:

- While shareholders in UFCs generally recognise that the increasing complexity of financial reports is part of the modern corporate landscape, they nevertheless become frustrated with reports which are difficult to comprehend and even suspicious of management and boards who are responsible for their composition. These negative sentiments are counter-productive to a healthy corporate environment and boards and management are acutely aware of the risks inherent in trying to simplify reports to facilitate easier comprehension of the UFC's financial performance and position.
- UFCs typically seek to maintain the privacy of their financial information and most question the need to provide the information required under the contemporary reporting statutes which, it is understood, is largely to inform investors or potential investors from the general public.
  - The relevance of this need in the case of UFCs – and the attendant cost of complying with the AIFRS, for example – is questioned.
  - UFCs also question the need for what they consider private financial information to be presented in the public domain.
- Other relevant stakeholders include the UFCs financiers, who typically rely on information outside that provided in statutory company reports. In other words, it is suggested that such stakeholders have little need for the Annual Report as a source of information pertinent to their needs.

### **The particular needs of shareholders who may have limited knowledge of corporate and financial matters**

The needs of shareholders in respect to financial matters has largely been addressed above.

A further issue which relates to this broader issue concerns shareholders in UFCs who may be faced with a decision in respect to a share transaction. In the event of shares in the UFC being offered for sale, or a party offering to buy shares, the shareholder with limited knowledge might typically seek the advice of an accountant, lawyer, sharebroker or financial planner.

As set out above under the characteristics of UFCs, for a family member, ownership of shares in such a firm can offer a unique set of rewards, but few traditional advisers are equipped to provide objective counsel in such matters. The shareholder requiring advice in respect to such a transaction needs objective counsel as to the financial and non-financial benefits and draw-backs of share ownership in the UFC and particularly the consequences of relinquishing ownership, especially if (say) the shareholder has a temporary need for cash but there is limited opportunity to reacquire shares.

The Family Council can be a useful means to informing shareholders with limited knowledge on a range of matters pertinent to the UFC.

It is also suggested that educational or professional development programs for share brokers, financial planners, accountants and lawyers might include specific insight to the unique aspects of ownership in an UFC.

## **In conclusion: What FBA is proposing:**

### **The need for any legislative or regulatory change**

- Remove the 50 shareholder rule (section 113 (1) of the Corporations Act) and instead permit companies with less than say 300 shareholders to remain small or large proprietary companies, if their shareholders so determine. It is suggested that this election should be determined by a 75% vote of shareholders, rather than on the basis of shareholding, to mitigate the oppression of minority shareholders in this regard.
- Financial Reporting:
  - Permit UFCs to provide AIFRS non-compliant special purpose reports to shareholders, should shareholders prefer to receive simpler form financial reports.
  - Consider the merit of the claimed public interest benefit of financial information being placed on the public record versus the commercial benefits of security from unscrupulous use of the information – and the general benefit of preserving corporate privacy.
- Allow 'private companies' (ie companies with pre-emptive rights in their constitutions) to include in their constitution a requirement that proxy-holders be a member of the company or the member's power of attorney or legal representative.
- Create an environment which encourages family meetings to discuss succession planning, strategic planning, investment planning; also family retreats, etc by allowing more liberal taxation concessions for such activities and similar activities designed to provide a more effective and efficient UFC sector.
- Further to the above suggested legislative and regulatory changes, FBA considers that many of the issues which are the subject of this inquiry could be effectively dealt with in the UFC context if those companies adopted FBA-FBBP. Creating an effective Family Council and professionalising the Board, both by qualification and composition – including the election of suitable independent non-executive directors – are considered key initiatives. The challenge for FBA is to raise awareness amongst the UFC sector and solicit engagement by UFCs with these principles and practices.

## Beyond the scope of these Terms of Reference

- Recognise UFCs (and unlisted companies generally) with pre-emptive rights in their constitutions as being a discrete type of company (private company) essentially similar in style to a proprietary company (small or large).
  - It is suggested that only companies which permit general public membership should be called 'public' companies – and should be subject to a different set of statutes than private companies.
- Having regard for UFC characteristic 1 a i above, consider specific takeover provisions for UFCs with a pre-condition requiring 75% shareholder consent to a takeover prior to the bid being offered to shareholders (at no less than the original indicative price).

Remove the double standard in respect to share transfer provisions (section 140 (2) (c))

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### References:

Aronoff, C.E. and Ward, J.L. (2001), *Family Business Ownership: How to be an Effective Shareholder*, Family Business Leadership Series, No. 15: Family Enterprise Publishers.

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