Family Firms and Family Constitution

LAW AND MANAGEMENT OF FAMILY FIRMS

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Family Firms and Family Constitution

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Preface

The Conference Series

The *Hamburg Conference: Law and Management of Family Firms* is a joint initiative of the Max Planck Institute for Comparative and International Private Law, Hamburg, and the Institute for Mittelstand and Family Firms (IMF), also based in Hamburg. Family firms have increasingly become object of research activities in a variety of disciplines, such as law, psychology, management, and sociology. Exchange between the disciplines has taken place in some cases; for instance, the concept of socioemotional wealth (SEW) reflects contributions from management and psychology. However, exchange between law and management has been very rare so far, although fields like law and economics, law and finance, or corporate governance have been examples of how beneficial such an exchange could be. That was the starting point to originate the *Hamburg Conference: Law and Management of Family Firms*. The conference is supposed to be a forum of exchange for legal and management scholars who share the interest in family firms. It is structured as a research conference with about 10 presentations from both fields, providing enough opportunities for discussion among the participants. Participants include, in addition to the presenters, a small group of further researchers and practitioners with an interest in family firms. In the best case, a cross-disciplinary discussion unfolds. To our great satisfaction, that is what happened in the first edition of the conference. This experience has encouraged us to define the conference as an annual event, taking up a specific topic each year that is of interest for law and management.

The family constitution was the topic of the inaugural edition of the conference. This increasingly important, but under-researched instrument is part of the family governance structure, which in turn forms, together with the business governance structure, the governance framework of family firm and owning family. As already pointed out above, governance is a subject for which the benefits of interdisciplinary exchange between law and management have already been proven. This volume assembles 12 contributions, 10 of them were presented during the conference. For these articles, the book includes a brief summary of the discussion following the presentation. Unfortunately, hurricane "Irma" made it impossible for Isabel Botero to present her paper in Hamburg. The article by Patrick Ulrich and Sarah Speidel was integrated subsequently into this collection, as it adds welcome and substantial information and facts about family constitutions in Germany.

In its entirety, this collection of articles represents the richness of family business research. There are comparative and conceptual papers as well as empirical articles analyzing either a single case or data from a large sample.

Part 1 of the book begins with two surveying articles by Fleischer, and Prigge and Mengers. Therefore, this preface could be rather brief. Fleischer considers historical development and legal nature of family constitutions in five countries. Prigge and Mengers provide an overview of the stock of research on family constitutions that management research has put forth.

Part 2 on managerial research covers conceptual and qualitative analyses. Botero and Fediuk develop further Botero's reasoning about family business governance in a framework made up of equity theory, psychological contracts, and organizational justice. In their article, they claim that governance actually involves interactions between two parties, i.e., sender and receiver. Thus, governance analyses should be aware of the existence of these two parties; their contribution explores the receiving party's perspective in greater detail. Matser and her colleagues Heeringa and van der Vloot van Vliet share their insights they derived from the very close companionship of a Dutch family and its family governance. Jungell focuses on owner families where ownership disperses more and more. She derives from in-depth interviews and her own experiences conclusions about the potential benefits of family governance systems for those families. Kormann introduces the Failure Mode and Event Analysis (FMEA) from the design of mechanical systems into the discussion of family businesses and applies this framework to explore the contribution of governance to the longevity and survival of the family firm.

Part 3, also on managerial research, is dedicated to quantitative analyses and surveys. Graves and his collaborators Caspersz and Thomas have submitted one of the very few studies that explore family constitutions empirically on a large sample, in their case of Australian family-owned businesses. They found a positive and significant relation between the existence of a family constitution or a code of conduct and financial performance, however, surprisingly, not for family-oriented performance. Ulrich and Speidel report about the results of their recent questionnaire of German family firms and provide fresh evidence about, for instance, the reasons why families develop a family constitution and the importance of the development process leading to the final document.

Part 4 focuses on legal research. Bong explores the interplay between a family constitution and the family business's binding legal agreements. In doing so, he describes four different forms of family constitutions that have evolved from different consulting approaches in German practice. Kalss concentrates on the complicated interplay between company law and succession law in family firms. Deckert gives an overview on family constitutions and their legal relevance in the French company law landscape. Holler explains in detail the complexity of family businesses from counsel's point of view. He points out that, contrary to a widespread belief, family constitutions may indeed have legal effects of one sort or the other under German law.

Fleischer and Prigge conclude the book with a brief survey of future research opportunities that were developed by the participants during the two days in Hamburg.

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The IMF is a private research institute that is supported by the HSBA Hamburg School of Business Administration, KPMG, Esche Schümann Commichau, the Hamburg Institute of International Economics (HWWI), and the Hamburg Chamber of Commerce. The IMF particularly acknowledges Esche Schümann Commichau's invitation to the conference welcome reception in their premises.

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Part 1

Legal and Managerial Foundations

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Chapter 1

Family Companies and Family Constitutions: Historical and Comparative Perspectives

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Abstract

This chapter provides an introduction to the world of family companies and family constitutions from a legal perspective. It first studies the legal types of business organizations that family firms have chosen across time and jurisdictions. It then illustrates how early predecessors of family constitutions evolved in the late Middle Ages and what modern family constitutions look like in different countries today. Further considerations are devoted to the governance framework of family firms. The chapter concludes by exploring the potential legal effects of family constitutions under German company and contract law.

Keywords: Family constitution; comparative legal perspective on the family constitution; early precursors of the family constitution; family constitution and German company law; standardization of the family constitution

1.1. The Rise of Family Constitutions and Legal Research

Family constitutions are becoming more and more fashionable in Germany, Europe, and around the globe. Our conference seeks to contribute to a better

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understanding of this new governance instrument. So far, in-depth research has largely come from the field of management studies. Legal scholarship, on the other hand, is lagging behind. The analysis of family constitutions through the lens of company and contract law is still in its early days. Recently, however, a couple of law review articles (Bochmann & Driftmann, 2022; Fleischer, 2016, 2017, 2018; Foerster, 2019; Holler, 2018; Lange, 2013; Reich & Bode, 2018; Uffmann, 2015) and two doctoral theses[1] have been published, so that further progress is in sight.

With this caveat, the following chapter explains how a business lawyer would consider the remarkable rise of family constitutions. Leaving aside doctrinal details, it traces the historical and comparative developments of family companies in general and family constitutions in particular. It first studies the legal types of business organization that family firms have chosen across time and jurisdictions (Section 1.2). Then it demonstrates that modern family constitutions have early precursors, namely the house laws of the high nobility and the guidelines of the moneyed aristocracy. This is followed by a comparative tour through family constitutions in different jurisdictions: United States, France, Spain, Belgium, Germany, and Italy (Section 1.3). After that, family constitutions are located within the governance framework for family firms (Section 1.4). Finally, family constitutions and their potential legal implications are analyzed more closely in the light of German company and contract law (Section 1.5).

1.2. Family Firms and Legal Forms

Family businesses can be classified according to various criteria: age, sector, size, strength of family influence, or economic and financial key figures.[2] Another taxonomy could be organized around different types of owners in the lifecycle of the firm: founder and sole owner, sibling company, cousin consortium, and family dynasty.[3] A trained lawyer would probably first look at the legal form of the family enterprise. This is because in the world of corporate law there is no family company as such, i.e., no specific codified form for family businesses,[4] but only a family partnership, family limited liability company, family stock corporation, family limited partnership, family foundation, etc. Four spotlights will illustrate which legal forms family businesses have chosen for their respective purposes across time and national borders. In doing so, it will become apparent that family firms have contributed significantly to the shaping of company law with their gradual development from a house community to a trading company.

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[1]Bong (2022); Hueck (2017); for a doctoral thesis in the field of management studies recently, Neumueller and Henry (2020).

[2]See the classifications in Davies (2008), Pieper and Klein (2007), and Sharma and Nordquist (2008).

[3]For example, May and Koeberle-Schmid (2011, p. 661 et seq.); also Gersick et al. (1997, p. 17).

[4]Aptly, Kalss and Probst (2013, p. 115): "no codified company law for family businesses."

1.2.1. Family Firms as First Users of the Roman Societas

According to widespread understanding, the roots of partnership arrangements in Roman law go back to the pre-classical *consortium*.[5] In the old days, after the death of the *paterfamilias*, all his household heirs remained united in a community of co-heirs, the so-called *consortium ercto non cito*, through which the family continued to exist. Individual heirs did not have a specific part in the inheritance; instead, all rights were vested in the community of co-heirs. Over the course of time, partners who wanted to form a profit-oriented business partnership were allowed to enter into a classical partnership (*societas*) on the model of the co-heirs of an undivided family (see Zimmermann, 1990, p. 452). This type of partnership was often referred to as partnership of brothers (*societas fratrum*).[6] Against this historical background, it can be rightly stated that family businesses – especially in the form of the jointly continuing household heirs (*heredes*) – were the first users of the Roman *societas* and of partnership law in general (see Fleischer, 2017, p. 1202).

1.2.2. Family Firms as Promoters of the Medieval Compagnia, Accomenda and OHG (Medici, Fugger)

In the Middle Ages, most trading houses had the character of family businesses as well.[7] Their names were all family names (Peruzzi, Bardi, Medici, Welser, Fugger),[8] their partners were mostly close relatives who teamed up to form trading partnerships with joint and several liability.[9] This happened first in the cities of northern Italy, where the so-called *compagnia* emerged in the 14th century.[10] Its very name – translated: community of bread[11] – indicates its preferred use

[5]See Wieacker (1936, p. 126 et seq.); more recently, Zimmermann (1990, p. 451 et seq.).
[6]In this sense, the subheading in Meissel (2004, p. 91), paraphrasing a text by Gaius speaking of a "societas ad exemplum fratrum suorum"; also Wieacker (1936, p. 152): "fraternitas of the partners."
[7]In-depth, M. Weber (1889, p. 44 et seq.) under the chapter heading "The Family and Working Communities"; further Kuntze (1863, p. 183): "The family is also in the world of commerce the natural starting point for the development of the commercial company."; Lastig (1879, p. 431 et seq.).
[8]On this, Kuntze (1883, p. 184 et seq.).
[9]More closely, Mehr (2008, p. 55 et seq.), who traces the roots of these family, household and inheritance communities back to the Lex Langobardorum from the seventh century.
[10]In summary, Fleischer (2021c: § 1 marg. no. 128 et seq.).
[11]Derived from the Latin "cum pane"; on this, for example, Goldschmidt (1891, p. 272 with fn. 131); further Hawk (2016, p. 210): "[T]he medieval Italian *compagnia* originally reflected small family relationships between father and son or among several brothers – men who lived in the same house, who broke the same bread (as the word *compagno* implies) and who found it natural to accept unlimited liability for each other's actions."

as a legal form for family businesses.[12] The Medici, for example, resorted to it when they founded their Florentine banking house in 1397 at the instigation of Giovanni di Bicci de' Medici (1360–1429).[13] Unlike other banking families of their time, such as the Bardi or Peruzzi, who conducted all their business under the legal umbrella of a single *compagnia*,[14] the Medici Empire was structured as a group of partnerships.[15] At the top, there was a main partnership made up of family members and one or two non-family partners (see McCarthy, 1994, p. 13). It in turn owned majority stakes in various subsidiaries, subject to strict control by the main partnership.[16] All this is exemplified by the partnership agreement of the Bruges subsidiary of July 25, 1455.[17]

But the Medici not only knew how to use the *compagnia*, they sometimes also sought to limit risk in the expansion of their business. In doing so, they made use of a Florentine law of November 30, 1408, which allowed the foundation of an *accomenda* or *società in accomandita,* in which some of the partners had only limited liability (see Goldschmidt, 1891, p. 271; also Goldthwaite, 2009, p. 67) – the Italian archetype of today's limited partnership.[18] An example that has come down to us is the partnership agreement of 1422 on the founding of a bank in Naples, to which the partners of the Medici bank contributed a (limited) sum of 3,200 florins and were thus, according to the partnership agreement, exempt from

[12]See Schmidt (1883, p. 8): "In fact, the largest and most famous trading companies of the later Middle Ages grew up on the soil of the family; they are large manorial estates continued through a series of generations. [...] The close bond of trust which embraced the partners gave these companies a special support and enabled them to carry out undertakings for which companies based solely on contracts were not equally suited."

[13]More closely, de Roover (1946, p. 28 et seq.); McCarthy (1994, p. 10 et seq.).

[14]See de Roover (1946, p. 28): "The essential feature of the form of organization exemplified by the Bardi and the Peruzzi companies is that there was only one partnership. It owned the home office in Florence and all the branches abroad."; de Roover (1963, p. 77).

[15]More closely with diagrams, de Roover (1963, p. 81): "In studying the organization of the Medici Bank, one cannot fail to notice how closely it resembles that of a holding company."

[16]See de Roover (1946, p. 29), explaining: "[T]he Medici banking house was not one partnership but a combination of partnerships. A separate partnership was formed for each of the Medici enterprises. The 'bank' or home office in Florence, the branches abroad, and the three industrial establishments in Florence."

[17]Reprinted in Grunzweig (1931, p. 53 et seq.); also in Gutkind (1938, p. 308 et seq.); in-depth analysis bei Fleischer (2021a, p. 97 et seq.).

[18]See Fleischer (2021c: § 1 marg. no. 91 et seq.); further Goldthwaite (2009, p. 67), explaining that the *accomenda* never realized its potential for evolving into something like a joint stock company; further Hawk (2016, p. 238): "However, the *accomandita* never became widely accepted. Other than by the Medici Bank, it appears that it was infrequently used. From the late 15th century to the 1530s, fewer than six *accomandita* contracts, on the average, were registered annually."

any further liability (see de Roover, 1963, pp. 43 and 89 et seq.). After decades of economic prosperity and political influence, adverse political circumstances led to the decline of the bank and the expulsion of the Medici from Florence in 1494.

Just in the year in which the Banco Medici collapsed, the brothers Ulrich, Georg, and Jakob Fugger associated themselves in southern Germany to form a family business. Their partnership agreement of August 18, 1494,[19] which has been called the "Basic Law of Fugger Trade" (Pölnitz, 1949, p. 58) is considered one of the first ever commercial partnership contracts (*offene Handelsgesellschaft, OHG*) in Germany. It was concluded under the name "Ulrich Fugker und gebrudere von Augsburg" with a term of six years. Restrictions on withdrawals, individual power of representation, a ban on competition and majority decisions in the event of disagreements testify to the will of the participants to place all individual forces at the service of the overall family business. A follow-up contract of 1502,[20] in a special agreement on Hungarian trade, for the first time restricted the succession of partners to the "male line" of one's own family.[21] In the event of the death of a partner, the survivors were to continue the trade, pay out the female descendants of the deceased and prepare the fittest among their sons for future participation in the management. With the death of Georg and Ulrich Fugger, the partnership of three brothers with equal rights came to an end; Jakob Fugger (1459–1525), as the last remaining partner, was entitled to continue the partnership on his own. He then concluded a new partnership agreement with his four nephews in 1512 under the name "Jacob Fugger und seiner gebrueder süne," which reserved him the right to set the profit shares, exclude partners and dissolve the company.[22] Until his death, he was the most powerful and politically influential banker in Europe – reverently called Jacob Fugger the Rich by his contemporaries.

1.2.3. Family Firms in the 19th Century Between Partnerships and Corporations (Baring, Rockefeller)

The next major developmental step occurred in the late 19th century with the introduction of new forms of limited liability companies. They had been longed for everywhere, especially by small entrepreneurs who were looking for a way to develop under the protective shield of limited liability (Fränkel, 1915, p. 17). In Germany, an urgent need for reform had been identified especially for family and hereditary companies, which the legislator largely satisfied with the GmbH Act of 1892.[23] In England, practical guides in the last quarter of the 19th century

[19]Reprinted in Jansen (1910, p. 263 et seq.); in-depth analysis by Fleischer (2021b, p. 139 et seq.).
[20]Also printed in Jansen (1910, p. 270 et seq.).
[21]Häberlein (2006, p. 39) adds: "At the same time, the Fuggers were breaking with their own family history, because in the 15th century it had been women who had ensured the continuity of Fugger trade."
[22]Reprinted in Jansen (1910, p. 289 et seq.).
[23]See Fleischer (2021c: Introduction, marg. no. 54); Fränkel (1915, p. 17).

contributed significantly to the popularization of the private company.[24] This new, but at first still legally unsecured, offer was used primarily by family companies, which converted their already existing small businesses into the legal form of a company.[25] The reasons for this were, to a large extent, to protect themselves from the disgrace of private insolvency by compartmentalizing their liability[26] – a danger that seemed all too real in view of the Great Depression of 1873–1896 in the late Victorian period (see Ireland, 1984, p. 248). In addition, considerations of business succession played a role.[27] Both of these factors may also have guided the case in what is probably the most famous decision on English company law, *Salomon* v *Salomon*: In 1892, Aron Salomon had transformed his sole proprietorship shoemaking business in London into a company by acquiring his wife and his five eldest children as co-partners – in order to meet the minimum number of shareholders of seven – and endowing them with one share each, while he held 20,000 shares. The House of Lords ruled in 1897 that the privilege of limited liability was also available to such a company with nominee shareholders.[28]

However, it was not only smaller family businesses that discovered the attractiveness of limited liability, but also large business dynasties. One example is the famous Baring banking house, which was originally organized as a partnership. In 1890, defaults by Argentina and the withdrawal of considerable sums by the Russian government brought it to the brink of collapse putting all family partners in danger of having to assume unlimited liability with their private assets.[29] After this existential crisis was overcome with the help of the Bank of England and potent private banks, namely the Rothschilds, the company was converted into a limited liability company and henceforth traded under the name Baring Brothers and Company, Ltd. (see Landes, 2006, p. 61).

On the other side of the Atlantic, the Rockefellers underwent a similar change of legal form under quite different circumstances. Their entrepreneurial rise in the oil business began in 1865 when John D. Rockefeller (1874–1960) teamed up with the English engineer John Andrews in Cleveland to form a partnership under the name "Rockefeller and Andrews" (see Becht & DeLong, 2005, p. 626; Charnow, 1998, p. 87 et seq.). Two years later, Henry M. Flagler joined them (Charnow, 1998, p. 108). In view of their firm's growing financial needs, they looked for

[24]For a pioneer publication, Palmer (1877).

[25]See McQueen (2010, p. 142 et seq.): "Many of these enterprises were conversions of existing family businesses. Conversions were quite often an attempt to revitalize a family firm that had exhausted family financial reserves or managerial talent."

[26]See McQueen (2010, p. 221); previously, Cottrell (1980, p. 265).

[27]On this, Harris (2013, p. 369): "This motivation led hundreds of other family firms, moving from first-generation sole proprietorship to second-generation partnerships, to the corporate form."; further McQueen (2010, p. 193).

[28]See *Salomon* v *Salomon* [1897] (HL) AC 22; for an in-depth and comparative law analysis, Fleischer (2016, p. 44 et seq.).

[29]See Landes (2006, p. 58), with the additional remark: "Unlimited liability then still meant just that, and the partners were liable by law to their last shilling and their last acre, not to mention houses, animals, paintings and furniture."