Review of the Governance of Family Run Businesses in India: Importance of succession planning in a business

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September, 2011

Thought Paper 2011/003

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Introduction

Family run businesses in India: Overview

In the wake of the Satyam Computers scandal[1] there has been a renewed interest in the management of family owned businesses in India. While that was a case in accounting fraud, bribery and investment in an unrelated family business; and the importance of good governance practises in family run businesses, including the issues of dominant ownership, (lack of) independence of board and collusion with the audit firm; there is, separately a rising concern on the issues pertaining to the succession issues in Indian family run businesses e.g. in the split of the Reliance Group between Anil and Mukesh Ambani[2] after the demise of their father the creator of the group with a charismatic "rags to riches" story and acrimonious public mudsling between them as well as the much publicised debate over the lack of succession plans for Mr Ratan Tata[3] when he turned 70. This paper will focus on the goals of family run businesses and the different approaches to succession planning that have been successful.

Survival and growth of family businesses beyond two or three generations is not always easy. Globally out of the 100 first generation businesses, 38 survive in to the second generation; and 12 survive in to the third generation says Ashish K Bhattacharya[4] quoting a CII study that indicates that for Indian family run businesses, only 3% survives the third generation. This is a serious challenge, because 71% of employment, 65% of GDP and 75% of market capitalisation depended on this sector in 2001. Family managed organizations dominate the Private Sector in Indian Business.

As pointed out by Bajaj (2004)[5], 'Of the 100 private sector companies in India with market capitalization of over Rs. 1,000 Crores (1 crore=10 million), in my assessment about 75 are family managed, 18 are subsidiaries of MNCs and 7 are managed by professionals. One can quibble about the numbers, but the overwhelming fact is of family management'.

Moody's and ICRA 6surveyed certain corporate governance practices of 32 Indian companies in 16 prominent family groups, covering a broad cross-section of Indian industry; ICRA(2007) and found that although a few notable companies are leading the way in emphasizing the importance of good governance and adopting global best practice, important governance issues persist. These potentially have negative credit implications, and typically effect issues not (or only partially) covered by regulations – including leadership transition, transparency on ownership/control and related-party transactions, and independence of directors. The lack of board nomination sub-committees in most of the companies surveyed suggested that succession planning is not fully deliberated with appropriate involvement of independent directors. Lack of clarity on ownership and the financial position of non-listed family-controlled holding companies (which may have raised significant amounts of debt to fund the group) were also identified as material credit weaknesses. The survey also found that despite regulations regarding independent board directors, families retained significant control over listed companies – and sometimes appeared to be acting primarily for the benefit of the family, independence of directors was a big corporate governance challenge.

Some recent developments in Indian Business have clearly bought to the forefront the role of the succession planning in family run businesses and how it has impacted Corporate Governance in the organization. Succession usually happens in one of three ways: one is the corporate style, where a successful CEO creates a raft of choices for his board to select the best man for the job. The second is the dynastic way, where leadership passes from father to son (sometimes daughter). This is what happens in Indian family-owned businesses. The third approach is to do nothing. This is essentially a Darwinist approach, where success goes to the fittest. Its downside is that it is usually preceded by struggle and bloodletting. Dhirubhai's failure to leave a will has resulted in the biggest corporate fight in Indian history--a fight that hasn't ended even after the two brothers signed a deal brokered by mother Kokilaben in 2005. But deal, we now know, was merely the end of the beginning. Sibling wars, especially those that are born of mistrust, never end unless the break is clean.

The sordid saga of Corporate Governance at Reliance which came into limelight in the dispute between the two Ambani brothers - Anil and Mukesh- has been very well documented by Dalal (2005)[7].

Not only were these grave charges of mis-governance against one of the largest Indian Companies, Dalal (2005) points out that ironically they were levied against a Company that had been showered with awards of Corporate Excellence (Institute of Company Secretaries) in 2003 and Corporate and Social Responsibility awards (Golden Peacock, by the Institute of Directors) in 2004 which coincided with the period when these misdemeanors had actually taken place!

Managing a family run business:
Key governance strategy frameworks

The five attributes of enduring family businesses according to Christian Caspar, Anna Karina Dias and Heinz-Peter Elstrodt of Mckinsey & Company[8] are:

i. Business & Portfolio Governance
    a. Business portfolio
    b. Capital composition; structure
    c. New business development

ii. Family
    a. Family forums
    b. Family policies
    c. Family services

iii. Ownership
    a. Shareholder agreements
    b. Holding structures
    c. Legal covenants

iv. Wealth Management
    a. Investment office
    b. Legacy assets and new opportunities
    c. Governance

v. Foundations & philanthropy
    a. Management & governance of the family's own foundation
    b. Third party foundations

In the Indian context these have been reinforced in the case of successful family transitions. Mr. Muruguppa Subbiah[9] highlights the future challenges for his family business (a successful third generation family run business) as

i. Wealth planning
ii. Agency challenges as future generations are not necessarily actively in the business
iii. Bill of rights & responsibilities
iv. Ownership to trusteeship
v. Leadership & succession planning.

In a study "Indian Family Business: Their Survival Beyond Three Generations" by Prof K Ramachandran, Indian School of Business he has built the Ten Commandments of Family Business:

i. Family vision, strategy & governance
ii. Business vision, strategy & governance
iii. Conflict resolution mechanism
iv. Preserving wealth

v. Ownership structure

vi. Induction & grooming

vii. Retirement & estate planning

viii. Recruitment & reward of non-family professionals

ix. Compensation & rewards for family

x. Succession Planning

Family councils, advisory board and independent non-executive directors:

Family run businesses in India, framework

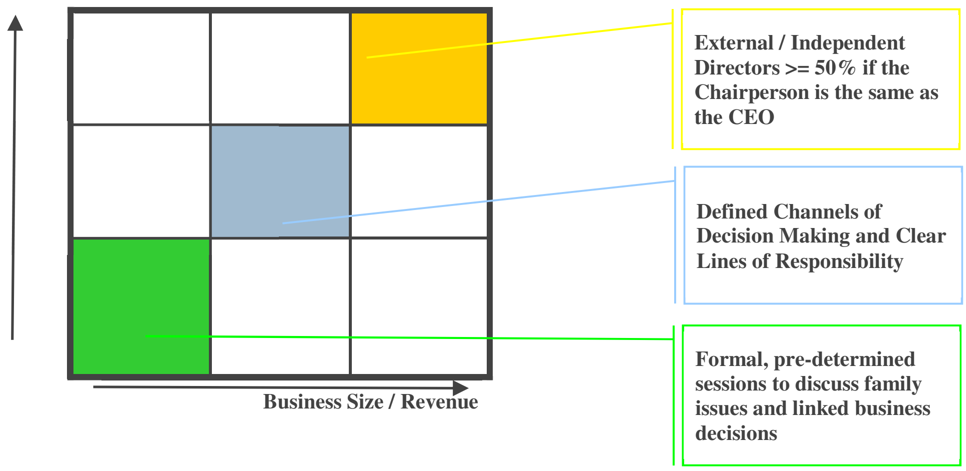
Cadbury had three requisites for family firms to manage successfully the impacts of growth:

i. Able to recruit & retain the very best people for the business

ii. Develop a culture of trust & transparency

iii. Defile logical and efficient organizational structures

In the book "Corporate Governance" by Christine Mallin on Page 68 we have an interesting framework that I have adapted to show the evolution of a governing framework for family run businesses:



The advantages of a formal governance structure are several. Firstly there is a defined structure with defined channels for decision making and clear lines of responsibility. Second, the board can tackle areas that might be sensitive from a family viewpoint but which, nonetheless have to be dealt with – succession planning is a case in point (deciding who would best fill key roles in the business should the existing incumbents move on, retire, or die). Succession planning is also important in the context of raising external equity.

Conclusion
Future direction for Indian family-run businesses

The Government of India continues to focus on legislation to ensure that frauds like the Satyam Computers one are not repeated; examples of what they have addressed are:

- **Clause 49** of listing regulations of the Stock Exchanges set up under Kumara Mangalam Birla committee: 8 sections covering Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management of Shareholders, and Compliance.
- **Revised** by SEBI committee headed by Narayana Murthy Committee in 2004: 50% independent directors if CEO & Chairman are same person, CEO & CFO to certify Company's financial statements & the adequacy of internal controls,

disclosure requirements, penalty of non-compliance: delisting / financial penalties

- **Naresh Chandra Committee** recommendations on Financial & non-Financial disclosure, independent audit & board oversight of management
- **Companies Act revision in 2009**: Key Management Positions: definition & process for nomination; rights & duties of auditors.

The future of family run businesses however requires a lot more than just regulation that addresses accounting & financial gaps. Here are some important areas that would define a successful framework:

- Family councils, family boards and independent directors that are mandated by size of business.
- Societal change through education?
- Making Independent Directors personally liable / accountable?
- Regulation that protects rights of minority Shareholders

It is, of course, important to bear in mind that there will be the natural "cycle of life" in family run businesses in India; however – delving into the experience of the West and adapting lessons learned from mature economies to the rich historical and cultural legacy that dominates the Indian businesses can ensure that there is a successful transition through a difficult era as many Indian family run businesses pass on the reins beyond the third generation and transform into truly global empires.

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[1] http://www.nytimes.com/2009/01/07/business/worldbusiness/07iht-satyamtime.19149807.html

[2] http://www.indianexpress.com/oldStory/73285/ Ambani Aftermath

[3] http://www.business-standard.com/india/news/ratan-tata%5Cs-successor-may-beforeigner/78630/on

[4] "Corporate Governance in Family Business" presentation by Prof. Ashish K Chatterjee, IIM Calcutta, at the 3rd Directors' Leadership Program

[5] Bajaj, Rahul, (2004); Competing with the Best in the World, Speech at the BMA Golden Jubilee Lecture, 15th December 2004.

[6] ICRA, (2007); Corporate Governance and related Credit Issues for Indian Family – Controlled Companies; Moody's ICRA Corporate Finance, October 2007.

[7] Dalal, Sucheta, (2005); Is Reliance rewriting rules of corporate governance, www.suchetadalal.com.

[8] McKinsey Quarterly; Organization Practice. January 2010. "The five attributes of enduring family businesses" by Christian Casper, Ana Karina Dias and Heinz-Peter Elstrodt

[9] "The Vision of An Indian Family Business: The MURUGAPPA Case" Presentation to Congress for Family Business Companies in Austria by Murugappa Subbiah 9th May 2007