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## Addressing Problems That Tear Families Apart: Why Good Governance Matters for Family Firms

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### Article at a glance

- Family-owned businesses face unique problems with continuing their operations successfully over several generations due to governance issues.
- While corporate governance is conventionally regarded as applicable to public corporations, family-owned companies are equally in need of sound governance mechanisms.
- Creating and applying a system of good governance is crucial for the preservation of not just financial wealth, but also human and intellectual capital of family firms.

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## Introduction

Corporate governance is conventionally regarded as applicable in the domain of public corporations and family firms have long been excluded from the good governance debate; however, the fact that only 15 percent of family-owned businesses survive until the third generation indicates that governance is also a crucial issue for family businesses. What causes family firms to fail the test of time?

In case of the Pakistani family businesses, the fall of Dacca and the subsequent massive nationalization of industries during the early 1970s was a time of great change. Events of that period placed a great deal of pressure on the weak fabric of business families, many of which fell apart immediately or weakened to the point that they were torn apart in subsequent years. While some may blame the events of those years for the failure of family firms, others say that “the fault, dear Brutus, lies not in our stars but in ourselves.” If 1971 never happened, many business families would still have broken apart, perhaps a few years later. The reasons lie within those family firms.

Families are no different than any other institutions, even countries. They require values, codes of justice, fair play, and support for the weaker members of the family. They require a mechanism for redressing grievances and for having open and candid discussions.

## Problems Faced by Family Firms

The Dawood Family Industries were unique in the sense that it broke up while the first generation was still at the helm of affairs and the second generation had just entered the business. Ahmad Dawood, who founded the Dawood family business, was an individual of many faces. To some he was a colossus and a captain of industry, but to others he was a tyrant. Some faced his wrath, others faced his affection. He was just the same with his family as with the family business.

He had a vision, he was ambitious, and, at the same time, he was ruthless. He could smell opportunity miles away and pursue his goals with tenacity. I am personally grateful to him for he sent me to England and USA for studies which allowed me to add to my intellectual capacity and my grooming. He placed Dawood Group of Industries on the map as a

leading business house with a reputation for running profitable enterprises and paying dividends. Ahmad Dawood was a smart man, but not a wise one. He had little appreciation for the collective human capital and intellect in the Dawood family. He could not understand the importance of having guiding principles or checks and balances, and he gave little attention to elements required for institution building.

The Dawood family did have a family council; however, the objectives and governance procedures of the council were not clear, even to its members. It met at the whim of the chairman. From time to time, discussions were recorded but were later changed or not implemented. The family soon started to perceive the council to be ineffective and unjust. The members never discussed the most contentious issues, as it was too embarrassing to talk about them. Conversations avoided key issues such as the security of family members, ownership structure (as divided within the family), and the mechanism for an individual to leave the family business. There was no succession planning. All those and other issues led to internal pressures, disillusionment, and exasperation.

This experience led to the realization that the Dawood family could benefit greatly from managing the relationship between family members like a family business. These lessons apply in other countries and in other family businesses as well. For a family-owned business to have good governance within its enterprises, it must have good governance between the family members. Poor governance in the family leads to tensions that will inevitably spill over to the boards of various companies and then into the management. The opposite of this scenario is also true – good governance in the family will lead to good governance in the company.

Briefly, problems within a business family are summarized below:

- Very few families understand that their assets comprise three forms of capital: human, intellectual, and financial. Even fewer families understand that without preservation of their human and intellectual capital, they cannot

preserve their financial capital; unfortunately, families often concentrate solely on financial capital.

- Many families fail to understand that preserving wealth is a dynamic process. Each generation of the family must maintain the wealth-generating spirit of the first, founding generation.
- Families often fail to measure properly the time frame for successful wealth creation. Planning for the use of family's human and intellectual capital is too focused on the short term and on individuals rather than wealth creation mechanisms. The lifespan for a family business should instead be measured by generations, and long-term planning is essential.
- Families must also understand that fundamental issues of wealth preservation and good governance are qualitative, not quantitative. Most families measure success based on the size of their financial balance sheets. But without a qualitative assessment of human and intellectual capital, the family balance sheet is incomplete and ineffective in measuring whether a family is achieving its wealth preservation goals. Family wealth includes human behavior, teamwork, and understanding.

### Qualitative issues crucial to a family business

- Is each family member succeeding and satisfied with the family business?
- Does the family provide incentives for leaders of each generation to stay in the family business and to listen to each member's concerns? Do family members know how to leave the family business amicably for retirement or other reasons?
- Are family stories being shared with younger generations? These stories are the glue that binds the family members together. Do all family members understand and accept that although good governance within the family over a long period of time is difficult, it is indispensable?

## What Is To Be Done?

If a family is to function as a business, then it follows that a well-managed family business should have a statement of its purpose, values, and goals. The creation of such a statement is the starting point for the process of organizing a family to preserve wealth through good governance. There are several points to keep in mind:

- The objective of a system of family governance must be to align the aspirations of each individual family member with the goals of the family as a whole. Enhancing synergies between individual and family objectives encourages the long-term preservation of the family's wealth: its human, intellectual, and financial capital.
- A family's wealth consists primarily of human and intellectual capital; financial capital is secondary. Financial capital alone cannot provide long-term wealth preservation. What a family's financial capital can provide is a means to promote the growth of its human and intellectual capital. Without intellectual capital, even with all the money in the world, under-educated family members will not make optimal decisions. Therefore, the development of human and intellectual capital contributes to growth of financial capital.
- An explicit and voluntary statement of the family's values and goals is necessary to create a system of governance through which those family principles can be practiced. It ultimately allows for more effective wealth preservation. Each successive generation must reaffirm its commitment to this system of governance, including a process for settling family disputes and grievances. Any such governance system must recognize that family members will be willing to give up some freedom if they realize the greater benefit for doing so, and it also allows each member to play a role in the evolution of that system.

## Conclusion

Each family has to decide what its objectives are. If the objective is purely to enhance financial capital, by any means and as fast as possible, then corporate governance is not for those families. If family leaders want a long-term strategy for wealth preservation, then corporate governance is a good beginning.

I am now a first generation family business owner. While waiting for my two sons to join the business, I concentrated on building professionalism in our companies. We have made some progress on good governance, but have much ground to cover to make our boards truly effective, to make various board committees operational, and build strong systems of checks and balances in all functional areas. My sons are now part of our family's firm. Once they have more experience and knowledge of the business, we will collectively begin the long journey towards good governance by setting out our purpose, objectives, values, and the form of governance that best suits us.

We will certainly address issues such as the role of women members of the family (in particular, daughters-in-law), retirement age, succession planning, education trust, security of members, and options for leaving the family business. The mere enhancement of financial capital is not the objective; rather, it is the long-term preservation of all assets through good governance, creating a lasting, multi-generational institution. If, 20 years from now, one of my sons states that he is now a first generation family business owner, then I will have miserably failed. If my grandson says this, I will be very disappointed. If subsequent generations say this, then perhaps I didn't work hard enough.

Families that choose to enter the process of long-term wealth preservation face the daunting fact that, if they are successful, this process may never end. They have to commit to good governance practices for all generations to come. The result of good governance within the family and its companies is a family-based, professionally-run, continually growing institution. Many family leaders have such dreams. We will know in 100 years whose dream has come true.

*This paper was presented at the launch for the Corporate Governance Guide for Family-Owned Companies, organized by Center for International Private Enterprise in partnership with Pakistan Institute of Corporate Governance and the Institute of Chartered Accountants of Pakistan on June 4, 2008, in Karachi. A. Razak Dawood is the former Federal Commerce Minister and currently Chairperson of the Pakistan Business Council. He manages his own businesses in the engineering, chemical, and power sectors and is chairperson of the first family-owned Pakistani multinational company.*

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