Governance Code for Family Businesses

(commission version dated September 4, 2004)

GOVERNANCE CODE FOR FAMILY BUSINESSES

Having circulated through public limited companies for the past couple of years, talk of Corporate Governance has now also reached family businesses. In setting up the commission for the Governance Code for Family Businesses, INTES and WELT AM SONNTAG newspaper have set as their objective providing these companies and their partners a reliable framework for evaluating and optimizing their company constitutions.

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Excerpts of the Governance Code for Family Businesses, as ratified by the commission, were presented to the public for the first time on September 12, 2004 in the WELT AM SONNTAG newspaper. You can obtain the complete text at the following web site:

„www.kodex-fuer-familienunternehmen.de“

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Foreword

In February 2002 the German Corporate Governance Code was presented to the public. It set in motion a discussion pertaining to recognized standards of responsible management and supervision structures in companies. The code primarily pertains to public limited companies. The vast majority of German companies, however, does not involve perpetually changing shareholders. Mid-sized companies, in particular, are usually controlled by a single person or family for a long time.

Good governance considerations are no less valuable for family businesses. We only have to look at the Revised International Capital Framework (Basle II) to see that these companies will increasingly have to align their efforts with the requirements of capital markets. Furthermore, good governance is a core element of company management assuring future viability. Improved governance structures are vital to ensuring a company's sustainability.

Family businesses cannot simply adopt the recommendations made in the German Corporate Governance Code as they stand. These businesses differ significantly from public companies in view of the closer connections between management and ownership. This offers special opportunities, but also involves specific risks. Good governance in public companies is primarily intended to protect anonymous shareholders from the incompetence and despotism of their trustees in the management board and supervisory board. In family businesses, on the other hand, the following question is of primary concern: how can we ensure the responsible behaviour of owners for the long term?

The objective of the Governance Code for Family Business, initiated by INTES and the newspaper WELT AM SONNTAG, is therefore to provide a code of behaviour which is specifically tailored to the requirements of family businesses.

As opposed to the standards laid forth by the German Government Commission in the German Corporate Governance Code, the code presented here cannot provide binding rules, but rather serves as a statement of recommendations. Nonetheless, it is the expressed hope of the commission that its work will enable German family businesses to improve the quality of governance in their companies and provide their partners with tools for reliable evaluation.

The code is primarily intended for mid-sized and large family businesses with several partners. For those family businesses listed on the stock market, this code should serve to further the rules set forth by the "Cromme Commission", because it places special emphasis on the relationships between partners. Small family businesses are also encouraged to adhere to the basic principles of the code, especially with reference to management and succession.

The code will be updated on a regular basis as deemed necessary by current developments.

1. Avowal of responsible entrepreneurship

Those who wish to keep a company as a family business for the long term, not only have to carry out entrepreneurial activities, they also have to ensure sufficient unity within the owner family and make sure that those involved make clear avowals of loyalty to the family business and the associated entrepreneurial responsibility.

1.1 In the case of conflicts, every entrepreneurial family should be prepared to put noteworthy company interests ahead of the individual interests of partners.

1.2 It should also be prepared to give up control of the company should the family no longer possess the will or the ability to manage the company itself.

1.3 Good governance in the family business includes

- being aware of these relationships,
- making a believable and documented avowal to responsible entrepreneurship for this purpose,
- and renewing these from generation to generation.

2. Transparency of company structures

Transparency is one of the basic requirements of good governance. This means that, even in family businesses, the company structures have to be created so as to allow the management and control bodies, the owners and other financiers of the company to accurately evaluate the financial status and revenue of the company at any time and arrive at accurate conclusions based on this evaluation.

3. Ensuring qualified management and succession

3.1 Number of managing directors, allocation of duties

3.1.1 The number of managing directors should be based on the size of the company and the level of difficulty of the duties.

3.1.2 In companies with several managing directors, rules of procedure and a schedule of responsibilities should be established. Furthermore, decisions should be made as to whether one of the managing directors should be appointed chairman or spokesperson.

3.2 Selection

3.2.1 Professional and personal qualifications should be the decisive factors in selecting management. Potential managers from the family should be subjected to the same requirements and the same selection procedures as external applicants. There should exist no special contractual arrangements, which entitle a specific person or group of people (e.g. family lines) to be managing director.

3.2.2 Neither should members of the entrepreneurial family be treated differently than external candidates when designing employment contracts. Compensation, the term of contract and other significant components of the contracts should correspond to those offered to non-family members for the same duties.

3.2.3 If several partners have a share in the company, non-family members should be involved in decisions related to selecting management staff for reasons of neutrality. This should be observed most closely when the person in question is a member of the owner family.

3.2.4 If several family members are involved in management, an appropriate mechanism for solving conflicts should be put in place.

3.3 Management succession

3.3.1 Well managed family businesses should carry out professional long-term succession planning. This should at least include considerations pertaining to selection, preparation of potential successors and creating a transfer process which is as smooth as possible.

3.3.2 The contracts of the family business should include an age limit, i.e. a point in time at which members of management have to retire, regardless of the person's own intentions.

3.3.3 Furthermore, an emergency plan should exist, which specifies procedures to be followed in the case of early or unplanned succession.

3.4 Management duties

3.4.1 Management should develop a strategy and make sure that this strategy is implemented. The strategy should be clearly based on the owners' long-term objectives in close agreement with the owners or with a controlling body put in place by the owners.

3.4.2 Management should carry out strategic planning and annual planning to implement the strategy in operation. This should also be done in close agreement with the owners or with a controlling body put in place by the owners.

3.4.3 Management should report results related to the success of its activities to the owners or a controlling body put in place by the owners. Reporting should occur regularly and be up-to-date, comprehensive, in the written form and provided in due time before meetings. The report should include information pertaining to current business development, variations from planning, business opportunities, risks and measures for counteracting these risks, as well as any unusual events occurring during the reporting period. Content and scope of the reports should be specified by the owners or a by controlling body put in place by the owners.

4. Ensuring qualified control of management

4.1 Responsibility

The owners are responsible for making use of control mechanisms. If the family business has several partners, then it should set up a volunteer controlling body (a so-called advisory board, governing board, supervisory board, management committee, etc.). This even applies to those companies which are not required to do so by law.

4.2 Structure of the controlling body

4.2.1 The size of the controlling body and its internal organization should be aligned with the size of the company and the significance of its duties.

4.2.2 In order to improve objectivity and quality, it is recommended that expertise from outside the family be included in the controlling body. As the will or capability of the family decreases with regard to qualified perception of the controlling function, it becomes increasingly important to implement external members in the controlling committee.

4.2.3 Attention should be paid to the fact that all members of the controlling body are adequately qualified for the tasks.

4.2.4 Upon selecting members of the controlling body, appropriate measures should be taken to avoid conflicts of interest. This especially applies to people who have significant business relationships with the company.

4.2.5 It should also be ensured that the members of the controlling body can be available at the time required to carry out their duties in a responsible manner.

4.2.6 If possible, members of the controlling body should not acquire their positions due to delegation rights held by a single owner or group of owners. At least a majority of the members should be selected unanimously by all owners.

4.2.7 An age limit should also be set for members of the controlling body.

4.3 Duties of the controlling body

4.3.1 The most important duties of the controlling body include:

- Appointing managing directors and relieving them of office,
- Entering, ending and creating the contents of the company's employment contracts including all compensation issues,
- Making decisions pertaining to the rules of procedure, allocation of duties and appointing a chairperson or a management spokesperson,
- Preparation of or passing a resolution pertaining to dismissal.

4.3.2 Furthermore the committee, as a body representative of the owner, can be involved in significant management decisions. Passing the strategy and all planning derived from this strategy, as well as management measures of essential significance should require previous approval by the controlling body. For this purpose, the controlling body should specify a list of those management measures requiring approval without removing the basic separation between management and the controlling body. The controlling body is not a "higher management entity".

4.3.3 The controlling body should monitor the success of management activities. In doing this, it should place special emphasis on the reports created by company management.

4.3.4 In most cases, the controlling body should meet four times per fiscal year.

4.4 Rights and duties of the members of the controlling body

4.4.1 Company management and the controlling body should work together in a trusting and organized manner. This especially applies to the chairperson of the controlling body and the company management chairperson or spokesperson.

4.4.2 The members of the controlling body should be obliged to further the prosperity of the company as a whole, or that of all owners as the case may be. They should not represent particular interests and they should not be bound by instructions from individual owners or owner groups.

4.4.3 The members of the controlling body should receive appropriate compensation for their duties.

4.4.4 The members of the controlling body should be held responsible for errors in carrying out their duties at least in cases of criminal intent and gross negligence. Limitation of liability according to amount or using insurance to cover the risk of liability should be allowed as long as an appropriate deductible is agreed upon.

5. The membership rights of partners in the company

5.1 Legal standing of the owners

5.1.1 The owners remain the highest authority even in family businesses, in which control of the company management is delegated to an independent controlling body.

5.1.2 They should specify values and goals for their company. They should make clear statements particularly pertaining to the company remaining in family possession as well as growth, profitability and stability expectations. The compensation system for company management should be closely connected with the degree to which these objectives are met.

5.2 Individual membership rights of the partners

5.2.1 The primary membership rights of the individual partners include the right to vote, the right to participate in general meetings and the right to information. Access to information should be organized. This should also ensure confidentiality of all included information.

5.2.2 In the case of shares held by minors or those subject to execution of a will, the required measures should be taken to ensure appropriate participation of representatives.

5.3 Decision-making

5.3.1 Decision-making processes of the partners should be organized in such a way as to prevent the interests of individual partners from blocking decisions which are in the company's interest.

5.3.2 Special rights granted to individual partners or partner groups should be limited to a minimum. These special rights should always be substantially justified.

5.3.3 Appropriate dispersal mechanisms should be put in place to avoid tied situations which are destructive to the company.

5.3.4 The necessity of unanimous decisions should be avoided at least in those companies with a large number of partners.

5.3.5 Majority and minority rights should be balanced appropriately.

5.4 Employment by the company; other contractual and payment relationships

Ownership of the company does not guarantee automatic right to employment in the company or preferential treatment in other contractual relationships (service contracts, rental contracts, etc.) between the partner and his/her company.

5.4.1 If this type of relationship is allowed at all, then members of the owner family should be subject to the same evaluation criteria as other non-family members.

5.4.2 The principle of equal treatment should be implemented within the family; the access requirements should be the same for all family members.

5.4.3 Decisions when made should be based on a formal procedure. If an independent controlling body exists, then this body should be responsible for all contractual relationships with family members.

5.4.4 The decision criteria as well as all contractual relationships between the company and members of the owner family should be transparent to the owners or to the controlling body put in place by the owners.

5.4.5 The above rules also apply to all payments received by the owners from the company.

6. Accounting standards, profit distribution

6.1 Accounting standards

6.1.1 When at least one partner is no longer active in company management, then the family business's annual statement of accounts should be checked by an auditor or auditing company. The owners, or a designated controlling body, should decide on the auditor and agree on any incurred fees.

6.1.2 The owners, as well as the members of a controlling body, should have the opportunity to acknowledge the annual statement and auditor's report in due time before a resolution is passed based on these findings.

6.1.3 The owners, and/or the controlling body designated by the owners, make decisions based on the findings of the annual statement. The auditor should participate in consultations pertaining to the annual statement and give an oral report pertaining to significant findings of the audit.

6.2 Profit distribution

6.2.1 Profit distribution should be dealt with in such a way as to avoid yearly discussions pertaining to the amount of distributions, thereby limiting potential conflict related to this. The distribution quota should be specified in the statutes of the family business and should be binding if possible. It should still be possible to modify this with the required majority.

6.2.2 With regards to the appropriate balance between the company's best interest and the owners' interest in distribution, it is suggested that the amount of distributions be dependent on attainment of specific stability figures (e.g. equity ratio).

6.2.3 Entrepreneurial families, which want to keep the company in the family's possession indefinitely, should make sure that a sufficient portion of the profit after taxes remains in the company.

7. Measures to preserve family possession of the company

7.1 The statutes of the family business should clearly define who can become, be or remain a partner in the company.

7.2 In the case of transfers due to death, the rules set forth in the statutes and the last wills and testaments (testamentary contract, etc.) of the owners should match in order to prevent unwanted compensation claims against the company.

Contracts should also ensure that the family business will suffer as little as possible from claims to legal shares, inheritance tax and/or the results of divorce.

7.3 The statutes of the family business should contain clear and legally sound specifications pertaining to the right to give notice, claims to compensation and claims to payment of partners wishing to leave the company. This should represent an appropriate balance between the interests of the person leaving and the company's interests. The book value clause frequently used in practice usually does not meet this requirement.

8. Family governance as an indispensable enhancement to corporate governance in family businesses

8.1 Principle

Corporate governance alone cannot guarantee the lasting success of a family business. Professional management of the family itself is necessary in order to obtain unity and avowals of loyalty to the family business.

8.2 Elements of family governance

8.2.1 The owner family should not only develop values, goals and a strategy to reach these goals for the company, but also for the family itself. This family strategy should also contain rules for relating to one another and dealing with conflicts, as well as common activities serving to strengthen the family bond.

8.2.2 The agreed measures should be recorded in a document (a so-called family constitution or a family contract).

8.2.3 Responsibilities should be specified in order to promote implementation of agreed family governance measures. Introduction of controlling tools to measure progress is also recommended.

8.2.4 Good governance requires knowledge of the most essential principles of successful family business management. Entrepreneurial families should be responsible for making this knowledge accessible to partners and family members, and especially to the generations to come.