

Corporate Governance in Small and Medium-sized Companies

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My personal background

- Grew up in a family business
- Jurist
- Professor at the Department of Law, the Aarhus School of Business
- Vice-president of the Danish Securities Council
- Research areas:
 - Company Law (incl. corporate governance), especially small and medium-sized companies
 - Commented on FSR´s recommendations on good corporate governance in small and medium-sized companies
 - Working on a major project on small and medium-sized companies
 - Survey (1300 private limited companies)



Corporate Governance – what is it?

- **Action plan**
 - “Usually understood as the system by which companies are directed and controlled”
(based on Cadbury)
- **OECD Principles of 1999:** “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”
- **Nørby-udvalgets anbefalinger 2001:**
“De mål, et selskab styres efter, og de overordnede principper og strukturer, der regulerer samspillet mellem ledelsesorganerne i selskabet, ejerne samt andre, der direkte berøres af selskabets dispositioner og virksomhed (her kollektivt benævnt selskabets “interessenter”). Interessenter omfatter bl.a. medarbejdere, kreditorer, leverandører, kunder og lokalsamfund.”



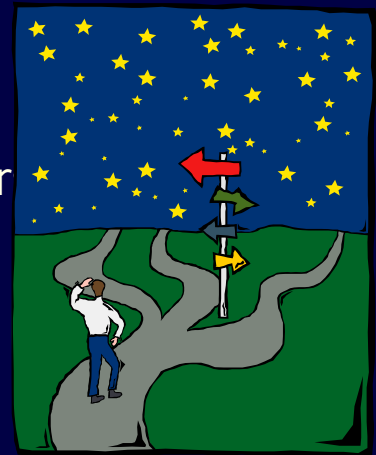
A need for a more varied debate on corporate governance

- **Originally an Anglo-Saxon problem (Berle and Means 1932)**
 - The conflict of interest between the shareholders and the management
 - Corporate governance essentially focuses on the problems that result from the separation of ownership and control, and addresses in particular the principal-agent relationship between shareholders and directors.
 - The separation of the beneficial ownership and executive decision-making allows the firm's behaviour to diverge from profit-maximization.
- Based on
 - Separation of ownership and management
 - Widely spread ownership



Convergence or divergence?

- Continental Europe adopted the Anglo Saxon discussion in the 1990s in spite of the following facts:
 - A weaker Capital Market
 - A different ownership structure – concentrated ownership in most listed companies
 - The importance of small and medium sized companies
- There is a need for a more differentiated discussion – one model does not fit all
 - Different ownership and control structure – other problems – need for other solutions
 - Nørby does not fit all companies
- **Examples:**
 - Listed companies with widely spread ownership
 - Foundations as owners
 - Small and medium-sized companies
 - Joint ventures
 - Silicon Valley model
 - Networks



Corporate governance

- **Preda-rapport**

"Corporate Governance, in the sense of the set of rules according to which firms are managed and controlled, is the result of norms, traditions and patterns of behaviour developed by each economic and legal system and is certainly not based on a single model, that can be exported and imitated everywhere."



The backbone of the economy – the small and medium-sized companies

- In the 1990s the small and medium-sized companies made up 99.9% of the businesses in the EU
- In 1990 91.3% of the EU's 13.4 million businesses were micro businesses
- Businesses with 10-99 employees made up 8%
- Businesses with 100-500 employees made up 0,54%
- Danish companies
 - Less than 190 listed companies
 - 38.000 active public limited companies (aktieselskaber)
 - Approx. 98.000 active private limited companies (anpartsselskaber)



Ownership and governance structure in small and medium-sized companies

- Few shareholders
 - Survey of 1313 private limited companies with more than one owner

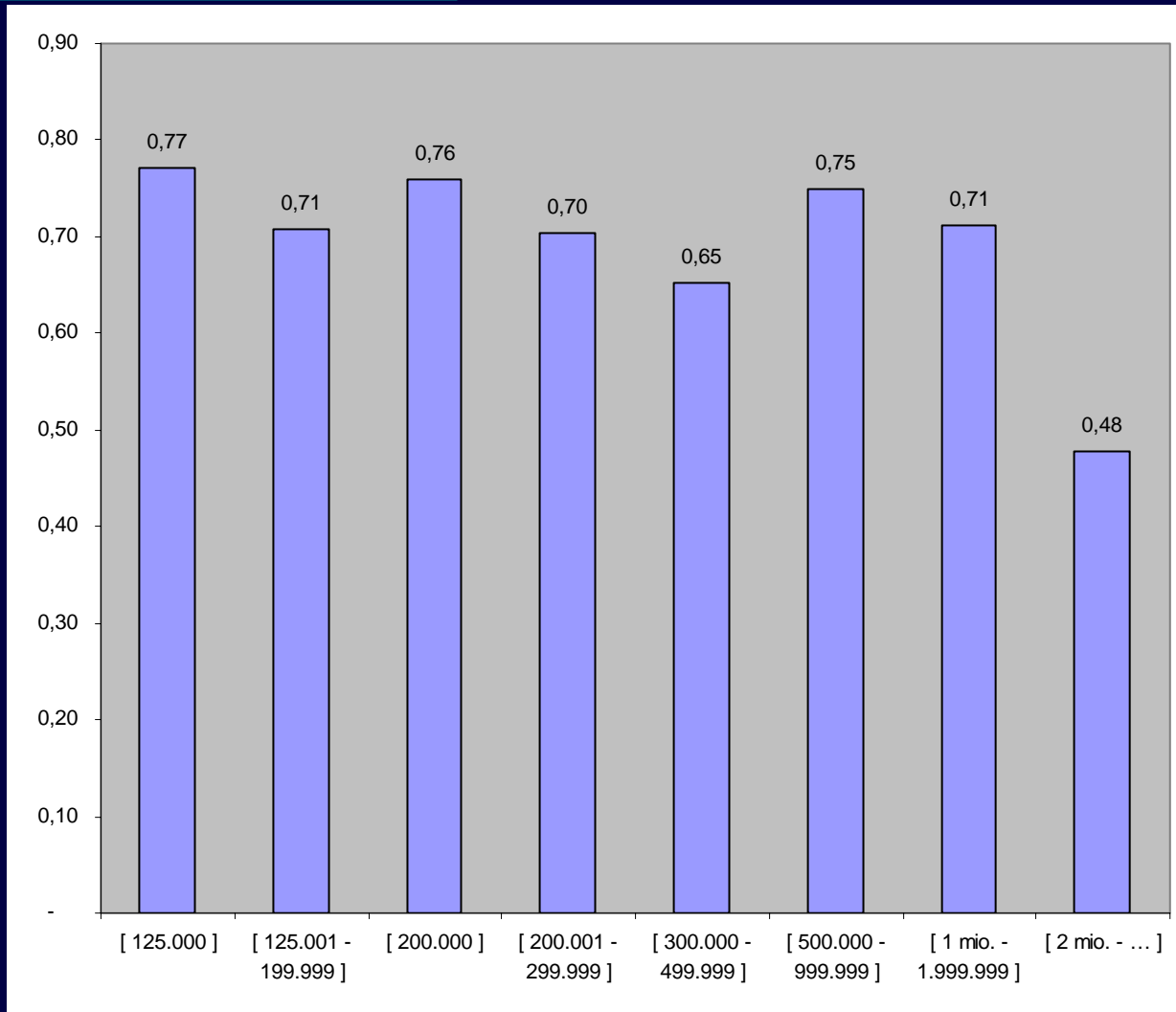
2 owners	67%
3 owners	22%
4 owners	7%
More than 4 owners	4%

Ownership and governance structure in small and medium-sized companies

- **Few shareholders**
- **Control and risk go together – overlap between owners and management**
 - **It is often an essential condition – implied or expressed – for participating in the company that he or she has influence on the management of the company**



Ownership and Control go together



Average S-score



Ownership and governance structure in small and medium-sized companies

- Few shareholders
- Control and risk go together
 - It is often an essential condition – implied or expressed – for participating in the company that he or she has influence on the management of the company
- Typically there are close personal relations between the shareholders
 - Very often family relations (35%)
 - Friendship (25%)
 - Former business connection (28%)
 - They often regard each other as owners



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- Profit maximization is not the only measure of success
 - "Master in their own house"
 - They want to see their ideas become reality
 - It should be a nice place to work for the employees



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 - Create a "nice workplace"
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 - 100% in 62%
 - Some of the shareholders in 20%
 - None in 18%



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- Big economic risk.
 - Small business owners typically have undiversified personal financial portfolios, so their entire wealth is tied up in the business.



Small and medium-sized companies

- The need to control who the owners are
- The transferability is often restricted in the articles of association
 - the right of first refusal or
 - consent clauses



Differences

	<i>Listed companies (Berle & Means)</i>	<i>Small and medium-sized companies</i>
<i>Ownership</i>	<ul style="list-style-type: none">- Many owners- Separation between ownership and control- "Anonymous" investors	<ul style="list-style-type: none">- Few shareholders- Control and risk go together- Close personal relations between the shareholders
<i>Investment</i>	<ul style="list-style-type: none">- Profit maximization- Diversifying their portfolios of shares (spread the risk)	<ul style="list-style-type: none">- Profit maximization is not the only measure of success- The shareholders are often employed in the company- Big economic risk.



Strengths, risks and solutions

- Which advantages are linked to this ownership- and control structure?
- What are the corporate governance problems in small and medium-sized companies?
- Who and how do we solve them?
 - What role does the management (supervisory board and management board) play?
 - What role does legislation play?



Strengths linked to the SME structure

- Different studies show that owner-managed SME's have a better performance than companies where management is separated from ownership
- "Effective" decision-making process
 - Overlapping ownership, governance and management roles secure a speedy and flexible decision-making process
 - The personal relations and the mutual trust help creating mutual goals for the business and secure a long term commitment/investment
 - A stable management increases the credibility of the enterprise
 - A management with a personal commitment and economic investment is often considered a kind of guarantee against fraud, inefficiency etc.



Strengths linked to the SME ´structure

- SME´s contribute to economic development
 - They finance new ideas
 - Personal funds
 - The family "fortune"
 - Long-term investment
 - No proportionality between work hours and income
 - No one expects a return on their investment in the short term



Strengths linked to the SME structure

- Shareholders manage the company
 - No conflicts of interest between the management and the shareholders
 - Reduces agency costs
- In family firms
 - Family relations prevent conflicts of interest
 - Disciplining factors – for example trust, altruism and loyalty
 - The incentives are for example
 - Family pride
 - Loyalty
 - Reputation in the local community
 - The want to create values for the next generation
 - Family firms have a clear identity in an otherwise faceless business community
 - Employees in family firms are generally more loyal to the firm in a crisis than employees in non-family firms
- If the owner- and governance structure changes, the control mechanisms must change



Risks linked to the SME structure

- Conflicts due to a breakdown of the personal relations
- Succession
- Inefficient management
- **Who and how do we solve the corporate governance problems in small and medium-sized companies?**

Conflicts between shareholders

- The close personal relations make it impossible to distinguish between business matters and family matters
- Conflicts between shareholders might result in:
 - Dead-lock
 - 50:50 companies
 - Squeeze-out
 - Shareholders often expect that they participate in the conduct of the business and that the control is consensual
 - The majority rule in the companies Acts makes "Squeeze-outs" and breach of reasonable expectations possible
 - A majority of the shareholders elect the board of directors
 - The board of directors appoint the management board
 - Distribution of profit is decided by a majority
 - The management board can fire the employees



The consequences of a conflict between shareholders

- Conflicts between shareholders that move into the "board-room" can be "life-threatening" to the business
- Very serious consequences for the shareholders
 - They lose the money invested in the company
 - The family breaks up
 - They lose their job
 - Etc.
- HOW DO WE DEAL WITH CONFLICTS?



Conflicts in SME´s – the role of the Law

- In corporate governance theory, the legal regulation of companies is considered as part of the control mechanisms, and company law rules and structures ought to be framed to help ensure efficiency.
- A paradigm shift in international company law thinking
 - Earlier the prime aim was to prevent abuse
 - Today there is a clear tendency to focus on making company legislation "business friendly"
- Company law cannot prevent conflicts but it can provide appropriate solutions when a conflict has arisen
- The management (board of directors) must try to prevent conflicts



Appropriate solutions

- In listed companies the right to sell your shares is a basic and very important minority protection rule
- In SME's
 - Both the Public limited Companies Act and the Private limited Companies Act are based on the principle of free transferability
 - BUT:
 - No market for shares in SME's
 - The transferability is often restricted in the articles of association
 - the right of first refusal or
 - consent clauses
 - So we need other solutions – other exit mechanisms

Conflicts – appropriate solutions in the Companies Acts?

- **The Danish Private Limited Companies Act from 1997**

- The government wanted to adapt the private companies Act to the need of small businesses.
- This was done by repealing all "unnecessary" provisions dealing with the internal relationship between the shareholders
- This meant that the burden of regulation was put on the parties
 - No appropriate standard articles of associations

- Examples:

- **Breakdown of the relationship between the shareholders**

- No provisions in the Danish Companies Act

- The shareholders' reasonable expectation to be involved in the management of the company, and maybe to be employed by the company and receive a salary.

- No provision that deals with this problem in the Companies Act



The consequences of the Danish method of regulation

- The Danish Private Companies Act, means that there are no rules to fall back on if a contract is silent on an issue
- Supplementary rules have to be laid down on the basis of general legal principles
- The courts will play a central role in this development, as the rules will be based on the decisions of the courts on internal company disputes, in the same way as with partnerships.
- One advantage of this method is that, with the freedom to create rules, the courts are free to find solutions which are adapted to the company structure and the actual circumstances which exist at the time. BUT:
 - It is costly
 - It takes time
 - The parties cannot predict what the applicable law will be
 - Supplementary rules are often more static than legislation
 - So it is not a very satisfactory situation



Regulation by Contract

- The parties have to contract for solutions
- Contractual freedom increases flexibility, BUT there are some problems associated with freedom of contract
- Shareholders seldom take full advantage of their contractual freedom (46% did not have a shareholder agreement)
 - The shareholders do not have the necessary knowledge to anticipate the problems that may arise
 - Need for legal advice – is the legal advice good enough?
 - High transaction costs
 - Shareholders might find that the benefit of regulating situations that seldom arise is too small in relation to the costs involved. It is "better to keep the money in the company".
 - Mutual trust
 - They never believe that they will end up in a conflict
 - No one wants to sow the seeds of distrust by suggesting measures to deal with situations like dead-lock, squeeze-out, breakdown of cooperation etc.



Insufficient protection from the law

- When the conflict arises, the shareholders obtain insufficient protection from the law
 - Often without knowing it
 - Often the shareholders expect the law to deal with the problem
 - Questionnaire!!! About 50% of the ownermanagers answered that the reason why they have not dealt with negligence or breakdown of relations between shareholders was that they expect the law to provide appropriate solutions.



Conclusions

- The Companies legislation should solve the key problems
 - Should for example provide for alternative exit-mechanisms
- The Danish Companies Acts do not provide such solutions
- There is a need for a reform – so take care on Island when you reform your Companies Act
 - Law is not always a bad thing!!!!



Conclusions - continued

- Consider the alternatives, for example:
- The Norwegian solution
 - It was decided to introduce freedom of contract by including default provisions in the Act.
 - 350 provisions dealing with all relevant
 - The Norwegian Companies Act has several articles dealing explicitly with conflicts
- **Advantages:**
 - Default rules ensure that those who either cannot afford professional advice or who, on the basis of cost benefit analysis, have chosen not to make a detailed and specific contract, have an appropriate set of rules to fall back on.
 - From an economic point of view there seems to be good arguments for introducing default legislation. The Act operates like a standard contract, as recommended in economic theory, so the transaction costs are substantially reduced.



Conclusions

- Disadvantages connected with default rules in the Companies Act:
 - The introduction of contractual freedom by including default provisions in the draft legislation means that they have to be suitable for a standard-type company.
 - The special problem associated with the use of default rules is that there can easily be doubts about the extent to which unclear provisions in a contract should be understood as deviating from the default rules, or whether they should be seen as supplementary rules, filling out detail.
 - Another problem which is often ignored is that, if the parties refrain from making an individual contract because the existing law covers the company's need for regulation, then any subsequent amendment to the law can effectively mean that the state writes a new contract for the company.



Risks linked to the SME structure

- Conflicts due to a breakdown of the personal relations
- **Illness and succession**
- Inefficient management
- **Who and how do we solve the corporate governance problems in small and medium-sized companies?**

Illness and succession – a threat to the survival of the business

- No plan in case of the ownermanager becoming ill
 - Fear of illness causes sleepless nights for about 60% of the ownermanagers
- Lack of succession plan (generation change)
 - In 1999, only 28% of the ownermanaged businesses (companies) had a succession plan
 - Italy 7%
 - USA 44%
- A succession can be life threatening for the business if not carefully planned
 - Succession means both a new owner and new management
 - The importance of the ownermanagers reaches beyond management issues
 - The personal commitment
 - The ownermanager's skills as entrepreneur
 - Often a very close relationship to the employees based on mutual trust



Succession / Generational change

- The question of generational change is emotionally hard for the ownermanagers
 - Not "when I die" but "...If I die..."
 - Emotionally
- Generational change
 - Should be planned and maybe carried through while the ownermanager is still alive
 - Important to define the ownermanager's role
 - The ownermanager as a shadow director is problematic
- Should the business be sold or should it stay in the family?
- Sale
 - The business has to be tuned for sale
 - Strategic business plans
 - Risk management
 - Organisational gearing



Generational change

- Succession (the business stay in the family)
 - Who has the right skills - both professionally and in terms of personal skills?
 - The ownermanager often wishes to treat his children equally
 - A succession will often extend ownership
 - Risk of conflicts between owners not involved in the management and owners involved in the management
 - Need for more formal organisation structures
 - Find confidence-building measures
 - Clear division between salary and dividend
 - Clear job specifications and criteria for evaluation and compensation
 - Consider new organisational bodies, for example a family council, family mission statement



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Risks of inefficient management

- **Lack of professional and personal qualifications**
- No market control due to the ownership structure:
 - No effective market for corporate control
 - No effective market for managerial labour
 - No way out of the company



Enhance the efficiency of the management

- Legislation cannot provide against inefficiency, but it can create an appropriate framework for the organisational structure
- Management can enhance efficiency
 - Create organisational structures that fit the company and which can handle changes, development, growth and different challenges
- Recommendations as a tool for creating good corporate governance?
 - FSR´s recommendations for good corporate governance in small and medium-sized companies



Growth of the business

- In the beginning the ownermanager is the central person who possesses the necessary skills
- **Growth of the business – the situation changes**
- An important but difficult realization that the informal governance structures have to be replaced by more formal governance structures
- The owners qualifications and business skills have to be complemented by qualifications and business skills from others than the owners, for example
 - Knowledge of market development and market research
 - Knowledge of the newest technology and technology management
 - Knowledge of the newest research results
 - Knowledge of organisational theory and organisational change
 - Knowledge of risk management
 - Knowledge of strategic planning
 - Knowledge of export markets and marketing economics
- The problem is sharing of control

Growth and development

- **Need for a second in command**

- Recruitment of the best executive is difficult
- Hard to prevent them from leaving
- The problem is delegation and the ownermanagers lack of respect of the agreements of delegation and sphere of authority

- **Need of a supervisory board**

- As a strategic sparring partner
- To make sure that the decided strategies are implemented
- To make sure that the necessary qualifications are represented in the company
- To make sure that the different spheres authority are respected
- To "cut through" the emotional part



Growth and development



- The composition of the board
 - The question of independence
 - How many external members
 - Which qualifications should be represented
 - Evaluation of the board

- What qualifications should be represented?

Not an easy task to be an external member of the board in an ownermanaged business

- Very different from the work in a listed company with widely spread ownership
 - Other problems
 - The ownermanager is emotionally involved
 - The ownermanager is often sceptical of "academic" knowledge
- More problems
 - Business
 - Emotions
 - Family problems
- The external member has to possess different skills and use other methods
 - "Psychologist"
 - Intuitive management
 - Able to sell solution
 - Professional skills are not enough



Not an easy task to be an external member of the board in an ownermanaged business

- **The board of directors (supervisory board) must:**
 - Have the skills and the courage
 - Understand the universe of the ownermanager
 - His money
 - His pride
 - His child



The challenge

- Growth and development is based on the ability to find management solutions, where the business makes the most of the ownermanager's invaluable knowledge and commitment and at the same time is reinforced by supplementing it with relevant competences and qualifications.

