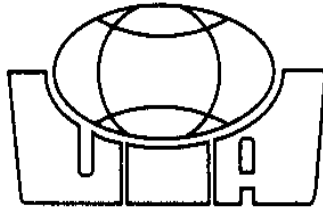


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CORPORATE GOVERNANCE ON NON- LISTED COMPANIES SPECIAL FEATURES OF CORPORATE GOVERNANCE IN CONNECTION WITH FAMILY-RUN COMPANIES

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I – INTRODUCTION

“Family controlled businesses”¹: A powerful trigger of wealth creation

Family businesses provide a range of socioeconomic benefits, especially in terms of wealth creation. Impressive statistics reveal that in North America they comprise some 80 to 90 percent of all business enterprises, and account for 60 percent of total U.S. employment, 78 percent of all new jobs and 65 percent of wages paid.²

In Europe they are collectively responsible for some two-thirds of total employment, being the cornerstone of efforts to expand and sustain growth in this area, and are a major source of innovation within the European Union economy, and natural progenitors of the entrepreneurial culture.

A number of these businesses have done exceedingly well, advancing to dizzying heights of accomplishment in the seemingly inconceivable transformation from humble origins into some of the biggest household names in the global markets, such as Microsoft and Ford. Yet, despite such marvellous potential and spectacular achievements, there remains a most glaring paradox: the vast majority of family businesses barely survive beyond the first or second generations.

While the rise and fall of commercial entities is a given part of the course, a closer inspection of the characteristics of typical family businesses reveals that they are, by their very nature, particularly susceptible to a series of potentially self-destructive Achilles heels.

Family and business relationships are highly closely interwoven which, together with the potentially thorny issues of succession and inheritance, can even at the best of times prove to be a source of immense conflict; with emotions running high they can be a figurative time-bomb waiting to explode. In this sense they are perhaps the ultimate expression of the maxim sagely forewarning against the dangers of mixing business with pleasure.

Equally, they may also suffer from the inexistence of a clear and consistent management strategy, insufficient separation between ownership and control, and reduced levels of expertise and objective analysis of the business, without which it is very difficult to achieve or sustain growth and gain access to appropriate sources of capital investment.

The consequence of factors such as these is that, where they remain inadequately addressed, small family owned companies will sooner or later fall prey to the ruthless onslaught of market forces which characterise today's highly competitive and unforgiving business environment.

One possible solution, while not a panacea for all the ills of family owned businesses, can make the world of difference between failure and success. It may be found in a two-fold strategy: through the adoption of sound corporate governance practices and by looking to private equity entities as a source of investment; and as it happens the former will often be a pre-requisite of the latter. Although often considered the exclusive domain of large companies, small family businesses would do well by mimicking, and adapting for their purposes, the strategies of their “big brothers”, in their evolution towards becoming increasingly sophisticated and credible entities.

These and related issues will form the subject of analysis for the present paper.

¹ “Family controlled business”, family-owned business, family business and family firm shall be used synonymously throughout this paper.

² Astrachan, J.H. and Shanker, M.C., in Family Business Review, Summer 1996.

II – CHARACTERISTICS OF FAMILY OWNED BUSINESSES

1. Valuing a family firm's uniqueness

“In a family business, the family and the business are so entangled that emotions are unavoidable.”³

a) Fundamental elements in defining a “family controlled business”

There is currently no widely accepted definition underlying the concept of a family business. Much of the confusion in this area is exemplified by the varying degrees of specificity across studies.

Although a broad review of the literature reveals three principal areas of focus that have been employed in elucidating the concept: content, purpose, and form, there are many more specific elements which could be considered essential in classifying a business as “family controlled”.

The elements which are commonly analysed, for the purposes of ascertaining the degree of “family control” over a given business, include the following:

- Ownership concentration;
- Voting power;
- Control over strategic decisions;
- Involvement of multiple generations;
- Active management of family members; and
- Intention for the business to remain in the family.

Some or all these elements may prove to be important characteristics when attempting to describe a family business, depending on what stage the business has reached in its life cycle. On the basis of such criteria, a broader or narrower definition may be constructed, subject to the number of factors deemed as essential for characterising a business as family-owned.

In order to overcome inconsistency in the definition, some specialists (Astrachan et al) have developed and advocated the use of a scale which measures the degree of family influence, the so-called F-PEC scale, rather than relying on a simple “black and white” dichotomy between family and non-family businesses:

“For a solution to the family business definition dilemma, we propose the application of a scale that assesses the extent and the quality of family influence via the measurement of three dimensions: Power, Experience, and Culture ...”⁴

Consistent with this approach, Chua et al stated that *“family and non-family businesses may simply represent the extremes of a continuum”⁵*

Ana Maria Ussman, one of the few Portuguese academics researching family businesses in depth, albeit from an economic perspective rather than a legal one, has suggested the following definition for a family business:

³ Alderfer, C.P., 1988, “Understanding and consulting to family business boards”, in *Family Business Review*, 1(3), pgs. 249-261.

⁴ The F-PEC scale of family influence: construction, validation, and further implication for theory, in *Entrepreneurship, theory and practice*, 1st May 2005, Astrachan, Joseph H.; Klein, Sabine B.; Smyrnios, Kosmas X.

⁵ Chua, J., Chrisman, J., Sharma, P. (1999), "Defining the family business by behavior", *Entrepreneurship Theory and Practice*, Vol. 23 No.4, pp.19-40.

“One in which ownership (even if partial) and control are in the hands of a group united through family relationships (regardless of the number of families constituting it) ...”⁶

In the absence of a broadly-agreed definition that can truly pin down the concept of a family business, and for the purposes of writing this paper, such businesses will be considered as any establishment or firm in which a given family (or families) displays a significant degree of influence regarding the decision-making and operations of the same.

b) Family business: From an economic concept into a legal framework?

The Portuguese legal framework does not provide a general legal definition for a "family controlled business" nor does it establish specific regimes applicable to such entities as a consequence of possessing such a character.

Several specific regimes will be applicable to the majority of family businesses but only in the wide sense that they are often small and medium enterprises (SMEs), which these regimes are designed to incentivise.

An exception to the lack of reference to these entities in the Portuguese legal framework can be found in Decree-Law 338/90, on the regulation of “Recognised Agricultural Family Businesses” (*Empresas Familiares Agrícolas Reconhecidas*).

These provisions identify the elements considered essential for characterising companies as being “family controlled” including the requirement for all shareholders to be linked by legal family relationships or the equivalent, and, effectively and on a permanent basis, to dedicate themselves to carrying out agricultural activities.

Such requirements are, however, only relevant for the purposes of distinguishing this very specific type of agricultural business and as such provide a very narrow and overly specific concept of family business, which is of very limited use in establishing a general legal definition.

In conclusion, there is no general legal concept of family business in the Portuguese legal framework, which is understandable given the fact that there are no legal regimes applicable to these entities – with the exception of the one referred to above – and therefore the legal definition would have little practical use.

c) Coupling size and ownership with control

Despite the large number of small and medium-sized family businesses, attention should also be drawn to the considerable proportion of large family companies and their relative weight in the global and Portuguese economies.

The great majority of family businesses start out life as small companies managed by one or two family members, often informally supported by other family members, and with a very limited sum of initial capital, management and governance strategy.

Many of these entities will never achieve a considerable level of growth, rarely amounting to more than a mere means of survival for their founders and close family members, nor will they survive, at least as family-owned businesses, the transition to the second generation.

⁶ Ana Maria Ussman, *Empresas Familiares*, Lisboa, 2004, pg 20.

One of the main characteristics of family businesses is the strong attachment to retaining ownership and control, which is considerably higher than in other types of businesses. This reluctance to relinquish – even partially – ownership and control has been identified as one of the central factors behind the stagnation, poor governance and difficulty in raising finance, by which they are so often characterised, and that may, *in extremis*, lead to the company’s bankruptcy.

Conversely, there are cases of brilliant success stories. Several of the largest Portuguese conglomerates (such as SONAE⁷, Banco Espírito Santo⁸ and Jerónimo Martins⁹) began as family businesses. Despite now being listed companies with a considerable amount of floating capital, they still remain dominated by the original founding family.

2. Competitive advantages and disadvantages

a) Positive horizons of controlled family businesses: the synergies

A company controlled by one or a few family members will have a totally different market approach from a non-family business and, in particular, from a non-family publicly held company. These differences may best be described in terms of the competitive advantages and disadvantages inherent to each.

On the positive side, stable controlling ownership does permit long-term strategies to be envisaged and implemented without being adversely affected by the forcible constraints of the short-term demands of rapid stock market appreciation. *“Patient, consistent investments can yield excellent future benefits.”*¹⁰

Where stable ownership and control exists, shareholders identify themselves with the company’s values and strategy and help it to maintain them in the long run.

Family business owners provide active and motivated ownership, encouraged by the idea of providing a legacy for their heirs.

Moreover, should the company go through a difficult period, family business owners tend to work harder and invest more time and money in the company, in order to protect their investment, while in a publicly held company shareholders tend to vote with their feet, simply selling their shareholdings and looking elsewhere for a better investment, leaving the company in an even more difficult position.

Furthermore, the company’s founder will know the fine intricacies of his “creation” far better than any other individual could possibly do so. Publicly held companies change boards frequently and new board members are frequently recruited from the outside, bringing with them a superb knowledge of the ultimate in management strategies but lacking essential familiarity of the actual company they are expected to oversee.

In effect, the systems of governance in family-owned businesses are more suited to the pursuit of unconventional strategies and it is usually easier to align interests and goals.

Finally, the familiarity and personal proximity between controlling shareholders may create synergies that cannot be achieved in other types of companies, let alone the fact that the existence of a “trust factor” allows a family business to progress at a more rapid pace than a traditionally organised

⁷ www.sonae.pt/

⁸ www.bes.pt/

⁹ www.jeronimomartins.pt/

¹⁰ “Governing Family Businesses”, John L. Ward.

business.

b) The drawbacks of long-term controlling ownership

The main drawbacks, where family businesses are concerned, find their origin in the same factors as the above described advantages.

On one hand, long-term controlling ownership can be positive when the management is effective. However, even where this is the case, when a company is controlled by a few family relatives it can suffer through excessive insulation from market realities and trends. This problem can be especially prevalent in very fast moving and innovative industries, such as high-technologies, where an overly stable management may become rapidly outdated through its conservatism.

Moreover, long-term controlling shareholders, especially in family businesses, tend to protect their investment from the market, through a protective suite of mechanisms and devices which include, among others, voting caps, golden shares, differing classes of shares, and control pyramids, rendering it virtually impossible to acquire control of the company, even in cases where management is inefficient and inadequate.

Other problems frequently encountered include organisational stagnation, lack of succession planning, family conflicts and emotional attachment to the company that may adversely affect many aspects of the business.

3. Legal structures and features

The decision as to which legal structure should be adopted by a family business start-up is often driven by the following factors:

- Number of shareholders;
- Initial capital;
- Growth expectations;
- Type of business;
- Liability regime;
- Operating costs;
- Tax issues.

a) Recent trends in the choice of legal forms of organisation

Over the last half century small Portuguese family businesses have tended to shift away from *Individual Proprietorship*, *EIRL* and Collectively-held Companies (*Sociedades em Nome Colectivo*) towards one of two limited liability corporate structures: private limited liability quota companies¹¹ (*Sociedades por Quotas*) and joint stock companies (*Sociedades Anónimas*).

This change was driven mainly by the limitation of liability provided by these vehicles, which allows a clear line to be drawn between the company and personal assets and liabilities.

In addition, these types of companies offer management structures and governance options, with the potential to deliver considerably better results in terms of the business' growth and development while at the same time eliminating issues of personal liability.

¹¹ For the sake of brevity, hereinafter referred to as limited companies.

Moreover, depending on the type of business and turnover involved, they may also be more tax efficient.

As such, family businesses will typically adopt one of the following legal forms of organisation:

(i) Private limited liability quota companies

The incorporation of a limited company requires at least two quotaholders (with the exception of sole quotaholder companies) and a minimum subscribed share capital of € 5,000, divided into blocks with a value of no less than € 100 each, i.e., of no less than 2 per cent of the share capital.

The share capital is divided proportionally into quotas which must be registered on the Companies Registry but are not represented by securities or certificates.

The share capital can be paid up either in cash or assets alone or alternatively in any combination of the two. Assets must be specified and evaluated by a *Revisor Oficial de Contas* - a statutory auditor - and their payment cannot be postponed. Cash payments may be partially postponed, up to a maximum of 50 percent of their total value, for a period of no longer than five years.

Where the capital is to be paid up partly in assets, the total sum of the immediate cash payment and the value of the assets cannot be lower than the statutory minimum share capital.

A quota cannot be transferred without the prior consent of the company, except where the transfer is to be made in favour of a spouse, parents or children, or is effected among quotaholders.

Prior to carrying out the transfer, the company's consent must be sought by the transferor and approved by means of resolution passed at a general meeting, unless otherwise stipulated in the articles of association.

Management of the company is assigned to one or more directors, who do not necessarily have to be quotaholders, and may be nominated either in the articles of association or by resolution of the quotaholders.

Auditing is optional in a limited company. However, those companies which do not have a fiscal board (*Conselho Fiscal*) are required to appoint a statutory auditor (*Revisor Oficial de Contas*), wherever certain size-related limits have been exceeded for a period of two consecutive years.

Unless otherwise stated by the law or the articles of association, decisions are passed by a majority of the votes cast, abstentions not counting.

(ii) Joint stock companies

In order to incorporate a joint stock company, the Portuguese Companies Code requires the existence of at least five shareholders and a minimum subscribed share capital of € 50,000, divided into shares with a value of no less than one Euro cent each.

The share capital can be paid up either in cash or assets alone or, alternatively, in any combination of the two. Assets must be specified and evaluated by a statutory auditor, and their payment cannot be postponed. Cash payments may be partially postponed, up to a maximum 70 percent of their total value, for a period of no longer than five years, while the remaining 30 percent must be paid up immediately.

The sale and purchase of shares does not involve any specific contractual requirements. However, a

record must be kept of all shares issued by joint stock companies.

While the transfer of shares cannot be forbidden, it may be restricted by means of the company's articles of association, wherever permitted by law, through the granting of pre-emptive rights to shareholders, by requiring the company's prior consent or compliance with specific requirements deemed to be in the company's best interest.

In accordance with the applicable provisions of the Portuguese Companies Code, joint stock companies must adopt one of three management structures:

- i. A unitary management structure, which consists of a board of directors (*Conselho de Administração*), overseen by:
 1. a fiscal board (*Conselho Fiscal*)
 2. a single auditor (*Fiscal Único*) or
 3. a fiscal board and a statutory auditor (*Revisor Oficial de Contas*);
- ii. A dual management structure in which powers are shared between an executive board (*Conselho de Administração Executivo*) and a supervisory board (*Conselho Geral e de Supervisão*), overseen by a statutory auditor, and
- iii. A structure inspired by the Anglo-Saxon model, consisting of a board of directors which includes an audit committee (*Comissão de Auditoria*) and a statutory auditor (*Revisor Oficial de Contas*).

b) Limited companies vs. joint stock companies

As mentioned above, limited companies have lower fixed costs and may not be subject to supervisory requirements, provided they are small to medium-sized businesses. Shareholders enjoy broader powers than they do in joint stock companies and larger majorities are required to pass resolutions on amending the articles of association and mergers.

Moreover, the existence of a sub-type within limited companies, the so called sole quotaholder company (*sociedade unipessoal por quotas*) allows incorporation by a single quotaholder, whether a company or individual.

Mechanisms for the transfer of quotas, such as prior consent from the company, award a greater level of control for the founding quotaholders in relation to the entrance of new shareholders.

Joint stock companies require a more complex administrative and supervisory structure, being subject to stricter accounting requirements. However, they are more flexible in terms of shareholder remuneration and management structure.

Therefore, while joint stock companies are appropriate for larger projects and/or widely-held companies, limited companies will generally be better suited to small and medium-sized business projects.

III – THE ROLE OF CORPORATE GOVERNANCE IN A FAMILY-OWNED BUSINESS: THE CHALLENGES

1. Introduction

“Rather than functioning as a costly system of checks and balances, governance in family businesses must serve to enable transparency and partnership across the system”¹².

Most family businesses have a common beginning: an entrepreneurial founder who generally retains control over decision-making.

However, issues concerning business growth and succession between family generations raise demands for a more organised governance structure.

Not only is the implementation of specific Corporate Governance measures considered a fundamental prerequisite for the survival of many family businesses but it also triggers effective benefits for them at the levels of management efficiency, access to finance channels, credibility and sound business reputation, improved performance and competitive edge, sustainability of the business, shareholder rights, disclosure, transparency and accountability, investor confidence, efficiency in responding and adapting to changing conditions, separation between ownership and control, internal risk management, and management of conflicts of interests.

Although family businesses encompass an extremely heterogeneous reality, they all have in common the close relationship between family and business, and therefore will typically benefit by implementing a suitable system of corporate governance, which addresses specifically the following issues:

a) Conflict resolution

Family businesses are unique in the sense that they have to manage their business and family affairs, jointly. Misunderstandings and conflicts therefore tend to occur in all family businesses, a source of much stress and resentment that can adversely affect business performance if suitable mechanisms are not put in place to deal with them effectively. Sibling rivalry and intergenerational conflicts are also commonly encountered issues.

Specific Corporate Governance models contribute to solving these and other conflicts, unique to family businesses. Implementing clear structures in relation to communication and organisation is essential. An effective board of directors, concentrating policy and strategy and logical management with clear reporting lines, delegation of authority and rules of responsibility are basic building blocks with which to construct sound running of the business.

It should also be ensured that rules and chains of command are respected by both family members and employees, irrespective of their “family status”.

b) Creating value and improving longevity

¹² John L. Ward, Governing Family Business in <http://usinfo.state.gov/journals/ites/0205/ijee/ward.htm>

Data from the International Chamber of Commerce (ICC) confirms that small and medium enterprises (SME's) and family-run businesses that exercise a sound strategy of corporate governance on average tend to grow faster and survive longer.

It will also encourage succession planning for senior management, often one of the main issues in family businesses, as well as enhance the long-term future prosperity of companies.

c) Access to capital

Sound corporate governance rules, namely clear rules, effective board management and periodic disclosure of financial data are essential requirements to attract investment from certain capital sources, namely private equity and hedge funds, not to mention capital markets too.

Moreover, it will also assist in securing bank loans with a more favourable interest rate, because the fact of implementing a corporate governance strategy increases company ratings and reduces credit risk.

d) Sustainability

A better level of corporate governance increases the likelihood that the business will satisfy the legitimate claims of all stakeholders and fulfil its environmental and social responsibilities, contributing to the long-term sustainable growth of related companies, and to a healthy and sustainable economy.

2. One size does not fit all – Trends and Tendencies: a flexible model

There is no ideal, “one size fits all”, corporate governance model.

The corporate landscape varies within Europe and there are several corporate governance structures being implemented across the developed world, although no particular one can be singled out as better than the others, in all its aspects.

Those who initially defended rigid standards suggest nowadays a more flexible approach, proposing that, in the next stage of evolution in this area, companies are sufficiently advanced to “*look at what good governance really is*”.¹³

Recent research¹⁴ has identified a strong correlation between business performance and governance practices, identifying common characteristics between governance styles and correlated business performance metrics (i.e. a more management-controlled company delivers better sales growth performance, while companies with independent boards are more profitable – improved return on equity and profit margins).

In this instance, companies will benefit exponentially if they implement corporate governance measures, not as a regulatory “box ticking” process but as a flexible and tailor-made model taking into consideration the company's level of maturity, size, ownership, control and main business goals.

¹³ Peter Dey in Alex Todd, “Corporate Governance Best Practices: One size does not fit all”.

¹⁴ Alex Todd in “Corporate Governance Best Practices: One size does not fit all”.

a) Soft and Hard Governance Rules

Throughout Europe, efforts towards the creation of a legal and regulatory framework have been consistent in order to ensure that not only public companies but also privately-held ones adopt good governance procedures.

During the last decade Portugal has also made a considerable effort towards regulating corporate governance procedures. The existing legal framework is spanned across numerous provisions of the Portuguese Companies Code, the Portuguese Securities Code and in several recommendatory documents and regulations issued by the Securities Market Supervisory Authority (*Comissão de Mercado de Valores Mobiliários*), hereinafter “CMVM”). A Code of Corporate Governance that will substitute CMVM’s recommendations is currently undergoing public consultation.

The Portuguese Companies Code regulates the most general and structural issues on a company. After the revision carried out by Decree-law 76-A/2006, the Code now includes several rules purely addressing corporate governance (such as remuneration and independence), and has become one of the most advanced legal frameworks on this particular area in the European Union.

The Securities Code incorporates specific rules for publicly-held companies and rules on public offers, including takeovers.

Based on the OECD “Principles on Corporate Governance”, the CMVM recommendations aim towards the protection of shareholders' rights, which include the right to secure methods of ownership registration, to convey or transfer shares, obtain relevant information on the company, to participate and vote in General Meetings, to elect members of the board and the right to receive a share in the company's profits.

The legal framework on corporate governance and the CMVM recommendations also envisages an equitable treatment of all shareholders, including minority and foreign shareholders, forbidding insider dealing and abusive self-dealing, and encouraging the disclosure of any material interests of the members of the board of directors in transactions or matters affecting the company.

The existing regulatory framework is composed both by mandatory rules and non-binding recommendations. The Portuguese Companies Code and the Portuguese Securities Code contain mandatory rules on fundamental issues on corporate governance, as described above. CMVM’s recommendations aim at contributing to the optimum development of companies and protecting the interests of all the stakeholders in the company. They were not designed to impose rigid and uniform models.

Basic corporate governance principles, included in the Portuguese Companies Code, are common to both listed and non-listed companies.

Non-listed companies normally benefit from a much higher level of autonomy, while listed companies are subject to a certain level of standard and compulsory detailed rules so as to protect sufficiently both shareholders (investors) and creditors.

b) A tailor-made governance model

As aforementioned, basic corporate governance rules, stated particularly in the Portuguese Companies Code, are common to both listed and non-listed companies as well as being mandatory to both instances.

Despite the regime's flexibility – particularly in relation to the several options it provides on types of companies and management structure – minimum requirements on disclosure, supervision, the protection of shareholder rights, and management are set up as being mandatory across the whole universe of company types, which creates a minimum level playing field.

These rules are, however, insufficient alone to ensure sound corporate governance, and should, therefore, be complemented by additional similar principles, tailored to a specific company's business, control and decision-making structures.

As the ownership and management structures of a small family business differ fundamentally from widely-held public companies – that is, they tend to lead to more concentrated forms of control and therefore decision-making is more easily facilitated – the corporate governance model and rules will necessarily have to address such characteristics and features.

c) Action Plan for the effective improvement of Corporate Governance

An ideally efficient corporate governance model in small privately-held companies will aim towards:

- Gradual separation of powers between the functions of ownership, supervision and management;
- Improvement of internal controls;
- Greater transparency (especially in relation to external sources of finance)
- Regulation of the relationship between family and business.

The action plan to be adopted will, however, depend on the starting point. The essential argument is based on persuading companies that corporate governance involves more than merely complying with certain legal and accountancy rules and that an effective, tailored governance system may indeed provide drastic improvements in terms of their performance.

Most companies, in particular those which are joint stock, will already have a board of directors and possibly also a supervisory board/audit committee, depending on the chosen management model.

The challenge is to go one step further, by integrating corporate governance devices which, although not legally obligatory, may help to improve the company's performance and enhance its level of growth.

The following section outlines how a basic governance model for a small joint stock company may be constructed using the basic corporate bodies:

(i) Corporate Governance Policy

Ideally a set of rules and regulations addressing the several aspects concerning the corporate governance policy of a given firm will be laid out in an autonomous document.

This document shall cover the role, composition and remuneration of the board of directors; creation, composition and role of an advisory board, as well as address provisions suitably addressing the regulation of minority shareholders rights, appointment of independent auditors and directors, organisation and publication of a calendar of events.

It will globally broach matters not covered by the articles of association or further develop the main principles and rules contained in the same.

(ii) Effective Board of Directors:

The board of directors shall play a central role in the leadership and governance of the business, providing an operational interface between ownership and management.

The composition of the board (number of members, number of independent directors, appointment) must reflect the stage of evolution which the family enterprise has reached, as well as its size and complexity of business. Factors such as diversity of ownership, owners' strategy and functional needs must be given in-depth consideration.

The board will be subject, on a regular basis, to a multidimensional assessment in relation to the board's model, skills required, recommendations for improving its effectiveness, and eventual creation of specialised commissions.

Finally, it is not advisable for the roles of the Chairman and the CEO to be carried out by the same individual and, ideally, at least one of them will not be a non-family member.

(iii) Creation of an Advisory Board:

The purpose of the advisory board will be to assist in the decision-making process by providing both the management and the board of directors with an independent and informed external view on the company's strategy and main decisions.

Where a supervisory board already exists, it would ideally assume this role.

In terms of the other advantages which it may offer, the Advisory Board will act in order to counterbalance external and internal opinions and viewpoints; as well as to facilitate the creation of a succession plan, by allowing for the selection of the "Heir Apparent," without the conflicts that typically arise when one child is "favoured" over any others.

In addition, it will afford a level of expertise and experience which may be lacking in the organisation, provide a network of new opportunities using the board members' contacts and influences, provide sound management practices necessary to advance to the next level of professionalism; and, where applicable, prepare the management team for dealing with outside directors, shareholders and regulators, if the company intends to plan an IPO.

(iv) Corporate Secretary:

The corporate secretary is already a mandatory requirement amongst certain management structures in joint stock companies. This role includes the preparation and execution of meetings concerning the Board of Directors and Advisory Board, as well as shareholders' General Meetings.

The appointment of a corporate secretary may benefit the company in the sense of acting as a communication channel between the shareholders and the firm, providing information on managerial operations and on company performance, thereby multiplying its advantages.

(v) Professional CEO

Appointing a CEO will often prove to be one of the most controversial yet crucial decisions in the life of a company. In the first generation of most family-owned companies, the CEO is the entrepreneurial founder. In fact, initially, the founder tends to embody the entire governance system, concentrating the functions of ownership, decision-making and management in the same individual.

During the first generation, where the founder has the necessary level of experience and knowledge it may make sense to maintain his role as CEO, in this way taking advantage of having an advisory board while still retaining his control over the decision-making process. However, even in such circumstances, the fact of addressing the issue of succession is still advisable.

In most cases, however, especially in larger companies or those which have reached the second or later generations, and where power is shared among several family members, the professionalisation of the management board by bringing in an outside CEO will prove advantageous in several ways to the company. The advisory board will generally be the most suitable corporate body to advise on candidates for this role.

In certain circumstances, the head of family may retain a role in the board as Chairman, thereby ensuring the board's efficient and effective performance.

(vi) Company documents

The company's articles of association will benefit from periodic reviews and updates in line with the changing legal and regulatory framework, and also to ensure that they adequately reflect the company's evolving economic and strategic reality. These documents will guarantee the equitable treatment of minority shareholders as well as non-family shareholders.

(vii) Non-executive Director

In line with CMVM Recommendations, and wherever there are minority shareholders who are unrelated to family shareholders, the appointment of independent executive directors may also be recommended, in order to prevent corporate decisions from being taken in the interests of dominant shareholders alone and to ensure that the best interests of the company are preserved.

The definition of 'independence' is linked to the non-representation of dominant shareholders in the company.¹⁵

This role is therefore paramount in representing the interests of minority shareholders and in overseeing executive directors in financial areas and matters that affect the strategy and future of the company, as well as in areas where conflicts of interest may arise in relation to the same. Independent and non-executive directors may also assume an important role in the appointment and remuneration committees and audit boards, whatever the case may be.

The number of independent Directors will ideally be progressively increased.

(viii) Training for Board members

Periodic training for board members is advisable on matters such as its role and responsibilities. This training is especially relevant in the case of board members who are family members without specific managerial education.

¹⁵ Regulation 7/2001, as amended by Regulations 11/2003, 10/2005 and 3/226, establishes certain criteria for determining the independence of board members, stipulating that directors cannot be considered independent and non-executive if they are associated with any groups having a specific interest in the company or which may, under any circumstance, be capable of affecting the objectiveness with which directors analyse and make decisions.

(ix) Annual Report

In order to uphold the right to information in relation to minority shareholders and to assess how well the company's corporate governance policy is being implemented, the board of directors will ideally commit to disclosing certain corporate governance considerations in an annual report, which will typically include:

- Content and degree of implementation of the company's corporate governance policy referred in (i) above;
- Extent to which the company complies with CMVM Recommendations on Corporate Governance;
- Explanation for non-compliance.

d) Instruments dealing specifically with family businesses:

Given the excessive proximity often characterising the relationship between business and family, to the point of confusing these two organisational systems, it may be advisable under certain circumstances to opt to incorporate, as an alternative to or in parallel with other corporate governance mechanisms, the following instruments or what might be termed "family governance structures":

(i) Family Council

The family council, by providing a suitable forum for family members to meet and discuss issues central to the running of the business, ensures that effective channels of communication remain open and that the family voice remains united. It is an effective mechanism in assisting with the resolution of conflicts of interest and for handling differences in opinions in terms of management and family relations.

It is generally made up by all adult members of the family with a direct or indirect link to the company.

Mediation by an outside member is highly recommended, as is the fact of keeping a record of council meetings by way of minutes, describing the several issues discussed and decisions reached.

(ii) Family protocol

The family protocol will embody "*a set of norms designed to regulate relationships between the family and the business*"¹⁶, functioning as a code of conduct whose objective is to limit the family's power in favour of ensuring the success of the family business.

It may regulate, in particular, pre-emptive rights and restrictions on the transfer of shares, internal regulations laying out the roles and duties of management, board election and remuneration, distribution of dividends, admission of other family members as employees or shareholders, the relationship with non-family members such as employees or shareholders, and succession rules.

It is advisable for the family protocol to be put in place by the first generation in order to avoid the future possibility of family conflicts and breakups, which are commonplace in the transition to the second and later generations.

¹⁶ Ana Maria Ussman, *ibidem*, page 97.

As a further example of a corporate document, this protocol shall need to remain subject to periodic revision, to keep up with the changes in the company and family that are inherent to their evolution.

Moreover, as family protocols legally qualify as shareholders agreements¹⁷ they will therefore be regulated as such, being entirely independent of, and external to, the deed of incorporation and articles of association.

e) Dealing with succession: Passing the torch

“No recurring event in the life of the family firm is more critical to survival than the transfer of power from the incumbent to the successor.”

Despite the high number of family businesses in existence, only around 30 percent of them survive through to the second generation of ownership and only 15 percent to the third generation.

Small enterprises, especially when solely managed by the founder, are more susceptible to loss of vision and purpose during periods of leadership transition. The reasons for this succession crisis are threefold:

Firstly, founders often have difficulty in relinquishing their leadership of the company they created. In fact, *“succession planning is in direct conflict with the entrepreneur’s needs for control, power and meaning.”*¹⁸ Therefore, while such individuals generally desire the business to continue on following their departure, they typically refuse to acknowledge the need to plan their retirement, and therefore, in most cases, succession takes place as an inevitable event – following illness or death – rather than as a planned and orderly process.

Secondly, in family-owned businesses, the most obvious successors are generally family members in the next generation. After all, the fact of leaving behind a family legacy is one of the driving incentives behind the creation and continuation of such businesses. However, the heirs may not necessarily possess the suitable skills, knowledge and experience that are necessary to carry on the business.

Thirdly, succession involving transfer of ownership and management is an expensive process and difficulties may arise in securing sufficient sums of capital to fund liquidity and growth.

Retirement of the owner and handover to a younger generation may trigger capital gains tax which can only be paid by raiding the company's funds, thereby causing serious damage to the firm.

In this regard, the implementation of sound corporate governance mechanisms may positively contribute to overcoming the manifold issues brought about by the succession process.

¹⁷ Regulated by Article 17 of the Portuguese Companies Code.

¹⁸ Duffy, P.B. and H. Stephenson, 1984, “Entrepreneurship and Self-employment: Understanding distinctions” in J.A. Hornaday F. Tarpley Jr., J.A. Timmons and K.A. Vester (eds), “Frontiers of Entrepreneurship Research”, Babson College: Wellesley, MA, 461-477.

IV – GROWING THE BUSINESS – FINANCE AND GOVERNANCE AVENUES

“As a business grows, it becomes increasingly complex, creating its own demands for a more formal organizational structure. Success drives the need to adapt and change.”¹⁹

1. The turning point

Family companies may experience periods of exponential growth which will inevitably pose a series of new challenges: existing corporate governance rules no longer fit the company size and structure and additional sources of finance and strategic support may become necessary.

Furthermore, the fact of passing on the company to successive generations will result in more dispersed and structurally complex systems of ownership, management and control. The natural progressions in a company’s life cycle tend to create fundamental changes in roles, functions and practices.

These factors will challenge the family business to periodically re-invent their business governance and finance strategies.

The evolving system of governance may be strongly influenced by the type of finance sources elected, especially when that choice will produce a change in the ownership or control structure.

2. Finance Options

“Family businesses have their own perspective on capital”²⁰

Family businesses often have an aversion to outside capital infusions, which may end up affecting the capacity of development and growth. Their preferred sources of capital are retained earnings, family funds and bank financing.

Although in a transitional period, continental Europe continues to display a preference for raising debt capital rather than relinquishing part of the ownership in the company.

These financing decisions are especially influenced, in family businesses, by the family’s desire for control and privacy. Generally-speaking, families are uncomfortable with strangers assuming any degree of control over their businesses or enquiring into the same, as they consider them to be private family matters.

However, the recourse to “alternative” capital sources – such as private or public equity – in order to finance the business' growth and expansion strategies may prove extremely interesting in the sense that they may reveal a number of advantages over more traditional sources of capital.

These are exactly the cases which shall now be analysed in further detail: private equity and IPOs as sources of financing, and their pre- and post-influence on corporate governance models for family businesses.

¹⁹ Ward, John L. “Promoting Family Businesses” in “Promoting Growth Through Corporate Governance”, Economic Perspectives, February 2005.

²⁰ Upton, Nancy and Petty, William (2000) “Venture capital investment and US family business”, in Venture Capital – An international journal of entrepreneurial finance.

a) Private Equity Capital²¹

(i) Taking family owned businesses to the next level

In addition to the injection of specialist know-how, experience and industry-wide contacts, raising growth capital for family owned businesses through private equity offers a number of advantages over other more traditional sources of capital. Such benefits will range from the true commitment of the private equity investor to the business, who assumes the active role of partner, to the higher level of flexibility in terms of the capital base. Equally, it may be said that the return on the private equity investment is dependent on the business' performance which acts as a powerful incentive for the investor to ensure its viability.

The type of expertise usually transmitted to the business, and particularly to the senior level of management, includes regulatory, compliance-related and transactional advice, analysis and redress of any potential conflicts of interest, as well as the provision of strategic assistance in *ad hoc* projects.

The private equity investor will offer, therefore, a great deal more than just straightforward capital input, which may well prove to be a decisive factor in determining a successful outcome for the project.

(ii) Corporate Governance perspectives

Fine-tuning the Corporate Governance model is of instrumental importance where the family takes the decision to allow a “stranger” into the business. The corporate governance structure to be implemented should adequately address specific objectives such as defining the relationship between the private equity investor and the family, establishing a system of “checks and balances”, defining the relationships between shareholders, management and board, and defining a reliable system of information disclosure which maintains the private equity investor fully abreast in terms of the company's financial performance.

- Governance structures incorporating the role of the private equity investor as active decision-maker in the company's management.

Several structures may be adopted to allow the private equity investor to participate actively in the decision-making process. The type and degree of participation will be defined according to the structure and nature of the investment, as well as the investor's assessment on the effectiveness of the current board.

- Shareholders agreements

Conflicts often arise between shareholders when expectations are unclear or based on erroneous principles at the outset. Many of these issues can, however, be alleviated by clearly agreeing and documenting all parties' expectations before and at the time of the investment, through shareholders agreements.

The intensity of rights and obligations of the private equity investor will effectively vary directly in line with the amount of equity held in the invested company.

At a very minimum, a shareholders agreement will regulate board appointment rights, veto rights, eventual pre-emptive rights and dispute resolution, as well as special information rights and exit mechanisms for private equity investors.

²¹ Private equity houses and funds are currently regulated by Decree-Law 319/2002, as amended by Decree-laws 151/2004 and 52/2006. The regime is presently being reviewed in order to include business angels and increase the sector's dynamism.

In minority shareholdings, the private equity investor frequently assumes a non-executive role. In these cases, his main responsibility will be to monitor the performance of the family business.

Where larger shareholdings are concerned, an executive role usually forms part of the deal. In these cases the private equity investor is more proactive in the definition of strategy. Such powers should be exercised for the benefit of the invested company and not only the investor's interests.

The third option is for the private equity investor to assume the role of chairman.

However, regardless of the percentage of the stake acquired, should the private equity investor consider that a certain invested company is being well managed, a non-executive role may be considered adequate, while if, on the other hand, he feels that the project has unrealised value waiting to be tapped through better management, he may demand an executive role.

- Devices promoting efficiency and transparency

Devices promoting efficiency and transparency may also be implemented. Private equity investors tend to view the implementation of these procedures and devices as an efficient means of adding value to the company.

Such procedures often include internal control, otherwise known as the "four eye principle" - identification, assessment, mitigation and risk management - which is fundamental to the success of the business, the creation of independent committees on risk management, remuneration policy, auditing, executive action and investment, the implementation of a code of conduct on disclosure, ethics, compliance, fairness, accountability, the professionalisation of management in terms of industry knowledge and insight and technical knowledge, as well as the preparation of exit strategies.

- Exit routes

As the private equity investor is, by nature, a temporary shareholder, the preparation of clearly defined exit routes will be of the essence. Fundamental issues to be discussed and agreed in advance include pre-emptive rights, drag along/tag along rights and the replacement of board members who were appointed by the private equity investor. Typical exit routes for the private equity investor include sales to other private entities, trade sales, write-offs and Initial Public Offerings (IPOs).

b) Going public – IPOs

*"Almost since the first company listed on the first market, capitalists have sought to raise money without sacrificing control"*²²

Going public may be either an alternative to private equity or, as mentioned above, an exit route for previous private equity investment. In fact, such investment may be an intermediate stepping stone towards an eventual public offering.

However, family businesses do not usually consider IPOs as an option, since the fact of being a publicly-held company brings about issues such as public exposure, regulatory and shareholders' demands for information and possible relinquishment of the company's command.

Moreover, preparing the company for an initial public offering is usually a somewhat complex and costly process, which involves a thorough corporate restructuring. Depending on the degree of

²² The Economist, 15 March 2007, "Our company right or wrong".

sophistication of the corporate governance model already in place, there may well be much work to carry out before a company may in fact go public.

In order to become a leading public company, clear lines of authority, a strong and independent board of directors and a committee structure are cornerstones which, if not already in place, will in any case prove beneficial. When a company takes the decision to float, early and planned adoption of the legal and securities exchange requirements will most certainly assist in facilitating the transition to a public company.

(i) Mechanisms for maintaining control

Although competition is an essential trigger of strong and healthy markets, in which change of control is a determining factor, companies in fact continue to create systems designed to retain power over corporate decisions and, clearly, employed in order to avoid undesired change of control.

In family businesses, the maintenance of control and the capacity to pass on the company to future generations are two of the most cherished objectives. In reality, however, they may prove to be two of the fundamental hindrances to the further development and growth of the company.

In this sense, such entities have tended to develop a number of mechanisms which enable them to retain an elevated degree of control and, in fact, this is the case with several international conglomerates, which although having a great percentage of free float are totally dominated by the founding families. Some of the most notorious examples include companies such as Porsche, Cargill, Michelin, Benetton, Hermes and Zara.

Some of the most commonly used mechanisms to maintain control when raising capital, namely through the public issue of shares, include cascades, classes of shares with different voting rights, and voting caps.

In the so-called cascades of companies (also known as Chinese boxes), widely used in Italy to maintain control of a larger group of companies, each stage of the cascade amplifies the capital governed by the tiny company at the top, dominated by the family.

The issue of dual-class shares permits families to retain control whilst still being able to raise capital through the public issue of shares. Effectively, the attachment of special voting rights to the equity held directly or indirectly by the family members allows them to attain both objectives sought in relation to the type of finance source chosen and the control mechanisms put in place: in other words, raising finance whilst still maintaining firm control over the reins of the business.

Voting caps, designed to avoid a change of control over the company, set out a maximum number of votes to be exercised by each single shareholder regardless of the amount of the shareholding in question.

In Portugal, whilst some of the most commonly employed control mechanisms throughout the world are also widely used, others are restricted or forbidden:

(1) Cascade of companies:

There are no legal restrictions on the use of a cascade of companies as a type of corporate structure. However, a group of companies structured in order to give control to the top company may trigger provisions regulating groups of companies.²³ This regime includes provisions on special protection for minority shareholders, liability for subsidiaries' losses, conflicts of interests and directors' liabilities.

²³ Articles 488 to 508-E of the Portuguese Companies Code.

(2) Voting caps:

Voting caps are one of the most commonly used devices by Portuguese companies to avoid hostile takeovers. They are permitted, subject to the restrictions imposed by the Takeover Directive²⁴ and concern the breakthrough rule. In this regard, restrictions in the exercise of voting rights, established in the company's articles of association, may be voluntarily suspended during the offer period. Should the company decide not to include this suspension within its corporate provisions, it will not be able to establish a majority of cast votes higher than 75 percent to amend or eliminate the said voting caps.²⁵

(3) Restriction of voting rights:

The company's articles of association may also lay out provisions setting out a minimum number of shares (not exceeding € 1,000 of the nominal share capital) necessary to grant one single vote, thereby preventing the access to and attendance at General Meetings by certain minority investors.

(4) Multiple voting rights:

Multiple votes are forbidden by the Portuguese Companies Code²⁶. Exception is made, however, for companies that had this provision enshrined in their articles of association prior to the enactment of the new Companies Code (1986).

(5) Non-voting shares:

Whilst multiple voting rights are not allowed by the applicable provisions of the Portuguese Companies Code, the issue of non-voting shares to the public may sometimes be an option in order to acquire capital investment while still retaining control. Preferred non-voting shares do not confer on their holders any voting rights but entitle their holders to a dividend paid out with preference to any other share on an amount of no less than 5 percent of their value. In practice, such payments may often render this means of raising capital quite an expensive source of finance, thereby discouraging its frequent use.

(6) Shareholders agreements:

Shareholders agreements may become, in certain circumstances, a quite common control mechanism in order to retain dominance. Clauses concerning pre-emptive and voting rights, as well as management control are some of the most frequently addressed subjects, where the intention is to preserve domination by certain control groups.

²⁴ Incorporated by Decree-Law 219/2006 of the 2nd November.

²⁵ Article 182-A of the Portuguese Securities Code, introduced by Decree-law 219/2006.

²⁶ Article 385 (5).

V – CONCLUSION

It is clear then that sound governance practices are applicable also to family business entities and that the measures and strategies elucidated in the previous few chapters, where adopted and tailored to its particular circumstances, may offer numerous advantages to the typical family controlled business. By providing a suitable framework and mechanisms for implementing much needed improvements to organisational and operational structures, former weaknesses can be turned into strengths, thereby increasing resilience to the challenges presented by changes from both within and outside of the company.

The new level of critical self-awareness attained, in conjunction with a valid business concept and the powerful funding avenues which such practices tend to open up, will effectively act to provide the capacity to unleash, for the family business, a formidable level of “firepower” on the market. In a highly competitive business environment, where the mortality rate of newly formed family businesses remains extremely high, this will have the potential to become a crucial factor towards levelling the field with the bigger players.

Getting this balance right will benefit not only family businesses but also two much bigger but less immediately apparent stakeholders in this process: the wider consumer and general society. Family businesses are in many senses the socioeconomic glue that binds together much of society and the economy, and if more of them can survive and flourish long into the future it will serve to increase competition and choice which in the end can only be better for the consumer and society as a whole which finds much of its strength in diversity.

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