

## Chapter 18

# Discussion Report Part 4: Legal Research III

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Lorenz Holler: Family Constitutions and the Complexity of Family Businesses from a Counsel's Point of View

The discussion first revolved around the relationship between the family constitution and the founder's intention. A practitioner said that in family businesses, the founder's intentions and values typically shape family traditions as well as the company charter. In later generations, his intentions may be replaced by the family's intentions and values, which in turn shape tradition and the company charter. The family constitution serves as a vehicle to shape the family's intentions. A law professor added that this role of the family constitution fits nicely with the historical development of family constitutions as modern forms of house laws, in which the patriarch's dominance is replaced by a family consensus. According to another legal scholar, German courts acknowledge that the founder's intentions may play a role in the interpretation of partnership agreements and even corporate statutes if they find an expression in the document. Since the founder's intentions can fade over time and the family constitution is constantly revised, this may speak in favor of considering the family constitution as an aid for interpretation. Holler admonished that, in practice, it is very dangerous to touch the founder's intentions and replace them with a family constitution without making sure that all agreements within the family business are properly coordinated. A managerial scholar explained that, from a governance perspective, the first-generation business is entirely different from the following generations. After the

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**Family Firms and Family Constitution, 249–250**



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first generation, the governance framework needs to be revised and adapted for the future. Founders cannot anticipate all future contingencies and they cannot imagine a business 10 times the size of their initial business. To emancipate the company from its founder is of enormous importance. If the next generations run the company like the founder, it will collapse within two generations. Nature invented succession as an incentive to adapt. It is hard to eliminate structures that the founder implemented.

A second strand of discussion dealt with the pros and cons of a branch structure (family lines, “Stammesprinzip”) in family firms. A managerial scholar said that not one researcher would recommend a branch structure. From a governance perspective, a branch structure has only disadvantages. Inherent in a branch structure is the logic “branch first” instead of “business first.” In a branch structure, discussion is taking place only within the branches. On company level, only positions of the branches will be exchanged, rather than arguments. A branch structure therefore creates conflicts. And it is very difficult to abolish a branch structure because every branch has to waive its special rights. Usually, unanimity is necessary. In 30 years, the managerial scholar predicted, it will no longer be *leg artis* to draft contracts which follow a branch logic. Without a branch logic, there will be shifting alliances between the shareholders; everybody will be the winner sometimes. This is necessary for decision-making bodies to function. Holler added that a branch structure can lead to conflict of interest. It may also encourage vote-buying and tit-for-tat. A management consultant cautioned, however, that one must examine whether a branch structure is a question of design or a given fact. A branch structure typically evolves naturally from the first in the second generation, especially if there is a reluctance to involve legal advisors. A law professor added that a branch structure might be advantageous because it helps to overcome collective action problems and it facilitates decision-making. As an alternative, a management consultant suggested to appoint multiple representatives based on various interests instead of family relationships, such as a representative of the next generation.

Finally, there was an exchange of ideas about the role of legal advisors in family firms. A law professor stated that they serve an important precautionary function in family firms. They gain experience with sensitive topics such as powers of attorney in the case of legal incapacity. Following up on that, Holler explained that every shareholder should designate a representative beforehand to ensure that the company remains able to act and make decisions. The obligation to have such a power of attorney may be enforced indirectly in the articles of association by stipulating that the right to vote rests until the shareholder has complied with this obligation.