Governing Famiy Business: Issues and Challenges

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The seminal work of Berle and Means (1932) provides the foundation for research examining corporate ownership structures. The central premise of their work was the recognition of problems associated with the separation of ownership and management.[1] These lines are found in almost every paper on corporate governance. It underlines the fact that corporate governance is seen as a solution to the problem of separation of ownership and management. A discipline that was developed in response to the problems faced by companies with diversified ownership was first made applicable to all listed companies and then slowly to all unlisted companies as more Companies Acts started incorporating these solutions. This could have been more understandable if there was an overwhelming predominance of diversified ownership in companies. Obviously, this is not the case.

2. Family controlled businesses are important. Examples include Acer Computers, Wal-Mart, Ford Motor Company, SC Johnson Company, Tetra Pak,, Anheuser-Busch, DuPont, Kosh Industries...etc. Moreover, family ownership of listed companies is a common feature of several capital markets in Asia, Latin America, and Europe. Many studies indicate that family controlled businesses contribute greatly in the economic wealth creation in most economies. Between 65% and 80% of all worldwide business enterprises are owned or managed by families. In Europe, family firms dominate small and medium size firms. In Singapore and Hong Kong, the numbers are similar as many of the family business enterprises have recently gone public. In Taiwan the small and medium-sized family enterprise accounts for more than 98.5% of companies, 80% of employment and 47% of the total economy. It is estimated that 40% of the Fortune 500 are family owned or controlled.[2]

3. With such overwhelming predominance of family controlled business, it is remarkable that corporate governance theory and practice has largely developed as relevant to companies with diversified ownership. At best family businesses were given some advice to create separate structures to solve their specific problems but the basic compliance is required to be the same as applicable to companies with diversified ownership.

4. Business is complex. Family relationships are complex. When the two are combined, the cocktail is potent and heady. The complexity of the issues can be appreciated if we just look at the ways in which a family business can be defined.[3]

5. The first definition we consider,[4] states that family firms are those in which multiple members of the same family are involved as major owners or managers, either contemporaneously or over time. This leaves us with a situation where all single owner, first generation businesses are taken out of the pale of the family firm.

6. The second definition views?family firms as those in which the family controls the business through involvement in ownership and management positions.[5] The proportion of members who are family members determines the extent to which the business can be considered as a family business. This leads to a situation where some families like some Birla groups, where often family did control the groups but where family members did not traditionally hold positions in companies will not be counted as family businesses.

7. The third definition views of family business as one governed and/or managed with the intention that it is potentially sustainable across generations of the family or families. Presence of 'intention' in the definition makes its usefulness much lesser.

8. Fourth, ?a more comprehensive definition views a firm of any size as a family business if:

i. The majority of decision-making rights, direct or indirect, are in the possession of the natural person(s) who established the firm, or their spouses, parents, child, or children's direct heirs.
ii. At least one representative of the family or kin is formally involved in the governance of the firm.
iii. Listed companies meet the definition of family enterprise if the person who established or acquired the firm or their families or descendants possess 25 percent of the decision-making rights mandated by their share of capital[6].

9. This article is organized in four sections. In the first section the negative perceptions about family controlled firms, both economic and regulatory, are examined. In the second section the given wisdom how family controlled businesses should conduct themselves is recorded. The third section will examine the research questions that are

being examined. Fourth and final section will examine why a separate corporate governance structure should be created for family controlled companies.

Section I
Negative Perceptions of Family Business

Economists' View

10. There are good and bad aspects of any form of business organization. Most of the negative perceptions about family businesses have often an immediate counter-example. There is a strand of thought that family businesses are more conservative as they have a family name to defend. There is often a counter evidence that not constrained by formal processes they can pursue growth opportunities more aggressively. Similarly there is a view that long tenure of employees in family business leads to status quo and stagnation. There are counter arguments that the long serving employees actually are repositories unparalleled skills. However, even if we leave aside such questions, there are two major negative perceptions about family businesses that must be examined.

11. The term political rent seeks to describe self-interested dealings between the political and business elites. The term rent is appropriate in its economic usage, which includes unearned income of any kind[7]. Randall Morck and Bernard Yeung conclude in their paper that the small number of very large family-controlled corporate groups in many countries combined with their long continuity of control and ability to act discretely give these organizations a comparative advantage in political rent-seeking. Political rent seeking and low general levels of trust combine to stymie growth. First, that family controlled firms become big because of rent seeking i.e. their connections with government and it leads to stasis as it would prevent newer companies to come into the market. Logically, these companies would perpetuate themselves while the economy stagnates. Driven by these views, policy makers often see family control in business as an unmitigated evil that needs to kept in check by stringent laws and regulations.

12. Tarun Khanna and Krishna Palepu have examined these propositions with reference to India.[8] They ranked top 50 Indian companies in the order of their assets in the years 1939, 1969 and 1997. There are major changes in the fortunes of these family controlled companies. Thirty-two out of fifty of the top groups in 1969 were not in the top-fifty list in 1939. Forty- three of the top groups in 1997 were not in the top-fifty list in 1969. This gives lie to a blanket conclusion that family controlled companies necessarily lead to stasis. Such a turnover within 30 year periods cannot be called stasis by any stretch. Khanna and Palepu further go on to examine the fortunes of two most famous Indian groups viz. Tatas and Birlas.

> "… the House of Tata, in the pre-independence period, presided over a group that was, in fact, quite reliant on government contracts. Before World War I, Tata Steel would not have started without a guarantee from the British government for Indian Railways, nor would Tata Steel have grown into the largest integrated steel factory in the British Commonwealth without such government contracts. And Tata Steel was protected by tariffs against German and Japanese, if not British, (Hazari 1986). The Tatas adopted a neutral stance in the Independence movement. As Piramal (1998, p. 481) puts it, in the British Raj, the Tata Group "bristled" with knights."

13. The above quotation would perhaps go on to reinforce the conclusion by Randall Morck about rent seeking as the assets of Tatas increased from Rs. 62 crore in 1939 to 505 crores in 1969. In the post independence era, Tata group reportedly made 119 new proposals for expansions in (existing or de novo) businesses between 1960 and 1989, and every one of them was rejected. As a result, the assets of Tatas increased from Rs. 505 crore in 1969 to Rs. 37,510 crore.

14. Next, we turn to Birlas.

> "As the movement for freedom from the British Raj gathered momentum in the 1920s and 1930s, close relationships developed between Indian businesses and leaders of the political movement for India's independence. Underscoring their symbiotic relationship in a letter, as he was building steam for India's independence movement in 1927, Mohandas Gandhi told G. D. Birla, a prominent Indian businessman, "I am ever hungry for money" (cited in Piramal 1991)."

> The assets of House of Birlas rose from Rs. 5 crore in 1939 to Rs. 456 in 1969. Post independence,

> "..the Birla group became the target of criticism for its manipulation of the licensing system, as it was targeted by the Hazari reports and criticized for preempting licenses—that is, for applying for licenses that it then failed to use. Indeed G. D. Birla's successor, Aditya Birla, was allegedly sufficiently disappointed by being, in his view, unfairly tarnished by the government's allegations, that he simply shifted his expansion plans overseas. So much so that, between 1970 and 1995, the Birlas had established plants in Egypt, Indonesia, Malaysia, the Philippines, and Thailand, with overseas activity accounting for a third of their overall business, and the world's leading position in viscose staple fiber, palm oil, and insulators, and the world's sixth-largest position in the manufacture of carbon black"

In 1997 Birla group had assets of Rs. 19,497 crores from earlier 456 crores. The two largest groups continued to grow irrespective of government patronage or otherwise. We are not arguing that rent seeking does not exist. It is only to make a point that the two main arguments, of "necessary stasis and rent seeking" against family businesses do not hold up to close examination.

Regulators' view

15. Generally, regulators take a dim view of family controlled businesses. These are usually associated with siphoning off money from listed companies to private enterprises owned by the promoters through various means and cutting side deals with acquirers to the detriment of minority shareholders. These views are reflected in the G20 OECD Principles of Corporate Governance.[9] Controlling shareholders are mentioned in 11 places out which 8 are in some negative context. For example, they are associated with

- Misuse or misappropriation of company funds
- Discouragement of minority from trying to influence direction of the company
- Pyramid structures being used to debilitate minority shareholders
- Their relationships outside company about which they should be obliged to inform the Board
- Abusive behaviour in pay and voting rights from which minority should be protected
- Exhortation to Independent Directors that Duty of loyalty is to company and not to controlling shareholders
- Exhortation to the Board that it should treat all shareholders fairly even if selected by controlling shareholder
- Emphasis on independence of Board Members from controlling shareholders.

There are 2 neutral references about

- Provision in some jurisdictions to buyout minority and delist
- Informing the controlling block through disclosures

And there is one grudging appreciation that presence of controlling shareholders can reduce agency problem.

16. There are many scandals that would explain why regulators feel about family controlled businesses the way they do. Yet the more interesting point is their grudging appreciation about the presence of controlling shareholders reduces agency problem. Which agency problem are we talking about? What is addressed in the extant corporate governance framework is a situation where shareholders are principal and Board is the agent. The issue in family controlled businesses is that of principal- principal agency problem among shareholders. This is sought to be addressed by applying patches, such as regulations for related party transactions, rather than tackling the main principal-principal agency problem. This paper will examine whether the present structure of corporate governance is at all suitable for family controlled businesses and whether the entire framework addresses the wrong problem.

Section II
Given Wisdom

17. Academic research papers don't count for given wisdom. Extreme and unconventional views are possible in academic literature. However, lenders are by definition more conservative and more so if they belong to the World Bank Group. Similarly, if some advice is given by a Government Department, it too can be counted as given wisdom. In this section we draw heavily from two documents viz. IFC Family Business Governance Handbook, 2011 and Government of UK Department of Business and Innovation – Research Report on Family Business, 2014.

18. First, the family—as the business owner—shows the highest dedication in seeing its business grow, prosper, and get passed on to the next generations. As a result, many family members identify with the company and are usually willing to work harder and reinvest part of their profits into the business to allow it to grow in the long term. It is also not uncommon that they dip into family silver to save a company from drowning. Second, families in business make it a priority to pass their accumulated knowledge, experience, and skills to the next generations. Many family members get immersed into their family business from a very young age. Even though they may not have formal training, much knowledge seeps in through atmosphere at home. This increases their level of continuity when compared with diversified firms, which face a paradigm shift every time CEO changes. Even the employees tend to stay much longer and over more than one generation. Third, their products and services are often famous for reliability. They maintain long term relationships with their customers, suppliers, employees and community and which augments reliability.

19. On the negative side, family controlled businesses have their weakness in family emotions complicating the business decisions. In more than one instances business families in India have taken a major acquisition decision for finding a business to keep their children occupied.[10] Second, there is usually very little interest in setting clearly articulated business practices and procedures. As the family and its business grow larger, this informality can lead to many inefficiencies and internal conflicts that could threaten the continuity of the business. Third, there is lack of discipline in key strategic areas such as succession planning, family member employment, and attracting and retaining skilled outside managers.

Stages of Business

20. Family businesses are thought to exist in primarily three stages. The first being when founders of the business are still in charge of the business. The business is most vigorous and innovative. The issues pertain to succession and estate planning only. In the second stage, when the siblings are running the business, maintaining harmony is a challenge and failure may lead

to loss of control by the family. In the third generation, ownership lies among cousins and their spouses. There are too many members in the family with different needs for liquidity and different ambitions. Allocation of capital and sale of shares for liquidity become contentious issues. The family needs a clear vision and mission and there is need to communicate it the family at large.

Risk Appetite of Family Business

21. A superficial survey of literature regarding the risk appetite of family business throws up contradictory conclusions. Some feel that the family businesses don't take enough risks and therefore are unable to grow fast enough while others think that they are able to take much longer-term risks and are able to give extraordinary results. Closer examination reveals that family businesses are chary of taking financial risks, e.g. they have lower Debt to Equity Ratio[11], lower ratio of Debt to Assets[12] and have higher levels of liquidity[13].

22. However, the family businesses are more likely to take long term strategic risk as the security of senior management positions which derive from their family status facilitates longer term planning and the build up of in-depth knowledge and memory. The Managing Director (MD) is less likely to face redundancy for any short-term failure to grow or generate profits.[14] However, they have tendency to scrutinize opportunities very carefully and eschew diversification into new market areas, unless closely related to the existing line of business.[15]

23. No generalizations can be drawn. The risk strategy also depends on aspiration. Family business performing below expectations risks the continuation of the business, prompting it to consider more risky explorative Research & Development (R&D). By contrast, when performance is above expectations, they rely more on R&D, which is exploitative of their current products and processes; this may increase the reliability of sales but also the risk to socioemotional wealth.[16]

24. Families in business are not totally rational economic beings maximizing the dollar returns. Businesses are associated with social prestige and founders and their children are often emotionally attached to their businesses. This may be called as In 'socioemotional wealth' (SEW) which seen as highly important to family businesses. It could be defined as 'non-financial aspects of the firm that meet the family's affective needs, such as identity, the ability to exercise family influence, and the perpetuation of the family dynasty'.[17] Family businesses will pursue goals which may be non-economic, in order to increase or preserve socioemotional wealth in regard to which family owners are highly loss averse, leading them to preferences that come about from the desire to preserve SEW often result in risk aversion and the pursuit of lower risk strategies.

25. IFC views family businesses as comprised of two sets, those who keep family first and those who keep business first, with an implicit assumption for preference for the latter. The differences between the two are spread over different areas such as compensation, leadership, business resource allocation, and training. Family first businesses tend not to formally train family members, give equal remuneration to all and the senior most rises to leadership position whereas business first companies give formal training, pay according to performance and responsibilities and leadership position is earned. The first set would not mind company resources being used for personal use whereas the other set would never think of doing it.

26. The composition and working of Board of Directors in family controlled businesses depend much on the stage in which the business exists. At the founder stage, the Boards are normally paper boards with all decisions being taken by the founders. In the intermediate stage, the Boards perform mainly advisory function. In the final stage, the Board nominates independent directors who bring, outside perspective, new skills and knowledge, contacts and Connections, as well as independent and objective view. Hiring and Promotions are made independent of family and the Board acts as a balancing factor among family members.

Recommended Governance Structure

27. IFC recommends that family controlled businesses should create governance structures with the aim of

- Communicating family vision, mission and values
- Keeping those who are not participating in business informed
- Communicating Rules of Decisions – Employment, Dividends
- Establish channel through which members can convey ideas
- Allowing Family to come together to make decisions

This governance structure may consist of Family Constitution, Family Governance Institutions, and Family Office.

28. Family Constitution should first of all state the vision and mission of the business. Then it should give details of what family institutions should be put into place. There should be clear rules about who can join the Board and how senior management will be appointed. The authority and relationship between family, Board and senior management should be clearly spelt out. It should also spell out policy regarding in-laws joining the business, how shares could be sold and whether a Share Redemption Fund would be established to facilitate selling. Policy regarding employing family members in business also needs to be delineated. Finally, Family Constitution should deal with the issue of Succession of CEO.

29. Family Institutions are established to increase interaction among family members and to open op

communication channel to all the family members. These need to be distinguished from the company governance institutions like the Board and its committees. The most important institution is the Family Assembly. It is like general meeting of family members. It may be held once or twice in a year to approve vision, mission and value statement, to approve policies such as Family Employment Policy, and to elect Family Council, which is like an Executive Committee. The Family assembly increases not only bonding among the family members and make them understand the business and their place in it but also to provide a two-way channel of communication.

30. Family Council is a smaller body that meets two to six times in a year and acts a link between family, board and senior management. It drafts vision and mission statement, drafts policies and discusses names for board membership. Family Office is run by outside professionals and acts as Investment and Administrative Centre for the family. Family Council oversees it. More institutions, depending upon need, may be established such as Education Committee, Career Planning Committee, Family Reunion and Recreational Committee to provide support to the family. It needs to be emphasized again that all the family institutions need to be established in addition to the corporate governance structure mandated by regulation or law. Families may view them as an added layer of interference in their businesses if regulators make even a recommendatory mention.

Section III
Researchers' Perspective

31. The literature on corporate governance in family firms is so extensive that it is a substantial task to review the literature. We shall therefore rely on Oxford Handbook of Corporate Governance, Chapter 18 written by Lorraine M Uhlaner. It summarizes the various strands of research and enunciates nine research questions (RQs). Before we tabulate those questions, it will be relevant to explain two words viz. Contractual Governance and Relational Governance used in these questions. Contractual Governance refers to the web of contracts through which governance is exercised. These may include the structures formalized by law or regulations or through specific contracts. These may include the duties of Board of Directors and that of the various Board Committees. On the other hand Relational Governance refers to governance exercised through Mutual Trust, shared vision and commitment to the success of the firm. The formulated questions are reproduced below:

RQ1 Do Family Owned Firms (FOF) perform better than Non Family Owned Firms (NFOF) solely because of their ownership form?
RQ2 Do FOFs have different type of Contractual Governance than NFOF?
RQ3 Does family ownership moderate the relationship between contractual governance and firm performance?
RQ4 Does family ownership enhance relational governance?
RQ5 Does family ownership moderate the relationship between relational governance and firm performance?
RQ6 Does family ownership moderate the relationship between contractual governance and relational governance?
RQ7 What are the effects of family governance practice on business performance?
RQ8 What is the appropriate role of non-managing family owner?
RQ9 Does the governance style most appropriate for family firm change over time?

31. The above list of research questions appears to be very comprehensive. However, most of research is being done with reference to performance of family firms vis-à-vis non-family controlled firms. The second strand of research is to analyze various attributes of family business such as trust, relational capital etc. There too, the sub-text is whether such attributes help family firms perform better or otherwise than non-family firms. Despite extensive research done in the last couple of decades, no firm conclusions could be drawn.

32. Even if research threw up definite answer, it is not clear whether the answer will be of any practical importance. Even if a family owner is aware that diversification of ownership will make the firm perform better in the decades to come, there is no incentive for him to divest. First, the family is likely to ignore any such research because keeping business within family brings in Socio Emotional Wealth. Mere having a big bank balance is no substitute to the social prestige that comes with being owner of a large industrial enterprise. Secondly, it is very unlikely that the act of divestment of its own will enhance the present value of the firm. The relevant question should be as to what can be done that family controlled firms are able to perform better in their own right and not whether they perform better than non-family controlled firms.

Section IV
Corporate Governance in Family Controlled Businesses

33. Sir Adrian Cadbury in his report said that corporate governance is the system by which companies are directed and controlled. These words from father of modern corporate governance practices are encouraging enough to let us explore different models of corporate governance than what has been suggested in the Cadbury Report itself. Family businesses are thought of being more poorly managed and less open to new ideas than non-family businesses, risking slower growth and profitability. In recent years, this view has been strongly associated with analysis of the London School of Economics World Management Survey (see e.g. Bloom et al., 2012), arguing that – across many countries, on

average, family businesses are the worst managed type of business.[18]

34. On the other hand there are those who find that family firms are more likely to deviate from standards of best practice in corporate governance. However, lesser governance standards in family firms are not associated with lower performance because the family shareholder is the monitor in-place. In contrast, governance practices and disclosures matter in widely held firms because they alleviate the conflicts between managers and dispersed share-holders and non compliance makes performance worse. More broadly, results show that family ownership and board governance practices are substitute governance mechanisms.[19]

Choosing Independent Directors : Do they solve agency problem?

35. The prevalent way in which Independent Directors are chosen is that the controlling shareholder decides on a name and the Board / nomination committee formally approves it. The ID is appointed and his name is put before the next AGM and since the controlling shareholder holds complete sway over the AGM, there is no question of the name being turned down. On the other hand the procedure suggested by OECD Principles of Corporate Governance involves the Nomination Committee deciding on what skill set is required in the Board and then choosing an incumbent whose name is finally approved by the AGM. The prevalent system is of course not satisfactory, as the Independent Directors basically owe their loyalty to the controlling shareholders. In the latter case, Independent Directors slowly evolve into an elite club where they are chosen on each other's board. Either way, there is no one to represent the minority shareholders specifically even if it could be argued that this elite group represents other stakeholders. For example, while approving a related party transaction, it is extremely unlikely that the Audit Committee will go and consult minority shareholders. In no way, the present system of independent directors and the Committees they control ameliorates the agency problem between the minority shareholders and the controlling shareholders, even if the controlling shareholders stopped selecting independent directors.

36. IFC and other lenders recommend that family controlled firms should create family governance structures like family constitution, family council, family office and other committees to meet with problems peculiar to the family firms and these structures are required to be in addition to the structures recommended for diversified firms. This just increases the time that controlling shareholders have to spend handling two separate governance structures and is unlikely to help family firms.

The way forward

37. It is not within the scope of this paper to suggest an alternate corporate governance structure for family controlled firms, which will deal with their issues, and still be fair to all stakeholders including minority shareholders. Every country has family firms that have their own genius. There is a need that a detailed survey be conducted and seek the opinion of major controlling shareholders as to what institutional arrangement would help the family firm to meet its own challenges while meeting the aspirations of all other stakeholders including minority shareholders.

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