GOVERNING FAMILY BUSINESSES

John L. Ward

Corporate governance of family businesses differs fundamentally from that of widely held public companies. Family ownership concentrates control and facilitates decision making, which can both lower governance costs and permit unconventional but strategically advantageous decisions.

A well-functioning system helps build trust within the family, and a good family dynamic, in turn, becomes an asset to the business because it enables each separate piece of governance to function better and add more value while remaining aligned with the other components of the governance system. These governance advantages can provide clear economic benefits.

However, a growing business becomes increasingly complex and creates its own demands for a more formal organizational structure. Family business managers must adapt their governance practices accordingly. Indeed, success drives the need to adapt and change—and all family businesses eventually face this reality.

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FAMILY BUSINESSES: PROS AND CONS

With ownership controlled by one or a few people from a family, family firms have competitive advantages and disadvantages over publicly held companies. On the plus side, controlling ownership can take the long-term view. Patient, consistent investments can yield excellent future benefits. Investments in corporate culture can also yield benefits that firms that are run for short-term stock market results do not have the time to reap. And companies controlled by a small group of hands-on owners can pursue contrarian strategies and reject mediocre conventional wisdom.

On the other hand, firms controlled by a few can be isolated and insulated from market realities. Seeking personal comfort and forsaking external accountability can lead to stale strategy, no succession planning, and organizational stagnation. And unchecked quarrels among family owners can be catastrophic to a company.

The difference between a family firm that succumbs to its weaknesses and one that exploits its relative strengths lies in the quality of the governance system. Successful family firms appreciate the power of their ownership control, volunteer for the accountability of an independent board, and take care to properly define the roles and responsibilities of ownership, management, and the board of directors.

The essence of the family business difference is that the nature of ownership is different. Successful family firms also understand how governance practices need to evolve to reflect the changes in the business and within the family.

THE NATURE OF FAMILY OWNERSHIP

Family ownership groups not only concentrate control but also often have a strong emotional attachment to their businesses. A family can have a sense of moral obligation to other stakeholders, or even view their business as a vehicle for making a positive contribution to society. Moreover, family owners sometimes see the

business as a social legacy built by past generations, and one that should continue in succeeding generations.

The lack of readily available liquidity is another important difference between public and family ownership. Relinquishing ownership of family companies is often difficult. Some families create legal restrictions on the sale of stock, and many family businesses are privately held. In these circumstances, creating a market for the sale of stock can be complex. Tax policy can also come into play, making the sale of stock in the family business costlier than continued ownership.

Owning stock in a family company tends to concentrate the wealth of individuals in a single asset. In family ownership groups, a disproportionate percentage of the net worth of many individuals is often tied up in the family business. This means that family business owners, as a group of investors, have less diversification and higher risk than they would as investors in the broader stock market. Such concentrated risk makes family business owners more attentive to their investment and tends to keep them more active and engaged. And this, in turn, makes families more committed to fixing what is wrong with their businesses, rather than fleeing them economically. At times, concern for the family's reputation can seem as important as safeguarding the collective family business investment.

Business Governance in Public Companies

Governance in the public market is built on a paradigm that relates directly to the nature of widely held ownership. Owners of shares in a public company can "vote with their feet" by selling their shares when performance is below expectations. The individual shareholders of such companies have little recourse to influence the decisions of their boards or managers. Instead, they join other individuals in the market and create pressure for performance through their collective short-term decisions to buy or sell stock. The governance of public companies reflects this paradigm of inactive but mobile shareholders creating market pressures for performance.

Public companies have independent boards that act primarily as fiduciaries, or agents, of potentially mobile shareholder interests. These boards operate under the paradigm of maximizing near-term share value in order to sustain and expand their pool of shareholders. Market demand for the company stock is the primary measure of success, and this market fluctuates daily based on the fluid relationship of many economic factors, both inside and outside of the company. Because of this, the board of directors is the locus of power in the governance of public companies. The board is charged with the oversight of management and must ensure that management is creating value that will be recognized in the market.

In widely held public companies, management is often perceived as self-interested. Active governance is seen as necessary to curbing potential management abuses, as well as to assuring the effective alignment of management interests and shareholder interests. The boards of public companies spend a great deal of time and effort designing systems to control and monitor management activities and compensation, reinforcing a potentially adversarial relationship. In addition, boards and their practices are under increasing scrutiny today, and many new laws and regulations are being written to reform the governance of public companies. Many of these laws are designed to strengthen the independence of boards and increase their accountability.

As the boards of public companies become more independent and powerful, the expectation that they should provide more than oversight increases, as does the expectation that they should actively direct management on behalf of ownership interests. However, boards focused on corporate performance and share value can become averse to taking risks that may have significant short-term impacts. They can become captive to the conventional wisdom of the market and forgo more unconventional strategies that might better capture long-term value in their unique market segment. Often, management is better positioned to see how dynamic new strategies will create value for customers and improve business performance. Unfortunately, the governance paradigm of public companies does not always enable the pursuit of creative new business strategies.

How Governance Differs in Family Companies

Family business governance systems are more uniquely suited to the pursuit of unconventional strategies. Family businesses can more readily bypass the adversarial qualities of conventional business governance. Ownership can exert influence and care on multiple levels, making the family an agent of more effective decision making in management, on the board, and among owners. Rather than functioning as a costly system of checks and balances, governance in family firms often serves to enable transparency and partnership across the system. This, in turn, can enable the pursuit of strategies that are

Russ & Daughters' landmark store on New York City's lower east side. Established in 1914, the business has been run by four generations of the Russ family. (Photo courtesy of russanddaughters.com)

potentially more productive in the long term, despite short-term costs or risks.

Conventional business governance often focuses on establishing boundaries and defining the separation of decision-making powers. In contrast, family business governance is often focused on establishing productive, procedural engagement across the system. Practices that provide for simultaneous consultations among owners, directors, and managers permit a freer flow of ideas as well as speedier decision making. They also contribute to an ongoing alignment of interests and objectives over time.

The active participation of owners is the key to effective family business governance. Family ownership defines the values, vision, and objectives of the business. It articulates the financial goals and performance expectations that guide board and management decisions. Owners also provide an overall vision of the company that generally defines a business strategy. This clarifies and focuses objectives across the system and helps set appropriate strategic constraints on board and management decisions.

But establishing a clear, shared understanding of the separate functions of the ownership, board, and management also is vital to effective family business governance—all the more so because family members often wear multiple hats, functioning as owners, directors, and managers.

While the direct involvement of the family on multiple levels complicates the system, it also provides an important link between the different areas of governance. This built-in link, combined with a positive development of family ties and relationships, can fundamentally change the dynamic of trust that pervades the governance system. A well-functioning system helps build trust within the family, and a good family dynamic, in turn, becomes an asset to the business because it enables each separate piece of governance to function better and add more value while remaining aligned with the other components of the governance system.

Stages of Family Business Development

Most family businesses begin with an entrepreneurial founder. Initially, the founder embodies the governance system, being the all-powerful owner and operator of the business. Founders sometimes make use of advisory boards, but they generally retain all decision rights. In many cases, the chief challenge of founders is deciding how to sustain their family business through succession. Some founders seek a single heir who can re-create the concentrated power of the owner-operator. More, however, see the business as a collective inheritance and divide it among members of the family.

When ownership passes down across generations, it passes through distinct stages. The first stage is the sibling or family partnership, with parents sharing ownership with their children. Eventually, the involvement of the parents ends, and the siblings come to share ownership in a partnership spirit. They must decide among themselves how to govern the business; often, this is described as the "kitchen table" period. The siblings can sit down together and consult informally, and sometimes they form a board to help build consensus for strategy. Roles may begin to separate at this stage, as some siblings may be active in the business while others are not. From this point on, the level of trust in the family often determines how formal governance practice becomes.

The third generation succession often involves a diverse group of cousins. This generally changes the scale of the family and differentiates family roles further. Family members may continue to be involved in management, the board, and ownership. Ownership

holdings can become increasingly variable in size, with some remaining quite concentrated. Family members can be active to varying degrees in the business and governance, and their level of involvement may not necessarily reflect their level of economic interest. These complications generally lead to the development of more formal governance practice. When majority ownership moves outside of management, the board will often take on more of a fiduciary characteristic. The extent to which trust is cultivated directly between the controlling owners and the leaders of management often determines how formal governance practice becomes at this stage and whether the family can continue to create effective agency in governance.

The next family succession causes another significant change in ownership scale. At this stage, the development of family governance, which functions in parallel to business governance, is often an added feature of an increasingly formal and complex governance system. Family members may continue to be involved across the governance system, linking ownership, the board, and management. Often, the business at this stage has become a holding company, creating the need for a board that can strategically manage a portfolio of businesses.

The Evolution of Family Business Governance

As a business grows, it becomes increasingly complex, creating its own demands for a more formal organizational structure. While adapting governance practices to the emerging needs of families and businesses as they grow is a very complex and challenging endeavor, over time it is also unavoidable. Success drives the need to adapt and change. At certain stages, business or family growth will tend to become exponential. All family businesses eventually face this reality.

Because family and business life cycles often challenge the effectiveness of existing governance practices, family businesses are actually quite attentive to adapting their practices over time. With each generation of succession or change in business scale, family companies are often confronted with the need to re-create their business governance. Family business life cycles can lead to fundamental changes in the roles, functions, and practices of the governance system. Faced with the dilemmas of change, families frequently study current best business practices. However, rather than simply adopting prescriptive best practices, families tend to adapt practices to their historic business culture, and so renew the effectiveness of their governance agency over time. ■

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