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Industry Agenda

A Primer on Governance of the Family Enterprise

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Foreword

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Family and private companies have been trusted partners and major contributors to the World Economic Forum since its inception over 40 years ago. To better recognize and engage its stakeholders, the Forum has created the Family & Private Company Community. Within the Forum, the community unites members distinguished by their expertise in family business governance, long-standing entrepreneurial experience and desire to leverage their unique position to further improve the state of the world. Comprising members from across the globe, spanning industry sectors and generations of ownership, the Family & Private Company Community forms a vibrant network of founders, owners and operators of family and private companies. By contributing and sharing new insights and values, they have one of the largest, most relevant impacts on the mission of the Forum.

Jonathan Quigley
Director
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World Economic Forum

The Family & Private Company Community seeks to address the most pressing global, regional and industry issues, as identified by the community's members. As a principal counterpart, the Forum supports an enriching exchange between leading experts and peers to jointly contribute to new insights, leading practices and knowledge-sharing that is unique to their experience.

This report represents the culmination of the work undertaken by the community since it was formally established in July 2012. I would like to thank all of the community members that contributed to the development of the paper through our sessions in Mexico, New York and, earlier this year, during the World Economic Forum Annual Meeting in Davos. I would also like to make a special note of thanks to Professors Raphael Amit and Belén Villalonga, without whom this work would not have been possible.

Executive Summary

A Primer on Governance of the Family Enterprise is written both for families and for practitioners associated with or interested in family enterprises. By combining a rigorous review of existing studies with a practical perspective, the report seeks to identify best practices in family enterprise governance. Specifically, the two major questions are:

– How is the family enterprise governed?
– How does governance impact performance of the family enterprise?

The family enterprise includes family members; one or more family-owned, -managed and/or -controlled businesses (which may be private or public); often a philanthropic entity such as a foundation; and a family office. The governance system of the family enterprise is an integrated, interdependent and coherent architecture composed of the specific governance structure of each of its entities.

Family governance refers to the rules, processes and institutions that enable family decision-making and the management of family affairs. The family is often characterized by multiple generations and multiple family branches, which over time present great challenges to maintaining family cohesion and norms. A customized governance system, tailored to the context of the specific family, can help ensure the sustainability and prosperity of the family business, enable family harmony and happiness, manage succession of ownership and control, and mitigate family conflict. The family governance system rests on the family's shared beliefs and values. Formal elements often include family constitution, family council, family assembly and family committees. It is important to design an adaptable governance structure where decision-making is perceived to be fair.

This report discusses six major components of family firm governance: ownership structure, control mechanisms, board of directors, executive compensation, dividend policy and succession. The objective of corporate governance is to enable investors (owners) to obtain an appropriate return on their investment in the firm. Widely-held public corporations face the so-called "agency problem" – managers and investors may have different and conflicting incentives. While family firms can typically align management and ownership incentives, they are more likely to face another agency problem – the potential conflict of interest between family and non-family shareholders. Attention to this issue is an important consideration in all aspects of governance of the family firm (and enterprise).

Substantial families with investable assets in excess of US$ 100 million often choose to set up their own family office – a professional organization dedicated to serving the financial and personal needs of the family. Recent studies have identified several best practices of family offices, including effective internal controls to reduce sources of risk for the family, in-house handling of key activities, extensive and frequent communication with family members, education programmes for younger generations and succession planning.

The family foundation – typically a private philanthropic foundation supported by the family, the family business and its investment income – can be beneficial to the family for reasons beyond tax reduction and reputation. Three positive effects on family dynamics include provision of opportunities for financial education and cross-generational mentoring to family members, enhancement of family interaction and communication, and enlargement of the sphere of discussion in the family. This report describes the different family foundation structures, the potential advantages of hiring a non-family administrator and the need for family foundations to choose between diversification and concentration in their grant-making strategy.

Finally, the report explores in detail the relation between family enterprise governance and economic performance. The key findings are:

– The use of family governance practices enhances the financial success of the firm.
– The relation between family ownership and performance is similar to an inverse-U-curve: at first, it increases as family ownership increases, but decreases after a point. However, this positive relation is conditional on the family firm being transparent.
– The use of a "wedge" between voting rights and cash-flow rights (whereby the family hold voting or control rights beyond their ownership rights) adversely affects performance. This reinforces the advice that family firms should carefully consider which mechanisms to use to control their firms as their effects on performance differ.
– Family firms generally prefer to have the heir manage the family business rather than an outsider.

This report concludes with a discussion of the main findings and an extensive bibliography. The clear message that emerges from this review is the important role that a well-defined governance structure plays in the prosperity and longevity of the family enterprise. A codified family enterprise governance system contributes to enhancing family harmony and happiness, as well as family wealth.


Process
Management
Vision
strategy

1. Introduction

This report offers an up-to-date critical assessment of the received academic and professional literature on governance of the family enterprise. The family enterprise includes family members; one or more family-owned, -managed and -controlled businesses (which may be private or public); often a philanthropic entity such as a foundation; and a family office. The report's aim is to identify the best practices in family enterprise governance. Specifically, it attempts to answer two major questions:

– How is the family enterprise governed?
– How does governance impact performance of the family enterprise?

1.1 Background on Corporate Governance

The concept of governance is prevalent in a broad range of settings. In the context of a widely-held public company, the separation between shareholders and management lies at the core of the governance problem.[1] Such separation leads to a so-called "agency problem".[2] Managers are shareholders' agents and have control of day-to-day decision-making in the firm. However, separation between those who finance a firm and those who manage it may create conflicts of incentive between the two parties. When managers' interests and shareholders' interests are not aligned, managers may choose actions that benefit them and adversely affect shareholders' returns on their invested capital. In this context, corporate governance is the mechanism created to minimize the risk of such a situation arising. In other words, the objective of corporate governance is to enable investors to obtain an appropriate return on their investment in the firm.[3]

In corporations that have one or more very large shareholders and many small shareholders, a conflict of incentive between these two types of shareholders may also arise as the large shareholders may navigate the firm in a way that benefits them and adversely affects the smaller shareholders.[4] In this context, "corporate governance structures serve to ensure that minority shareholders receive reliable information about the value of the firm and that a company's managers and large shareholders do not cheat them out of the value of their investment."[5]

Hence, the governance of a firm needs to be designed so as to alleviate these incentive issues and induce investors to provide financing to firms while minimizing the risk of misappropriation of their capital. With this in mind, governance can be defined as "the set of mechanisms that influence the decisions made by managers when there is a separation of ownership and control."[6] An alternative definition could be "the set of contracts that help align the actions of managers with the interests of shareholders."[7]

Scholars have addressed a range of major corporate governance issues, including concentration of control in the hands of one shareholder,[8] hostile takeovers,[9] proxy voting contests,[10] control by the board of directors,[11] and executive compensation schemes aligning managerial interests with shareholder interests.[12]

The provision of transparent information to shareholders is critical to the effectiveness of the governance structure. Scholars have suggested that "limited corporate transparency increases demand on corporate governance systems to alleviate moral hazard problems resulting from a more severe information gap between managers and shareholders."[13] In fact, a large body of research has found that financial reporting mitigates these information asymmetries,[14] thereby significantly alleviating the agency conflict.

Management scholars have built on the agency theory perspective on corporate governance to include such theories as resource dependence theory, stewardship theory and power theory.[15] Resource dependence theory suggests that the board of directors, in addition to being a monitoring body, is an important catalyst of resources such as access to finance, legal advice and social capital. Stewardship theory broadens the perspective on the motivations driving managerial behaviour to highlight both the self-interest motivation of managers and their role as stewards of corporate resources, which is consistent with shareholders' interests. The power perspective offers insights on the interaction between management and governance bodies. This thesis suggests that managers, while being legally subordinate to directors, may acquire extra power in certain situations, thereby having the opportunity to circumvent the monitoring function of the board.

The objective of corporate governance is to enable investors to obtain an appropriate return on their investment in the firm.

Governance mechanisms can be both internal and external.[16] Among the internal mechanisms, the main examples are board of directors, executive compensation contracts and concentration of control. The main external mechanism for corporate control is the market. Furthermore, management scholars have also addressed the governance roles of organizational culture and norms, which serve as a powerful social control mechanism driving behaviour and contributing to organizational cohesion and alignment of incentives.[17]

By exercising substantial control on business and through their participation in management, family firms often manage to align the incentives between ownership and management. This has the effect of alleviating the classic owner-manager conflict that characterizes widely-held, publicly-traded corporations and on which much of the so-called "agency" literature has centred. However, family firms are more likely to be faced with another agency problem: the potential conflict of interest between family and non-family shareholders. Specifically, the controlling family may force managerial decisions that are in the best interest of family shareholders but may not be in the interest of all shareholders, thereby gaining private benefits at the expense of non-family shareholders. This is a widely prevalent phenomenon, and any discussion of governance in the context of the family firm must address this issue.

1.2 The Family Enterprise

The various parts of the family enterprise include the family members, one or more family-owned, -managed and -controlled businesses (which may be private or public), often a philanthropic entity such as a family foundation, and a family office.

Figure 1 depicts the key components of the family enterprise. The following definitions have been used for these entities:

- Family: A group of individuals related by blood, marriage or adoption, who have a claim on the family business or other common family assets. Family members may belong to multiple generations and may be part of multiple family branches. It is important to highlight that the family is not an investment group, meaning that people do not choose to be a part of it. This is the fundamental source of many of the distinctive features of the family enterprise that shall be discussed below.
- Family Firm: A firm characterized by a substantial presence of the founding family. Whenever the founding family exercises significant influence through its equity ownership, voting control and/or management, this report considers such a firm as a family firm. According to this definition, a family firm can be private or public; it may be led by the founder, by a later-generation family member or by professionals that are not members of the family. However, it should be noted that the literature has used a variety of different definitions. These can be divided into two groups: structural definitions (based on structural characteristics of the firm) and process definitions (based on the role of the family in the business).[19]
- Family Office: The professional organization, owned and controlled by the family, created to serve the wealth-management and personal needs of family members.
- Family Foundation: The organization through which the family carries out its philanthropic activities.

The interconnections between family members and the family business can be depicted by the three-circle model illustrated in Figure 2.

Figure 1: Family Enterprise Key Components

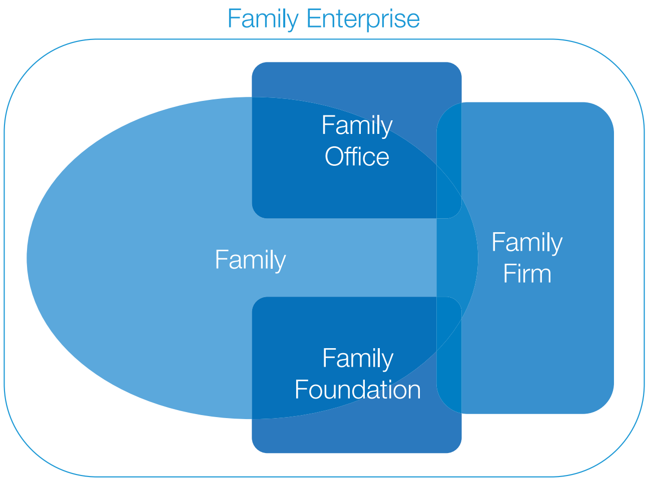
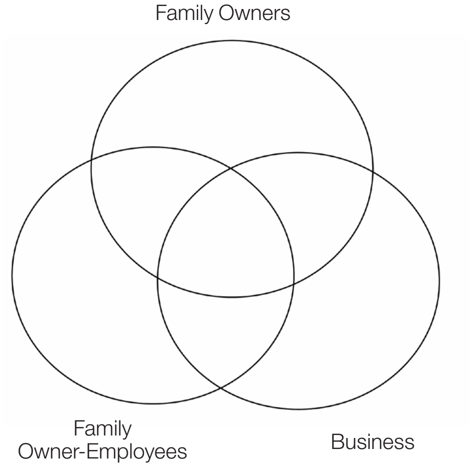


Figure 2: The Three-Circle Model

Source: Tagiuri and Davis, 1996



The family firm is the primary source of the family's wealth. The literature has highlighted a set of characteristics differentiating the family firm from its non-family counterpart:

- Family firms have a preference for control, while non-family firms have a preference for cash-flows.
- Family firms have a long investment horizon, while non-family firms have a short investment horizon.
- Family firms are characterized by conflict of interest between family blockholders and minority shareholders, while non-family firms are characterized by conflict of interest between management and shareholders.
- Family firms face trade-offs between control, liquidity and growth, while non-family, widely-held firms do not face a significant degree of such trade-offs.
- Family firms typically focus on investment projects with long payback periods, while non-family firms often focus on cutting costs to maximize short-term profits.

1.3 Governance of the Family Enterprise

Family enterprise governance refers to the collection of mechanisms that enable family decision-making and implementation of policies concerning the management of family affairs, its businesses and related entities, such as its foundation and family office, in a manner that meets the mission and goals of the family. These mechanisms include formal structures, processes, rules and agreements, as well as informally shared family values, culture, beliefs and norms.

The governance system of the family enterprise is an integrated, interdependent and coherent architecture composed of the specific governance structure of each of the entities of the family enterprise, including:

- Governance of the family
- Governance of the family firm
- Governance of other family entities such as the family office and family foundation

Each of these specific governance systems is focused on in subsequent sections.

1.4 Why Family Enterprises Matter

The study of family enterprises is important mainly because family enterprises are prevalent in most economies worldwide. Despite this prevalence, the mainstream literature in business and economics has traditionally considered the widely-held corporation as the predominant paradigm of a firm. Therefore, most research has focused on questions relevant to that context. Only over the past two decades has attention been given to family firms. Academics have traditionally held the belief that in developed economies, at some point all firms would pass into the final stage of their evolution process – the public corporation with dispersed ownership. However, this phenomenon is far from universal. In few economies is the public corporation the dominant paradigm, and even in those economies family firms represent a large fraction of the market. In many economies of the world, family firms are clearly the most common type of firm.

The dominance of the widely-held corporation has been questioned by many contributions over the past decade. A 2009 study of a representative sample of public companies in the United States (US) showed that 96% had a blockholder and these blockholders owned 39% of the common stock in the sample.[20] Moreover, it found that the ownership concentration level of US firms was similar to other countries in the world when taking firm size into account.

In fact, the prevalence of family firms has been documented in a number of studies. A study of the ultimate ownership of the 20 largest public companies from the 27 richest economies in the world found that 30% of the sample were family-controlled, while 36% were widely-held and 18% state-owned.[21] Of course, this result underestimated the importance of family firms as the authors considered only the largest firms and only in rich countries. Among the countries with higher family ownership among their 20 largest firms were Mexico (100%), Hong Kong (70%) and Argentina (65%).

A 2006 study of the 508 US-listed firms that have ranked among the Fortune 500 between 1994 and 2000 found that 37% in the overall sample were family firms, a percentage that increased in specific industries such as personal services (67%), motion pictures (77%) and health services (56%).[22] An analysis of ownership in 13 Western European countries found that 44% of firms were family-controlled; this percentage was above 50% in most countries in Continental Europe.[23]

This trend holds in East Asia too: a study of ownership in nine East Asian countries found that the top 15 families controlled very large fractions of the market capitalization in most countries, including Indonesia (62%), the Philippines (55%) and Thailand (53%). The top 15 families controlled even larger fractions of the GDP in certain countries, such as Hong Kong (84%), Malaysia (76%) and Singapore (48%).[24]

1.5 Methodology

The objective of this report is to capture the key findings that the literature on family enterprise governance has offered, and translate them into best practices.

The methodology consists of critically reviewing the received academic and professional literature on problems related to the governance of the family enterprise. More specifically, the procedure has involved:

- Reviewing and selecting a subset of the received literature based on a rigorous quality criterion
- Using an interdisciplinary approach which draws from the fields of Management, Finance, Accounting, Psychology, Sociology and Economics
- Combining the academic and professional literature, in order to have rigorous treatment along with practical perspective
- Considering the contributions of studies that use qualitative, analytical and empirical approaches

This report will be useful primarily to families and, more generally, to practitioners whose work relates to family enterprises.

2. Governance of the Family

The family is often characterized by multiple generations and multiple family branches. As time passes and more generations are added, there is less interaction among family members, a decline in common experiences and decreasing similarity. Unless steps are taken to hold family members together, they will tend to grow apart, thereby making the preservation of family norms, culture and legacy challenging. The multi-generation, multi-branch family often has multiple objectives, including: ensuring sustainability and prosperity of the family business; enabling family harmony and happiness among future generations; sustaining the family brand; maintaining control of the family business; managing succession of ownership, control and management; and mitigating family conflicts to maintain unity. To allow the family to realize these objectives, a customized family governance system, developed by the family and tailored to the context of the family, is needed.

> Family governance refers to the rules, processes and institutions that enable the decision-making and implementation of policies concerning the oversight and management of family affairs.

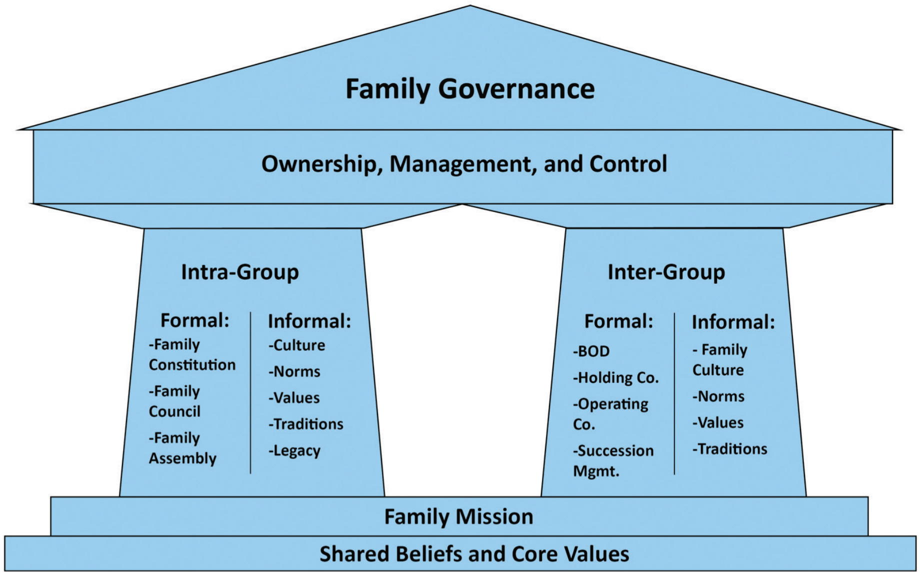
2.1 Foundations of Family Governance Systems

The family governance system needs to be crafted so as to:

- Enable coordinated decision-making about common assets and their management
- Enable orderly succession in ownership, management and control
- Minimize interpersonal conflict within the family
- Enable family harmony and happiness in future generations
- Preserve and enhance family wealth
- Ensure sustainability and prosperity of the family business
- Enable long-term estate planning

The family governance system includes intra-group and inter-group elements. Intra-group elements refer to the governance of relationships and decision-making within the family. Inter-group elements refer to the relation between the family and the other family enterprise entities such as the family business, the family office and the family foundation. Figure 3 illustrates the foundations of a family governance system.

Figure 3: The Family Governance System

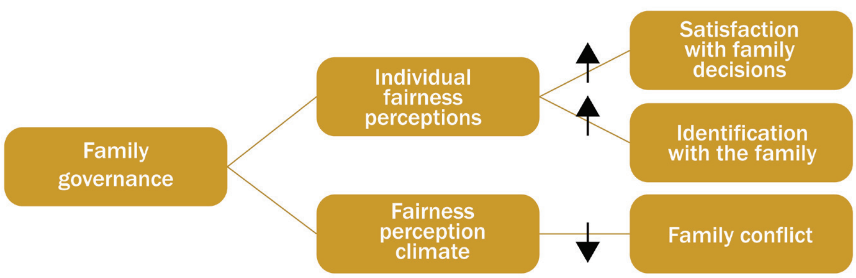


2.2 Informal Elements

As depicted in Figure 3, the base of a robust family governance system rests on intangible elements that belong to the sphere of family culture. Family culture can be seen as the system of shared values and norms that define appropriate attitudes and behaviours for family members.[25] Values are concepts and beliefs that guide selection and evaluation of actions and events.[26] These shared values and norms may be related to different spheres: ethics, religion, environment, politics, justice and so on.

Recent research suggests that an important informal element of family governance is the "fairness perception" among family members.[27] As per the fairness hypothesis, the fairness perceived by family members is both the main driver of happiness and the main deterrent of conflict, in that the degree to which family decisions are perceived to be fair shapes the individuals' judgements and thus determines their behaviour. More specifically, individual fairness perception leads to higher satisfaction with family decisions and stronger identification with the family, and a fairness perception climate decreases family conflict, as illustrated in Figure 4.

Figure 4: How Perceptions of Fairness Impact Family Dynamics



Therefore, families should build their institutions with the objective of promoting a sense of fairness. This can be done if one keeps in mind that fairness is fundamentally related to the idea of justice. Justice is thought of as taking three forms: distributive (fairness of outcomes), procedural (fairness of decision-making processes) and interactional (fairness of treatments). When family governance shows these three forms of justice, family members have a higher fairness perception, ultimately being more satisfied and less prone to conflict.

Beyond its benefits to family relationships, fairness has a positive effect on the family business, as suggested by a study centred on the impact of procedural justice on the family business.[28] Defining a fair process as a construct that includes both a clear description of the steps and a precise characterization of each step, it outlines the following steps that a process has to go through to be seen as fair:

1. Engaging with and framing the issue
2. Exploring and selecting the options
3. Deciding and explaining the reasons underlying the choice
4. Implementing and executing the chosen option
5. Evaluating the outcome and learning from it

Moreover, each step should be characterized by five qualities: communication, clarification, consistency, changeability and commitment to fairness. Drawing from case studies, the study discusses how the implementation of fair processes has a positive impact on the family firm. Fair process generates better solutions and the perception of positive results leads individuals to demand more fair process, activating a positively reinforcing cycle. On the other hand, the absence of fair process may prompt forms of redistributive justice, where individuals react to the perceived lack of fairness.

Family governance mechanisms may have an enduring effect on family members. Specifically, their characteristics affect the mindset and behaviour of the next generation of the family. The effect of two qualities of the family governance structure – family cohesion and family adaptability – on the attitude of the second generation forms the subject of a 2006 study of Chinese family firms.[29] Family cohesion is defined as the degree of emotional closeness among family members, while family adaptability is defined as the degree to which the family is able to change its structure following situations of stress.[30]

Based on survey data from 88 Chinese family firms, the study finds that family adaptability has strong effects on second-generation members. Particularly, family adaptability is very positively related to commitment to the family enterprise, life satisfaction and job satisfaction. Moreover, commitment to the family enterprise and job satisfaction are negatively related to the propensity to leave. Interestingly, this research suggests that family cohesion does not have a significant effect on the attitude of second-generation family members. This in turn suggests that, regardless of family cohesion, designing an adaptable governance structure is important for the longevity of the family enterprise.

2.3 Formal Elements

The formal elements of a multi-generational, multi-branch family ordinarily include:

– Family Constitution: A morally binding document, it contains rules and regulations about coordinating decision-making among family members. It generally contains information about the family mission, code of conduct, history, values, beliefs and norms, as well as the family's mechanisms for conflict management and succession, its institutions including business institutions, and its employment, liquidity and exit policies.
– Family Council: A forum of certain family members elected or appointed by the family, it is responsible for coordinating family decision-making and managing family affairs.
– Family Assembly: A forum of all family members dedicated to preserving the family's heritage, culture, norms and traditions, it also discusses family affairs.
– Family Committees: Groups of elected or appointed family members, they are responsible for specific aspects of family life, such as education of family members and family philanthropy.

The above governance structure emerges over time as the family grows beyond the first generation. The development of the formal governance structure is often visible in the second or third generation. Yet, the specific institutions depend on whether the family continues to own, control or manage in later generations the business or businesses founded by the first generation. In instances where the business is sold and family members share interests in common financial assets, a single family office, which includes a private asset-management organization, may be developed. The specific structure of the investment vehicles depends on a broad range of factors including estate plans and tax considerations.

Broader environmental factors and societal trends also affect the evolution of family governance. Since the 1970s, families in Western societies have been changing, following two main patterns: increased individualism and increased democratization.[31] An analysis of the evolution of family governance among 50 Australian family firms finds that these two trends threaten the stability and continuity of the family. Families have been attempting to counter these trends by developing governance policies such as a family code of conduct, along with governance institutions and traditions that facilitate communication and negotiation, including family councils, family assemblies, family meetings and family retreats.

Finally, the family governance structure is likely to have an impact on the family firm governance.[32] Survey data from 192 family firms in Finland shows that the variety of family institutions is positively related to the degree of social interaction among family members, defined as the intensity of social ties among family members. Moreover, social interaction increases shared vision, and shared vision improves decision-making in the family firm. Therefore, ultimately, the implementation of family governance institutions has a positive effect on the decision-making process in the family firm.

2.4 Conflict Management

Conflict among family members can be highly detrimental to both the family and the family firm. Therefore, the family governance structure should be designed with the aim to minimize family conflict.

The first question to ask is where family conflict comes from. Family conflict can be divided into two categories: family conflict concerning business and family conflict concerning personal relationships.[33] Based on survey data, family conflict is positively related to three main variables:

– Lack of clarity of business leadership
– Lack of procedural justice
– Resource distribution based on need or equity criteria, rather than on equality criteria

As expected, beyond threatening the happiness of the family, conflict can spill over into the family business. In particular, family conflict affects the family firm's management team, causing anxiety, a stalemate in decision-making, lower levels of risk-taking, less information-sharing and reduced commitment.

Family conflict depends on the traits and characteristics of the family.[34] Research suggests that family conflict increases down the generations. The presence of the founder in the business after having formally left control – the so-called "generation shadow" – significantly increases family conflict.[35] There is evidence that greater family involvement in the business increases task conflict – the disagreement among family members over business affairs.[36]

Particularly, a higher number of family members involved in the daily business operations increases the frequency of conflict. Moreover, the degree of social interaction among family members increases the extent of conflict. These two results hold independently of which generation the family is currently at.

A study on the specific strategies used by families to manage conflict identifies five conflict management strategies:[37]

- Competition (high concern for self, low concern for others)
- Collaboration (high concern for self, high concern for others)
- Compromise (moderate concern for self, moderate concern for others)
- Accommodation (low concern for self, high concern for others)
- Avoidance (low concern for self, low concern for others)

Competition involves strategically using information to manipulate others in order to reach the goal. Collaboration involves attempting to generate solutions satisfactory to all. Compromise involves reaching an agreement where all parties are moderately satisfied. Accommodation involves recognizing and fulfilling the desires of others. Avoidance involves refusing to face conflicts and address problems.

The study finds evidence that the most successful strategy for both the family and the business is collaboration. Collaboration is the only conflict management strategy that seems to enhance both family objectives and business objectives at the same time. Conversely, the strategies that seem to deliver the worst outcomes for both the family and the business are competition and avoidance. Therefore, the study concludes that families should attempt to use a collaborative approach in managing conflicts. It is suggested that collaboration can be facilitated by the creation and enhancement of family governance institutions that encourage and support communication, such as family councils, family planning and family meetings.

3. Governance of the Family Firm

The standard perspective on corporate governance is based on the longstanding idea that the separation between ownership and management in a widely-held public corporation generates an agency problem due to the potential conflict of interest between owners and their agents, the managers of the firm. Yet in the context of family firms, there is another agency problem, namely, the potential conflict of interest between family shareholders and non-family shareholders. In what follows, six main aspects of family firm governance are discussed: ownership structure, control mechanisms, board of directors, executive compensation, dividend policy and succession.

Six key aspects of family firm governance are ownership structure, control mechanisms, board of directors, executive compensation, dividend policy and succession.

3.1 Ownership Structure

Ownership refers to the amount of firm equity owned by the shareholders, which reflects the right of the shareholders to the firm's cash flows. The family can own equity in two ways: directly, by owning shares of the company with no intermediate entity; or indirectly, by owning one or more investment vehicles such as various types of trusts, foundations, corporations or partnerships.

The choice between alternative ownership structures is guided by several factors including estate plans, liabilities protection, philanthropy, succession planning and tax considerations. Typically, family firms employ a combination of direct and indirect forms of ownership, as shown in Figure 5.

In multi-branch, multi-generational, family-controlled firms, the ownership structure of the main family business may involve a range of intermediate entities and types of investment vehicles, as illustrated by the example in Figure 6.

Figure 5: Example of Direct and Indirect Ownership

Source: Villalonga and Amit, 2009, Data as of 1994

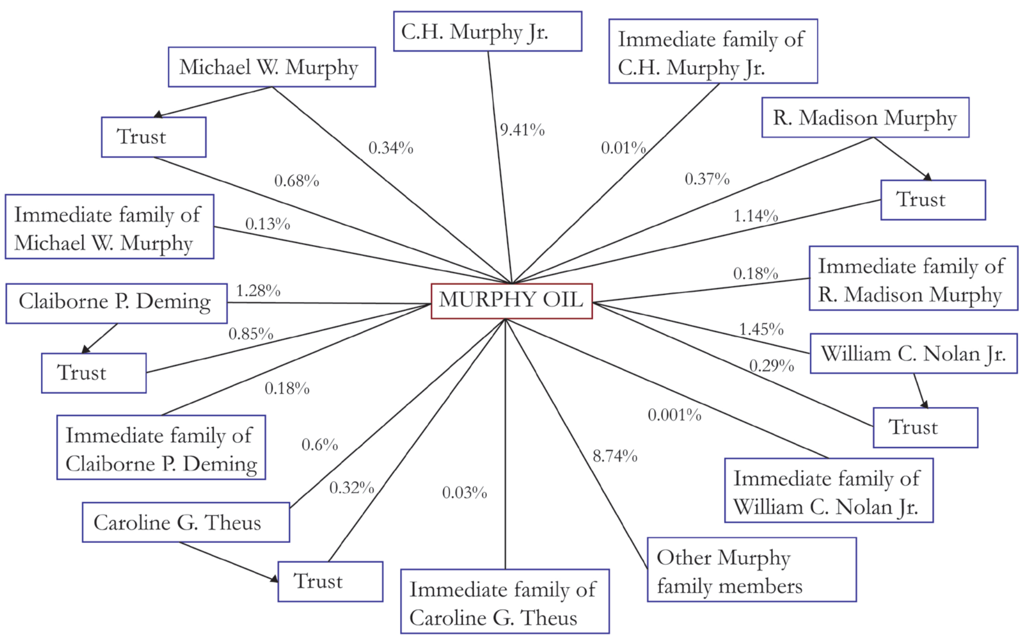
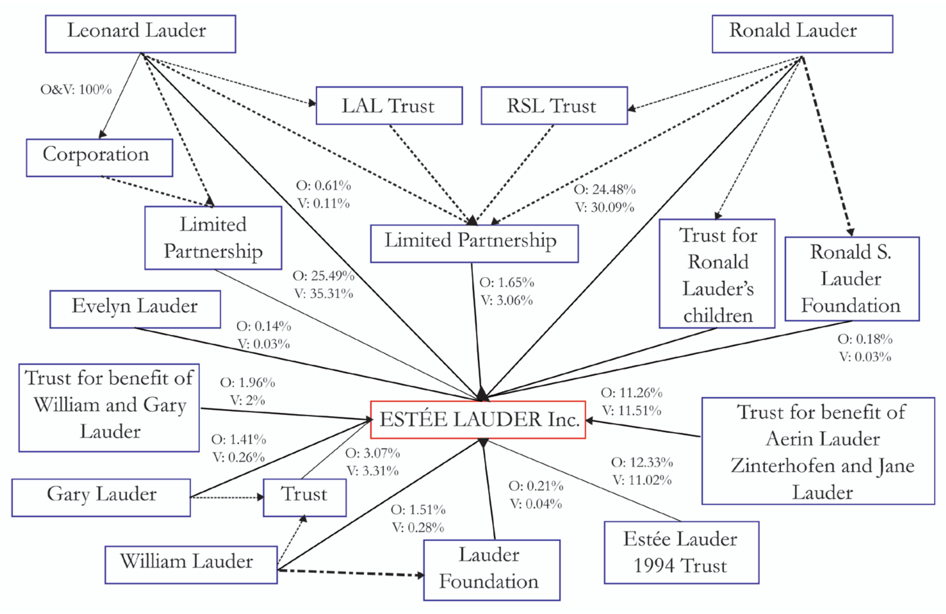


Figure 6: Example of Complex Ownership Structure

Source: Villalonga and Amit, 2009, Data as of 1996
Legend: O = ownership; V = votes



Among all US family firms in the Fortune 500 from 1994 to 2000, the founding families owned on average 15.3% of their firms' equity.[38] When distinguishing between founder firms (family firms owned, controlled or managed by the founder) and later generation family firms (family firms owned, controlled or managed by second or later generation family members), the average ownership was 14.4% and 16.1%, respectively. Direct ownership was the most prevalent structure: 96% of the sample firms were directly owned by their controlling families, for at least a fraction of the firm. However, direct ownership rarely accounted for the total family ownership of the firm: 80% of the family firms in the sample showed some form of indirect ownership. On average, 62% of the equity was directly owned by a family with the balance 38% owned indirectly through some investment vehicle. The most prevalent investment vehicles were trusts (present in 66% of the sample firms) and foundations (present in 37% of the sample firms).

The evidence of the use of indirect ownership is confirmed in Europe. A 2007 study of the ownership structure of family firms in Spain, based on a sample of 195 firms listed in the Spanish stock markets, found 53.9% of all firms and 72.5% of closely-held firms having some form of indirect ownership.[39] This confirms the use of indirect ownership in family firms, given that family firms represent 43.1% of all firms and 59.2% of closely-held firms.

3.2 Control Mechanisms

Control typically refers to the way the shareholder can influence the direction of the firm. The literature has discerned three main measures of control:

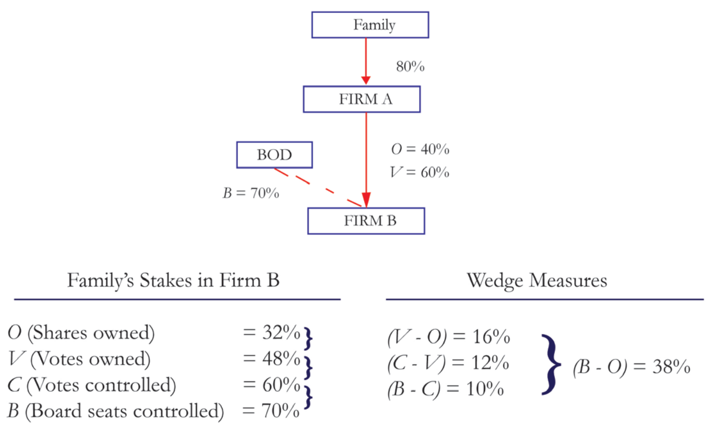
1. Votes owned: the number of votes at the shareholders' meeting associated with the shares owned by the shareholder.
2. Votes controlled: the number of votes at the shareholders' meeting controlled by the shareholder.
3. Board seats controlled: the number of seats in the board of directors controlled by the shareholder.

A common characteristic of family firms is the wedge between ownership and control; namely, the voting control that the family has, through one or more mechanisms, in excess of its ownership. The difference between ownership and control can be computed through the framework illustrated in Figure 7.[40] It depicts the wedge between:

- Votes owned vs. shares owned
- Votes controlled vs. votes owned
- Board seats controlled vs. votes controlled
- Board seats controlled vs. shares owned

Figure 7: Measuring Voting Rights When They Differ from Cash Flow Rights

Source: Villalonga and Amit, 2009



The existence of the wedge between control and ownership enables the controlling shareholder to benefit in some way at the expense of other shareholders. This is commonly referred to as appropriation of private benefits of control.

Family firms have been shown to deploy one or more of the following control-enhancing mechanisms:

- Dual-class stock: Issuance of shares of different classes, where one class is associated with superior voting rights.
- Pyramidal structure: An ownership structure whereby a focal firm owns a fraction of another firm through a chain of ownership relations.
- Cross-holding: An ownership structure whereby a lower-tier company in a pyramidal structure owns equity in its owner, an upper-tier company in the ownership chain.
- Voting agreement: A contractual arrangement through which different shareholders pool their votes to reach a common objective.

Multiple studies have investigated what mechanisms firms use to achieve the wedge between ownership and control, where control is defined as the number of votes controlled. A study of US firms finds that the most prevalent mechanism is dual-class stock (21% of the sample).[41] Voting agreements, pyramidal structures and cross-holdings are either marginally relevant or irrelevant among the sample firms of this study. Most importantly, there is evidence of a substantial wedge between ownership and control. On average, family firms show a ratio between voting rights and cash-flow rights of 1:28.

In another study focusing on Western Europe, a dataset comprising 5,232 corporations from 13 Western European countries was examined.[42] It found that family firms use mostly dual-class stock (17.61% of the sample) and pyramidal structures (13.81%). This is different from firms controlled by either the state or a financial institution: in the latter, the most frequently used mechanism was pyramidal structure. While this study gives no information on the wedge between control and ownership specific to family firms, across all firms in the sample the average wedge was 1:15. The wedge was higher in Switzerland (1:35), Italy (1:35) and Norway (1:29), and lower in Spain (1:06), Portugal (1:08) and France (1:08). However, the concentration of family control, gauged by measuring the average number of firms controlled by a single family, showed that such concentration was higher in Italy, Norway and Sweden with, respectively, 1:46, 1:29 and 1:27 firms under control.

Finally, a study on the same issue in East Asia, which analysed a dataset of 2,980 firms from nine East Asian countries, found that in the overall sample firms used mostly pyramidal structures (38.7% of the sample) and cross-holdings (10.1% of the sample).[43] However, it gave no information on the most used mechanisms specifically among family firms. There was no evidence of use of shares with superior voting rights. In most countries, family firms had larger separation between ownership and control compared with other firms. On average, these firms achieved a positive wedge between voting rights and cash-flow rights: higher in Indonesia (1:46), Singapore (1:39) and Taiwan (1:32), and lower in Japan (1:02), Thailand (1:09) and South Korea (1:20).

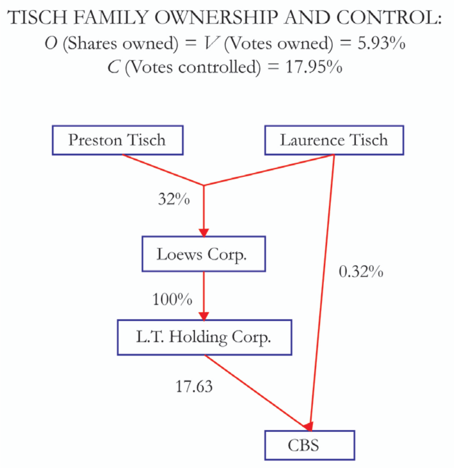
As stated, in many countries the most prevalent mechanism to achieve control in excess of ownership is dual-class stock. Dual-class stock involves controlling a firm through the trading of at least two classes of shares, where one class has higher voting power. An analysis of a comprehensive dataset of US dual-class firms during the period 1995-2002 confirms the relevance of this control structure.[44] It finds that 6% of the firms and 8% of the market capitalization in the sample used dual-class shares. In this subset, 85% had at least one traded share class that generally had superior voting power.

The study examines what induces a firm to engage in the use of dual-class stock. Its hypothesis is that firms choose this control structure if, before the initial public offering (IPO), expected benefits (the private benefits of control enabled by the wedge between voting rights and cash-flow rights) exceed expected costs (the discount at which the inferior shares are likely to trade in the future). Therefore, the firms test the relation between the choice of using dual-class stock and proxies of the expectation of net benefits. Specifically, this study finds that having the founder's name in the company name is a strong predictor of choosing dual-class stock and is particularly common among family firms.

Another important mechanism is the pyramidal structure, which defines an ownership structure where a firm controls another firm not directly but through a chain of intermediate ownership relations. The diagram in Figure 8 provides an example.

Figure 8: Example of Pyramidal Structure

Source: Villalonga and Amit, 2009



What drives the existence of these ownership structures, going beyond the standard argument based on the search for control in excess of ownership? One study examines an environment with low investor protection where a family owns a firm and is about to set up another.[45] In this situation, the family has to choose the ownership structure of the newly created business group: either horizontal (the new firm is owned directly by the family) or pyramidal (the new firm is owned, in part, by an upper-tier existing firm). With low investor protection, the family is able to divert cash flow among its entities. This makes the pyramid more attractive as it creates a financing advantage. If such financing explanation is right, it seems probable that a firm with low access to external financing is more likely to be controlled through a pyramidal structure.

There is convincing evidence for this explanation from empirical analysis. One study used a dataset of 28,635 firms across 45 countries to test the financing explanation of pyramidal structure formation, and found that at the country level, external capital availability is negatively associated with pyramid formation.[46] At the firm level, it found that firms in pyramidal structures are more investment-intensive, younger and riskier, which makes it harder for them to raise external capital.

Disproportionate board representation is another control mechanism widely used by family firms. This defines the situation where families have the right to elect board members in excess of both their cash-flow rights and their voting rights. Disproportionate board representation is largely frequent in US family firms, being present in 60% of the sample of one study.[47] Among firms where the fraction of the board control exceeds ownership, the average difference between board rights and control rights is 10%, the study found.

Finally, family control may be related to the price of family firms' stock at IPO. Issuing underpriced shares has the effect of favouring oversubscription, meaning that the demand exceeds the total number of shares available. This allows the owner to decide to which buyers to allocate the shares and what amounts to allocate them. The family may be willing to use this strategy to ensure diffused external shareholdings and avoid large blockholders. This may be attractive to the family, since one large external blockholder could monitor the family's activity, complicating the potential appropriation of private benefits. Based on such motivation, it has been hypothesized that family involvement in the firm is positively related to the degree of IPO underpricing.[48] A sample of IPOs on the Hong Kong Stock Exchange shows that firms with strong family involvement pursue more IPO underpricing than firms with low family involvement.

3.3 Board of Directors

The board of directors is a central element of the governance structure of any firm, private or public. Its main role is to monitor the management on behalf of the shareholders and ensure that management actions are in the shareholders' best interest. This includes both controlling and advising the managers' activities. In the context of the family firm, the board is expected to represent the interests of both the family blockholders and the non-family shareholders.

The board should make two contributions to the firm:[49]

- Overseeing the managerial activity (monitoring)
- Offering expertise, knowledge and support to the management (resource provision)

Two characteristics of the board are taken into account: board dependence (the degree to which the board is subordinated to the management) and board capital (the sum of directors' human and social capital). It is suggested that:

- Family power influences positively the dependence of the board and negatively the capital of the board.
- Board dependence is negatively related to monitoring, and board capital is positively associated with resource provision.
- Therefore, family power impacts negatively both functions of the board: the more powerful the family in the firm, the less helpful the board.

However, the negative relation between family power and board performance is moderated by two important factors: family culture and family experience. When these two forces are conducive, family power has a less detrimental effect on the board's performance. Ultimately, this model suggests that the board's performance depends on family characteristics, such as family power, family culture and family experience. Therefore, there is no unique board structure that may be optimal for all family firms; the board needs to be structured based on the specific family context.

While there is no single best structure of a family firm's board of directors, there is broad support for the importance of board independence, as the presence of independent directors on the board reduces the risk of appropriation of private benefits. The importance of board independence has stimulated a range of studies centred on the relation of board independence to firm-level and country-level characteristics. One study of board independence in relation to firm ownership concentration and country legal environment, using data on 229 firms from 14 European countries, finds that when ownership concentration is greater, boards are less independent. It also finds that boards are more independent where legal protection is greater. Therefore, when firm ownership is concentrated or a country's legal environment is weak, the board is unable to fully exercise its control function, creating room for the family blockholder to extract resources from minority shareholders.

3.4 Executive Compensation

The founding family often has substantial power in determining executive compensation. This may be a complex issue, particularly when the family firm is led by a non-family CEO. In such a case, the compensation scheme has to cope with potential incentive conflicts and time-horizon differences between the two parties. Executive compensation typically includes monetary and non-monetary rewards. It includes salary, short-term incentives (such as bonuses) and long-term incentives (such as stock options).

The main question concerns what elements drive the family decision-making process when it comes to establishing executive compensation. A sample of 253 US family public corporations during 1995-1998 shows the existence of a compensation discount for family CEOs compared to non-family CEOs: family members leading the firm are paid less than their non-family counterparts.[50] This compensation gap increases when the family ownership is higher: family ownership concentration decreases family CEO pay and increases non-family CEO pay. Moreover, the compensation discount decreases when systemic risk is higher – high systemic risk increases family CEO pay and decreases non-family CEO pay. The combination of these facts suggests that the family affects family CEO compensation, not through higher pay, but mostly through greater risk protection. Finally, the presence of an external institutional blockholder in the firm decreases the long-term incentive for the family CEO. This fact supports the view that institutional investors may avoid long-term incentives for the family CEO for reasons related to risk: a higher long-term incentive would exacerbate the CEO's risk-aversion, which in the family context is already likely to be strong. This would lead to a suboptimal risk profile and negatively affect firm performance.

As discussed, the most relevant agency problem in the family firm context is the incentive conflict between family blockholder and non-family shareholders. CEO compensation is one of the instruments the family may exploit to extract private benefits. A study of the relation between CEO ownership and CEO compensation using a sample of 412 public corporations in Hong Kong during the period 1995-1998 finds managerial ownership of up to 35% to be positively related to CEO compensation among small firms.[51] Among large firms, managerial ownership of up to 10% is positively related to CEO compensation. In general, the lack of managerial ownership is negatively related to CEO compensation. These results provide evidence that the owner-managers may use their position to determine a higher personal salary. This confirms the idea that family CEOs may be using this channel to extract benefits for themselves, at the expense of other shareholders.

Families may also try to alleviate the incentive conflict with non-family shareholders – especially in situations where such risk is higher. Also, certain control-enhancing mechanisms put the family in a position to extract private benefits. One of these instruments is dual-class stock. An investigation of the relation between dual-class stock and executive compensation in a sample of Canadian public companies between 1998 and 2006 finds evidence that family executives are paid more in dual-class family firms than in single-class family firms.[52] However, most of this compensation is incentive-based: stock options and bonuses. This suggests that the extra compensation in dual-class firms may have the objective of aligning the incentives of the owner-manager with those of the minority shareholders. This is a way to mitigate the possibility of private benefits appropriation generated by the additional control of dual-class stock.

Finally, consider the case in which the family chooses to hire a non-family CEO. In this situation, a particularly complex issue concerns how the family should pay the non-family CEO: family and professional managers typically differ in preferences, risk profiles and time horizons. Drawing from classical contract theory, the short-term incentives to be offered to a non-family CEO should be low in the following cases: when the CEO is interested in signalling performance of executives to the outside market; when the CEO's effort to improve short-term performance is hard to observe; when the CEO is considerably risk-averse; and when the CEO is more sensitive to incentives. Since family CEOs are less motivated to signal their performance to the executive market and are likely to manage the firm in the long-term, they are less responsive to short-term incentives. Thus, the effect of short-term incentives is more intense for non-family CEOs. This suggests that the compensation schemes for family managers should include higher short-term incentives, in order to reinforce the family CEO's incentive to perform well in the short term.

3.5 Dividend Policy

The family can use dividends to either compensate for – or take advantage of – its controlling position in the firm. Therefore, dividend policy may alleviate or exacerbate the conflict between family blockholder and non-family shareholders.

The wedge between ownership and control can be seen as a proxy for how much the firm is subject to the risk of having a controlling blockholder appropriate private benefits of control, as discussed in Section 3.2. A study of the way firms use dividend policy, using a sample of public companies from Europe and East Asia, identifies some interesting facts.[53] First, firms pay higher dividends when they are tightly affiliated with a business group and when they have a stronger wedge between ownership and control. This suggests that affiliated firms tend to use dividends to alleviate the investors' expectation of potential appropriation of private benefits. In fact, there is no evidence of this phenomenon for loosely affiliated firms: in that case, shareholders perceive a lower risk for appropriation. Second, among corporations affiliated with a business group and with a positive wedge, European firms pay higher dividends than East Asian firms. This suggests that European investors are more aware of the potential for expropriation, inducing European firms to be more willing to use such a compensation mechanism. Since family firms are generally affiliated with business groups, this study suggests that families do use the dividend policy to offset the effect of potential conflict with minority shareholders. Moreover, the degree to which this instrument is used depends on the degree of financial development of the economy.

The literature examining the dividend policy of family firms has reported mixed evidence. Part of the literature suggests that family firms pay lower dividends than non-family firms. A study on a sample of Spanish firms finds that family firms pay around 40% lower dividends than non-family firms and this difference is statistically significant.[54] This may increase tension with other family shareholders and decrease family firm attractiveness to outside investors. However, another part of the literature offers contradicting evidence. A study of the dividend policy of family firms using a sample of European corporations finds that family firms pay higher and more stable dividends than non-family firms.[55] Moreover, family firms with a non-family second blockholder pay higher dividends than family firms without such a second blockholder. Also, family firms with no separation between ownership and control pay higher dividends than families where the wedge is positive. Overall, this contribution supports the idea that family firms pay higher dividends, suggesting an attitude to compensate for the potential agency problem.

The dividend decision has to be considered in the broader context of the firm's financial management. In fact, a firm's dividend policy varies depending on other firms' policies.[56] In particular, the relation between dividends and board independence is negative among family firms and positive among non-family firms. This shows that there is a strong interdependence between these two policies. Such interaction differs between family firms and non-family firms. Family firms use these two governance mechanisms as substitutes: when the board is not independent, the firm pays higher dividends to compensate for that, and vice versa. In contrast, non-family firms use these two governance tools as complementary.

Thus, there is evidence for the idea that families use dividends to alleviate the agency problem with minority shareholders, which is perceived to be more salient when the board is not independent.

3.6 Succession

The succession decision is a crucial step for the family firm. This process concerns whether and how to transfer the family firm's ownership, control and management to the next generation. There is substantial evidence to show that families often prefer to transfer their business to their offspring. It is often assumed that such behaviour is simply the manifestation of some form of nepotism. However, the literature suggests there is much more involved.

One common argument posits that the major determinant of the succession outcome is the legal environment where the family firm is located.[57] Considering the standard typology of a founding family firm – one that is owned and managed by its founder – when the transition is approaching, the founder has to make a decision regarding ownership, control and management of the firm. In particular, the founder can choose the next CEO from potential family heirs or appoint a professional, who is assumed to be a better manager.

This decision depends on the extent that the law protects minority shareholders:[58]

- In a strong legal protection environment, the founder would hire the professional as CEO and sell the firm in the stock market.
- In a weak legal protection environment, the founder would choose the family heir as CEO and keep the firm ownership.
- In an intermediate legal protection environment, the founder would hire the professional as CEO but keep a controlling stake in the firm.

This last case, perhaps the most common in many Western countries, is a situation that involves two agency problems: the conflict between management and shareholders and the conflict between family blockholders and non-family shareholders.

An alternative argument suggests that the choice of transferring the family firm to a family heir may be motivated by an economic rationale that centres on the specificity of the family firm's assets. Typically, the family firm's most crucial assets – its human and social capital – are rather individual-specific and idiosyncratic. Consider a founder having to choose the next CEO between the family heir and an outsider. The founder can hire the professional for one period and then re-evaluate that decision. The main consideration in this decision is the so-called appropriation of risk: should the skilled manager be hired for one period or for a longer period? The issue here is that once the manager acquires the idiosyncratic knowledge, they may use that knowledge to bargain for a higher level of compensation from the founder. Hence, the founder is trapped in a dilemma: hiring a skilled professional manager, both firm profitability and appropriation risk would increase, making it unclear whether or not this would be the best choice to make.[59]

This dilemma may motivate the founder to transfer the firm leadership to a family heir who may be less skilled at managing the firm, in particular when performance depends on idiosyncratic knowledge. In fact, in such a case, the founder would perceive a very high appropriation risk and be willing to trade it off with the initial lower profitability caused by the lower ability of the family heir. This dynamic explains why families often choose their heirs to lead their firms, without relying on the usual nepotism argument. Therefore, this study suggests that founders should carefully take into account the appropriation risk, since family firms are known to depend profoundly on idiosyncratic knowledge. Finally, in the extreme case where the heir is poorly qualified, the authors suggest that the family should undertake what is known as the seat-warmer strategy: hiring a professional temporarily, even if having to pay a premium in compensating the professional, until a suitable heir is available to lead the firm.

In addition to addressing what motivates families to retain control of the business across generations, there is need to question the best way to do so. Using a case-study approach to identify the features characterizing the successful transfer of the family business to the offspring, five ways have been identified through which successful transitions have taken place:[60]

- The heir voluntarily took the lead of the family firm
- The family explicitly requested the heir to succeed to the helm of the firm
- The heir chose to take the lead out of a sense of moral duty
- The transfer was implicitly predetermined and there was no need to make any explicit request
- The family softly pushed the heir to take control of the firm

Six steps that can be taken to better prepare for the transition are summarized in Figure 9.[61]

One study classifies the drivers of effective family succession into three categories:[62] the preparation of the heir; the nature of the relationships among family members; and the planning and control activity in the family firm. Based on econometric analysis of survey data, it finds that the transition occurs more smoothly when heirs are more accurately prepared, when the firm does considerable planning activity, and when family relationships are based on trust and affability. Among these three elements, the main driving force is the nature of family relationships. Therefore, this study suggests that families should strive to develop and maintain relationships based on trust and affability among members; not only will such effort be beneficial in the short run, it will also be critical at the moment of passing the business on to the next generation.

Figure 9: Six Steps to Prepare for a Successful Succession

Source: Adapted from Lambrecht, 2005

1. Involve the heir in the business very early
2. Have the heir undertake studies related to the business
3. Provide the heir with internal education tailored to initiate her into an understanding of the business
4. Encourage the heir to gain work experience in other companies
5. Officially introduce the heir into the business
6. Regulate the debut of the heir into the family business by a written agreement

4. Governance of Other Family Entities

Multi-generation, multi-branch family enterprises often establish a family office and a family foundation. These two entities play a vitally important role in family life and therefore require the development of appropriate governance structures. Since governance issues associated with these entities have only been sparsely studied, a short review is provided below.

> Families with substantial investable assets in excess of US$ 100 million often choose to set up their own family office - a professional organization dedicated to serving the financial and personal needs of the family.

4.1 Family Office

As the family grows in size and complexity, and its business flourishes, family members increasingly face the need for wealth management, broadly defined. Substantial families with investable assets in excess of US$ 100 million often choose to set up their own family office, which is a professional organization dedicated to serving the financial and personal needs of the family. While family offices vary in size and scope, their mandate includes managing the liquid wealth of family members (i.e. those financial assets that are not tied to the family-controlled operating company), serving as the administrative backbone of the family enterprise and providing a range of services to the family.

Specifically, the services offered by a family office fall into three broad categories:

– Investment management services, including asset allocation, manager selection, manager monitoring and performance measurement.
– Administrative services, including technology support, financial information aggregation, financial record-keeping, compliance, accounting and banking.
– Family-related services, including estate planning to manage tax-efficient inter-generational wealth transfer, education programmes for younger family members, risk management, insurance, concierge services and security.

Some of these services are provided in-house by professionals who are hired by the family office under various specializations such as investment, finance, accounting and legal, while other services are outsourced to external vendors. It is common for a family member to lead the family office.

There are potential vulnerabilities in the family office and sources of risk for the family therein.[63] Family offices are subject to three types of risk: financial (such as cash misappropriation and inaccurate book-keeping), technology-related (such as information theft and technical problems in the system) and employment-related (such as payroll fraud and tax issues). Therefore, an effective set of internal controls must be incorporated into the family office governance – internal processes designed to identify and mitigate these risks, allowing the family office to achieve its objectives.

The most effective internal controls fall into five main classes:

1. Governance practices reflecting the family standards with respect to ethics
2. Procedures regulating and limiting access to family funds
3. Practices supporting the segregation of duties
4. Processes for conducting frequent reconciliations
5. Practices of documenting all significant transactions

A recent benchmarking study of family offices provides insights on the drivers of family office performance, based on survey data from a sample of 106 single family offices (SFOs) located in 24 countries.[64] The majority of families in this sample operate a family business in addition to managing their wealth through the SFO. American family offices seem to be more versatile than their European counterparts: the former emphasize non-financial services (administrative and family-related) more than the latter. What emerges from the benchmarking study overall is that high-performing SFOs share several best practices, as listed in Figure 10.

Figure 10: Best Practices of Single-Family Offices

Source: Amit and Liechtenstein, 2012

– Expanded capabilities to handle key activities in-house
– Significant number of family members involved
– Superior governance and control structure
– Detailed documentation of every activity within the family office
– Codified investment-management processes
– Extensive and frequent communication with family members
– State-of-the-art human capital processes and compensation practices
– Education programmes for younger generations
– Succession planning

A study examining Swiss family offices highlights the important roles of family office boards, which are a central element of the governance structure of family offices.[65] The board should be responsible for setting the overall direction of the family office as well as monitoring its activities. The composition of the family office board should reflect diverse skills and backgrounds. There should be clearly defined roles for its members, who should be integrated into the activities of the family office as well as of the family members and other stakeholders. The functioning of the family office and the performance of its board depend on a culture of trust, which has a major role in minimizing conflict, enabling conflict resolution and allowing a smooth monitoring process.

4.2 Family Foundation

The family foundation is the entity through which the family enterprise carries out its philanthropic activities in a tax-efficient manner. Typically, the family foundation is a private foundation, which is supported by the family, the family business and its investment income. Its main activity is providing grants according to its mission. Although foundations play a crucial role in many developed countries, the study of family foundations is still at its early stages and the literature has not yet produced as many insights on this subject as on other aspects of the family enterprise.

> The family foundation can be very beneficial for the family for reasons beyond tax reduction and reputation.

The family foundation can be very beneficial for the family for reasons beyond tax reduction and reputation. Mainly, the family foundation can have three positive effects on family dynamics by:[66]

- providing financial education
- enhancing family communication
- enabling a larger family discussion

The family foundation offers an excellent opportunity for family members to learn about financial and investment issues, serving as a platform for the older generation to mentor the new generation on issues such as due diligence, valuation and investment strategy. Moreover, family foundations provide additional occasions for the family to meet, thereby enhancing communication among family members. Finally, family foundations have the effect of enlarging the discussion within the family, putting emphasis on issues that would otherwise remain understated.

To maintain its tax exemption, the family foundation needs to distribute about 5% of its market value for charitable purposes each year. A key governance decision for family foundations is how to carry out their grant-making activity – give it directly to the receiving subject or indirectly through another organization. Family foundations typically prefer to fund charitable activities indirectly by funding other charitable organizations.

The main governance institution of family foundations is usually a governing board. Typically, numerous family members serve on the board, including the founding donor.[67] The board can also include non-family members, particularly representatives from the community. The board meets at various times every year to review the foundation's activities and direction, particularly grant proposals and investment performance. The majority of family foundation board members are often volunteers, so they typically receive only an expense reimbursement. Four main foundation structure models – trustee, administrator, director and presidential – are described in Figure 11.[68]

A key governance decision for the family foundation – similar to the family firm – concerns hiring outsiders. As family foundations grow, family members may no longer be willing or suitable to lead the family foundation, so families tend to hire outside administrators. The non-family administrator is likely to lead the foundation to a new stage of its existence, changing its previous processes and dynamics. As such, the non-family administrator may offer three important contributions:[69]

1. Bringing in a new level of professional management
2. Enhancing the relationship between the foundation and the community
3. Bringing a fresh and objective perspective into the family

Since the foundation is often a small entity, the relationship between the family and the administrator is key to the foundation's performance. A close relationship is desirable, but if it becomes too close, there is a possibility that the administrator becomes subordinate to the family and fails to bring objectivity and expertise to the foundation's decisions. This will obviously harm the foundation's performance.

Finally, family foundations have to make the choice between diversification and focus in their grant-making strategy. Diversification in grant-making may require professional skills only available outside. This may not be accepted by family members and may create conflict within the family.

A study of the drivers of this decision-making process using a sample of the 200 largest independent foundations in the US finds a number of interesting results:[70]

- Family foundations are significantly less diversified than non-family foundations.
- The board size is positively related to diversification.
- Later generation foundations are more diversified.
- Family foundations with lower family control on their boards are more diversified.

The combination of these facts confirms that the family presence tends to be an obstacle towards grant-making diversification.

Family foundations play an increasingly important and visible role in both traditional areas of philanthropy and innovative research and development (R&D) initiatives. It is hoped that future research on family foundations will yield new insights on this important component of the family enterprise.

Figure 11: Four Models of Family Foundation Structure

Source: Adapted from Brody and Strauch, 1990

- **Trustee model:** There is no additional staff and the board also performs daily administration
- **Administrator model:** A small staff is hired to perform daily administration, while the board makes decisions
- **Director model:** An executive director guides the board activity
- **Presidential model:** The board sets policies and monitors progress, while an administrator has wide authority

5. Governance and Performance

The relation between the governance architecture of the family enterprise and economic performance is important to understand how each aspect of the governance system may differentially impact the performance of a family entity. By reviewing the relation between each governance element and performance, an attempt is made to infer best practices to be shared with family enterprises.

> Researchers find strong evidence that the use of family governance practices enhances the financial success of the firm.

5.1 Family and Performance

While common wisdom suggests that the family affects performance only through the role it plays in its business, empirical evidence suggests that family composition and size per se have a profound effect on performance. A study of the effect of family structure on family firm performance using data from 93 Thai family business groups finds a significantly negative relation between the number of sons and firm performance.[71] This relation is mitigated to some extent during the lifetime of the founder, and appears stronger in those firms where the founder has passed away. The number of daughters also has a negative effect on performance, although this is weaker. Hence, family size seems to adversely affect performance, suggesting that family size may provide incentives to extract resources from the firm, thereby generating conflict.

Family processes also affect performance. Using survey data on US firms, an analysis of how family relations and processes impact performance, as measured by firm revenues, shows that family tension has a strong negative impact on performance.[72] The data also suggests that there is a positive relation between family members working in the company and performance. Considering the effect of the so-called disruptive variables, the study finds that shifting time from the family to the business is positively related to performance. Conversely, using family money for the firm, or skipping a business task in order to spend time with the family, and having occasional free labour from family members in the business, are all negatively related to performance.

Family governance can mitigate family tension, as discussed in Section 2. Therefore, family governance mechanisms should have a relevant effect on performance, given the link between family tension and performance. A study of six family governance practices – family constitution, family code of conduct, clear selection and accountability criteria, family councils, family reunions and family communication tools – to examine their effect on family firm performance shows that family governance reinforces family ties, building a unified team with common preferences and goals.[73] A unified team is likely to lead to enhanced performance. Based on survey data on 94 family firms from 18 countries around the world, the study finds strong evidence that the use of family governance practices enhances the financial success of the firm.

The succession decision is a key dilemma in the family enterprise. Much evidence suggests that families tend to prefer to keep control of the firm across generations. Stewardship theory further suggests that the intention to keep the business within the family may have a positive effect on performance.[75] Families intending to pass their business on to the next generation will:

- have a more forward-looking approach in their business decisions
- make an effort to build reputation and social capital
- invest in business education and apprenticeship of family members, and develop a strong organizational culture
- build a strong relationship with the professional managers, so that they will support a new family member who will eventually lead the enterprise

This combination of practices – driven by the intention of keeping the business within the family – will have a positive effect on long-term performance.

5.2 Family Ownership and Performance

The common perception is that family ownership is not a value-maximizing ownership structure. However, an analysis of the relation between family ownership and family firm performance using a sample of 403 US family firms between 1992 and 1999 finds that family firms outperform non-family firms in both accounting and market measures of performance.[76] It finds that the relation between family ownership and performance is similar to an inverse-U-shape: it increases as family ownership increases, but decreases after a certain point.

An empirical examination of all Fortune 500 firms between 1994 and 2000, looking at the impact on performance of family ownership, management and control, establishes that family ownership per se creates value for the firm.[77]

A large body of literature has studied a separate but related problem: the effect of insider ownership – the ownership of the firm by managers or board members – on performance. An analysis of data on US firms during the period 1994-1999 to investigate how insider ownership affects firm value supports the idea of an inverse-U-shaped relation: insider ownership increases performance at moderate levels, but decreases it at excessive levels.[78]

This evidence of the positive effect of family ownership on performance is confirmed by a number of studies focusing on different regions of the world. Canadian family firms' performance is not worse in market terms, and is better in accounting terms, than that of non-family firms.[79] A sample of 675 public companies from 11 European countries finds that family ownership positively affects performance.[80] An examination of 1,672 firms from 13 European countries finds that family ownership is associated with a 7% higher valuation and 16% higher profitability.[81] Finally, a study of data from 1,301 public companies from eight East Asian countries also finds family ownership positively related to value.[82]

Corporate transparency refers to the degree to which shareholders have easy access to all information regarding the firm and is an important monitoring device. In family firms, family members might be in a position to effectively determine the level of corporate transparency. They could have the incentive to diminish it, in order to extract private benefits from the firm more easily. Alternatively, transparency could just be diminished because it would become less useful when family members would directly serve the function of monitoring the management. Opacity plays a key role in determining the performance of family-owned firms – family firms are significantly more opaque than widely-held corporations, as a study using a sample of 2,000 US public companies shows.[83] Most importantly, opacity plays a key role in the relation between family ownership and performance. In fact, family ownership affects performance positively only among firms with low levels of opacity. As opacity increases, family ownership decreases performance. This evidence suggests that the positive relation between family ownership and family firm performance is conditional on the family firm being transparent. If the firm is not transparent, the market perceives that the family may be extracting resources from the firm.

Finally, the literature has highlighted the role of the environment in the relation between family ownership and performance. The environment may affect firms mainly through two channels: the cultural channel and the institutional channel. The first domain includes values and norms traditionally embedded in the behaviour of individuals. The second domain concerns characteristics of market development and the legal framework. Therefore, environmental characteristics may bias our results about the relation between family ownership and family firm performance. A sample of Chinese firms – chosen because China is seen as an appropriate location characterized by cultural homogeneity and institutional heterogeneity across provinces, allowing for isolation of the institutional effect from the cultural effect – confirms that family ownership is positively related to performance.[84] However, this relation is only strong in regions with low institutional efficiency. This finding suggests that family ownership is the optimal structure when it can stand in for the underdevelopment of the market.

5.3 Family Control and Performance

Family firms tend to achieve control rights beyond their ownership rights. Through the use of control-enhancing mechanisms, they manage to achieve this wedge, which gives them additional decision-making power over a broad range of corporate matters. This may allow them to make additional contributions in terms of motivation, expertise and social capital. But this may also give them the possibility to extract resources from the firm. When the latter effect is more significant than the former, the situation is detrimental to minority shareholders. A range of empirical studies using data from numerous countries suggests that the wedge between voting rights and cash-flow rights adversely affects performance.

A study of a sample of US firms finds that, in general, the use of control-enhancing mechanisms is negatively related to performance.[85] The resulting wedge between control and ownership decreases value proportionally: the higher the difference between voting rights and cash-flow rights, the higher the reduction in value. A further investigation of this issue, by analyzing a sample of US public companies between 1994 and 2000, finds that the impact of control-enhancing mechanisms on performance depends on the specific mechanism used.[86] There is evidence that dual-class stock and disproportionate board representation are negatively related to value. Conversely, there is no evidence of such negative relation when families use pyramidal structures or voting agreements, which may rather have a positive effect on value. The finding about dual-class stock is confirmed by another study, which analyses a comprehensive list of US dual-class firms between 1995 and 2002.[87] This evidence suggests that family firms should carefully consider which mechanisms to use to control their firms, as their effects on performance are different.

The evidence of a negative effect on performance of a separation between ownership and control is confirmed by data from around the world. Using a sample of 675 public companies from 11 European countries, a study finds that the existence of a wedge between control and ownership adversely affects family firm performance.[88] A study examining the same question from data on 1,301 public companies from eight East Asian countries confirms that, in this region of the world too, a positive wedge between control and ownership decreases the value of the firm.[89] Interestingly, it highlights that this negative effect is strongly significant only for family firms, but less relevant for state-controlled and widely-held firms. Family firms are perceived to be particularly prone to take advantage of their control position to extract resources from their firms.

The literature has also addressed the separation between ownership and control in the context of insider ownership – the situation where managers or board members have an ownership stake in the company. This context is applicable to family firms, since typically families are actively involved in the business. An investigation of the effect on performance of the difference between control and ownership of the management group, using a sample of 1,433 firms from 18 emerging markets, finds that whenever the management group has control rights exceeding ownership rights, firm value decreases.[90] Moreover, a look at the same question using data on 800 firms from eight East Asian countries during the 1997 Asian financial crisis finds that during the crisis, stock returns declined significantly more for firms with strong separation between management control rights and ownership rights than for other firms.[91] This evidence is consistent with the negative effect of the wedge between ownership and control on performance.

Family firms are typically characterized by a concentration of control in the hands of a unique shareholder group, the family. The literature has highlighted that the distribution of control rights has an effect on firm performance. Among Finnish public companies, between 1993 and 2000, there is evidence that family firms with a more equal distribution of voting power among blockholders performed better.[92] Therefore, the presence of at least another blockholder with substantial control, besides the family, increases the value of the family firm. This result is conceptually consistent with a theoretical argument that, in closely-held corporations, the optimal ownership structure has either one large shareholder or multiple shareholders of similar size.[93]

An important instrument through which the family maintains control of the firm is the board of directors. The composition of the board of directors has a relevant effect on the performance of the family firm. Among the 500 Standard & Poor's firms during the period 1992-1999, family involvement on the board was non-linearly related to performance: family involvement at moderate levels was helpful; at excessive levels, it was detrimental.[94] This suggests that, at moderate levels, the presence of the family on the board may provide benefits to the firm. However, if the family has too much power in the board, it is likely to extract resources from the firm, hindering performance. The family role in the board can be regulated by the presence of outside directors. Typically, outside directors are of two types: independent (directors having no other connection with the firm) and affiliate (directors having some business tie with the firm). The key finding of this study is the expected positive relation between board independence and performance: the more independent the board is, the better the firm performs. Conversely, the presence of affiliated directors is negatively related to performance. This evidence suggests that only independent directors are able to play a moderating role in the board.

5.4 Family Management and Performance

Family management occurs when either the founder or a descendant manages the firm. This latter case is very common. There is wide evidence suggesting that family firms often prefer to have the heir managing the family business, instead of an outsider, as discussed in Section 3. However, it is important to ask how this impacts family firm performance.

The literature has offered contradictory evidence of the effect of family management on performance. Some studies have identified a positive effect. In the US, family-managed firms have been found to be more valuable and more efficient,[95] while Norwegian firms that are family-managed are seen to be significantly less productive than non-family firms.[96]

More recent literature has investigated the issue at a deeper level, clarifying that the result depends on the type of family management. Among US firms, having the founder as CEO is positively related to performance, while having the descendant as CEO is negatively related to performance.[97] In other words, family firms perform well when they are led by the founder but not when they are led by a descendant. Further, the presence of an outside CEO is beneficial for the family firm, as long as the founder acts as a chairperson, confirming the crucial importance of the contribution of the founder's skills and expertise to the family firm. This result is consistent with the findings from a study of 896 US public companies that the outperformance of family firms is entirely attributable to lone founder firms.[98] Therefore, there seems to be evidence of a positive founder-CEO effect and a negative descendant-CEO effect.

A vast body of literature has investigated the positive founder-CEO effect on family firm performance. A significant founder-CEO effect on firm performance is visible among US public companies.[99] A positive relation between having the founder as CEO and long-run investment performance is also found among US companies, but mostly in high-technology industries.[100] A sample of 2,327 US public companies between 1992 and 2002 confirms the positive performance of these firms, by showing that a hypothetical investment strategy to buy founder-CEO firms would have significantly outperformed the market by more than 10% annually.[101] Moreover, a strong difference in behaviour is in evidence between founder-CEO firms and descendant-CEO firms. In particular, founder-CEO firms invest more in R&D, have higher capital expenditures and make more focused merger and acquisition (M&A) decisions.

The key finding seems to be the negative effect of the descendant CEO on family firm performance. This problem is related to family succession decisions and has been widely studied. A sample of 335 CEO transitions in firms with concentrated ownership shows that any transition involving a family relation – where there is a family tie between the new CEO and the previous CEO, the founder or the blockholder – has a negative impact on performance.[102] Firms appointing CEOs based on family ties perform 14% worse in accounting terms and 16% worse in market terms during the three years following the transition. The findings suggest that family firms may be making succession decisions based on reasons other than merit. In testing this hypothesis by investigating the effect of education on family CEO performance, the study finds that firms where the family CEO did not attend a selective undergraduate institution significantly underperform firms appointing a non-family CEO, while this effect is not observed in firms where the family CEO attended a selective college.

An investigation of family CEO performance impact using a sample of 5,334 CEO successions in Danish firms between 1994 and 2002 confirms that appointing a family CEO implies a significant 4% decrease in accounting-based performance.[103] Moreover, this underperformance is particularly evident in large firms, fast-growing industries and skilled-labour industries. An analysis of the quality of management practices on a sample of 732 medium-sized manufacturing firms from the US, the United Kingdom, France and Germany, involving an innovative survey technique, finds that family firms choosing the CEO based on primogeniture are very poorly managed.[104] Having a first-born descendant as CEO has a significantly negative effect on management quality, which is shown to be positively related to various measures of performance such as firm productivity and firm value.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6. Key Insights

The academic and professional literature on the governance of the family enterprise has produced a number of important findings. It offers an important resource for families, as well as for practitioners working closely with family enterprises.

The family is the cornerstone on which the related entities are based. Therefore, its successful governance is crucial to the survival of the entire family enterprise.

The family enterprise is a complex and distinctive organization, in that it pursues multiple objectives: maintaining unity and harmony within the family; achieving prosperity of the family firm; keeping control of the business across generations; mitigating family conflict; preserving its liquid assets and so on. The survival and success of the family enterprise, which encompasses the family, the family-controlled operating company or companies, one or more foundations, and often a family office, requires a coherent and interdependent governance system to enable the realization of the family's multiple objectives.

Family governance refers to the rules, processes and institutions which enable the decision-making and implementation of policies concerning the oversight and management of family affairs. It includes informal elements, such as values and norms shared among the family members, as well as formal elements, such as the family constitution, family council and family committees. Informal elements play a primary role: without a common ground of shared values, beliefs and norms, no formal structure can successfully operate. The family is the cornerstone on which the related entities are based. Therefore, its successful governance is crucial to the survival of the entire family enterprise.

The literature points to fairness perception as the core informal element in family governance. Fairness perception leads to higher satisfaction with family decisions and stronger identification with the family, while alleviating family conflict. Enabling a climate of fairness, a collaborative approach to resolving conflict and frequent communication has been shown to enhance family harmony and the effectiveness of management in the family business.[105]

These "soft" aspects of family governance are particularly important in the multi-branch, multi-generational family. Hence, close attention must be paid to these aspects during the process of developing family governance policies and institutions.

The family firm is the primary source of wealth for the family. Governance of the family firm must be designed to carefully address the potential conflict of interest between family and non-family shareholders through the ownership structure, the composition of the board of directors, the compensation schemes and the management of the family firm. By proactively addressing these issues in the design of family business governance, family firm owners can alleviate the adverse effect on value that may arise.

Families frequently use control-enhancing mechanisms, that is, instruments that allow them to have voting rights in excess of cash-flow rights. These instruments include dual-class stock, pyramidal structures, cross-holdings and voting agreements. The resulting wedge between voting rights and ownership rights gives the family the possibility of exercising majority control on the firm. The existence of a large wedge could be perceived by non-family shareholders as an attempt by the family to extract private benefits and thereby depress firm value. Elements of the governance structure of the family firm, such as the composition of the board of directors and the design of executive compensation and dividend policy, are useful in mitigating the potential adverse effects on value that arise from the wedge.

The succession decision is a major challenge for the family: how to transfer ownership, control and management to the next generation. The literature has shown that failure to carefully manage all aspects of this transition may lead to lower firm performance, ultimately threatening the survival of the family enterprise. There is substantial evidence that families tend to keep control of their business across generations. The main rationale behind this behaviour is simply that families have multiple concurrent objectives: they seek family harmony and unity while pursuing financial wealth. The research has given additional, complementary explanations for this phenomenon – that succession occurs internally when the legal environment is weak,[106] or that the business is kept within the family due to the high specificity of the family firm's assets.[107] The main takeaway is that families should approach the transition decision carefully and wisely. If the choice is to transfer the family business to the heir, the key message is that such transition requires wide preparation and detailed planning.[108]

Wealthy families often choose to create a family office dedicated to serving the financial and personal needs of family members. While family offices vary in size and scope, their mandate includes managing the liquid wealth of family members (i.e. those financial assets that are not tied to the family-controlled operating company); serving as the administrative backbone of the family enterprise to facilitate family life; and providing a range of family services including estate planning, which encompasses, among other matters, tax-efficient wealth transfer to future generations. The governance and management of the family office needs to be structured with a mix of family members and professionals so as to enable smooth functioning of the family office while ensuring sufficient controls to mitigate the exposure faced by the family.

Family enterprises typically carry out their philanthropic activities through foundations. The family foundation's main activity consists of providing grants to recipients in a tax-efficient manner. The benefits of the family foundation can extend beyond tax savings and reputation. In fact, the establishment of such an entity has major positive effects on the family dynamics: it provides financial education to family members, strengthens communication and facilitates discussion.[109] The family foundation requires its own effective governance structure. In particular, an important aspect concerns whether to designate a family member or an outsider as administrator. The literature suggests that the choice of an outside professional administrator has multiple advantages including professional management, better relationship between the foundation and the community, and infusion of a fresh perspective into the family.[110]

The key question is how the governance elements of the family enterprise affect the wealth, unity and happiness of the family. The clear message that emerges from the literature is that a codified family enterprise governance system – one which has been developed through a process of elaborate consultations and dialogue among family members, and which reflects the family structure and dynamics as well as the various incentives-related issues that characterize a family firm – contributes to enhancing family harmony and happiness as well as family wealth.

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