Family-owned business in crisis: introduction of Outside Manager in the Board

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Abstract

Family-owned business is a company owned and/or controlled by family members. Nowadays FOBs occupy an integral part of world economics and contribute greatly into the world's GDP. However, financial crisis made FOBs suffer from losses even more than non-family companies. One of the threats connected with family executing the company is decision-making process being influenced by family interests and relations. With this regard, an introduction of the outside manager and vesting him with executive power is proposed for the crisis period to maximize the effect of managerial decisions and corporate strategy. Criteria for the outside manager are similar to independent directors' criteria.

Keywords: family business, control, decision-making process, independent directors, ownership, crisis

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Introduction

The key purpose of corporate governance is to promote accountability, transparency, fairness, disclosure and responsibility - core values that are relevant to the success of all businesses, irrespective of the countries they come from. The family-owned business (FOB), which is prevalent, even dominant, in many economies, is not an exception as it implements corporate governance. Nowadays in order to be successful FOBs have not only to consider and content interests of the family members but also have an eye on the financial performance, clients' satisfaction and company's expanding according to demands of the business world.

However in the conditions and negative consequences of crisis family management is not always the best one to cope with arising problems, make quick and abrupt decisions. The influence of family background could lead to making wrong emphasis while building the anti-crisis strategy. Pursuit of defending the family prosperity could overlap the necessity to rescue business. The solution here lies in introducing an independent outside manager (OM) into the organizational structure and endowing him/her with administrative authority. As the requirements to the OM it is proposed to use the criteria for independence of directors from the codes of corporate governance and listing rules of stock exchanges.

This article considers one central element of board governance – the presence and role of independent directors, however the peculiarity of the issue lies in the sphere of these independent bodies' introduction. They are involved into the administrative process in the companies with the management consisting of the family members. That should not be treated only as a drastic measure in world economic crisis and after-crisis periods, but for the in-house declines also as the FOBs in most cases deal rather good with day-to day business. Outside directors at these rates can challenge the family to look broader at its long-term financial interests. In this article we research how an outside decisive body can be introduced into entirely family board in different models of doing business.

Literature review

Family firms were not in the centre of attention of scientists in management and organizational researches for a long time even though they dominate in many national economies. The relevance of the issue was recognized increasingly in the last two decades. Beside the fundamental research stream to gain definitional clarity about what family firms definitively are or how they can be distinguished from nonfamily firms, the research interests concerning concrete managerial problems and strategic topics, e.g. performance management, succession management, and financial management, gathered momentum.

The words 'family business' only occasionally appeared in the literature before the 1980s, and it was not until 1988 that the first journal devoted to family business studies, the Family Business Review, was published (Astrachan, 2003). But while the field is in its early development stages, family business research is becoming increasingly empirical and more rigorous (Bird et al., 2002).

La Porta, Lopez-de-Silanes, and Shleifer (1999) showed that a large fraction of public and private firms

around the world are family-controlled. M. Bertrand, S. Johnson, K. Samphantharak and A. Schoar (2008) found a strong positive association between family size and family involvement in the ownership and control of the family business.

Some family companies' owners and managers can privilege family agendas and independence above entrepreneurship, profitability and competitive advantage. However, family ties can bring significant assets such as loyalty, trust, longevity and stability (Howorth et al., 2010).

Particular group structures emerge not only to perpetuate control, but also to alleviate financing constraints at the country and firm levels. At the country level, family groups are more prevalent in markets with limited capital availability. At the firm level, investment intensity is greater for family firms, reflecting the financing advantages of the former (R. Masulis, P. Pham, J. Zein, 2010).

According to R. Trevinyo-Rodríguez and J. Tàpies (2010), one of the most critical organizational changes family businesses deal with at some stage in their lives is the succession process. When evaluating it, two main targets are sought: quality and effectiveness. To meet these quality-effectiveness standards three elements should be transferred from the predecessor to the Next Generation Member(s): 1) Ownership/power, 2) Management responsibility and 3) Competence/Knowledge. In the case when family members are not capable of coping with the above mentioned elements, the non-family member should be introduced to the board and vested with managing and decision-making power. FOBs could face roadblocks from world wars and natural catastrophes to increasing number of family members and necessity to manage a family and working relationship (M. Bennedsen, L. Van der Heyden, 2010). So the operational and business strategies that enhance the value of the family unique assets should be worked out.

What is "Family-run business"?

The main definitions of family-run business as a corner stone have its special approach to ownership and control.

According to Friedman (1998), FOB is a company that is either owned or controlled by one family. Hunt & Hamdler (1999) claimed that FOB is a business that is both owned and controlled by one or more family members.

In terms of the size family businesses can range from a small corner store to a large multinational corporation (Birley and Godfrey, 1999).

With reference to article by W. Shuster (2003) only one in three family-owned businesses survive into the second generation, and one in eight into the third all because of problems with transferring business control from the older generation to children or relatives. Dr. T. Kirchmaier and J. Grant (2008) stated that an important question is the optimal level of family ownership in public markets, and whether the founding family should retain over 50% of the voting rights. However, the academic evidence in this area indicates that the second and third generations of the founding family are better off diversifying their wealth, as the optimal level of ownership and control for these later generations is in the 25% – 30% area, well below the absolute level of control. In this case the family also benefits from a higher degree of liquidity in the stock.

The conclusion of the research made by L. Ceja, R. Agulles, J. Tàpies (2010) showed that values in the world's largest family-owned firms seem to have three main characteristics: they emphasize a collective orientation; they have a long-term perspective; and they have a sense of stewardship.

In the business community family-run business could be represented in two main forms. First one concerns small business owned by the closest relatives. As a rule the number of personnel in such firms doesn't exceed 10 people. They are commonly found in the USA, Canada and Russia. According to this principle consulting firms, recruiting agencies, small family publishing houses are often launched. The pitfalls here could occur while controlling the activities of the firm, decision making process, creating job description, understanding the purposes and objectives of the overall business.

The second considerable group of family-run business is represented by the firms handed down in the family. The owners of the firms are entire family clans. The group forms foreign family capitalism and is introduced by large and global companies such as multinational corporations with multiple subsidiaries. In this case "the family" only controls the company through a family shareholding. In each country, the family must maintain a different percentage of shares in order to have the right to be called a family firm. Families are still the dominant owners in many European countries. In Finland this percent should be not less than 50%, in America and Germany it is enough to keep about 25% of the shares in the hands of one family, provided that it is the most powerful share of all the stock package of a given company, and the remaining shares are dispersed among large volume of small owners of small packages of shares.

However, in both cases family is an essential decision-controlling body. Its agreement or disagreement on the issue is final word whether for its acceptation or rejection. Sometimes it turns to be a significant pitfall to the prosperous life of the company.

Family-owned business in figures

According to facts mentioned above, family-run business is an essential factor of economy's stability. On the one hand, it influences not only the financial component of the economy, but the social one as well. FOBs provide considerable share of GDP in most of the developed countries. On the other hand, FOBs serve as employers for about 50% (and more) of employees of explored countries (Table 1).

Table 1. Data on family-owned business by countries

#	Country	Share of Enterprises	Share of Employees	Share of Turnover	Share of GDP	Source
1	USA	35% of 500 largest enterprises	50%		50%	The Wharton School's Prof. Richard Lai's, 2010
2	Canada	80% of the companies listed on the Toronto Stock Exchange				Phan, Butler, & Lee, 2005
3	UK	65% of private sector enterprises	41.9% of private sector employment	38.2% of private sector turnover	40.7% of GDP	IFB report, 2008
4	France	75% of medium-sized and 20% of large (3,000 or more employees)	49 %	59 % of the 500 largest manufacturing enterprises' turnover		FBN International, 2007
5	Finland	80%	49% - in medium-sized companies; 22% of large companies	41% of medium-sized companies' turnover; 16% of large companies' turnover		Tourunen, 2007
6	Germany	95% (97% - companies with annual turnover of less than EUR 1 million; 86% - with EUR 1 - 5 million; 74% - with EUR 5 – 10 million; 58% - with EUR 10 - 50 million; 34% - more than EUR 50 million)	57%	42%		Hauser/Wolter, 2007
7	Thailand	72% of manufacturing sector	63%			Wali-ul-Maroof Matin, 2006
8	Taiwan	Small and medium-sized family companies – 98.5%	80%		47%	Kuang S. Yeh, Hsi-Mei Chung, Family Businesses Research Center 2007

For more comprehensive data we appealed to IFERA. The ratio between family- and non-family-owned spheres of business in different countries again reminds the importance of FOBs as it is shown in the Figure 1. Italy is leading here. Its family business acquires approximately 80% of the whole economy. Finland, Greece, Cyprus and Sweden are also close to 80%. As we can analyze from the graph, European countries are reaching the peak in terms of prevalence of FOBs.

In the Middle East region, family-owned business accounts for 95 per cent of all private sector companies.

Family-owned or controlled companies are the leading form of business organization in Latin American countries, even among large listed companies: one recent study from Brazil revealed that 51.5 percent of the 200 largest listed companies are family-controlled.

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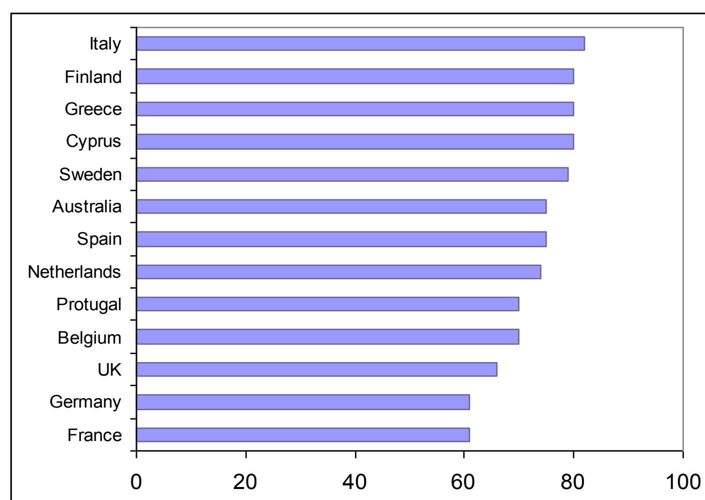

Figure 1. International comparison of family ownership (number of family firms as a % of total, IFERA data)

The global financial crisis caused changes in financial situation in almost all the businesses in the world. FOB appeared under its influence too.

Research on the financial performance of FOBs in different countries showed that financial crisis made a negative impact on them. Net income was chosen as an indicator of financial situation in the companies.

Table 2. USA FOBs' net income dynamics (2005-2010) in million dollars

USA	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Walmart	11231	11284	12731	14848	13899	13137
Ford	1440	-12613	-2795	-14766	2717	6369 (9 months)
Cargill*	-	1540	2340	3640	3330	2600
Qualcomm	2143	2470	3303	3160	1592	3250
Motorola	4578	3661	-49	-4244	-51	109 (9 months)
GAP	1113	778	833	967	1102	839 (9 months)

Table 3. Germany and Japan FOBs' net income dynamics (2005-2010) in million dollars

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
GERMANY						
Villeroy & Boch	17,62	24,3	31,77	14,75	-128,88	-89,02
Würth	447,19	409,81	559,32	489,91	148,17	-
Robert Bosch GmbH	3358,95	2975,07	3907,35	510,01	-1664,39	-
BMW	307,1	393,48	429,12	526,46	276,94	-
Berenberg Bank	68,55	74,03	83,63	64,44	89,12	-
JAPAN						
Kikkoman	114,39	112,08	129,49	138,02	33,11	103,72
Sony	1980	1490	1520	4450	-1190	-490

* "-" stands for not available figures

After analyzing the data contained in Table 2 and Table 3, it can be concluded that financial crisis excepted a set of companies from the list of profitable ones. The research was conducted on the basis of companies representing three main Corporate Governance models – Japanese, Anglo-Saxon and Continental. Some of the representatives still are found in losses. However, the majority of companies under consideration managed to handle the situation. This difference between the financial situations in the companies could be attributed to the management and managerial decisions in general. In some companies managers succeeded in overcoming the crisis echoes, in others - failed.

Introduction of Outside Manager into the FOB

As it has been stated above, family owned business is a special type of business whereas family can appoint, monitor, compensate and fire managers. These possibilities offer the controlling family the best advantages – it runs its business following the plan it had worked out itself. However, such approach may not always lead to estimated positive outcomes.

In general, the main patterns of the family-run business model could be shown through the scheme created by Tagiuri and Davis in 1982.

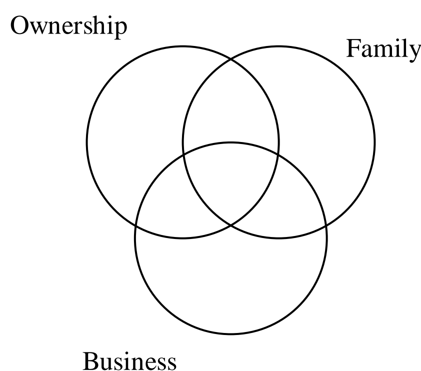

Figure 2. Components of the family-run business model (Tagiuri and Davis, 1982)

In contrast to non-family businesses that are mainly influenced by a single owner or a partnership of few partners, in family businesses the family is at the centre of the company's administrative processes, formally or informally influencing the business.

The FOB appears when the owners and managers of certain business are represented by one family. There are a set of different types of FOBs – the ones with entirely family head of the company, the ones with independent representatives in the board, the ones with separated ownership and control functions according to the Agency theory.

The research based on more than 80 US family companies showed that an active independent (not controlled by the family) board of directors is the most important aspect in ensuring the viability and success of these companies.

Provided that when the question of membership in the council occurs in practice, most family companies pass this right to family members and only in some cases to individual managers who are not members of the family. This practice is commonly used to maintain control over the business. Unfortunately, the lack of outside independent directors prevents the board of directors of family companies from obtaining the missing knowledge and experience.

Our research is specially based on working out the recommendations for the first type of FOBs. In that case, it means that the FOB under discussion is a sector made by intersection of business interests, family sphere and ownership relations.

However the business environment changed under the crisis conditions. To fight through them entirely family-run business requires "fresh" managerial decisions which are hard to generate by the same team. Here, the agency theory comes to the first place – the decision whether to separate ownership and control needs a quick answer as it is essential for further life of the company.

So, we offer to include an outside manager as an essential part of model in particular difficult times for the organization. The corresponding proposed model is represented by Figure 3:

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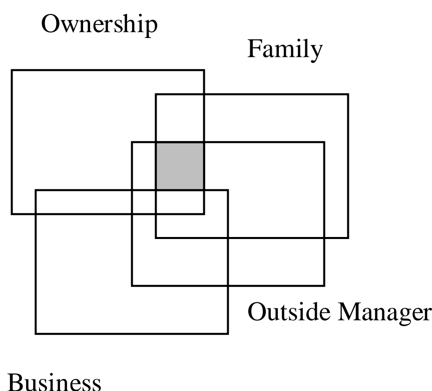

Figure 3. Anti-crisis model for entirely family-owned business

According to that scheme the blue square is showing the perfect outcome for the family organizations that are consequently potentially more successful in overcoming crisis effects.

The Outside Manager is an anti-crisis administrator, whose main responsibilities are concentrated on working out special plan for the company to struggle for surviving in after-crisis period. The Outside Manager has to be proficient enough to design an appropriate action plan for the entire organization. Thereby the requirements for selection the OM are essential. As the concept of the 'Outside Manager' is quite close to the 'Temporary Administrator for banks' one, the requirements could be taken from the legislative base of every specific country. However, the difference between these two terms is in type of his assignment: in case of OM it is the track of solving-problem technique rather than the measure of compulsion (case of Temporary Administrator).

The Outside Manager could be chosen according to the professional sphere he represents:

- delegate of a Governmental body;
- independent expert;
- legal person.

The requirements for the OM could be based on recommendations given by the IFC for the independent director, as both bodies should be independent from the family that owns and runs the company.

So, here "Outside Manager" means a manager who is a person who:

- has not been employed by the Company or its Related Parties in the past five years;
- is not, and is not affiliated with a company that is an advisor or consultant to the Company or its Related Parties;
- is not affiliated with a significant customer or supplier of the Company or its Related Parties;
- has no personal service contracts with the Company, its Related Parties, or its senior management;
- is not affiliated with a non-profit organization that receives significant funding from the Company or its Related Parties;
- is not employed as an executive of another company where any of the Company's executives serve on that company's board of directors;
- is not a member of the immediate family of an individual who is, or has been during the past five years, employed by the Company or its Related Parties as an executive officer;
- is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the Company or of a Related Party; or
- is not a controlling person of the Company (or member of a group of individuals and/or entities that collectively exercise effective control over the Company) or such person's brother, sister, parent, grandparent, child, cousin, aunt, uncle, nephew or niece or a spouse, widow, in-law, heir, legatee and successor of any of the foregoing (or any trust or similar arrangement of which any such persons or a combination thereof are the sole beneficiaries) or the executor, administrator or personal representative of any Person described in this sub-paragraph who is deceased or legally incompetent,
- and for the purposes of this definition, a person shall be deemed to be "affiliated" with a party if such person (i) has a direct or indirect ownership interest in; or (ii) is employed by such party; "Related Party" shall mean, with respect to the Company, any person or entity that controls, is controlled by or is under common control with the Company.

As it is FOBs' initiative to invite an outside anti-crisis manager the pieces of advice were worked out:

1. Establish a clear family employment policy and make its content available to all family members.
2. Make sure family is hands-off, contributing mostly shareholder capital and oversight.
3. Identify the role of each family member clearly not to let them have temptation to exceed their decision-making power.
4. Provide long-term planning as recruitment is one of the major factors in a family's long-tem success.
5. Make an outside manager feel him/herself a part of the company so that to unite competence and cultural fit, give a manager some leeway but at the same time inspire him/her with respect to company's traditions and spirit.

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With the introduction of the OM in a family-run organization a set of problems that existed before is solved. As the FOB could be represented in three main models – Anglo-Saxon, Continental and Japanese – there are differences in the procedure of implementing the OM in the management structure of the company and his practical activities in the company structure as well. Since the decision-making process has its peculiarities in each model, we should have a deeper look at each of the models. Basically, the decision-making process is stated in Table 4:

Table 4. Decision-making processes in different corporate models

#	Stage	Models		
		Anglo-Saxon model	Continental model	Japanese model
1	Decision initiating	Operating Committees	Management Board	Board of directors
2	Decision approval	Board of directors	Supervisory Board (Board of employees + Board of directors)	Board of directors
3	Decision executing	Executive directors	Management Board	Executive Committee
4	Decision control	Control Committees	Supervisory Board (Board of employees + Board of directors)	Board of executive auditors

The OM works out the whole strategy for the company on how to overcome the crisis consequences. As a result, he/she needs rather large room for maneuver starting from initiating the decisions. It implies partial seizing of responsibilities on the 1st stage.

As the second and forth stages are the most essential in terms of making decisions that would lead a company out of the crisis situation, the responsible bodies should be maximally independent from the family members. That drastic measure is obliged to serve as a recovering move for the family-owned firm.

Table 5. Decision-making processes in FOBs with implementing of outside manager through different corporate models

#	Stage	Models		
		Anglo-Saxon model	Continental model	Japanese model
Stage 1	Decision initiating	Operating Committees + OM	Management Board+ OM	Board of directors+ OM
Stage 2	Decision approval	IDs	Board of employees + IDs	IDs
Stage 3	Decision executing	Executive directors	Management Board	Executive Committee
Stage 4	Decision control	Control Committees +OM	Board of employees + OM + IDs	Board of executive auditors + OM

Source: Authors' research

As could be seen from the table, the changes in Anglo-Saxon model bring us to:

1) enlarging the number of bodies that are responsible for decision initiating with the OM as the one, who brings a new strategy to the company;

2) introducing the independent directors on the stage of decision approval;

3) adding the OM as a controlling body on the last stage.

Further, the continental model also faces internal changes:

1) the OM is responsible for decision initiating together with the Management board;

2) decision is approved by Board of employees and the Independent Directors;

3) control of decision-making process is executed by Board of employees together with the OM and the independent directors.

Finally, the Japanese model is also influenced by the anti-crisis changes and the composition of the management team was revised:

1) the OM is in the structure of decision initiating body;

2) stage 2 is given to Independent Directors to be responsible for;

3) decisions are under control of the Board of executive auditors and the OM.

According to the following changes in the management structure the solution of managerial strategy for overcoming the crisis is worked out by the independent body and executed under its control.

Opportunities and threats issued from the OM

According to the definition of the OM he is entirely independent and new person in the company scheme. So, he could equally serve as a factor for solving the inside problems of FOB.

With reference to Lee Iwan, the President and owner of The Iwan Consulting Group, the FOB has to cope with specific challenges not inherent to non-family businesses or affecting these to a lower extent.

Implementing of the OM as a part of company's management could create some threats prolonging the challenges as well.

Table 6. FOBs' challenges transformation under the influence of OM introduction

#	Challenge	Content	OM introduction	
			Opportunity	Threat
1	Emotions	Family problems will affect the business. Divorce, separations, health or financial problems also create difficult political situations for the family members.	Only business relations within the family members	Changes in traditional strategy
2	Informality	Absence of clear policies and business norms for family members	Only business relations	Psychologically difficult for family members to accept
3	Tunnel vision	Lack of outside opinions and diversity on how to operate the business	"Fresh" ideas from outside	Success depends on quality of decisions
4	Compensation problems for family members	Dividends, salaries, benefits and compensation for non-participating family members are not clearly defined and justified.	Compensation is stated in the contract	Could be an "expensive treat"
5	Role confusion	Roles and responsibilities must be clearly defined	The role is stated in contract	Implies changes in the management structure
6	Lack of talent	Hiring family members who are not qualified or lack the skills and abilities for the organization. Inability to fire them when it is clear they are not working out	Criteria for choosing the OM is his talent in relating sphere	"Wrong choice"
7	Succession Planning	Most family organizations do not have a plan for handing the power to the next generation, leading to great political conflicts and divisions	OM is in head of working out the anti-crisis operation plan	Might be contra traditional lifestyle of the organization
8	Paternalistic	Control is centralized and influenced by traditions instead of good management practices	OM brings good management practices	Implies operational process changes
9	Overly Conservative	Older family members try to preserve the status quo and resist change. Especially resistance to ideas and change proposed by the younger generation	Changes are guarantee of success	Change of traditional strategy might be hard to accept
10	Exit strategy (essential for crisis period)	No clear plan on how to sell, close or walk away from the business	The strategy covers different outcomes	Priorities of owners on the 2nd rate

The family members in Board should bear in mind the possibility of threats origin caused by the OM introduction. That will prepare them to such kind of difficulties and help to overcome them.

Conclusion

Family-owned businesses are an essential part of worlds' business sphere. Employing half the world's workforce, they generate well over half the world's GDP. That means the success in FOBs' activity is very important for the world financial situation.

Family companies in the post-crisis period slowed down their pace of growth as well as the other business representatives, many FOBs were made to reduce production or even leave the market. However, according to the experts' researches, family firms were more successful in overcoming the consequences of the crisis than non-family ones. From our point of view, family-run companies, which have no separation of management and control in their structure, should acquire external support for entering the break-even line of their profits. Such a person in the company could neutralize challenges that appear in family and affect business; moreover he/she offers an effective action plan for the further period. For being more confident in his plans' success it is necessary to temporarily introduce the OM into the management

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structure. The representative must meet the independence criteria to be outside from the influence of family decisions. Nevertheless, his introduction to the structure may entail some threats that are important to foresee.

The greatest advantage of such track of problems' solution is that the OM can be represented in the company not only to fight the consequences of the global crisis, but also to serve as a strategy designer for further development of the company in subsequent generations. It is due to the fact that the managerial abilities of future generations may not be sufficient enough for the prosperity of the family business, and then the outside manager has to be introduced into the management structure as a permanent body.

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