

## FAMILY BUSINESS GOVERNANCE: PERSPECTIVES, RESEARCH AND RECOMMENDATIONS

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### Abstract

Recent research raises serious questions as to the applicability of current corporate governance recommendations for family businesses. While perhaps valuable for listed companies, they may be harmful to family businesses because they arise from a *market model* rather than a *control model* of corporate governance. This chapter provides guidelines that will lead to greater board accountability and, in turn, positive identifiable results in board and company performance. These guidelines also incorporate propositions for further consideration by family business researchers.

**Keywords:** corporate governance, family business

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### Introduction

Fraud, mismanagement, strategic renewal, and many other issues have made corporate governance an important and timely issue. Many corporate leaders, acting of their own volition, have already reconfigured the moral compasses by which future executive conduct is to be reckoned (Donaldson, 2003). The U.S. Congress stepped in with Sarbanes-Oxley, a sweeping federal statute providing business leaders with a road map by which they are able to align corporate goals with more effective governance systems. Yet what is the significance of these governance reforms for the closely-held, family-owned business? Should these family-owned entities be held to the same governance guidelines and standards that apply to the public firms making up the ranks of the Fortune 500, for example? To put it another way, does one size fit all (Corbetta & Salvato, 2004)?

This is not a trivial question. Data, disclosed by Astrachan and Shanker (2003), conclude that family businesses in the US represent the lion's share of all annual US tax return filings: a stunning 89 per cent of the total. These entities generate no less than 64 percent of the Gross Domestic Product. By another compelling measure, the family-owned business employs 62 percent of the nation's workforce. Similar statistics are seen throughout the rest of the world as well (<http://www.ifera.org/research.html>). Because of the contribution family-owned companies provide to the world economy, it is imperative that they undertake a concerted effort to maintain and enhance

governance standards of their own to assure their continued success.

We sound here a dramatic note of caution lest the cure be worse than the disease. While perhaps valuable for large public companies, many of these recommendations may be harmful to family-owned businesses (Corbetta & Salvato, 2004). Many "best practices" may well be at odds with the fundamental nature of most family companies and could harm family unity leading to ownership and consequently managerial chaos. Popular corporate governance practices come from a *market model* of corporate governance, which is relevant for companies with a widely dispersed shareholder base. On the other hand, typical family businesses exhibit characteristics of a *control model* of corporate governance, which involves companies with concentrated shareholders.

Many of the current "best practices" may also be problematic in that they are often generalized lists, rather than measurable actions that lead to quantifiable results (Atkinson & Salterio, 2002; Robinson, 2002). Additionally, most of these recommendations ignore what we believe to be the central issue in corporate governance: accountability. By accountability, we mean the need for decision-makers to justify and accept responsibility for decisions taken and their implementation. For family firms, accountability also entails avoiding conflicts between family members' roles in the family and roles in business, while preserving an atmosphere of trust and unity. Corporate governance guidelines for family firms, therefore, must focus on the need for the primary governing body—the board—to have the

competencies to hold others accountable, and be held accountable, for their actions.

This paper describes guidelines and their rationale that we argue will lead to greater accountability and positive identifiable results in company performance. We also provide ideas for future research in family business governance as we develop testable propositions. In the next section, we point to a significant source of bias in popular proscriptions for 'best practices' for board behavior. Following that discussion, we describe: (1.) The board competencies necessary to ensure shareholder accountability; (2.) Ways in which shareholders should exert their rights in order to hold the board

accountable; and (3.) Actions the board must take to hold management accountable for their actions, all of which incorporate propositions for further consideration.

**1. The 'market model bias' in corporate governance reform**

Corporate governance is embedded in the cultural, legal, and financial frameworks of various countries (Mayer, 1997). These frameworks have given rise to two models of corporate governance: market and the control.

**TABLE A. CHARACTERISTICS OF THE MARKET AND CONTROL MODELS**

MARKET	CONTROL
<p style="text-align: center;">Setting</p> <ul style="list-style-type: none"> <li>• Prevalent in UK, US</li> <li>• More reliance on public markets</li> <li>• High ownership liquidity</li> <li>• Shareholders are anonymous investors, not managers</li> <li>• Widely-dispersed shareholders</li> <li>• Shareholders only have financial connections to the company</li> </ul>	<p style="text-align: center;">Setting</p> <ul style="list-style-type: none"> <li>• Prevalent in Continental Europe, Asia, Latin America</li> <li>• More reliance on private capital</li> <li>• Illiquid ownership</li> <li>• Concentrated shareholder base often overshadows minority shareholders</li> <li>• Shareholders view company as more than an asset and as interested in financial and non-financial returns</li> </ul>
<p style="text-align: center;">Elements of governance</p> <ul style="list-style-type: none"> <li>• High level of disclosure</li> <li>• Focus on short-term strategy</li> <li>• Independent board members</li> <li>• Shareholders view company as one of many assets held</li> <li>• Ownership and management are separate and at arm's length</li> </ul>	<p style="text-align: center;">Elements of governance</p> <ul style="list-style-type: none"> <li>• Secretive</li> <li>• Focus on long-term strategy</li> <li>• Shareholders with control rights in excess of cash flow rights</li> <li>• Shareholders have connections to the company other than financial (i.e. managers, board members, family)</li> <li>• Insider board members</li> <li>• Ownership and management overlap significantly</li> </ul>

**Market model.** The market model of corporate governance is common in countries where capital markets are highly liquid and shareholders are widely dispersed, such as in the US, UK, and Ireland. This model involves a large dispersed class of investors with no prior connections to the companies listed on the public exchanges (Coombes & Watson, 2001). The focus of corporate governance reform in countries employing this model is on board structures and practices that ensure that the board is a distinct entity, capable of objectivity and able to act separately from management (Gregory & Simmelkjaer, 2002). It also insists on independent boards with no conflicts of interest and demands a high level of financial and business disclosure. Examples of companies that follow the market model include most public

companies in the United States, such as General Electric.

**Control model.** The control model of corporate governance, commonly found in Asia, Latin America, and much of Continental Europe, is prevalent where control rights are not fully separated from ownership, and ownership tends to be concentrated. The model sees conflicts of interest as endemic and seeks to institutionalize them or provide sanctions for them rather than eliminate them. An example of this is when a large shareholder, such as a family or institution, maintains a control stake. The purpose of investment for these types of shareholders is not to produce short-term gains (Shleifer & Vishny, 1997); rather, these shareholders tend to maintain a long-term perspective on their investments which may extend to future generations in time horizon. An

example of a control model company is IKEA which is controlled by the founding family through a foundation and holding company, or Fiat SA, (LaPorta, Lopex-de-Silanes, & Shleifer, 1999), where ultimate control (over 25 per cent) belongs to the Agnelli family, and members of that family are also board members and part of management teams. For control model companies, owners often expect to have a board presence, particularly because they are not anonymous (Coombes & Watson, 2001). Typically, shareholders of control model companies are managers, as well.

**The market model bias.** Perhaps because of media attention on dramatic cases of corporate abuse in the US and UK, corporate governance recommendations have a 'market model bias' towards best practices that lead to increased transparency and financial disclosure through outside, independent boards that attempt objectivity. Market model best practices maybe flawed in substance due to its excessive reliance on agency theory, a theory rooted in economics, finance, and western attitudes towards property. Agency theory is specifically concerned with problems that occur when ownership is separated from control (Berle and Means, 1932). Agency theory asserts top managers are interested in their own personal welfare at the expense of shareholders (Jensen & Meckling, 1976). Because of its focus on management opportunism, agency theory takes a 'monitoring approach,' in which the board's role of monitoring management and the value of extrinsic motivation (e.g. compensation) become of utmost importance (Hillman & Dalziel, 2003).

Due to the imbalance in the way risks, penalties, and rewards are shared (Daily, Dalton, & Canella, 2003; Plender, 2003), market model practices are potentially lacking the following key components:

First, market model practices do not address the board's ability to monitor management, which invokes the 'collaborative approach' of stewardship theory. Stewardship theory focuses on the need to enhance collaboration and decision-making between the board and management by empowering managers (Davis, Schoorman, & Donaldson, 1997). Contrary to agency theory's implications, stewardship theory stresses the board's advisory capacity and operates with the assumption that managers are able to personally identify with the firm, internalize its mission, and obtain satisfaction from intrinsic motivation (Sundaramurthy & Lewis, 2003). Concepts of agency and stewardship theory can be combined to encourage trust in capabilities, distrust of human limitations, and conflict aimed at tasks and not individuals in order to manage appropriate amounts of monitoring and collaboration (Sundaramurthy & Lewis, 2003). It is the balance between monitoring and collaboration among governance actors, particularly board members, that allows for an effective governance system (Daily & Dalton, 1993; Demb & Neubauer, 1992).

Second, market model practices overlook the diverse identities of various types of stakeholders and investors, such as families, who may have different interests, time horizons, and strategies from typical public firm investors (Aguilera & Jackson, 2003; Pieper, 2003). Market model proponents see family businesses as not maximizing

financial value of the business because families often have strong influence over management and the board (Bartholomeusz & Tanewski, 2006). Contrary to this view, family businesses, regardless of the legal, financial, and cultural frameworks in which they reside, have been able to successfully operate within the control model of corporate governance. For example, in Europe (Barontini & Caprio, 2006; Jaskiewicz, 2005; Mishra et al, 2001), and even in the United States and the United Kingdom (Westhead & Howorth, 2006; Villalonga & Amit, 2006; Anderson & Reeb, 2003) where the market model is most prevalent, family businesses have been successful with owners who act as managers and board members. The success of family businesses and control model companies in general may be because their investors value non-financial returns and long-term business health preserving the business for future generations. It is the long-term investment philosophy of family business shareholders that creates one of their greatest competitive advantages (Le Breton- Miller & Miller, 2006; Carney, 2005).

For a typical family-owned business (see Figure A), the control model of governance may be preferable, but in order to be successful, we argue the focus of governance must be accountability. The essence of effective governance is to hold leaders accountable for delivering on commitments, while still preserving owner trust and unity. Part II of this article discusses board competencies that ensure accountability.

**FIGURE A. PRIMARY ATTRIBUTES OF THE TYPICAL FAMILY-OWNED FIRM**

- The family can control effective strategic direction of the business.
- The business contributes significantly to the family's income, wealth, or identity.

## 2. Establishing accountability in family business governance

Accountability of the board for the activities of the corporation is a central theme of corporate governance codes. How accountability is expressed and to whom it is directed varies somewhat, depending on how the primary objective of the corporation is viewed (Gregory & Simmelkjaer, 2002). Corporate governance principles typically specify that the board should either promote the interests of the company, the interests of the shareholders, or both (Gregory & Simmelkjaer, 2002). While in most control model countries the emphasis is on promoting company interests, the focus of market model Anglo-American corporations is on promoting the shareholders' immediate interest (Mobius, 2001).

Family firms generally have the benefits of a strong identity and sense of unity that enables a long-term view of the business (Taguri & Davis, 1996; Kets de Vries, 1993). A potential hazard of this is that sometimes unification of the family through means such as nepotism, resistance to change, and curtailing growth can damage the economic interests of shareholders and cause company failure (Kets de Vries, 1993). Accountability for the family firm

means making decisions that do not sacrifice long-term health for short-term personal or corporate gain.

The following guidelines delineate ways in which a typical family-owned business operating under the control model can promote accountability. In addition to being practical, the following guidelines also incorporate propositions for further researcher.

### **Family business boards must have the competencies to be held accountable.**

#### **Director criteria**

The corporate governance literature for large public firms and family businesses alike focuses on board member's strategic business competencies and diversity of skills. An ideal board profile is seen as including active or retired CEOs and other professionals with expertise in such areas as finance, marketing, operations, technology, law, and public policy (Moore, 2002). In addition, quality, experience, and independence of board members are seen as greatly enhancing the board's ability to perform (Gregory & Simmelkjaer, 2002). Although these qualifications may be important and sometimes desirable, they are not sufficient for family firms. Sonnenfeld (2002) argues that a culture of open dissent is needed to assure accountability as the board needs to be able to deal with problems and potential failures. In an environment in which family roles can emotionally clash with business roles, open dissent can be at risk. Board members in family businesses, therefore, must be able to not allow such dynamics to impede open communication. In this setting, a *competency-based board* means that as long as board members conduct a forum of open communication, embody a culture of open dissent, have a basic understanding of business (i.e. have an understanding of risks and of the measures that lead to financial and non-financial indicators of success), and collaborate with the management team, board members can be held accountable for their actions and those of management.

In summary, while the market model has a bias toward directors with strategic business competencies and diversity of skills and background, these characteristics are important, but not sufficient. The most critical qualifications are having the ability to hold the company accountable and the discipline to not interfere in company operations.

*Proposition 1: An increase in board accountability will increase board performance.*

#### **Board size**

Corporate governance literature is split regarding the appropriate size of a board. Many assert that since individual responsibility tends to dissolve in larger groups, smaller boards are more desirable for family businesses (Ward, 1991; Neubauer & Lank, 1998). Large boards are also seen as encouraging coordination and communication problems (Felton,

Hudnut, & Witt, 1995). Between five and nine directors is commonly suggested (Nash, 1995; Newell & Wilson, 2002). Others believe a range of nine to 15 directors is beneficial (Moore, 2002). For example, in many of the European Union member states, the average size of the board is closer to 12 or 13 (Gregory & Simmelkjaer, 2002). Smaller boards may not have enough breadth and can hamper the separation of director and committee assignments (Moore, 2002). Larger boards can lead to greater accountability as long as each individual board member has the necessary competencies to render good judgment and can allow their judgments to be evaluated by peers. More board members can also mean more eyes capable of noticing problems and ensuring accountability. Recent research in the United States suggests that larger boards and audit committees provide greater monitoring of the financial accounting process leading to, among other things, a lower cost of debt (Anderson, Mansi, & Reeb, 2003). Family businesses with larger teams of directors and managers were significantly associated with higher levels of absolute growth in sales (Westhead & Howorth, 2006). In light of these data, we argue the most effective board for family firms has seven to twelve people. However, since larger boards (more than 12 members) may inhibit open participation (Yermack 1996), boards should not be too large as to create factions that limit participation and communication.

In summary, while many have argued that smaller boards are preferable, mid-sized boards promote greater accountability and have been shown to be associated with greater performance.

*Proposition 2: Boards that consist of seven to 12 members increase board accountability.*

#### **Independent outsiders**

The ability to accurately judge management's performance is critical to the board's ability to monitor management (Gregory & Simmelkjaer, 2002). Market model proponents proffer that objective judgment is preferred and that independent outsiders are better suited to this task (Gregory & Simmelkjaer, 2002). Most market model corporate governance advocates believe that boards should be comprised of a substantial majority of 'independent' directors, that is, directors who are free from commercial or personal ties that could impair their ability to probe and challenge management (Felton & Watson, 2002). While some contend that boards should be comprised of at least half outsiders (Newell & Wilson, 2002), others state an ideal board should consist of only independent outside directors in addition to the CEO and chairman (Ward, 1991).

Family businesses, however, have been criticized for being slow to adopt the concept of outsiders (Bartholomeusz & Tanewski, 2006). The American Family Business Survey (2002) indicates that family members still constitute the majority of board members. We suspect much of the reluctance to adopt

a board is due to a desire to avoid accountability. But despite the fact that businesses often need fresh creative perspective, objectivity, resources, expertise, and openness—all traits generally considered to be advantages brought about by independent outsiders (Aronoff & Ward, 2002; Daily & Dalton, 1993)—we believe that making this a board role may limit accountability as board members may have difficulty in taking appropriate action when strategies they have had a role in developing fail.

Since outsiders can often be easily swayed by compensation, perks, recognition, and potential as well as actual business dealings (with the company as well as with other board members), we suspect that a board occupied by outsiders does not guarantee objectivity. Even though boards consisting primarily of insiders (current or former managers/employees of the firm) or dependent outsiders (directors who have business relationships with the firm and/or family or social ties with the CEO) may be considered to be less effective at monitoring others (Lynall, Golden, & Hillman, 2003), insiders, in particular, are seen to provide rich firm-specific knowledge and strong commitment to the firm (Sundaramurthy & Lewis, 2003; Bhaget & Black, 2002). We believe a board member that has the ability to render an opinion unfettered by other board members is more important than whether or not the individual works inside the business. As such, it may be that personality traits take precedence over outside status when it comes to being able to hold others accountable.

While several studies suggests independent outsiders add value (Felton, Hudnut, & Witt, 1995; Rosenstein & Wyatt, 1990), particularly in terms of adopting policies and increasing the likelihood of an “efficient outcome” (Gillette, Noe, & Rebello, 2005), and improving market performance when coupled with long-tenured CEOs (Coles, McWilliams, & Sen, 2001), no significant relation has been found between board independence and firm performance (Anderson & Reeb, 2004; Bhaget & Black, 2002; Dalton, Daily, Ellstrand, & Johnson, 1998). Only in the presence of founding families did Anderson & Reeb (2004) find a positive relation between board independence and firm performance, yet they also found that a moderate family presence also produced substantial benefits. Jaskiewicz (2005) found that over-proportional family board presence does not show a significant negative performance effect in French and German family businesses, while other studies have indicated that family members or insiders are positively associated with performance when a family member with ownership is the non-executive board chairman (Kang, 2000), or when there is CEO incentive alignment (Coles, McWilliams, & Sen, 2001). Also Barontini & Caprio (2006) found that only when the family is *not* represented on the board of European family businesses do family controlled firms appear to perform worse than non-family controlled firms.

It appears that “independence” is a mindset of disinterest that cannot be predicted by the lack of prior relationships of the parties involved. Therefore, in order to promote objectivity and accountability, board members should consist of individuals who base their decision-making on the merits of the decision rather than extraneous influences or considerations, such as personal relationships or financial and personal gain.

In summary, the market model holds that boards should minimize the use of insiders and include a significant proportion of independent outsiders. In control model family firms independent status is largely irrelevant to achieving accountability. A board of owners may be beneficial when they have an “independent” attitude and personality that allows them to express their individual views.

*Proposition 3: A board of qualified ‘insiders’ can improve company performance.*

### **Frequency of board meetings**

Many governance professionals claim that six meetings per year in alternate months is a good balance for most companies, supplemented by occasional special meetings (Moore, 2002). The European average is about eight meetings per year (Gregory & Simmelkjaer, 2002). It has been proposed in the family business literature that boards meet formally at least four times per year, supplemented by additional monthly executive committee meetings attended by lead directors, the Chairman, and the CEO along with senior management (Ward, 1991).

Board meetings exist to provide a forum to conduct regular and purposeful communication, ensure accountability, and resolve conflict. In order for this to occur, the board of a typical family business would need to meet anywhere between three to six times per year in order to keep the lines of communication open between the board and management, and between the board and the shareholders. A greater frequency risks the board becoming involved in daily managerial decisions and any less makes it difficult to hold management accountable.

In summary, for family firms the focus of board meetings is communication, conflict resolution, and accountability. To achieve this, we recommend no more than six, nor less than three meetings per year.

*Proposition 4: Three to six board meetings per year will maximize board accountability and board performance.*

### **Content and process of board meetings**

Most governance recommendations properly suggest the content of board meetings should include all key matters brought forth by the CEO and other senior executives to the board, such as the results of operations, the status and outlook of financial and strategic plans, proposed or rejected business deals, the current financial forecast and early signals on

changing trends, the economic and competitive environment and any proposals for board approval (Moore, 2002). However, as to the process by which boards make decisions, many recommendations falter when they suggest that board members can make decisions by consensus rather than employing a formal vote. Decision-making by consensus allows the most powerful board member or coalition on the board to sway other members into complacency by stature rather than the merits of a decision. In such situations, consensus tends to yield a decision which most can live with rather than which the majority supports.

*Proposition 5: A simple majority voting process will increase board accountability.*

### **Board term and turnover**

Shen and Cannella (2002) show that a board member's effectiveness (and therefore accountability) decreases after 14 years, thereby indicating that in order to keep a director for a long period of time, he or she must be making significant contributions to the business. Anderson, Mansi, & Reeb (2003) found that board tenure is positively related to corporate yield spreads, thereby suggesting that as director tenure increases, managers are potentially more able to influence board opinion. Even in light of this evidence favoring long director tenure, terms for directors are popularly recommended, and should be for two to three years with a mandatory retirement age set between 62 and 65 years old (Ward, 1991).

However, we believe to maximize accountability, board members should be reviewed annually and if their performance is found lacking, they should be thanked for their service and replaced. While board entrenchment should be protected against, regular reviews, rather than term limits, will keep good members serving the family and company.

*Proposition 6: Regular annual reviews of the board increases board effectiveness and accountability.*

### **Board evaluation**

Board evaluations can be powerful tools to develop and support high-performing board members. Boards should regularly and formally evaluate its own performance against goals and performance standards. Evaluations should include annual assessments of the functioning of board processes and board committees. The board should conduct reviews of its own processes annually and make changes where necessary. Evaluating aggregate board performance it is not sufficient. In order to promote the accountability of the board, board members must also be evaluated individually. In order for directors to be held accountable for creating and maintaining a high performance board, they must be able to distinguish good contributions from poor (Felton, Hudnut, & Witt, 1995), and above all, ensure that all directors act to hold themselves and the company accountable.

*Proposition 7: Board evaluations will increase board accountability.*

### **Leadership: Role of Chairman and CEO**

The Chairman should play a central role in ensuring the effective governance of the enterprise (OECD, 1999). The chairman acts as parliamentarian and is responsible for agenda setting and controlling discussion on agenda items (Nash, 1995). Currently, 75 per cent of S&P 500 companies have a single person serving as both chairman and CEO (McKinsey US Directors Survey 2002), while Bartholomeusz & Tanewski (2006) indicate that in the United States, family firms are considerably more likely than non-family firms to allow the CEO and chairman to be occupied by the same person. Some claim that a company risks added divisiveness by splitting the role of the chairman and CEO and that it reduces the CEO's freedom of action (Felton & Watson, 2002). On the other hand, others believe that the separation of the CEO and Chairman roles ensures an appropriate balance of power and that if the Chair is also the CEO, he or she faces a significant conflict of interest (Gregory & Simmelkjaer, 2002).

We believe that the roles of Chairman and CEO should only be combined when one person can do the two jobs effectively. Since the role of the Chairman is to guide board processes, moderate meetings, ensure that the board completes all tasks in a timely and effective manner, and counsel the CEO—not direct the CEO, an increase in the role of the CEO with the additional responsibilities of the Chairman functions presents a limited number of conflict of interest issues. As long as the CEO is the best person to handle this additional moderator job effectively and be held accountable, the CEO may be able to carry on both roles. We caution, however, that the safest route is to split the roles so that the CEO has complete freedom to focus on CEO tasks.

*Proposition 8: Combining CEO and Chairman roles will generally limit board performance unless one person is the best option for handling these two jobs.*

### **Shareholder role in board composition**

Shareholder rights to elect directors are their strongest mechanism to influence the corporation, which leads to greater accountability (OECD, 1999). One significant way of influencing board composition, while not alienating minority shareholders in the process, is through cumulative voting. Cumulative voting is a procedure used in the election of directors whereby the minority shareholders have a greater opportunity to secure representation of their interests on the board because they can accumulate their vote for a single candidate. In the absence of cumulative voting, a shareholder, or group of shareholders, with greater than 50 per cent of the voting shares can elect the entire board of directors. However, under cumulative voting, the shareholder multiplies the

number of shares he or she holds by the number of directors to be elected in order to obtain the aggregate number of votes he or she is able to use. While we believe cumulative voting is an important mechanism to ensure accountability, it should be a last resort mechanism that is only invoked after a family breakdown or extremely poor corporate performance. We believe an effective nominating committee that works in concert with the board review process is the best and least disruptive way to insure the protection and promotion of interests.

*Proposition 9: Cumulative voting will increase accountability and thus, board performance.*

### **Involvement in strategic decision-making**

Shareholders operating under the market model tend to leave strategic decision-making entirely up to the board and management. Conversely, shareholders of family firms operating under the control model tend to direct management, make decisions on their own, or lobby individual board members. Some argue that over-involvement of shareholders weakens the power of both the board and management, and may result in factionalizing shareholders. We believe appropriate involvement by shareholders would entail establishing the values, vision, and goals of the business as well as being a 'partner' in strategy. More specifically, to ensure the greatest accountability, we believe that the CEO and management team should be responsible for developing the strategy which the board has the right to approve or reject. Once approved, the board must hold management accountable for implementing strategy and must have the strategy changed if it fails. The board must ensure the strategy meets the family's vision and values. To ensure this, it is advisable for the board and management to solicit the ideas and opinions of family owners, making them the partners in the strategy. This form of involvement in strategic decision-making allows shareholders, the board, and management to become united in their decision-making in order to add richness and strength to their business culture.

*Proposition 10: Family shareholder 'involvement' in strategic planning will increase board performance.*

### **Executive compensation**

In several countries, there is an increasing call for disclosure of executive remuneration among market model boards, such as those in the UK (Gregory & Simmelkjaer, 2002). Even though privately-held family businesses are not obligated to announce executive remuneration in most of the world, family businesses must also nurture an atmosphere of trust and transparency among family members and owners. Many family business owners are too comfortable keeping pay undisclosed. However, nondisclosure does not prevent family members from forming strong emotions, suspicions, and beliefs about one another's compensation (Aronoff & Ward, 1993). Therefore, we believe that information concerning compensation should be easily available to family member

shareholders and reviewed annually by the board in order to preserve an atmosphere of accountability.

Additionally there have been debates over how best to compensate executives. Many institutions operating under the market model primarily define performance simply as stock performance. This emphasis on stock performance, however, tends to stimulate extreme emotions –greed when things are going well, demoralization when the market falls (Elson et al., 2003). Further, business performance is only one ingredient in stock performance, which also includes economic, industry, acquisition prospects, and other factors. Compensating on market performance may also encourage fraud as managers who manipulate figures to increase share value stand to gain financially. Therefore, for market model companies it is now being recommended that businesses rebalance elements of executive compensation and tie compensation more closely to the organization's mission, annual business performance, and long-term financial results, which, in turn, will create real shareholder value over time (Elson et al., 2003). It has also been suggested that business owners utilize some type of fixed salary component in order to mitigate the impact of risk on the executive, while also inducing him or her to undertake riskier projects for the company (Coles, McWilliams, & Sen, 2001).

Shareholders of family businesses have a vested interest in long-term performance, and this is quite consistent with tying compensation to mission and long-term financial results. We also recommend that compensation be tied to the performance of non-financial measures, which are based in what the owning family values. These can include opportunities for the family, company reputation, employee satisfaction, information availability, family educational opportunities, and community and philanthropic activities. A written compensation policy, according to the family's philosophy of compensation, assures that the family's value system and vision are parallel to the way that they are operating -the business.

In summary, while the market model proposes that executive compensation should be transparent and tied to stock performance, in family firms, compensation should be transparent among family members and tied to the organization's mission, annual business performance (financial and non-financial), and long-term financial results.

*Proposition 11: Correlating management compensation to business short and long-term financial and non-financial performance will increase management accountability.*

### **Evaluation of corporate officers**

Another way for boards to promote accountability of management is to ensure that evaluations of top managers are in line with performance standards. Most companies operating under the market model conduct evaluations assuming emotions and prejudice

are cast aside. However, for family businesses emotions are unavoidable. Evaluating performance and making difficult decisions about promotions can be more difficult when managers are also family members. Many families use the same values to operate the business as the family, such as promoting family members based on birth order or gender, rather than on skills (Loeb, 2001). The difficulties associated with evaluating family members often causes performance management systems in family businesses to be overlooked entirely or implemented only for non-family employees (Driscoll & Korman, 2001). As the family and business grow, however, these decisions can have a negative impact on business growth as well as on the emotional health of family members (Loeb, 2001).

As a result of its potential for conflict and role confusion, we believe that performance management for family businesses is a system and not a once a year event (Driscoll & Korman, 2001). As such, an effective performance management system, implemented by the board, should have clear criteria and consequences for performance, position descriptions for family and non-family employees, and documentation of performance successes, issues, and results (Driscoll & Korman, 2001). Performance standards need not neglect the family dimension of the family business, yet they need to be set and monitored. In addition, boards need to ensure that management has a plan for building a reserve of new leaders and that the plan is followed.

*Proposition 12: Annual evaluations of corporate officers will increase accountability.*

## Summary

The thesis of this chapter can be summarized as 'accountability, accountability, accountability'. All of the recommendations herein are directed toward this goal. The board is the governor of the family business and as such sits squarely between the owners and their leadership. While the owners are ultimately responsible for strategic direction and this can clearly be seen in their investment, the board must insure that strategy as detailed by management is in keeping with the family owners' desires and that company leaders execute the strategy in a timely and complete fashion. To achieve accountability as described here, a competency-based board with a focus on balancing the appropriate amounts of monitoring and collaboration is needed for the typical family-owned business operating under the control model (see Quadrant 1 of Exhibit 1 below). The emotionality, overlapping roles, and oft-perceived unbusiness-like behavior have caused market model corporate governance specialists great skepticism about family-owned businesses' ability to be held accountable. However, as long as the family is psychologically mature and at least moderately unified, and the board executes the task of holding family business members accountable to clear standards and well-understood

expectations that are mutually set, accountability is likely, and the risk of underperforming reduced (Gimeno, Labadie, & Saris, 2004).

However, as family businesses move away from the typical control model, which occurs when the number of active family members decrease and ownership becomes more widespread, family businesses begin to move closer towards the market model (see Quadrant 4 of Exhibit 1), and assuring appropriate accountability may need to shift. Family firms operating closer to the market model need control mechanisms, such as independence, discipline and objectivity, to sustain the business. Such controls are needed to insure that independent management acts in the best interests of the owners. Family firms operating under the market model may not have some of the strategic advantages of family companies as they lack the ability to efficiently align the interests of management with ownership in order to create a shared sense of purpose, since the identities of the family and the identities of the business can become distanced.

There are two other ways in which family businesses migrate from the control model of governance. One is when family become less active in the management due to retirement or lack of interest by subsequent generations (moving from Quadrant 1 to 3 in Exhibit 1), but family shareholders maintain their stakes in the business. In this scenario, family shareholders become passive investors who see the business as merely one investment in a portfolio. One danger is when such 'portfolio model' shareholders become disinterested, they feel increased pressure to liquidate their shares and may even be prone to litigate to do so. Again, as they move away from the control model, the business loses some of the competitive advantages of a family company; in this case, the biggest loss perhaps being patient capital.

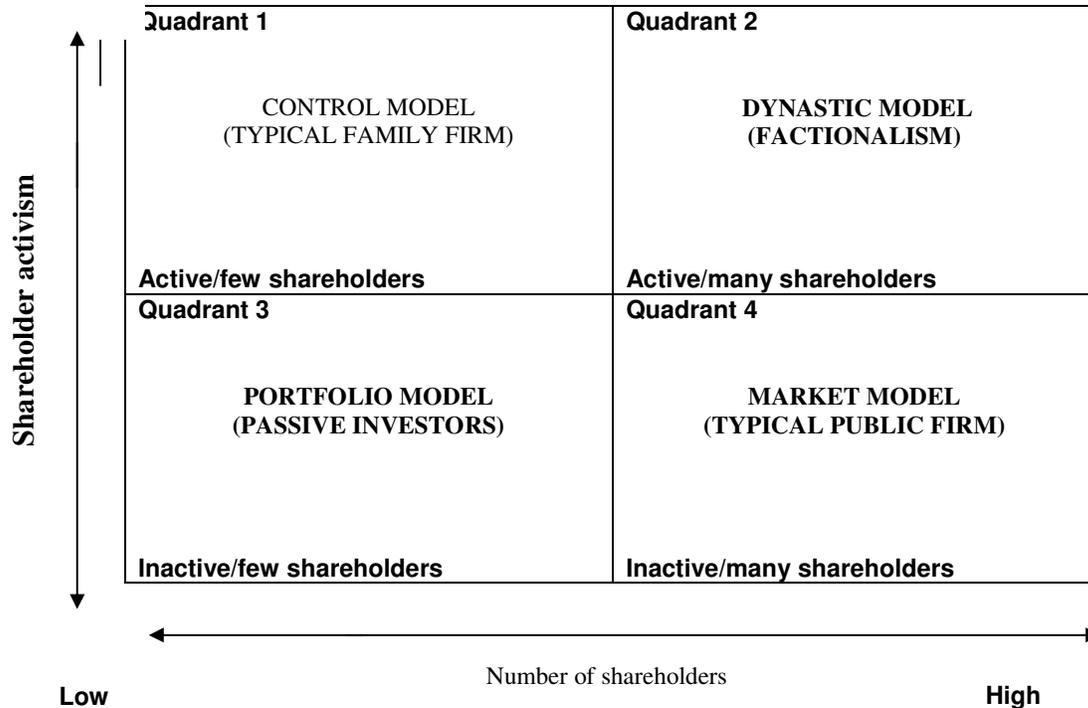
Another way in which a family business may move away from the control model is when family remains active in management or the board as the business moves through generations, but the family expands and becomes less unified as a result of expected centrifugal pressures. This situation may be characterized by multiple families or family branches in the business with different ideas on how the business should be run. This type of 'dynastic model' of governance is extremely unstable, where the lack of unity can create a sale of shares of the company (see Quadrant 2 of Exhibit 1), or the company may be at risk of failure. Governance in this arena needs to concern itself with family unity and ensure that unity among family shareholders is of utmost importance. Other mechanisms to nurture family unity are also advisable (such as retreats, separate family governance, strong values, and other joint activities).

One can see from this brief exploration that there is no single model for corporate governance that can account for the many differing configurations of family, shareholders, and business conditions (Gubitta & Gianecchini, 2002; Corbetta & Salvato,

2004). What have been outlined here are guidelines best suited to the typical family company. The intent was to explain why each guideline makes sense for the particular configuration of family, shareholder, and family involvement in the business. Additionally, for family business researchers, each guideline serves as a proposition for empirical research. For example, future research can examine the relationships provided in the propositions as they relate to company performance (profits, ROE, and other financial measures) and family variables, such as those in the

F-PEC scale (Astrachan, Klein, & Smyrniotis, 2002). Challenges to investigating these propositions include operationalizing and measuring the concept of accountability, as well as developing clearer measures of concepts, such as board performance.

With a modicum of careful analysis and consideration of family, ownerships, and business characteristics, these guidelines, or propositions, can be tailored to meet most family business situations, as well as further the field.



**Exhibit 1.** Four Quadrants of Family Firm Governance: Dimensions of Market and Control

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