Governance in Family Firms: How to Ensure Continuity

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Abstract: Family firms play a key role in the world economy, yet their success is often plagued by family-related issues and conflict. Succession is one of the most critical hurdles they face. The purpose of this paper is to illustrate how specific governance instruments, such as the family protocol, can aid mitigate the conflicts by establishing a set of guidelines and procedures to aid govern the operation, management and continuity of family firms. To study the underlying strategic decision making process of the multiple stakeholders involved, this paper resorts to game theory. The results will provide valuable determinants of the family protocol which may aid smooth managerial transfer in the family firm and uphold harmony in the family setting.

Keywords: Conflict, Family firm, Succession, Game theory, Corporate governance

1. Introduction

Families own and manage the majority of businesses worldwide. Seventy-five percent of entrepreneurs and 81% of established business owners co-own and/or co-manage their businesses with family members (Kelley et al., 2020). They range from sole proprietors to large international enterprises. Family businesses play a crucial role in the economy, providing employment opportunities and generating wealth.

However, family firms face unique challenges that can impact their longevity and success. One such challenge is the management of family dynamics, conflicts and succession planning. This is where governance can be critical.

Family firms are unique in that they are owned and operated by members of the same family, often spanning multiple generations. While the family connection provides many benefits, it also poses challenges, especially when it comes to succession. Succession is a critical stage in the life cycle of a family firm, as it involves the transfer of ownership and control from one generation to the next. The success of this transfer is crucial for the long-term stability and success of the family firm.

Indeed, most family businesses have a very short life span beyond their founder's stage and some 95 percent of family businesses do not survive the third generation of ownership (Abouzaid, 2018).

Governance and family protocol are crucial elements for the success and sustainability of family firms. Family businesses are unique in their structure and operation, often combining family and business interests, which can lead to conflicts and challenges. To overcome these challenges, it is important to have clear and well-defined governance and family protocol in place.

Family governance mechanisms serve to govern and strengthen relations between the family and the business, as well as the relationships between the members of the business family itself. However, despite agreement on the importance of adopting family governance structures, explicit research on the determinants of family governance mechanisms is currently missing.

Family protocol is a set of rules and guidelines that outline the roles, responsibilities, and expectations of family members within the business. A strong family protocol promotes family unity and helps prevent misunderstandings and disputes among family members. It also helps establish clear lines of succession and leadership, ensuring a smooth transition of ownership and control from one generation to the next.

Their paper examines the effectiveness of specific governance instruments, particularly the family protocol, in mitigating conflicts by establishing a set of guidelines and procedures to govern the operation, management, and continuity of family firms. By employing game theory, this study investigates the underlying strategic decision-making process of the multiple stakeholders involved. Our results provide valuable insights into the determinants of the family protocol, facilitating a smooth transfer of managerial responsibilities within family firms and promoting harmony in the family setting.

This paper begins with a comprehensive literature review on the Family Protocol and its application in family firms. The review also explores the utilization of game theory as a framework for studying the strategic decision-making process of multiple stakeholders. Subsequently, we present our proposed model, which integrates the Family Protocol and game theory to analyze its effectiveness in mitigating conflicts and facilitating smooth managerial transfer within family firms. Following the model, we present the results obtained from our analysis. Finally, we conclude by discussing the implications of our findings and their significance for enhancing operational and relational dynamics within family firms.

2. Family Firm Governance - The Family Protocol

Several conceptual models have already been developed with regard to the family firms, all of which attempt to highlight their particular characteristics. One of the most widespread is Davis & Tagiuri (1982) three-circle model. This model presents three interconnected subsystems (business, family and ownership) and four areas of intersection that illustrate the various roles that members of these organisations can play simultaneously.

Agency theory suggests that family firms either mitigate or exacerbate agency problems. Agency costs consist of the combination of costs incurred by a firm in terms of lower performance through its unwillingness or inability to effectively deal with agency problems, and of costs incurred through the incentives and monitoring activities used to deal with information asymmetries and align the interests or actions of an agent with the interests of a principal (Jensen & Meckling, 1976).

Proponents of the mitigation argument assert that family firms are one of the most efficient forms of organisational governance (Dyer, 2006; Dalton & Daily, 1992) because they incur in fewer agency costs (Jensen & Meckling, 1976) considering that the principal (owner) and the agent (manager) are usually one and the same, therefore, mitigating the information asymmetry and aligning managers' and owners' goals (Fama & Jensen, 1983).

Nonetheless, Morck, Shleifer & Vishny (1988) identified the potential for agency costs in family firms. Altruism is an agency problem which may occur in family firms (Moores, 2009). Schulze, Lubatkin, Dino and Buchholtz (2001) introduced the problems of altruism and self-control in the context of family business. Altruism makes it difficult for families to effectively monitor other family members who work for the firm. Parental altruism may lead family owners to have blind faith in their employed children (Lubatkin, Schulze, Ling & Dino, 2005; Lubatkin, Durang & Ling, 2007).

Adverse selection and entrenchment may lead to placing family members in positions they are not adequately qualified for (Burkart, Panunzi & Shleifer, 2003). In family firms, resulting from the mix of personal and professional relationships, decision making process tend to be more emotional rather than rational driven, when compared to non-family (Gómez-Mejia et al., 2001).

Family businesses are seen as being "fertile ground for nepotism, self-dealing, entrenched management, and utility maximization by the family to the detriment of corporate profits and other shareholders" (Poza, Hanlon & Kishida, 2004, p.99).

Under the conditions of asymmetric information and in the absence of complete contracts, two main kinds of agency problem may arise (Chrisman, Chua, & Litz, 2004). The first is adverse selection, which occurs when the principal enters into a contract with an agent who is not well qualified or is in some other way unsuitable for the tasks to be performed. The second is moral hazard, a term that "suggests that people cannot be counted on to do what they say they are going to do, and that failure manifests itself in prices and contractual arrangements" (Alchian & Woodward, 1988, p. 68).

According to Gersick et al. (1999), family businesses can enhance their chances of survival by implementing appropriate governance structures. Establishing such structures fosters trust among family members, promotes unity, and improves the business's chances of viability.

The corporate governance approach, which suggests a set of institutions and procedures targeted at regulating and decreasing agency costs and block holder conflicts, is the prevalent reasoning in the mainstream literature (Carney et al.,2014; Zellweger &Kammerlander,2015). The term "family protocol" was first used by Ward & Gallo (1992) to refer to a written statement of the family rules that govern interactions between family members and those who hold ownership and managerial positions in a family business; and captures the core rules and regulations of the family business and will often consist of the family business's purpose or values, key policies, ground rules, and conflict resolution guidelines (Leach & Bogod, 1999; Poza, 2010; Berent-Braun & Uhlaner, 2012).

A family firm protocol is a set of guidelines, rules, and procedures that are used to govern the operation and management of a family firm. The protocol is designed to ensure that the interests of all stakeholders, including family members, employees, and shareholders, are aligned and that the family firm operates in a stable and efficient manner. Family protocols are highly heterogeneous. The form and content will differ from one family business to another depending on the size of the family, its stage of development, and the degree of involvement of family members in the business. However, they must address some of the following issues (Aronoff et al., 1998; Neubauer & Lank, 1998; Gallo & Kenyon-Rouvinez, 2005; Montemerlo & Ward, 2005): statement of the principles that outline the family commitment to core values, vision, and mission of the business; definition of the roles, compositions, and powers of key governance bodies of the business (family members/shareholders, management, and board of directors). In addition, the family constitution defines the relationships among the governance bodies and how family members can meaningfully participate in the governance of their business.

Even if it is not possible to eliminate the conflict which arise in family firms these organisations need to deal with them in order to minimise their negative consequences (Arteaga & Uman, 2020). And, the family protocol, as a governance policy tool, can help ameliorate intra-family conflict and enhance the probabilities of survivability of the family business. Conflict resolution in family businesses is addressed by dealing with specific instruments such as corporate bylaws, corporate compliance and family protocol (Comelles, 2020). The lack of communication in companies and the difficulty to maintain relationships between the business and the family generate both internal and external conflicts. Some of those conflicts, as is the case with generational succession, are related to the lack of organizational structure (Bernal, 2021) and employing a family protocol can ease those conflicts and support the firm's continuity.

3. Family Firm Governance and Game Theory

Game theory is a mathematical framework that can be used to study and analyse decision-making in strategic situations. One of the key applications of game theory in the study of family firms is the analysis of the interaction between family members. This information can be used to design a family protocol that balances the interests of all family members and promotes cooperation.

One of the most difficult problems that family businesses encounter, the succession process, has been examined rigorously and objectively using the mathematical underpinnings of game theory. Due to its ability to strategic decision making and the elements that influence it, game theory has been shown to be a compelling option for better understanding family firm executive succession (Blumentritt et al, 2012; Jayantilal et al., 2016a,b; Jayantilal et al., 2020 and Jayantilal et al., 2022).

Corporate governance entails creating a variety of methods to reduce agency issues by offering rewards for achieving an effective organizational framework and performance in organizations (Samuelson & Marks, 2015; Hurwicz & Reiter, 2006). In light of this, Arifa & Islam (2020) have no doubt that governance is one aspect of corporate organisation that can be thought as a mechanism design (design a game) challenge where the ideas, techniques, and tenets of game theory and mechanism design can be used to create efficient corporate governance.

There are already many studies that apply game theory to various aspects of corporate governance. Wong's (1989) seminal paper explores the question of equity in the allocation of voting rights among corporation shareholders. But other constructs have been the subject of study: the effect of share repurchase on listed companies, which will diversify the capital structure and the structure of corporate governance will be improved (Peng & Tian, 2008); social relations network of the corporate governance from the perspective of social capital mutual trust and harmonious cooperation (Li, 2011); corporate governance based on control mechanism (Li et al., 2006); the function of independent directors with different payoff rules (Wang, 2013); the actual voting power of employees on boards and its effect on firm performance (Balsmeier et al., 2013); construct the optimal corporate board structure model (Zhao et al., 2011); measure voting power/ownership concentration (Crespi & Renneboog, 2010).

However, if the game theory is still in its infancy with regard to the family businesses succession process, in terms of a governance structure, and protocol design in specific, it is essentially unborn. We propose the use of Game theory to aid address the issue of imperfect and asymmetric information using principal-agency theory (PAT), more precisely, through adverse selection models' analysis, focusing on the Protocol contracts and their incentives.

4. Methodology

Game theory delves into the realm of strategic decision-making, formally describing strategic situations through games. These games are defined by the involved players, their information sets, the feasible actions at their disposal, and their individual preferences and payoffs. The players in a game represent various agents such as individuals, groups, or firms, who are responsible for making decisions. In a game of complete information, all players possess full knowledge of every aspect of the game, including the players themselves, the timing of decisions, available actions, and resulting payoffs. Conversely, games of incomplete information entail certain aspects being concealed from the players. Crucially, each player's payoff is not solely determined by their own actions, but also influenced by the actions of other players. This interdependence among players' strategies forms the cornerstone of any game.

Therefore, to study the strategic decision making in this case we draw the game, considering a principal-agent model in which the founder (principal) selects the family protocol. There are two sibling types (agents) willing to manage the family firm, the child with higher skills for family firm management (E) and the child with lower skills (Y). The founder has two options, hiring E or Y.

The founder maximizes the following payoff function:

$$F = \pi(r_i) - \Theta f(a_i)$$

$\pi(r_i)$ denotes the child's effort impact on the family firm profits. Given the child skills, i.e., managerial skills, competencies and know-how, the family firm performance will increase with the siblings' efforts, given by r_i, since $\pi'(r_i) > 0$. Moreover, the family firm performance increases at a decreasing rate as $\pi''(r_i) < 0$. Each child will earn a different payment for his effort (a_i) and this payment decreases the founder's payoff (where $f'(a_i) > 0$ and $f''(a_i) > 0$). Let Θ measure the intensity of that cost for the founder, since the payment can be addressed as salary, family firm's shares, or other compensation scheme.

The sibling's utility function is given by:

$$A = h_i u(a_i) - k\, d(r_i)$$

Let $u(a_i)$ stand for the benefit of the sibling for his payment, a_i, which increases at a decreasing rate since $u'(a_i) > 0$ and $u''(a_i) < 0$.The agent cost is increasing with the effort $d(r_i)$ at an increasing rate as $d'(r_i) > 0$ and $d''(r_i) > 0$. Each child may differ also in the emotional importance each child gives to legacy and emotional factors, h_i, given the payment scheme. Let k, be the costs of the child with lower skills, where k>1. Notice that k = 1, when the child has high skills.

When the siblings' efforts, r_i, is observable (under symmetric information) by the founder, solving the maximization of the founder's payoff function, F, subject to the participation constraints.

$$h_Y u(a_Y) - k\, d(r_Y) > B \text{ and}$$

$$h_E u(a_E) - d(r_E) > B$$

where B stands for the child's payoff from his best career option outside the family firm (net of any costs).

5. Results

Solving the Kuhn-Tucker conditions, the solution for the child with higher skills is given by:

$$\begin{cases} h_E u(a_E) - d(r_E) = B \\ \pi'(r_E)/d(r_E) = \Theta f'(a_E)/\, h_E u'(a_E) \end{cases}$$

Whereas, the solution for the child with higher skills is:

$$\begin{cases} h_Y u(a_Y) - kd(r_Y) = B \\ \pi'(r_Y)/d(r_Y) = \Theta k f'(a_Y)/\ h_Y u'(a_Y) \end{cases}$$

Therefore, contracts are different for each sibling, and we can conclude that $r_E > r_Y$.

If we consider the scenario where the effort of the siblings (r_E and r_Y) are not observable by the founder, the need to design a menu of contracts in the Protocol is irrefutable. Let p be the probability of being a child with high skills. PAT solves this adverse selection problem where siblings reveal their type when accepting a specific contract of the Protocol (in the PAT, this is the Revelation Principle). Under this asymmetric information, the founder optimization problem is now:

$$Max \quad p[\pi(r_E) - \Theta f(a_E)] + (1-p)[\pi(r_Y) - \Theta f(a_Y)]$$

$$subject\ to: (CP^Y)\ h_Y u(a_Y) - k\ d(r_Y) > B$$

$$(CCI^E)\ h_E u(a_{YE}) - d(r_E) > h_E u(a_Y) - \ d(r_Y)$$

Solving the Kuhn-Tucker conditions, the solution for the child with higher skills is given by:

$$h_Y u(a_Y) - kd(r_Y) = B$$

$$h_E u(a_E) - d(r_E) = h_E/h_Y * (B + kd(r_Y))$$

$$\pi'(r_E)/d(r_E) = \Theta f'(a_E)\ /\ h_E u'(a_E)$$

$$\pi'(r_Y)/d(r_Y) = \Theta k f'(a_Y)/\ h_Y u'(a_Y) + \Theta f'(a_E)/\ u'(a_E) * (p/(1-p)) * (k/h_Y - 1/h_E)$$

Therefore, the contracts for each sibling are different from symmetric information, since:

- there will inefficiency in the child with lower skills
- there will efficiency in the child with higher skills, since the effort is equal to the symmetric information scenario
- the child with higher skills has a surplus higher than B

In terms of the impact on the contract menu:

- when k increases, r_E and r_Y decreases and a_E increases;
- when Θ increases, a_E , r_E , a_Y and r_Y decreases;
- when h_E increases, both a_E and r_E increase, but both a_Y and r_Y decrease;
- when h_Y increases, r_Y increases;
- when p increases, both a_Y and r_Y decrease.

6. Conclusions

The findings of our model reveal that in the face of uncertainty regarding the orientation of potential children, factors such as their Leadership skills (including proficiency in business-related areas) and their Family Orientation (which reflects their value and commitment to the family business as an extension of the family), as presented by Jayantilal et al., 2020, play crucial roles in the selection of a successor.

Our findings underscore the importance of designing the family protocol to accommodate diverse scenarios within family firms. Specifically, we demonstrate that the family protocol can be structured to ensure that no siblings are excluded from joining the family firm, even in cases where there is a significant differentiation between them (k > 1). However, as the level of differentiation increases, it inevitably leads to a decrease in the level of effort undertaken (r_E decreases), particularly by the more endowed child.

Moreover, when the founder attaches high value to the family firm and finds it challenging to relinquish control (high levels of Θ), they tend to impose lower demands on their successor in terms of required effort (as seen by decrease in r_E and r_Y). Additionally, if a child possesses a strong Family Orientation and exhibits a high level of motivation to join the family firm (high levels of h_i), the proposed contract is likely to be more demanding (as seen by increase in r_E).

These various scenarios demonstrate the flexibility of the family protocol in accommodating different situations. To achieve this, a range of menus containing possible "contracts" or requirements can be established to promote higher efficiency within the firm and incentivize siblings to develop their capabilities, thereby creating greater value for the family firm.

In contexts characterized by uncertainty, the design of the family protocol becomes paramount in achieving optimal outcomes therefore we call for further research in this area.

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