Governance in family firms during economic recession

Family firms represent the predominant form of business across the globe. In the USA, at most conservative estimates, family-run businesses contribute nearly 30 per cent – or $2.6 trillion – of the gross domestic product (GDP), with 27 per cent of the national workforce employed by a family firm. In the domain of publicly-traded firms, family businesses constitute over 35 per cent of the S&P 500 index.

Given the ubiquity as well as the economic significance of family firms, both domestically and internationally, the burgeoning number of studies on this distinctive organizational form is not surprising. One popular stream of family firm research concerns their potentially superior corporate governance structure arising from a synthesis of family goals and business goals, with the results that family firms, in many cases, outperform their non-family counterparts. However, family values and business rules can conflict under certain circumstances, leading family firms and their associated stakeholders to suffer from the family imprint.

A particular circumstance that has been shown to exacerbate tensions within the family firm is economic recession. In general, recessions represent one of the most significant environmental threats to a firm’s viability and continued profitability. Risks and uncertainty arising from an economic downturn may lead a family to promote its interests at the expense of those of the business and its other stakeholders. However, because family firms are deemed to exhibit strong stewardship and stakeholder orientations, family systems and business systems may reinforce each other and strengthen the business for the benefit of all involved parties, specifically during a period of environmental uncertainty.

Agency theory, stewardship theory, and the family firm

Agency theory attends to the oft-divergent interests between parties that control firm resources (agents) and those who own them (principals). Agency problems arise when owners, as principals, seek to align the interests of their agents (i.e. managers) with their own in light of different goals and risk preferences. As these differences grow, so do the costs of structuring, monitoring, and bonding contracts needed to resolve issues of adverse selection and moral hazard.

However, agency costs in private family firms may be a non-issue since ownership and control are united. That is, the alignment of owner-manager interests regarding firm objectives and risk preferences make controls to curb managerial self-interest redundant. Moreover, since the family as sole decision agent holds the firm's residual claims, expropriation of owner wealth would come at the expense of their own welfare.

Another line of argument holds that family firms are nevertheless susceptible to agency costs when the family agenda takes precedence over that of the business and its other stakeholders. Nepotism and parental altruism can lead to inefficiencies in hiring managers (i.e. agents), making the firm vulnerable to incompetence and deficits of expertise. Moreover, established family businesses can become increasingly conservative and risk averse by curtailing resource allocations at the expense of the firm’s efficiency and performance. Similarly, agency problems may arise as family members, in their role as majority owners, advance their interests in the firm without regard for minority owners.
In efforts to counterbalance the emphasis on rational yet self-serving actors underlying agency theory, family firm researchers have looked to a more humanistic model of managerial behaviour, such as stewardship theory, to explore the family-business dynamic. Putting forth that human needs for achievement, responsibility, and social recognition in many cases offset intentions of self-interest, stewardship theory brings into view self-actualizing managers with altruistic motivations and non-economic aspirations, such as self-efficacy, involvement-oriented management, and worker empowerment.

Stewardship theorists maintain that family businesses are already representative of corporate stewards. For one, family businesses exhibit higher-order needs and objectives other than purely economic ones, such as intra-familial altruism, firm longevity, and intra-generational succession. As such, family firms manage for the longer term, making them less likely to engage myopic decisions in response to short-term profit pressures. Family members also identify more closely with their businesses, thus increasing responsibility for, and commitment to, the organization and its stakeholders. And, in exhibiting stronger qualities of clanism and collectivism, family firms place more weight on family and social ties, loyalty, trust, and stability, which in turn increases goal congruence.

Yet, in spite of the benefits of the so-called “familiness” in the firm, stewardship-like behaviour in management can have a disadvantageous impact on an organization. A focus on non-financial objectives can cause family management to forego resource allocations necessary for the firm's competitive advantage and growth. Likewise, the long-term orientation in family firms may result in managers overlooking opportunistic investments that can lead to strategic stagnation. On the other end of spectrum, since the family's prevalence provides for greater latitude in decision making, the firm's owner-managers may not exercise sound managerial judgments when engaging in risky behaviour.

**CEO duality in family firms during recession**

According to agency theory, boards of directors represent the primary means to protect shareholder interests. Using a variety of oversight and incentive prescriptions, a board can effectively mitigate agency costs arising from separation of ownership and control and, subsequently, improve firm performance. One particular control involves the separation of the roles of CEO and chairperson which, by allowing the board to assign decision management to the CEO while retaining decision control, diminishes the likelihood of managerial entrenchment and self-serving.

Whereas family control over firm resources may, at first glance, make the separation of the CEO-chair position superfluous, in family-controlled public firms (FCPFs) CEO duality nonetheless serves as a useful mechanism to protect non-controlling shareholders from wealth expropriation by the family. By splitting the positions, the family ensures broader representation of interests and agendas in the executive suite while also signalling an awareness of proper governance controls to minority shareholders and other stakeholders.

In an economic recession, the need to separate the CEO-chair position in family firms may be especially heightened as the firm's resource base becomes more vulnerable to demand shocks. As a consequence, the family may move to protect its interests in the organization at the expense of non-controlling shareholders. Under these circumstances, CEO duality compromises effective governance since it facilitates and speeds decision-making that can favour the family's agenda. In other words, concentrated authority arising from CEO duality may not allow for the dissension necessary to keep the family from engaging in self-serving activities. Given that family firms already exhibit a lower propensity for risk, CEO duality may afford family managers the necessary means to forego opportunities that could benefit firm performance and, thereby, non-controlling shareholders.

Stewardship theorists, on the other hand, argue that with a single individual occupying the CEO and chair position, strategic decision making is simplified, leadership is
unambiguous, and actions are facilitated, to the point where the benefit of retaining control and self-managing outweigh agency costs.

**Slack resources in family firms during recession**

While managers in widely-held firms have the latitude to diversify their personal wealth, any losses incurred from risky investments in FCPF's impact the family fortune. As such, rather than make risk-laden yet necessary investments to build shareholder value, owner-managers in FCPF's may use slack resources to engage in activities that protect family wealth, including tunnelling and redistribution of rents from employees to themselves.

In the context of recessions, family managers may be even less inclined to put the firm and, consequently, their wealth at risk. As the economic downturn makes access to alternative sources of capital increasingly challenging, the family may be more inclined to hoard or divert slack resources to secure its continued well-being.

In consequence, non-family shareholders may suffer from the family's neglect of necessary investments that can steady the FCPF's performance throughout the recession and favourably position the firm for the eventual recovery.

Slack offers management the necessary autonomy to pursue a wide range of profit-yielding activities. Likewise, slack alleviates goal conflict within the firm by providing the means to solve resource problems. Its availability can also facilitate strategic change via experimentation and innovation, including new product development and new market entry. Finally, slack eases a firm's environmental adaptation by providing a safeguard in face of environmental turbulence.

Slack attains a premium in recessionary periods as environmental ambiguity and uncertainty intensify and external funding resources dwindle. Acting as a buffer or shock absorber, slack can help a firm withstand the indeterminate length of economic hardship. Moreover, financial slack affords firms a degree of normalcy by permitting them to continue with activities deemed to be core to their survival and success.

**Practical implications**

The widely-held tenet concerning downward cycles continues to be that they represent largely uncontrollable events, and, as such, they "can only be tolerated – they cannot be fought". As a consequence, strategic decision making often takes a backseat to management's "battening down the hatches". However, by focusing on two types of discretionary management tools, CEO duality and financial slack, this article offers specific guidance for managers of family firms who can incorporate critical information into their strategic planning regarding the business cycle to improve firm performance.

The combination of clear leadership and ample resources can positively smooth performance effects over the course of a recession, and family firm managers should react quickly to hoard slack at the onset of recession. Furthermore, prudent slack allocations over the course of the downturn results in favourable post-recessionary firm positioning for both the family and its outside shareholders.

For managers in charge of organizations experiencing economic duress, appeasing various stakeholder demands can be an increasingly difficult task. Publicly-traded family firms during recessionary environments may experience institutional pressures to adopt governance controls for the benefit of minority shareholders. Nevertheless, the family's organizational stewardship leading up to the recession provides distinctive performance advantages. Furthermore, as market uncertainty arises and time becomes of essence, the gains of swift decision making with the firm's resources accrue also to outside shareholders. As such, the absence of agency-based governance mechanisms during recession does not necessarilly encourage the family to exploit firm resources for its own profit.
Agency-based governance controls can be damaging to outside shareholders in FCPF during economic recession. Instead, the stewardship qualities in the family firm suggest that any form of direct or indirect control may lower stewards' motivation, negatively affecting their pro-organizational behaviour.

Family businesses are a unique organizational form whose relative benefits have only recently received their deserved attention. As such, it is becoming more apparent that management tenets and practices relevant to the widely-held firm, for example, may not translate seamlessly to family-controlled organizations.

June 2009.

This is a shortened version of “When the big “R” hits home: governance in family firms during economic recession”, which originally appeared in Journal of Strategy and Management, Volume 2 Number 2, 2009.

The authors are Michael R. Braun and Scott F. Latham.