28th September, 2017

Family Businesses: Challenges and Conflicts

Family business is the most prevalent form of business in the world. According to IFC ,between 75% and 90% of all the world's business is carried on by family companies. Over 85% of the EU/US businesses are family run. Walmart, Ford, Koch industries, Samsung, Sabanci, Li and Fung are some examples of successful family businesses. However, Family Businesses (FBs) tend to have short life span – 95% of them do not survive third generation of ownership.

FBs outshine their peers, especially when the economy slumps. During the financial crisis of 2008/09, the Average ROE (Return on Equity) of FBs remained almost unchanged, while the average non-family businesses (NFBs) suffered a big drop in returns. In non-crisis periods also, the majority of FBs are outperforming their competitors in product and service quality, growth, productivity, innovation and financial performance.

We can classify the FBs in several categories:

i) Founder – owned and managed businesses, whether sole proprietorship, partnership, private limited companies etc.

ii) Family owned businesses, where the family runs and manages the business

iii) Family owned businesses where management is in the hands of the professionals but control, governance and supervision rests with the family.

iv) Family controlled businesses, where there are other diverse shareholders, but the control is held by the family. Publicly listed companies fall into this category.

Each category has different strengths and weaknesses. The challenges begin to arise when the organization becomes more complex and the size of the family

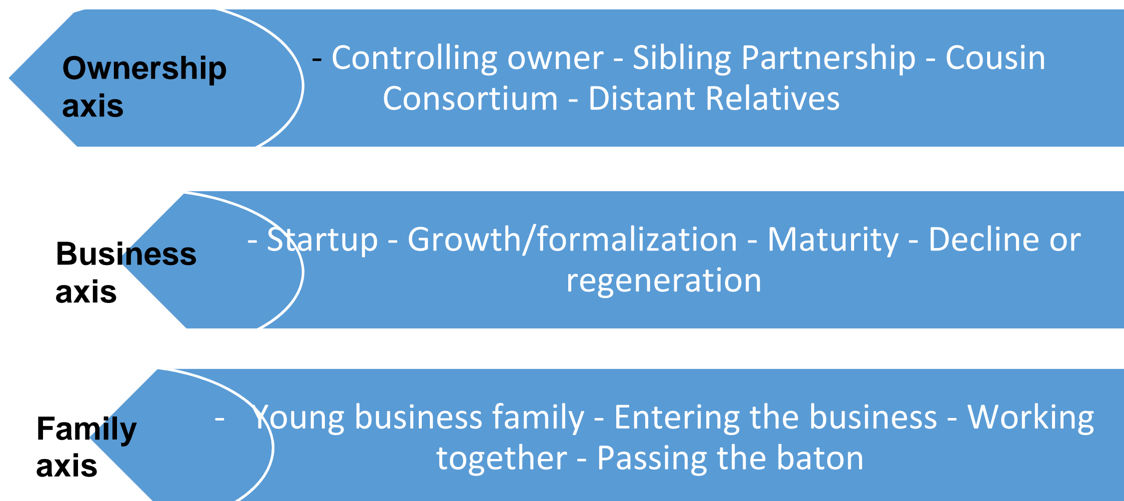
becomes bigger. At this point, it becomes imperative to strike congruence between the personal life cycle, business life cycle and organizational life cycle. For example, Risk-taking attitude is more pronounced at a young age, but it gradually gives rise to prudence and sticking to the tried and tested paths in the Middle Ages. Fear of failure becomes more ingrained among the family elders. Start-ups, Growth phase, Mature or Steady state, Aggressive expansion or Mergers and Acquisitions and Regeneration phases - all require different leadership styles and attributes. Most of the time, the continuity of the elder or the founder in the leadership position becomes a major hurdle if the business and organizational cycles are undergoing change. Rigid adherence to past traditions and behaviors may no longer be desirable attributes at that stage.

If the national economy is booming, and the company is doing well, complacency sets in and the owners stop looking for new opportunities. When the economy is in recession, however, the company has to adapt itself to survive beyond that period.

Organizational life cycle should, therefore, determine the type of leadership that suits the particular point in the cycle.

The Three Dimensional Matrix:

This matrix illustrates the interaction between ownership pattern, stage of business and the nature of family.



Another point that needs to be emphasized is the need for clear demarcation of the respective roles and responsibilities between:

Owners (shareholders)

Managers (senior management)

Directors (BOD)

Family members (family and its institutions)

Most of the problem arises when there is blurring of responsibilities or an implicit assumption on the part of the owners and the family members that they enjoy veto powers to overrule other shareholders or Board Directors. This problem can be resolved by adopting code of corporate governance and follow it faithfully. Many FBs go through the ritual but hardly comply with the code in actual practice. Most of the disharmony and tensions pulling the business in different direction arise because of this disconnect. They hardly realize that by doing so, they are subtracting value from the enterprise.

How can good **corporate governance** help the FBs?

- Global institutional investors pay a premium for well governed companies in Emerging Market economies (EMEs,) ranging from 20 to 30%
- Over ten years, well governed companies across a wide range of sectors have seen superior Valuation multiples over their badly governed peers
- Streamlined business processes lead to better operating performance and lower capital expenditures
- In large businesses, 51% of non-executive directors are non-family members, who bring in different perspectives and viewpoints
- Family firms with formal Advisory Boards perform better than those without such boards

Another instrument that has had some success in clarifying the roles and responsibilities of the family members and providing guidance for the future particularly when there are several siblings or a large array of cousins is **Family Constitution.** This constitution is a non-binding Contract to build and foster a mutual understanding or Charter of the rights and responsibilities of all persons who have an interest in the family wealth. It is the key to its preservation and growth. It is a framework that engages with the family members, family offices, family businesses, family investment companies and family trust. It includes specific policies on matters such as investment, education, employment in the family business etc. It provides a family governance Forum (Family Council) to develop a plan to deal with the issues that may arise even if they are unexpected. It has processes in place to facilitate swift and proper consideration of a problem, and to find the solution (Family Assembly, Family Council, and Committee Structures).

One of the frequently asked questions is: what are the pros and cons of the family owned businesses compared to others? The following table lists some of the main findings from various studies that have been carried out. It is not

necessary that each of these ingredients would be present in each case, but it broadly summarizes the oft repeated tendencies.

Pros and Cons of Family Businesses	
PROs	**CONs**
Long term outlook not driven by short term returns	Managing conflicts, Disputes, Differences, Disagreements among siblings or their children about the strategic direction is more cumbersome. Some may like to continue in the existing mode, others may have plans to diversify, get out of some lines of business, acquire new or expand
Quick decision making and problem solving	Maintaining harmony among siblings on formalizing procedures and drifting away from informality to bring about disciplines pose serious implementation difficulties in practice
Responding to crisis by taking immediate remedial actions	Agreeing upon clear rules of succession, family employment, compensation, family shareholding, retirement policy etc. proves contentious
Recognizing and grasping on a business opportunity and translating that into actions even if it implies departure from the conventional strategy	Evolving consensus on Family and Company's financial relationship proves knotty. Dividend distribution vs. retention of earnings, reserve accumulation, rights issues, equity injection by outsiders, IPOs, new-Venture support, particularly when the

	company is under financial stress
Adapt themselves to change, learn new things, be open to new ideas and be willing to let go of the old ways of doing things	The trouble spots are issues relating to • Ownership transfer • Stock buyout process and Valuation method • Shareholder responsibilities and rights
Value System of the Founder and ethos drives the Company	Clash of intergenerational value system is emerging as another area that is tearing the second and third generations apart

Conflicts and Tensions

Rifts and tensions arise when the family members do not have a clear mission or clear set of Values for the family members to abide by. What are the usual causes of conflict and tensions?

- Death of a key individual.
- Matrimonial disputes.
- Tax problems.
- Competency of heirs to manage the business or the absence of a clear Succession Plan, employment of younger members – at what level, educational qualifications, inclination?
- What level of benefits to be appropriated and on what basis?
- Disposal of interests in the business.
- Excessive spending by some members of the family.
- Role of spouses.
- Information sharing. Continuous open communication.

- Sibling rivalry.
- Son-father rivalry.
- Conflict with Managers and Executives.

The above list is by no means exhaustive, but indicative of the major points of fissures, disagreements and eventual break up.

The two set of relationships that have led to the demise of the FBs in India and Pakistan are the souring of the Son-Father and Brother-brother relationships. A word about each of these phenomena would highlight this issue.

Son – Father Rivalry:

The most common occurrence is when Father commits to pass his business to his son, but at the same time also does not want to lose his authority .The founder father always thinks his way of doing things is always right. He continues to demonstrate his own competence raising doubts about his son's. The son seeks increasing responsibility, commensurate with his growing maturity and the freedom to act responsibly on his own. The son may come up with a completely different business model and the father resists that and stonewalls him. The son is frustrated with his father's intrusions, condescending attitude and lack of confidence. He resents to remaining dependent on his father for his income level, title, promotion and perks. The father's erratic and unpredictable behavior makes this dependency more unpalatable. This is the beginning of bad blood and rivalry between the father and the son.

The father does not help through sagacity and wisdom and continues to remain set in his ideas. He does not think that his ideas may have become obsolete and management practices outdated. The organization may have grown beyond his capacity to control it effectively.

Brother – brother rivalry:

If the father tries to play the sons off against each other or has decided that one should wear the mandate the heartburn of the one ignored begins to contaminate the organizational culture. Mothers have their favorites, and each wife has a stake in her husband's position. He can become a foil for his wife's fantasies and ambitions and lead to battle in the Board Room between the brothers – turning the operation of the organization into a continuous family conflict.

The older brother may have a condescending attitude towards the younger, particularly if he drives himself harder and controls more rigidly. The younger brother finds it extremely difficult to think himself in a subservient role to the elder.

Intra-family friction:

The frictions may extend beyond the father-son and brother-brother rivalries to that among the spouses, mother-spouse etc. Factional divisions that spring up in the family and then organization may spill over to the associates and subordinates, who may choose the family member with whom they want to be identified.

What can be done to resolve or manage the conflicts amicably?

There are several ways in which the conflict can be resolved or managed without complete breakdown. Besides the code of corporate governance and Family constitution, which are powerful mitigants, several other ways can be explored.

a) Tilt the decision making more towards professional managers rather than family members or head of the family while keeping oversight, governance, strategy, accountability for results, within the Board, with strong representation of the family members

b) To have open, regular communication among all the family members. Information sharing and addressing concerns and questions raised at the spur of the moment rather than letting them accumulate are very helpful

c) To form an External advisory committee in which all the family members have faith and trust and seek their advice and counsel in matters of dispute

d) If (b) and (c) do not work, allow the members who are disgruntled or dissatisfied to do their own thing. Establish small new Ventures, for different members of the family who run the subsidiaries independently either under the corporate umbrella or outside of them

e) If (d) also doesn't produce result, let him take his share, quit the family business and start his own business

Going Public

One of the ways to grow and expand FBs is to inject private equity or go public. But there is a general reluctance among the owners to dilute their equity in the company without realizing that they can still have control of the company but with a much larger capital base. The returns they get now as the sole proprietor or owner would pale into insignificance compared to what they can get on a much larger and stronger capital deployed with some loss in equity holdings. Companies have earned windfall gains at the time of IPOs as their share value multiplied several times and if they operated on an even keel after going public there was further upside gain. They would be circumscribed by new rules and regulations and greater disclosure and transparency but this is good for the company in the long run.

What are the advantages and disadvantages o going public? The following table provides a summary:

Going Public	
Advantages	**Disadvantages**
Improved marketability of shares	Loss of privacy
Improvement in the Company's financial position	Loss of autonomy
Potential increase in the value of shares	Increased liability
Greater visibility, transparency and disclosure	Possibility of a takeover
	Additional costs

Generational Succession:

Finally, the question of succession planning is both intricate and sensitive and there are no easy answers. As stated earlier, the congruence between personal life cycle, organizational life cycle and business life cycle would produce optimal results. But the quest for such a congruence has proved elusive in real world. Therefore, some common sense principles can guide the process.

The earlier a successor is identified, the better off the organization would be. He would be given training, development tools, rotational assignments in various parts of the business and his performance evaluated on the basis of pre specified criteria. In case it appears that the person chosen falls short of the expectations, the Family Council should revisit the issue. There should be a candid and honest feedback given to him and a time line in which he can show

improved results and meet the expectations. If that does not materialize the next person in line should be tried and tested in the same way. There are several downside risks including alienation of the person debarred from succession who may feel publicly humiliated, the emergence of groupings in the Family Council if there is no consensus on the decision taken with negative impact on the organizational culture if the move does not find wide acceptance among the management and staff. The transition process has to be managed very carefully and skillfully. The outcome would very much depend on the nature of cohesion among family members and the strength of emotional bonding among them. The following chart brings out this distinction.

Cohesion between family members Emotional bonding			
Disengaged	**Separated**	**Connected**	**Enmeshed**
Highly independent	Some dependence and loyalty	Moderate, low dependence, highly loyal	Very highly dependent, loyal

The probability of amicable and cordial settlement of the succession issue would be high if there is enmeshed bonding among the family members where the degree of dependence on each other and sense of loyalty to the family feature quite high. At the other extreme, if the members are disengaged and are highly independent the chances for reaching a compromise solution or a consensus would remain bleak.