



# A model for the role of trust in firm level performance: The case of family businesses



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## ABSTRACT

We explore the process through which trust within family firm leadership contributes to firm level performance. Specifically, we develop a model describing the underlying process through which trust influences commitment and in turn organizational performance. The effect of trust on the performance of family businesses is further understood by addressing the role of family member status and generation in moderating the relationship between trust and commitment. We test this model using longitudinal responses from top managers in family businesses. Results indicate that the effect of trust on performance takes place through commitment with family member status moderating the relationship.

## 1. Introduction

For management researchers, family businesses represent a unique context from the standpoint of governance, management, and decision making as power and ownership are concentrated within the family (Schulze, Lubatkin, Dino, & Buchholtz, 2001). Furthermore, research indicates that this involvement of family in the management of family businesses has important strategic implications with family businesses outperforming their non-family counterparts in some circumstances (Anderson & Reeb, 2003). While research comparing the differences between family and non-family businesses relative to performance is interesting, it is essential for researchers to understand the unique structures and processes within family businesses and how those contribute to performance.

Researchers have argued that performance advantages of family businesses are tied to their closely held nature where both ownership and control are often embodied in the same individual or family (Chrisman, Chua, & Litz, 2004; González-Cruz & Cruz-Ros, 2016). Specifically, researchers have pointed to family firm governance as one source of competitive advantage leading to these higher levels of performance (Carney, 2005). This strategic benefit is the result of family businesses relying on a more personalized form of governance based on relationships, family influence and most importantly, alignment of interests between top decision makers and owners (Carney, 2005; Steier, 2001). This relational structure has been shown to contribute to increased levels of commitment, cooperation, and flexibility as well as reduced transaction costs leading to higher performance (Carson,

Madhok, & Wu, 2006; Jeffries & Reed, 2000; Poppo, Zhou, & Zenger, 2008; Uhlaner, Floren, & Geerlings, 2007).

This reliance on relational governance and high levels of alignment between leaders in a family business raises questions about the importance of trust in the family business context. Defined as a willingness to be vulnerable and place oneself at risk in relation to another (Mayer, Davis, & Schoorman, 1995), trust has been described as a “lubricant” facilitating relationships especially in the face of risks and uncertainties (Cruz, Gomez-Mejia, & Becerra, 2010, p. 79). Where market structures and organizational dynamics (bureaucracy and clan) control managerial behavior; trustee exposure, risk and vulnerability is controlled and trust is not needed (Ouchi, 1980). Specifically trust matters when risk-taking in relationships is prevalent such as when establishing or continuing a relationship with another party exposes one to risks related to that relationship (Mayer et al., 1995). In the case of family business, researchers have argued that because of the tight nature of the relationships and the high levels of alignment between decision makers, trust might matter less in the family business context (Schulze et al., 2001). While the importance of trust and performance among top leaders of non-family businesses is well established (Carmeli, Tishler, & Edmondson, 2012; Olson, Parayitam, & Bao, 2007), the role of trust among leaders in family businesses is less clear (Cruz et al., 2010).

In this manuscript we seek to clarify the role of trust in the top management team of family businesses and examine how it may subsequently play a role in family business performance. By building on work arguing that altruism within families can lead to alignment regarding decision making in family businesses (Schulze, Lubatkin, &

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Dino, 2003) we develop theoretical arguments regarding the importance of trust in this context. Contrary to traditional assumptions, we argue that risk taking in relationships does indeed exist in family business leadership creating a need for trust. We then explore the process through which trust contributes to firm level performance in family businesses and argue that this relationship takes place through the impact of trust on top management team members' willingness to commit to the organization. We further develop the trust to performance model in family businesses by outlining how contextual variables, unique to the family business form, namely generation and family member status, impact the extent to which trust influences the commitment of top management team members and in turn performance. The testing of this process, including context specific variables that might influence the relationship, represents an important contribution to our understanding of family business performance and further extends our knowledge of trust in an extremely relevant area of research.

## 2. Theory development and hypotheses

### 2.1. Family businesses and agency risks

An agency relationship exists when one or more persons (the principal(s)) hire another person (the agent) to perform a service on their behalf, typically involving delegation of decision making authority (Jensen & Meckling, 1976). This introduces agency risks and associated costs due to the fact that the interests of the agent may be different from those of the principal, causing the principal to incur residual losses as a result of the differing interests or monitoring costs to ensure that the agent acts in a manner consistent with the principal's interests. Historically, researchers have argued that the family business context, with its owner-managed model of governance, benefits from reduced governance costs (Bauweraerts & Colot, 2017). These reduced costs are argued to be based on lower levels of opportunism driven by altruism, strong familial relationships and significant overlap between ownership and management (Chrisman et al., 2004; Miller, Le Breton-Miller, & Scholnick, 2008). Indeed, primary agency theory research was focused on principal agent relationships where high levels of distance existed between the two parties (Jensen & Meckling, 1976). In family businesses, there is significant overlap between ownership and management and often family members play both roles (Fiegenger, 2010; González-Cruz & Cruz-Ros, 2016). In addition, researchers have theorized that strong family relationships may lead to feelings of altruism and significant alignment between leaders (Lubatkin, Schulze, Ling, & Dino, 2005).

Theoretically, however, it seems that the family business context does indeed suffer from unique governance issues and that these issues might be ignored in traditional agency models (Chrisman, Chua, Kellermanns, & Chang, 2007; Jensen & Meckling, 1976; Lubatkin, Ling, & Schulze, 2007). Specifically, labor pool inefficiencies stemming from operating with a reduced labor pool, the potential for self-control issues resulting from the unique tastes and preferences of individual leaders and a lack of market driven external controls all combine to create a set of unique agency issues specific to family businesses (Schulze et al., 2001; Schulze, Lubatkin, & Dino, 2000). While these agency issues are unique to family businesses and differ significantly from more traditional agency issues, they do create significant risks for family business leaders in their relationship to the family business. These unique risks present a situation where trust is needed to overcome potential risks and allow leaders to commit to the organization in spite of the inherent risks.

#### 2.1.1. Reduced labor pool

An agency risk that is somewhat unique to family business is related to a reduced labor pool. It is typically assumed that when an agent is hired, they are chosen from the pool of highly qualified candidates.

However, if you restrict this pool, you introduce another risk into the principal-agent relationship. Family businesses can face a reduced labor pool for several reasons. First, family businesses may lack the resources necessary to provide adequate compensation in order to attract and retain top talent (Schulze et al., 2001). This is particularly salient when looking at equity compensation, a common method of linking compensation with performance outcomes. Because family businesses seek to maintain control within the family they are very reluctant to distribute any equity outside the core family including the use of equity based compensation (Schulze et al., 2000). The result is that family firms could be less able to compete for top talent.

In addition to a desire to retain ownership within the family, family businesses have also demonstrated a preference to maintain decision making within the family by placing family members in high-level positions (Fiegenger, 2010). This can result in a perception among non-family job seekers that advancement opportunities within family firms will be restricted based on this need to fill top positions with family members further reducing the ability of family firms to compete for top talent.

Finally, because families often desire to fill top positions with family members, they are forced to deal with a significantly reduced labor pool in selecting family leadership. When families focus on only family members for some or all top positions in the business, they are dealing with an extremely constrained labor pool and the probability of finding a competent family member for the position can be reduced (Schulze et al., 2000).

All of these combine to create a situation in family firms where the possibility of leadership, be it family or non-family, has a higher likelihood of either lacking the necessary skills or at a minimum possessing subpar skills and experience relative to non-family firms. While not a traditional agency issue, the uncertainty this causes poses significant risk for members of top management working in family firms making it difficult for top leaders to have confidence in each other's abilities thus introducing another potential need for monitoring or possibility for residual losses.

#### 2.1.2. Self-control

In addition to labor pool inefficiencies, family firms also face agency risks associated with self-control (Schulze et al., 2001). While membership in the family or overlap between ownership and management due to family involvement might be higher in family firms, this does not preclude individual members of top leadership from acting in a way that is detrimental to the whole or even to themselves. Specifically, family business researchers have shown that in addition to preserving or maintaining economic wealth, family businesses also focus on preservation of socioemotional wealth (Gómez-Mejía, Haynes, Núñez-Nickel, Jacobson, & Moyano-Fuentes, 2007). Referring to the non-economic benefits provided by private ownership and control such as status, prestige or political influence, family businesses have been shown to focus on preserving family control even to the disadvantage of their efforts to build economic wealth (Gómez-Mejía et al., 2007). Thus, even in a situation where economic goals are aligned among top leaders within a family firm, individual leaders with differing preferences regarding non-economic benefits can still make decisions that are not in their own or the firm's best interests. This would be to the disadvantage of leaders who were more concerned with the financial benefits and had less interest in these non-economic benefits. In particular, this focus and the potential to negatively impact non-family leaders who would not see the same benefits from a focus on preserving socioemotional wealth. This tendency for family businesses to pursue socioemotional wealth creates agency risk for leaders in family businesses. Not knowing if individual leaders are making decisions in the best interest of the firm creates uncertainty making interactions among top managers and, in turn, execution, more difficult. As with other agency issues, this introduces the potential need for monitoring the agent or represents a possible residual loss from the perspective of the family if the agent and

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