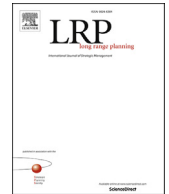




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The substitution of governance mechanisms in the evolution of family firms

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This paper examines how family firms substitute corporate governance with family governance and self-governance at different stages of their development. We argue that the types of agency problems that family firms face as they pass from one generation to the next determine the extent to which these mechanisms can be used as substitutes for one another. Our empirical investigation provides evidence that in the early stages of a family firm's life cycle, instruments of self-governance lessen the need for mechanisms of corporate governance, whereas in the later stages, instruments of family governance can substitute for mechanisms of corporate governance.

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Introduction

At the heart of research on corporate governance lies the agency conflict that arises when ownership and management are separate (Eisenhardt, 1989). In family firms, particularly in their early stages, this separation rarely occurs. For that reason, most classic works on governance assume that family firms do not need corporate governance at the outset (Fama and Jensen, 1983). More recent research, based on behavioural economics, indicates that family firms do face agency problems, which, however, are very different from those encountered by non-family firms (Lubatkin et al., 2005; Schulze et al., 2003). More specifically, these works report that in the early stages of family firms, owner-managers typically face intra-individual agency conflicts, which spring from parental altruism; in other words, owner-managers may make decisions that are in the interests of their families but not in the long-term interests of their firm. The problems that family firms face in later phases of their development are usually related to family opportunism, which arises when family members 'place their own nuclear household's welfare ahead of the welfare of their extended family members' (Lubatkin et al., 2005, p. 324). Scholars have argued that to solve these problems, family firms must have governance mechanisms in place in all phases of their development (Bammens et al., 2008).

Several studies have shown that, apart from mechanisms of corporate governance – in particular, having a board of directors – family firms often also use mechanisms of self-governance or family governance to address such problems (Gallo and Kenyon-Rouvinez, 2005; Gersick and Feliu, 2014; Lubatkin et al., 2005; Siebels and zu Knyphausen-Aufseß, 2012). The mechanisms of self-governance and of family governance are distinct from corporate governance as they do not have a

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corporate origin. Self-governance, which in the literature is often also referred to as 'self-control' (Thaler and Shefrin, 1981, p. 397), is defined as a set of '[self-imposed] rules that restrict the doer's opportunities'. Family governance is defined as a set of mechanisms whose purpose is to manage conflicts between family members. The classic mechanisms of family governance are the family assembly, which is defined as a periodic (typically annual) gathering of the extended family (Gersick and Felui, 2014), and the family council, which is defined as a group of representatives of different clusters of the broader family, who periodically assemble to deliberate on issues related to the family's involvement in the firm (Gersick et al., 1997; Melin and Nordqvist, 2007).

Several studies in the literature on governance in family firms have illuminated the different types of governance mechanisms that are encountered in family firms. However, to date no study has attempted to examine systematically the extent to which self-governance, family governance and corporate governance can substitute for each other. This is an important gap in the literature, given that researchers (Aguilera et al., 2008; Rediker and Seth, 1995) have emphasized the need to understand whether it is possible for companies to choose between different mechanisms of governance. There is already a considerable body of research on the extent to which different mechanisms of corporate governance, such as incentive payments or a board of directors, might be interchangeable and thus serve as substitutes for one another (Agrawal and Knoeber, 1996; Dalton et al., 2003; Desender et al., 2016; Misangyi and Acharya, 2014; Moyer et al., 1992; Rediker and Seth, 1995).

Against this background, this study will examine to what extent self-governance and family governance can substitute for corporate governance in family firms. More specifically, we will look at how the substitutability of these mechanisms interrelates with specific phases in the evolution of the family firm, which, as already mentioned, are characterized by different types of agency problems. Building on insights from behavioural economics, we hypothesize that the three mechanisms are not equally interchangeable throughout a family firm's life cycle. Specifically, we will argue that in the earlier stages of a family firm's development, self-governance tends to substitute for corporate governance, whereas in the later stages of a family firm's development, family governance tends to substitute for corporate governance. We test these two hypotheses using proprietary data from surveys conducted in 2003 and 2013 among private family firms based in Germany. Our results largely confirm our hypotheses. With these findings, we contribute to the literature on governance by illuminating how self-governance, family governance and corporate governance interrelate in general and at different stages of a family firm's development in particular.

The remainder of the paper is structured in five sections. In the first section, we adopt a generational perspective to describe the different stages of a family firm's life cycle and the agency conflicts that accompany each stage. In the second section, we elaborate on the mechanisms of governance that family firms can employ to address the various types of agency conflicts that they encounter as they evolve. This serves as the basis on which we will build our hypotheses on the possible ways in which family firms can replace corporate governance with self-governance and family governance. In the third section, we describe our sample and method. After presenting our results in the fourth section, we discuss and conclude our paper in the fifth and final section.

The evolution of agency conflicts in family firms: parental altruism, family opportunism and managerial opportunism

The development of family firms is typically described in the literature on the basis of the generations that own and manage these firms. Most authors distinguish among three ideal-typical stages: controlling ownership, sibling partnership and cousin consortium. These correspond to the first, second and third (or later) generations of ownership (Gersick et al., 1997; Ward and Dolon, 1998). Some scholars have refined this three-stage model further, taking into account the extent to which different generations are actively involved in the firm's operations, as well as the transition from one generation to the next (e.g., le Breton-Miller et al., 2011).

As more generations become involved and ownership becomes increasingly dispersed, different agency problems emerge, while some of the earlier agency problems become less salient. In their early stages, family firms typically face problems of self-control. At this stage, ownership is typically concentrated in the hands of a single individual—the founder—who also serves as the CEO of the firm. Most previous studies expected agency costs to be minimal at this stage, because early on there is hardly any distinction between ownership and management, whose relationship is the main source of such conflicts (Fama and Jensen, 1983). More recent studies, however, suggest that the founders face agency conflicts, even at this early stage (Lubatkin et al., 2005; Schulze et al., 2003). In particular, founder-CEOs typically face conflicts of 'self-control', because, as Thaler and Shefrin (1981, p. 392) explain, at that stage the (single) founder is 'assumed to be both a farsighted planner and a myopic doer'. When such conflicts represent two different types of logic, the decisions and actions of founder-CEOs are often incoherent.

In the specific context of family firms, problems of self-control relate to intra-personal conflicts between concerns for the immediate family and concerns for the business, which reflect the fact that while founders wish to promote the welfare of the family, they also wish to ensure the success of their business. These two wishes can prove incompatible. For example, family members may be hired at a higher cost than necessary, the firm's money may be used to finance luxury lifestyles for family members, children or spouses may be offered jobs that do not reflect their management skills and departments that are not actually needed may be established, merely to satisfy family members and family stakeholders (Bennett et al., 2005; Chrisman et al., 2007; Schulze et al., 2001). A well-known example of this scenario is the Steinberg company, whose

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