Agency Relations within the Family Business System: an exploratory approach*

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Researchers use various definitions to describe the family firm. The characteristics of family firms that are stressed in each of these definitions are somehow related to family control. All characteristics together reflect a spectrum of family firm types along one core dimension: family involvement in the firm. However, it is more helpful to distinguish among family firms by using their precise type. Each particular family firm type is characterised by a set of agency relations within and between the family system, ownership system and the business system. This paper is a first attempt to apply the insights from agency theory on a highly simplified (reference) family firm situation where the father is full owner and the daughter manager of the family firm. Agency theory establishes the foundation for the optimal contract conditions between father and daughter. While real life is often characterised by bounded rationality and incomplete information, future research should help identify the "optimal contract" between the family/shareholders and management in various family firm types under these circumstances.

Keywords: Family business, governance, agency theory, theoretical model

Introduction

Berle and Means' analysis of the separation of ownership and control has dominated thinking and research in the areas of strategic management and governance (Becht and Mayer, 2001; Schulze *et al.*, 2001; Lubatkin *et al.*, 2001; Marris, 1964 and 1968; Williamson, 1964; Baumol, 1959; Demsetz and Lehn, 1985). The separation of ownership and control leaves shareholders with little or no control over the actions of a company's managers (Berle and Means, 1932). In response, shareholders attempt to protect their investment by using a variety of control mechanisms (Targett, 2002; Shleifer and Vishny, 1997; Jensen and Meckling, 1976). However, recent studies reveal that dispersed ownership is the exception rather than the rule across Continental European countries. Scholars identify that the ownership of Continental European companies is primarily concentrated in the hand of families (Van den Berghe and Carchon, 2002; Faccio and Lang, 2002; La Porta *et al.*, 1998; Franks and Mayer, 1995). Family firms distinguish themselves in terms of ownership structure, leadership and evolutionary dynamics (Habbershon *et al.*, 2001; Schulze *et al.*, 2001; Melin and Nordqvist, 2000; Gersick *et al.*, 1997; Shanker and Astrachan, 1996; Ward and Aronoff, 1990).

Given this importance of family firms, there is a need for an in-depth study of family firms and the implications of this ownership structure for the resolution of agency conflicts. In addition to the study of conventional

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control mechanisms, we recognise the need for a "customized" analysis of mechanisms that minimise agency costs in family firms. This doctoral research attempts to contribute to the fields of strategy and corporate governance because we concentrate on the characteristic nature of family ownership and management and its implications towards the management of agency problems (Lubatkin *et al*., 2001; Neubauer and Lank, 1998; Perrow, 1986).

The family firm definition: a conceptual approach

A review of the literature reveals a long list of elements used by numerous authors to define the family firm (Lansberg, 1999; Habbershon and Williams, 1999; Litz, 1995; Donckels and Fröhlich, 1991; Barry, 1989; Handler, 1989; Lansberg *et al*., 1988). Donnelly defines a family firm as a company that:

> *has been closely identified with at least two generations of a family and when this link has had a mutual influence on company policy and on the interests and objectives of the family. Such a relationship is indicated when one or more of the following conditions exist: family relationship is a factor, among others, in determining management succession; wives or sons of present or former chief executives are on the board of directors; the important institutional values of the firm are identified with a family, either in formal company publications or in the informal traditions of the organization; the actions of a family member reflect on or are thought to reflect on the reputation of the enterprise, regardless of his formal connection to the management; the relatives involved feel obligated to hold the company stock for more than purely financial reasons, especially when losses are involved; the position of the family member in the firm influences his standing in the family; a family member must come to terms with his relationship to the enterprise in determining his own career. (Donnelly, 1964, p. 94)*

This definition covers two interacting dimensions of the family business, i.e. the family and the firm. To function properly, a business family may benefit from effective *family governance*, while the business may benefit from *corporate governance*. The primary focus will be on corporate governance, but without neglecting family governance.

Today, the prevailing view of the family firm is that the family, the company and non-family owners are three interconnected social systems where strategy and firm outcome depend on their interactions (Tagiuri and Davis, 1996; Davis, 2001; Stattford *et al*., 1999; Lansberg, 1999; Neubauer and Lank, 1998; Ibrahim and Ellis, 1994; Wortman, 1994; Whiteside and Brown, 1991). Based on this *structural* definition, Gersick *et al*. (1997) developed a typology of family firms using these three dimensions (Figure 1). The integration of time into the model to reflect the life cycle allows for further detailing family firm types into 36 hypothetical types. Past research has devoted much attention to classic family firm types like the first-generation firm which is managed and owned by the founder, the established family firm owned and managed by a brother/sister partnership, the complex cousin consortium and the family firm on the verge of a generational transition (Gersick *et al*., 1997).

Although helpful as a typology, this model provides little direction how the family, the business and the ownership shapes the governance arena. Neubauer and Lank (1998) distinguish 15 roles a person can assume:[1]

1. Just management.
2. Just shareholder.
3. Just board of directors.
4. Just family.
5. Family – shareholder.
6. Family – management/employee.
7. Family – board of directors.
8. Family – management – board of directors.
9. Family – board of directors – shareholder.
10. Family – shareholder – management.
11. Shareholder – management.
12. Shareholder – board of directors.
13. Shareholder – board of directors – board of directors.
14. Management – board of directors.
15. Family – shareholder – management – board of directors.

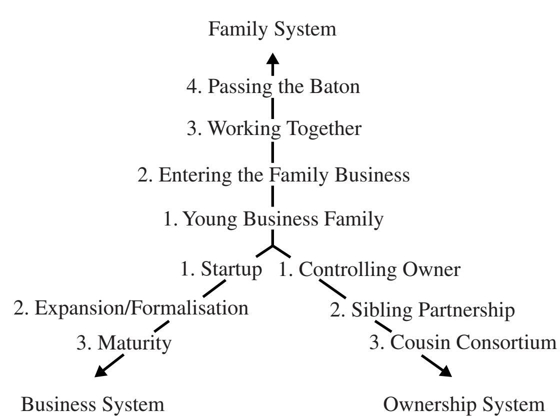

Figure 1: Three-dimension developmental framework (Gersick et al., 1997)

The potential for conflicts also increases. For that, corporate governance in family firms should include processes, principles, structures and relationships that resolve (role) conflicts in order to help the family to realise their particular visions, goals and objectives (Melin and Nordqvist, 2000). The emphasis is on the family's actual exercise of their power and influence over the firm inherent from their status as controlling shareholders. Habbershon *et al.* (2001) make explicit the visions, goals and objectives in terms of *transgenerational wealth creation* and call those families *enterprising families*. The vision of the family directs the business so as to maximise the potential wealth of current and future generations of family members.

Agency relationships in family firm governance

The notion of the *enterprising family* indicates that the firm's primary objective is the achievement of wealth creation across generations. Managers should orient corporate resources and capabilities in function of these objectives. But what if they do not fully act in the family's best interest? This setting can be framed in the theory of agency. Agency theory[2] deals with the problems that can arise in a situation where the family (members) are not in full control of all the decisions and activities within the company because either they lack the necessary skills or the resources (Macho-Stadler and Pérez-Castrillo, 2001; Eisenhardt, 1989; Jensen and Meckling, 1976; Ross, 1973). In this case, those who have decision power can benefit from information that is not known to the non-managing family members (i.e. information asymmetries) or take decisions/actions that favour their own interests and not that of the family (i.e. self-serving behaviour, private benefits) (Mayer, 1999; Shleifer and Vishny, 1997). According to the theory, it is rational for the family to incur costs up to the point where fully eliminating agency problems (conflicts of interest) exceeds the benefits of the actions (Jensen, 1998; Jensen and Smith, 1985).

Jensen and Meckling have extensively analysed the problems arising in the separation of ownership and control in terms of agency theory (Jensen and Meckling, 1976). When applied to the separation of ownership and control, agency theory analyses the relationship between principals/shareholders and agents/managers who act on behalf of the principals. According to Jensen and Meckling, managers have de facto corporate control when shareholders employ them to oversee the firm's resource allocation decisions. In addition, Jensen and Meckling assume that shareholders are indifferent to the specific (unsystematic) risk of any single firm, because they can diversify this source of earning variation away by spreading their investment across a diverse set of firms whose earnings are less than perfectly correlated with each other. In contrast, managers are concerned with firm-specific risk, for it exposes their personal (human) investment in a firm to uncertainty about the firm's survival and performance. As a consequence, managers have the incentive to protect their personal investment by taking decisions that do not necessarily maximise the objective function of the shareholders (Lubatkin *et al*., 2001; Chatterjee and Harrison, 2001; Boot and Macey, 1999; Garvey and Swan, 1994; Gedajlovic, 1993; Berle and Means, 1932).

The advantages of "familiness" to corporate governance

Fama and Jensen (1983a, p. 306) believe that family ownership is particularly efficient to minimise agency problems because shares are in the hands of "agents whose special relations with other decision agents allow agency problems to be controlled without separation of the management and control decisions. For example, family members . . . therefore have advantages in monitoring and disciplining related decision agents". Further, "family members have many dimensions of exchange with one another over a long horizon, and therefore, have advantages in monitoring and disciplining related decision agents" (Fama and Jensen, 1983a). Since ownership of family firms are concentrated in the hands of family firms, the risk of free riding also diminishes (Shleifer and Vishny, 1997).

A particular powerful argument in favour of family firms originates from household economics, i.e. the influence of *altruistic behaviour* on family dynamics. According to Batson (1990), altruism comprises a moral value that motivates individuals to undertake actions that benefit others without any expectation of external reward. The economic literature adopts the view that altruism is a trait that positively links the welfare (both intrinsic and extrinsic) of an individual (egoistic) to the welfare of the others (altruistic) (Lunati, 1997). Parents, therefore, will transfer wealth to their children because to refrain from doing so would harm the altruist's welfare.

In the context of the family firm, altruistic behaviour is beneficial in four ways. First, it creates a self-reinforcing system of incentives that encourages family members to be considerate of one another, which creates family firms a history, language and identity, that make them unique. Second, altruism creates a de facto collective ownership by all family members working in the firm (i.e. *family agents*) inherent to their residual claim on the family's estate (Stark and Falk, 1998). Third, the incentive to communicate and cooperate is enforced, thereby reducing information asymmetries among family agents. And fourth, the altruistic drive of family members creates a unique capability of loyalty and commitment of corporate leaders to the firm's long-run performance and strategic endurance (stability) through various circumstances and over longer periods of time than many non-family managed firms (Kang, 2000; Ward, 1987).

Governance bodies other than the board of directors may also contribute to corporate communication and transparency. The *family council* is, unlike non-family firms, a governance instrument where employed and non-employed family members discuss various corporate and familial issues. This forum can be seen as a platform outside the day-to-day management allowing the family members who assume different roles to transcend their day-to-day professional function and discuss common issues. This promotes sharing information that is related to the company and how the company's future is related to the family's future (Neubauer and Lank, 1998).

The pitfalls of "familiness" to corporate governance

Recently, some family firm researchers have questioned the highly appraised family firm form as immune to conflicts of interest between the family as shareholder and the family as manager of the company. The *roles approach* to family firm governance reflects a heterogeneous set of objectives related to each role. Conflicts of interests between family members in different roles create a situation that may jeopardise efficient collaboration and information exchange. It may even eliminate or motivate the absence of altruistic behaviour between members of the family. In particular, if family wealth is primarily invested in the family firm, they cannot reduce financial risk through diversifying financial assets (i.e. risk aversion). Increasingly, these family members will be most concerned to achieve their own objectives, rather than the well-being of the entire family.

In some cases, the family bond and the capability of altruistic behaviour are decreased for a number of reasons. The first reason is related to the closed nature of shareholding in family firms (Schulze *et al*., 2001). Private ownership may compromise the efficiency of the firm's factor markets and the external governance that these markets provide. Often, family firms create *internal labour markets* favouring family members (i.e. self-employment). Public firms, on the contrary, are more exposed to labour market forces that allow for competence-based recruitment. These inefficiencies have important implications for the cost of governing private firms in the sense that this type of firm may be perceived as less attractive to the very talented people, even those that are family related. This also increases the cost of monitoring because inferior compensation and limited promotion opportunities reduce the agent's incentive to monitor each other's conduct (Fama and Jensen, 1983a) and to compete with one another for advancement (Besanko *et al*., 2000). Finally, closely held family firms are faced with higher monitoring costs because the company is not susceptible to the disciplinary pressure of the market for corporate control.

Altruistic behaviour may also be counterproductive to efficient corporate governance. In the case of the relationship between parents and children, altruism links the parent's utility function to that of the children which creates the risk that, whatever the utility function of the children, parents will continue to provide wealth and resources as their level of altruism increases. It may even add up to a degree that is detrimental to the company's performance when, for example, financial resources are used for the children's personal benefit. Buchanan (1975) suggests that there is a positive relationship between a parent's level of altruism and their children's behaviour to shirk responsibilities and even misrepresent their actions with the objective to serve self-interest. Depending on the particular role, this behaviour may be more difficult to curb. If, for example, a child is a member of the board and assumes a management function, this child has a privileged information position with respect to the company's (financial) resources. In addition, in the eyes of the parents, this child may be considered as more successful and contributing to the family's wealth through the firm, which creates some kind of "blind faith" of the parent-shareholders in their child. Related to the differential positions assumed by different family and non-family people *asymmetric altruism* can also result, where one person is favoured more than the other. This results in a complex web of entwined agency problems that adversely affect vertical (founder/family agent), horizontal (agent/agent) and inter-group (family/non-family) agency relationships in family firms. Altruistic behaviour can cause the firm's non-family agents to experience a feeling of "distributive injustice". Family-controlled firms may, for example, withhold upper management positions for family agents and, thus, offer fewer promotional opportunities for non-family agents. In addition, this feeling is enhanced when perquisites and privileges are offered to family agents but not to non-family agents. As a consequence, non-family agents can feel the incentive to engage in shirking and other forms of opportunism (Lubatkin *et al.*, 2001; Baldridge and Schulze, 1999). According to Theo Compernolle (2002), distributive injustice may also manifest between family members when the "least" family members tend to receive more support than the better performing members.

Remedies to agency problems: optimal contracts for family firm agency relationships

In previous sections, we started the discussion with the governance complexity of the family firm in terms of 15 interacting roles, each with their particular objectives and job expectations. This conception of corporate governance is embedded in the family business system made up of three core dimensions, i.e. the family, the firm and the ownership. The time dimension allows for establishing a family firm typology of 36 types. Thereafter, we discussed what benefits and pitfalls may be presented when ownership and management are controlled by a group of people that are family-related.

Agency theory provides a strong basis for explaining why family firms may or may not outperform non-family firms with regard to corporate governance. However, this discussion is not yet sufficient to help a particular family firm type in determining how it should organise its governance optimally. There is an arsenal of governance mechanisms available from the literature. If we take into account the distinct nature of the family firm and the heterogeneity within the pool of family firms, the question is whether governance mechanisms used in non-family firms – mainly identified by Berle and Means' type of companies – are transferable to family firms (Schulze *et al.*, 2001; Habbershon *et al.*, 2001). The absence of in-depth research on the unique agency problems associated with the different family firm types, makes it questionable to limit the analysis of conventional control mechanisms to the internal and external governance mechanisms. For example, strategic planning can act as a device for shareholders to interact with the organisational situation and help them to develop a better understanding of the behaviour of managers (Fredrickson, 1985; Rediker and Seth, 1995). One can hypothesise that ongoing interactions with the organisation reduces the principals' information disadvantages.

Before one can associate governance mechanisms best suited to a particular firm type, we summarise the elements of the problem:

1. The family expects to maximise its objective to create wealth for itself and succeeding generation(s).
2. The family controls a company through its shareholding.
3. Business complexity requires the employment of family and non-family people.

From these elements, we will call the family the *principal* and the employed family and non-family people in the management of the company the *agents*.[3] In this paper, we discuss a *reference* situation where all shares are held by a single person (founder) and where management is in hands of a relative, say his daughter. One may think that the company is now in a second phase of evolution, where the founder/manager transfers the management of the company to his daughter. The father is well aware of what happens in the firm and how his daughter runs the business because of his past experience and close presence to his daughter. The daughter has been working in the business before being appointed as manager, which makes her an insider of the company too. We assume that both father and daughter have the same information before establishing the contractual relationship and during it. The daughter now becomes more independent in terms of financial support by the family and receives a wage as manager of the company. Previously, the daughter enjoyed the (financial) care generated through the firm's activities and performance. In formal terms, the proposed model is (Macho-Stadler and Pérez-Castrillo, 2001):

$$\underset{[e,\{w(x_i)\}_{i=1,\ldots n}]}{\text{Max}} \sum_{i=1}^{n} p_i(e)B(x_i - w(x_i)) \tag{1}$$

Subject to:

$$\sum_{i=1}^{n} p_i(e)u(w(x_i)) - v(e) \geq U \tag{2}$$

The mathematical problem stated here reads as follows. The principal's utility function $B(.)$[4] consists of the income x generated through the company and is only indirectly dependent of the daughter's management efforts (v). The wage $w(x_i)$ is dependent on the result x_i from a set of possible ($p_i(.)$)[5] results i ∈ {1, 2, . . . , n}.

Since the result depends not only on the agent's effort but also on a random component (e.g. corporate factors, industry and general economic circumstances, etc.), the result is also random (Macho-Stadler and Pérez-Castrillo, 2001; Ross, 1973).[6] As a consequence, expected utility for the father (and his wife and children still living at home, for example) is the sum of all possible expected net incomes multiplied by their probability of occurring.

The daughter receives a wage for her efforts as manager, formulated in equation (2). Her net utility $U(w, e)$ takes the (monetary) value of the effort, because the effort supplied implies some cost to her. The daughter obtains a certain satisfaction (utility) from working in the family business as manager, but the greater the effort she has to put into her job, the more problematic it becomes for her (e.g. time spent with her own family reduces as her job consumes more of her time).[7]

The implications of this setting are threefold. First, the father is *primarily* interested in the performance of his company. The daughter, on the other hand, is not *directly* worried about this aspect. Second, the father is not directly interested in how (much) effort his daughter puts into her job, as long as she does all the necessary for the health of the company. She, on the other hand, spends time as manager in the company of her father and she experiences this as a cost. But for that she receives a wage. The wage – taken from the total output of the company – is the compensation for the effort that her father demands and acts as a conflict-mitigating instrument between the objectives of the father and the daughter. It is important to know that the father should take into account that the wage paid to the daughter is competitive enough compared to other jobs. This condition is reflected by equation (2) in the fact that the expected utility function of the agent should be at minimum at a level where she is not willing to switch jobs. This utility level $\underline{U}$ is called the *reservation utility*.

An important aspect of the *contract* between father and daughter is the extent to which its content will be complied with. For a pure professional arrangement between non-related principal and agent, the contract is often structured such that it can be verified and judged by a court of law. For an arrangement between family members, this requirement may be less stringent. On the one hand, the family bond may strengthen the verifiability because the father is well aware of the business. On the other hand, this may not completely compensate for the power of external verifiability if no formal elements have been entered into the contract.

What contract does the father have to offer his daughter to ensure that his work and subsistence is well cared for by his daughter? Remember that he started and developed his company, of which he is still the full owner. The (Pareto) efficient contract will be the solution of the model presented by equations (1) and (2). The father maximises his expected utility under the restriction that his daughter is willing to accept the job (contract). The father will be able to maximise his wealth (and hence, that of his family) by paying a wage $w^0(x_i)$ where:

$$\frac{B'(x_i - w^0(x_i))}{u'(w^0(x_i))} = \text{constant} \tag{3}$$

The ratio of the marginal utilities[8] of the father and that of the daughter should be constant. This solution implies that the shape of the utility functions representing the father's and daughter's risk profile will determine the optimal payment scheme. If the father is risk-neutral – B' is constant – then the optimal situation requires that u' be constant as well. In order to make the daughter maximise her father's utility, she should receive a wage equal to $w^0 = u^{-1}(\underline{U} + v(e^0))$ and is dependent on the market conditions and the effort supplied. The father is assuming all the risk ensuring that the daughter receives a wage independent of the firm's result.

In the case of a risk-neutral daughter (u' = constant) the optimal contract will require B' to be constant as well: the profit that the father gets is independent of the firm's result. The daughter is willing to take all the risk to insure her father against variations in the company's result. The optimal wage is equal to $w^0(x_i) = x_i - k$, where the daughter keeps the result x and pays the father a fixed amount k, independent of the firm's result. If both the father and the daughter are risk-averse, each one will need to accept a part of the variability of the result. How the wealth created will be distributed will depend on their degrees of risk-aversion.

How does this analysis translate in terms of optimal corporate governance? The model presented here assumes that the father and the daughter enter a relationship in the family firm in which the daughter manages the firm that is fully owned by the father, and in which a random result is obtained. Both father and daughter have the same information, both before the daughter started working in the firm and during it, because of the close involvement of the father (not as a manager, however, but his shareholding and emotional attachment to the business allow him to be closely informed of the company's progress). The main conclusion of the model is that no conflicts will arise (i.e. no governance mechanisms are necessary to monitor and discipline the daughter in her job) when the wage paid to the daughter fully reflects the distribution of risk between the father and the daughter. If the father's utility is independent of the firm's results, then efficiency requires that the daughter should receive a fixed wage for her work. The wage becomes dependent on the job remuneration and content in comparison to jobs outside the company (cf. $\underline{U}$) and the effort demanded. When the daughter is risk-neutral and the father risk-averse, then the optimal contract is characterised by a fixed payment to the father and the rest of the firms' result goes to the daughter. If the father and the daughter are risk-averse, the contract should reflect their degree of risk-aversion.

Conclusion and future research

If we link this discussion to that in the previous section, it is likely one can find family firms where the family factor is helping communication and information exchange between family members in different roles. We discussed the father–daughter relationship where the father is family-shareholder and the daughter family-manager. The close involvement did not require specific disciplining governance mechanisms. The reference model assumes that both the principal (father) and agent (daughter) have the same information throughout the relationship. The principal and agent share common information regarding all relevant characteristics and variables (symmetric information), and the agent's effort is verifiable, so that it is possible for the principal to check that the agent fulfils the tasks. In addition, the principal (. . .) will offer the contract to the agent depending on the type of agent. The agent will accept the contract depending on the type of principal and the tasks for which the agent is asked. Since the agent's effort and the final result of the relationship are observable, it is possible to introduce these variables explicitly into the terms of the contract. Finally, the model reflects a single period (static situation).

In reality, principals and agents do not always share common information and have limited capabilities to process the available information (bounded rationality). The situation becomes even more complex when the principal loses full control over the firm (e.g. another family or non-family shareholder enters the ownership structure) or is not fully informed about the variables affecting his/her utility function. The shape of the utility function of the principal – family, non-family shareholders – will depend on the "full" ownership structure of the family firm, i.e. the "ownership" dimension as introduced by Tagiuri and Davis. In many of the family firms, non-family shareholders may have an important disciplining effect on family members, depending on the reason why they entered the company. Therefore, a more accurate picture is expected to emerge when family and non-family shareholders are included in the study. As mentioned earlier, agency problems are affected by shareholder and management identity (Becht and Mayer, 2001; Thomsen and Pedersen, 2000; Chami, 1999). The reference model is helpful because it simplifies reality to the core elements of the problem. Future modelling and empirical research should consider more fully corporate governance reality in the family firm system.

Notes

1. The governance playing field of a non-family company is composed of seven positions: (1) just management, (2) just shareholder, (3) just board of directors, (4) management – board of directors, (5) management – shareholders, (6) shareholders – board of directors, (7) management – shareholders – board of directors.
2. In general terms, agency theory describes the problems that can arise in any cooperative exchange when one party (the "principal") contracts with another (the "agent") to make decisions on behalf of the principal (Besanko *et al.*, 2000; Fama and Jensen, 1983a, 1983b). Agency problems arise when agents can hide information (i.e. information asymmetries) or take actions that favour their own interests (i.e. self-serving behaviour). According to the theory, it is rational for the contracting parties to incur agency costs up to the point where the cost of fully eliminating conflicts of interest (i.e. agency problems) exceeds the benefits (Jensen and Smith, 1985).
3. More specifically, each role, whether assumed by one person or multiple persons, complicates the identification of who is the principal and agent.
4. We assume this function B to be concave increasing: $B' > 0$ and $B'' \Leftarrow 0$, where the primes represent the first and second derivative, respectively. The concavity of B represents that the principal is either risk-neutral or risk-averse.
5. The probabilities $p_i(x_i)$ reflect that the result not only depends on the agent's effort but also on a random component. Therefore, the result is also a random variable. This reflects the idea that both parties are not necessarily fully informed as to all aspects of the relationship (perfect and symmetric information, i.e. rationality assumption). Both are in the same informational position (bounded rationality) (symmetric, but

possibly imperfect, information). The model does not exclude random elements affecting the relationship.

6. We assume a finite universe of possible results $X = \{x_1, x_2, \ldots, x_n\}$; as a consequence, the sum of all probabilities related to an outcome x_i given a particular effort level e equals 1.
7. Formally, this means that her utility function is concave and increasing: $u' > 0$ and $u'' <= 0$. In addition, we assume that the marginal disutility of effort is not decreasing: $v' > 0$ and $v'' \Leftarrow 0$.
8. The marginal utility is the utility that is generated with a unit increase of the wage paid.

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