Corporate Governance in Family Firms:
A Literature Review

by

T. Pieper

2003/97/IIFE
Corporate Governance in Family Firms: A Literature Review

Torsten M. Pieper

Research Assistant INSEAD
INSEAD Initiative for Family Enterprise
Boulevard de Constance, F-77305 Fontainebleau Cedex, France
Tel. : +33 (0)1 60 72 40 00 Fax : +33 (0)1 60 74 55 00
Torsten.Pieper@insead.edu

ABSTRACT
The governance discussion in the family business field has received much attention during the past years. The interest in the subject comes not only from the academic side; the topic figures also among the top priorities on the agenda of family business owners and their advisors alike.
This paper reviews the current state of research on family business governance and its link to family business performance. The review of the extant literature indicates that families bring an element of performance to the business, but that, nevertheless, this element of performance is not unconditional. It also appears that most of the so-called ‘best practice’ governance lacks empirical validation and that recommendations designed for an effective governance of large public firms should not be directly translated to the family business context. Herein lays an opportunity for academics to direct further research in this area and to explore these unanswered questions.

Keywords: Corporate Governance; Family Firm Governance; Family Business; Firm Performance; Board of Directors

ACKNOWLEDGEMENTS
This paper benefited from the financial support of the Tetra Laval Research Fund for the Large Family Firm, which is hereby gratefully acknowledged.
The author would like to thank Christine Blondel, Randel Carlock and Ludo Van der Heyden from The INSEAD Initiative for Family Enterprise for their contributions and their ideas on earlier versions of the paper.
He would further like to acknowledge the valuable comments made by participants in the 2nd International Doctoral Course on Governance in SMEs (2002) and of the International Family Enterprise Research Academy Meeting in Milan 2003.
INTRODUCTION

The idea of corporate governance can be traced back to Berle and Means (1932). The authors celebrated in the development of large multi-divisional companies with salaried professional managers the decline of traditional family ownership (Dallago, 2002). As we will see later on, contrary to this thesis, the widely-held corporation is rather the exception than the norm in most economies around the world. In recent years, the governance discussion has experienced stark revitalization in the general business context due to various corporate scandals and failures. But corporate governance issues figure on the agenda of most family businesses, as well. However, the raising interest in family business governance among researchers, business owners, and advisors to family firms seems to have different origins. Academics see in the topic an opportunity for theory building and research, like, for example, Jensen and Meckling (1976) who developed agency theory as a theoretical answer to the governance problem as described earlier by Berle and Means. On the other side, family business owners consider stricter corporate governance rules as a contribution to improve the performance of the company (Robert Half Management Resources, 2003). And, as a result, consultants to family firms use validated results from academic research on governance in order to assist business owners in choosing and implementing the most appropriate governance system for their particular case.

The present paper provides information to each of these groups. For the academic audience, it reviews and proposes an overview of established knowledge on family business governance. Furthermore, it shows off under-researched areas and, hence, gives motivations for future research projects and theory building. Family businesses are made sensitive to the necessity of a solid governance structure for the continuity of both the family and the business over time. Owners find information on and an evaluation of the link between corporate governance and firm performance. Finally, family business advisors may translate validated research results into practice. The paper is structured according to these issues and, hence, proceeds as follows: the first part is dedicated to a review and a classification of existing corporate governance definitions. Limitations of existing mainstream research on corporate governance are highlighted and the particularities of family firms and their special governance needs are explored. A literature review on family business governance is presented in the second part before the third section links family business governance (and so-called ‘best practice’) to firm performance. The conclusion finally summarizes what we know so far about family business governance and its impact on firm performance and outlines the missing parts of the puzzle.
CORPORATE GOVERNANCE – DEFINITIONS AND SHORTCOMINGS OF EXISTING APPROACHES

A Classification of Corporate Governance Definitions

Studies on corporate governance propose various definitions of this term. According to Huse and Landström (2002), this depends on the discipline where the definition is actually used, for example whether it is in the context of large public firms or small and medium enterprises. In their book on governance in family firms, Neubauer and Lank (1998) propose two definitions of corporate governance: one that emphasizes the ultimate aim to which corporate governance measures are set up, and another one that stresses the nature of the key corporate governance tasks. Continuing in this line of thinking, the following classification will thus distinguish between ‘goal-oriented’ definitions, describing what corporate governance should aim for (the ‘Why?’), and ‘task-oriented’ definitions, explaining what tasks need to be fulfilled in order to reach that goal (the ‘What?’).

In addition to this first criterion, that is the nature of tasks to be fulfilled and aims to be met, definitions can be grouped according to their scope, into ‘narrow’ and ‘broad’ ones. Narrow definitions are the more traditional ones which follow a shareholder approach and, hence, focus on the conflict between outside investors and the firm’s top management team. But since shareholders and managers are by far not the only two groups of actors who influence and ultimately determine a firm’s course, broader definitions try to integrate all stakeholder groups into the governance discussion. A more in-depth investigation of the share- and stakeholder approaches will follow in a later section of the paper.

These two criteria – the scope of the definition (narrow or broad) and its orientation (task- or goal-oriented) – span a two-by-two matrix that allows the classification of corporate governance definitions into four main groups, as shown in Table 1. (Due to space limitations, the table contains only a few selected definitions to exemplify the classification method. More definitions can be found in Appendix 1.) Definitions in the upper left cell have a narrow scope and describe the ultimate goal to which corporate governance measures are set up (i.e. Melin & Nordqvist, 2002). Definitions in the upper right part are also goal-oriented, but have a broader scope (i.e. Bain & Band, 1996; Neubauer & Lank, 1998). Both lower cells contain task-oriented definitions. However, those with a broader scope represent the largest group among all four (i.e. Demb & Neubauer, 1992; Blair, 1995; Neubauer & Lank, 1998; Cadbury, 1999; Hitt, Ireland, & Hoskisson, 1999; Huse, 2000; Vives, 2000; Corbetta, Gnan, & Montemerlo, 2002; Huse & Landström, 2002). Finally, those definitions putting forward the key governance tasks but having a narrow scope almost complete the classification scheme (i.e. Tirole, 2001; Nordqvist & Melin, 2002). Nevertheless, a sharp distinction among the definitions is not always possible: some combine both goal- and task-oriented elements while having a broad scope (i.e. Witt, 2002), whereas others have a narrow one (i.e. Carlock & Florent-Treacy, 2002). Another group puts forward the key corporate governance tasks, but applies both to a broad and a narrow scope (i.e. Maher & Andersson, 1999; O’Sullivan, 2000).
TABLE 1: Classification of Governance definitions according to scope and orientation

<table>
<thead>
<tr>
<th>Orientation</th>
<th>Scope</th>
<th>Narrow</th>
<th>Broad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goal-Oriented</td>
<td>Narrow</td>
<td>“CG can be defined as how the owners’ interest is organized and exercised in order to influence in the strategy processes.” (Melin &amp; Nordqvist, 2002)</td>
<td>“CG is a system of structures and processes to secure the economic viability as well as the legitimacy of the corporation.” (Neubauer &amp; Lank, 1998)</td>
</tr>
<tr>
<td>Task-Oriented</td>
<td>Narrow</td>
<td>“A good governance structure is one that selects the most able managers and makes them accountable to investors.” (Tirole, 2001)</td>
<td>“Corporate Governance is the system by which companies are directed and controlled.” (Cadbury, 1999)</td>
</tr>
</tbody>
</table>

It is important to mention that the relatively small selection of definitions cannot be an exhaustive list of corporate governance definitions. It only is meant to provide an impression about the variety of the different definitions of this term. However, it becomes clear that this variety comes along with several limitations for research that will be discussed in the following section.

Limitations of Mainstream Corporate Governance Literature

As we have seen in the previous passage, the concept of corporate governance is a very broad one. Several authors have already pointed out that there is a definite lack of consensus or agreement regarding the definition of corporate governance (Maher & Andersson, 1999; Corbetta, Gnan, & Montemorlo, 2002). The absence of a single and clear-cut definition is partly due to the national legal systems explaining the differences in corporate law and in the level of investor protection (La Porta, Lopez-de-Silanes, & Shleifer, 1999a; Shleifer & Vishny, 1997).

Another limitation derives from the basic theoretical foundations of corporate governance. Mainstream research on corporate governance is based on the separation of ownership (shareholders on the one side) and control (managers on the other side) in the large, publicly traded firm where ownership is distributed among an extremely large number of anonymous shareholders (Berle & Means, 1932). In this principal-agent approach with large, dispersed ownership, the main corporate governance tasks consist in the defense of shareholders’ interests and thus, in the establishment of efficient monitoring and management-control structures. However, reality shows that the concept of the widely held firm with dispersed ownership, as presumed by Berle and Means, is a rare phenomenon in most economies around the world (LaPorta, Lopez-de-Silanes, & Shleifer, 1999b; Barca & Becht, 1999). Beyond the United States and the United Kingdom, most companies, even listed firms, have a dominant owner (La Porta, Lopez-de-Silanes, & Shleifer, 1999a). In most cases, a family holds such a dominant stake, and shareholders (family members) often occupy key executive management positions within
the affair (Berglöf & von Thadden, 1999). Several cross-sectional and comparable country studies support this finding: a recent study by Blondel, Rowell and Van der Heyden (2002) establishes that the majority (57%) of the 250 largest public companies in France are controlled by a family or an individual person. The equivalent of this study on the 250 largest public companies of the Frankfurt Stock Exchange reveals a similar percentage (51%) for Germany (Klein & Blondel, 2002). Kang (2000) argues that research after Berle and Means (1932) found the separation of ownership and control to be a social scientific “pseudofact”. He provides evidence that large-block owners actually controlled many of the public corporations originally studied by Berle and Means.

Another point of criticism on the approach used by Berle and Means is the limitation of the discussion on the company’s share- or stockholders. These are individuals who hold the firm’s equity and whose interests, according to the authors, should be dutifully cared for by the management. But this view neglects another, at least equally important, group of actors to whom the corporation is responsible: its stakeholders and their governance demands. Stakeholders have an investment in the company, however not in the form of equity, but these non-equity stakes should also count as an ownership interest (Carver & Oliver, 2002). According to Freeman (1984) the definition of stakeholders includes shareholders, employees, customers, suppliers, creditors, and the society.

Freeman and Reed (1983) proposed already twenty years ago to invite stakeholders to participate actively in the governance process. Furthermore, they recommended to encourage stakeholder involvement in strategic decisions and to raise management responsiveness to their needs. This necessity has grown out of a raising concern for business ethics and the realization that the interests of the organization’s actors are interrelated. Today, the stakeholder idea has become a mainstay of management theory (Harrison & Freeman, 1999) and furthermore, any discussion about corporate governance should include considerations about who the company’s stakeholders are and what their particular governance demands consist in.

In conclusion, we can summarize that any definition of corporate governance focusing exclusively on the relationships between many, anonymous stockowners on the one hand and few managers on the other, while ignoring various equally important stakeholders, is simply not representative for describing the actual configuration of our economic landscape. Since the majority of all firms (publicly listed or private ones) in any economy are characterized by concentrated, mostly family-ownership, a narrow definition following a stockholder approach inevitably fails to describe the governance system in these firms. Therefore, before investigating what family business governance is about, a short section is dedicated to this form of enterprise.

**Bringing the Family Component into Play**

In the previous section, we saw a wide range of corporate governance definitions and the same is true for the diversity of configurations encompassed by the term “Family Business”. In this literature review, the term ‘family business’ includes small and large firms, founder-companies, multi-generational businesses, private and publicly traded companies, young and old ones. This diversity of species of family businesses shows the many facets in which a family business can appear. Therefore, it is necessary to dedicate a short section on the definition of what constitutes a family business.
The first answer to this question is that there is no general consensus among academics on its definition. Most studies apply a categorical, black-or-white, view differentiating between family business on the one side and non-family business on the other. However, a recent paper by Astrachan, Klein and Smyrnios (2002) proposes the measurement of family influence on a continuous scale, reflecting a family’s influence on any firm in terms of power, experience, and culture (the so-called F-PEC scale). Following this approach, in the present paper, a family business is considered a business in which a family has a major influence on the company and where this influence outweighs the influence of any other potential actor (shareholder). With respect to the aim of studying family-influenced businesses, this broad definition includes companies of various sizes, life cycle stages, and industries.

After this section dealing with family business definition issues, the following passage will investigate how the governance structure of these firms differs from the one of non-family-influenced firms and what particularities make up their governance systems.

**Particularities of Family Business Governance and a Definition**

As mentioned in the former section, the nature of ownership in family firms differs in several important ways from the one found in widely-held corporations. According to Ward (2001), these main differences are: first of all, family business owners are identifiable since they are limited in number; beside business, they have lifelong, interpersonal relationships and apply a long-term view in their actions. Secondly, beside purely economic goals, ownership has also non-economic meanings and accounts at a large degree to an individual’s net worth. Thirdly, the ownership position cannot be easily left, both financially and emotionally. In addition to the importance of identifiable and concentrated ownership, it becomes clear that family firms naturally apply a stakeholder view since their foundations are based on shared values and long-term relationships (Carlock & Ward, 2001). The care for stakeholders (and mainly for the employees) appears clearly in the case of the HP-Compaq merger where one of the reasons for Walter Hewlett’s rejection of the acquisition of Compaq was the announced lay-off of several thousands of HP’s employees as a consequence of the merger (Carlock & Florent-Treacy, 2002).

Beside the types of stakeholders found in any organization, family firms contain stakeholders different in nature from those described in the previous sections: family stakeholders are historically, culturally, and relationally different from the other groups. Historically, a family is related to its business for a long duration; furthermore, each family has its own culture and set of values which are internalized by the family members as they grow up; finally, family stakeholders are genetically related to each other. According to Ward (2003b), this is what differentiates family business from general business governance. In the widely-held firm, the relationships among the governance bodies (and mainly between the board of directors and the management) are characterized by distrust: does the agent (the manager) really act in the best interest of the principal (the shareholder)? On the contrary, trust and the quality of relationships are what make family businesses so distinctive. The role of trust as a governance mechanism and its importance in family firms will be further investigated in the next section.
With the background knowledge of the previous passages, we are now able to introduce a suitable definition of governance in family firms. Cadbury’s 1999 definition is well-adapted to assess the particular governance configuration in family firms: “Corporate governance is the system by which companies are directed and controlled.” Several reasons back the adoption of this definition: Firstly, it contains all important elements necessary to describe corporate governance, but employs simple language and is therefore easy to understand.

Secondly, governance is described here as a system. We can further develop this idea and analyze what elements constitute the governance system. A system contains actors (or structures) and processes describing how these elements interact with each other. Structures and processes constitute the governance system in any family firm, and furthermore, it is important to mention that each individual family firm has a particular governance system of its own, depending on the patterns of interaction between the structures and processes (Melin & Nordqvist, 2002). Structures (used as a synonym for actors) of family business governance system include (1) the family and its institutions (family meeting, family assembly, and family council), (2) the Board of Directors, (3) the Chief Executive Officer (CEO) and the Top Management Team (Neubauer & Lank, 1998). By some, family agreements are another important structural element of family firm governance (Hughes, 1997). This particular structure results from the nexus of the family-, the ownership-, and the business sphere. The model is often referred to in literature as the ‘the three circle model’ (Tagiuri and Davis, 1982; Gersick et al., 1997) and it is characterized by multiple relationships and interactions among the actors of the different spheres. In the same context, Neubauer and Lank (1998) speak of ‘the three circle and tie model’ as they add the board of directors as an individual system.

Governance processes in family firms are concerned with the activities of and the interactions among the different actors within the governance structure. These processes encompass both concrete and relational activities like social interactions, institutional forces and cultural patterns (Nordqvist & Melin, 2002).

A third reason for the choice of the Cadbury (1999) definition is that it is consistent with the requirements for a governance system claimed by Carlock and Ward (2001). The authors state that “Family business governance requires parallel family and business thinking to support the development of planning, decision-making, and problem solving structures for both the family and business system.” In their book, the authors propose a Parallel Planning Process for family firms to integrate and balance both the family’s and the business’s interests. This is an important insight, as Sir Adrian Cadbury (2000) mentioned earlier that “It is essential at the outset to recognize that the governance of a family firm is in many ways more complex than the governance of a firm with no family involvement. Family relationships have to be managed in addition to business relationships.” A sound and solid governance structure is fundamental for the family’s and the business’s continuity over time, as the case of the French Wendel family with its almost three hundred year-old history impressively illustrates (Blondel & Van der Heyden, 1999a and 1999b). As soon as at the end of the 1800s, the family established ownership agreements regulating ownership requirements and establishing management duties. Strong family commitment and shared values combined with business excellence are at the heart of this family’s success during times of turbulent changes and its success persists even today.
If we come back to the classification scheme (see Table 1), the chosen definition can be described as ‘task-oriented’ with a broad scope. The definition emphasizes the tasks that the governance system needs to fulfill: ‘to direct’ and ‘to control’ the company, where ‘to control’ implicitly includes ‘to account for’ the company. Neubauer and Lank (1998) distinguish between these two expressions, but characterize them as highly complementary. Directing a company means being involved in the strategic decision process of the firm (for more information on family business strategy, i.e. the business strategy plan, see Carlock & Ward, 2001). It is important to mention here that direction is fundamentally different from the every-day management of a company. Directing clearly is the job of the company’s board which determines the purpose of the business and sets the framework within which the business has to be managed, whereas the management actively runs the business on a day-by-day basis. Sir Adrian Cadbury, in the foreword of Carver and Oliver (2002), points out that the line between the board and the management needs to be drawn clearly in order to make sure that boards look outward to the owners (and not inward to the management) and govern the corporation on the owners’ behalf. Controlling (and accounting for) an enterprise means the evaluation of the management’s performance and the monitoring of the progress towards the objectives set by the board. Carver and Oliver give a good conclusion of these issues by stating that “Governance operates at a level that transcends current issues and specific company traditions and elevates people to a higher conceptual plane, one from which accountability can be seen more clearly.”

After this first section dealing with various definition issues and describing the context for family business governance, we will now proceed to the second part of the paper and take a closer look at the evolution and the treatment of the governance topic within the family business literature body.

FACTS ON FAMILY BUSINESS GOVERNANCE

The Review Procedure and a first Overview

The second part of this study is based on an extensive review of family business literature dealing with governance issues. The review process started with a focus on articles appearing in ‘The Family Business Review’ and dealing with governance issues. From each article identified, the reference list was again reviewed; this process was successively repeated and more articles from other journals (i.e. Entrepreneurship and Regional Development, Entrepreneurship Theory and Practice, Academy of Management Journal and Review, Strategic Management Journal etc.), conference papers, books and book chapters were identified. The analysis of the literature review resulted in an evolutionary path starting in the late nineteen-eighties as shown in Figure 1. Due to the large amount of literature resources, only the most important contributions are cited in the following and the main topics presented in this overview.
FIGURE 1-a: Family Business Governance – Literature Overview and Evolution from 1988 to present (topics)

- Cultural change in FBs;
  - Maximation of family and business potential;
  - FB life cycles; Board-stakeholder relations;
  - Fairness

- Proprietorial control in FBs
  - Include all the actors inside the family firm and their multiple relationships within the governance system; alternative theoretical foundations: trust, stewardship etc.; support of the decision making process (Fair Process, PPP)

- "System focus"
  - Only scattered work

- "Board focus"
  - Improving board structure
    - Professionalizing people
    - Multiple board issues (i.e. structure, functions, processes)

- Social networks Informal CG Culture Trust

- Ford (1988); Ward (1988); Ward and Handy (1988); Ford (1989); Ward (1989); Huse (1990)
- Dyer (1989); Berenbeims (1990); Ward (1991)
- Borch and Huse (1993); Corbetta and Tomaselli (1996)
- Cadbury (1997); Davis (1999)
- Huse (2000); Johannisson and Huse (2000); Carver and Oliver (2002)

A main finding of this overview is that the system- and process approach, as mentioned in the previous paragraph, has not always been the dominating view among academics. One can see that the focus has evolved over time, from an almost exclusive focus on individual governance bodies and structures, and mainly on the role of the board of directors in the family firm, in favor of a complementary system approach, consisting of
the firm’s management, its owners, and the family. This evolutionary path will be described in the next two paragraphs.

The Board Focus

Starting with the lower part of Figure 1, we see that the discussion about governance in family firms was engaged at the end of the nineteen eighties by authors emphasizing the importance of non-family members (outsiders) within the family firm. Supporters of this approach put forward the following argument: owners who occupy management positions sometimes fail to recognize business opportunities or pitfalls, in particular in times of change, whereas outsiders with a more objective view would see them and intervene (Berglöf & von Thadden, 1999). Hence, the primary objective of these recommendations was to improve the structure of the board by staffing it with outside (non-family) members. John Ward is the first and the most prominent supporter of this view at that time; he underlines the importance of outside board members, gives practical advice on how boards of directors should function and how to identify and recruit able board members in the family firm (Ward, 1988 and 1989; Ward & Handy, 1988). However, these recommendations stemming from the “pro-outsider” view have met with some criticism. Ford (1988 and 1989) argues that the foundations of this view are normative in nature and do not reflect correctly business reality. His main point of criticism about early studies on boards is that there is actually no evidence proving the added value of outsiders within the family firm. Huse (1990) focuses his board research on small firms and finds that board composition is a function of ownership structure and company size. Furthermore, he comes to the conclusion that firms operating in distinct industries define board roles differently and, as a consequence, have different board compositions. In the early nineteen-nineties, professionalization issues in family business became increasingly popular. Has the outsider discussion focused mainly on the staffing of the board of directors with non-family members, the professionalization discussion broadened the scope by including outsiders in the top management team bringing professional knowledge and values into the organization and the management of a family firm (i.e. Dyer, 1989; Berenbeim, 1990).

Beside this new and raising interest, several important contributions maintained the vitality of the board discussion, whereas its focus on pure composition issues began to shift in favor of a broader understanding of the role of boards. In his practical-oriented book, Ward (1991) illustrates the benefits and purposes of boards in family firms. He gives recommendations on how to establish a board and how to manage it to get most out of the directors’ involvement with the company. Borch and Huse (1993) investigated the relationship between the board and the management team instead of applying an isolated view on each of these institutions. The authors conclude that boards play an important role in the management of networking activities. From the mid-nineteen-nineties on, the board discussion in the family firm context has been enriched by new perspectives coming into play and promoting considerable changes in the discussion of directorates in family enterprises. Nowadays, normative literature and prescriptions on board demography have been replaced by quantitative and qualitative studies analyzing board structure (i.e. Cadbury, 1997) and its effectiveness (i.e. Davis, 1999). Some studies aim at reviewing the actual processes taking place inside and outside the boardroom (Huse, 2000 and 2002a), as suggested earlier by Pettigrew (1992), whereas others investigate the various board functions (Carver & Oliver, 2002). These studies have made important
contributions to the understanding of directorates in family firms. However, according to Pettigrew (1992) and Huse (2000), academic research on boards of directors – in the context of both small and large firms – is still in its infancy. Both authors point out that there is a definite need for alternative samples (small versus large firms, European versus US context), issues (studies on processes inside and outside the boardroom versus board composition), and methodologies (longitudinal case studies versus traditional research methods) to be treated in the study of boards of directors. After the exploration of the “Board Focus”, let us now proceed to the upper part of Figure 1, the so-called “System Focus”.

The System Focus

Although the board of directors represents a pivotal position in the design of any corporate governance system, a main critique on the practical (normative) literature dealing with board issues (i.e. board demography) is that they are explored exclusively on qualitative and anecdotal basis, with a lack of empirical verification and definite results (Ford 1988 and 1989; Corbetta, Gnan, & Montemerlo, 2002). Supporters of the exclusive board view would argue that focusing the discussion on boards of directors in family firms would considerably reduce the complexity of the corporate governance system. But on the other hand, reducing the corporate governance discussion solely on board issues means neglecting all the other structural elements of the governance system, in occurrence the family and its institutions and the top management team, both occupying an essential place in the firm’s governance mechanism, as documented in the previous sections. Ward (2003a) supports this finding by arguing that “the board [in family-controlled firms] is just one partner in the governance system rather than the dominant player”. Since the competitiveness and the ultimate success of a company is the result of teamwork that embodies all the organs of the governance structure, a broader view has been applied which includes the various actors in the family business arena (and outside the firm, i.e. the suppliers and customers). The upper part of Figure 1 illustrates this relatively young approach towards governance mechanisms in family firms which can be labeled the “system focus”.

The system view integrates all the diverse elements of the governance mechanism and considers family business governance as an interlocking system as a whole rather than the sum of several individual and distinct elements. The aim is to understand and thus to improve the governance system consisting of the management, the ownership, and the family. Researchers have started applying this view only a few years ago at the end of the nineteen nineties, beside two earlier studies by Dyer (1986), investigating business and family transitions from a cultural change perspective and Goffee and Scase (1991), examining the strategies and structures used by English family firms that allow considerable managerial autonomy while maintaining family control of administrative behavior.

According to the system focus, theories on corporate governance include all the actors inside the family firm and their multiple relationships within the governance system. Examples are the relationship between the family and the board of directors (Aronoff & Ward, 1996), the dynamics between the board and various stakeholders (Huse, 1998), the relationship between the family and the management (i.e. Karlsson Stider (2001), talking about ‘invisible managers’ and analyzing the role of housewives in the governance
process), and multiple relationships among the family, the board, and the top management team (Gersick et al., 1997; Neubauer & Lank, 1998; Cadbury, 2000; Carlock & Ward, 2001; Carlock & Florent-Treacy, 2002).

Another particularity of this approach consists in the theoretical foundations used to explain governance in family firms. The theories aim not to substitute the existing theoretical approaches to governance (mainly Principal-Agent Theory, Jensen & Meckling, 1976), but they draw on approaches different from the established ones and try to give an alternative and complementary view on the foundations of family firm governance, like stewardship theory (Salvato, 2002), formal- and social control aspects (Mustakallio & Autio, 2001), cultural aspects (Melin & Nordqvist, 2000) and the impact of governance on the strategy process (Mustakallio & Autio, 2001). Social network theory as illustrated by Nordqvist (2001) deals with the family firm, its ties with the environment and its many relationships with other stakeholders.

As introduced earlier, trust plays an important role in family firms and is a main trait of character differentiating governance of family-influenced firms from governance in companies lacking substantial family influence. Steier (2001) emphasizes the role of trust as a governance mechanism in family firms. According to the author, the nature of the trust among key parties of the governance system should be a major factor in determining the appropriate governance structure. Furthermore, in a recent article, Ward underlines the importance of trust in family-led firms as he states that “building and strengthening mutual trust among the governance parties – the board, ownership, and management – is the most critical issue of family business governance” (Ward, 2003a). The clarification of each actor’s roles and responsibilities is key to building this valuable trust. Justice is another rationale for governance in family firms as described by Baldridge and Schulze (1999) who conclude that governance mechanisms play a significant role in determining the employees’ perceptions of fairness. Later, the idea about justice in family firms has been further examined by Blondel, Carlock and Van der Heyden (2001). The authors have applied the “Fair Process” concept to family firms. The essence of Fair Process consists in engaging all involved members in decision-making. The process rests on five principles: communication, clarity, consistency, changeability and commitment to fairness. According to this concept, the governance system can be used to adequately institutionalize justice and fairness in the family business and can thus help to maintain the support and the participation of all family members in the planning- and decision-making process.

Studies applying the ‘system focus’ have increasingly gained in relative importance over the last few years. They are very rich in information about governance in family firms since they enlarge the common board view and provide a complement to the established and traditional agency approach towards corporate governance, which is solely not suitable for assessing the complexity of governance in family firms. At this point, it is important to mention that the overview in Figure 1 only represents the relative importance of different corporate governance topics. Research on boards of directors adds many valuable insights to corporate governance academia and makes important contributions to the exploration of this field. However, it seems that studies applying the ‘system focus’ and its approaches gain in number and in relative importance in comparison with board studies.
After this review of the existing family business governance literature, the following section highlights the question: What is the ultimate gain (in terms of performance improvements) for family firms improving their governance systems. In other words, the link between governance (and so-called ‘best practice’) and family firm performance will be investigated more thoroughly.

GOVERNANCE AND FAMILY FIRM PERFORMANCE

Best Practice Governance – Implications for the Family Firm

As we have seen in the previous sections, the governance discussion is very vital nowadays. The growing interest in corporate governance by national governments has been stimulated by the recognition that corporate enterprises are fundamental to the allocation of resources in any economy (O’Sullivan, 1999). In recent years, stock markets, investors, independent institutes, and governments have attempted to codify ‘best practices’ in corporate governance and have stimulated the examination and evolution of corporate governance in most OECD member states. The codes can be divided into supranational, national or institutional codes. Selected examples of supranational codes are proposed by, for instance, the OECD (Principles of Corporate Governance, OECD, 1999), ICGN (International Corporate Governance Network), or CACG (Commonwealth Association for Corporate Governance). At the national level, selected examples of country-specific codes are the German Code of Corporate Governance (Berlin Initiative Group, 2000), the Viénot II Report for France (MEDEF, 1999), the Cadbury Report for the UK (Committee on the Financial Aspects of Corporate Governance & Gee and Co. Ltd., 1992), or The King Report for South Africa (Institute of Directors in Southern Africa, 2001). At the institutional level, the most well-known code is the one established by CalPers (California Public Employees’ Retirement System) in the U.S.

These recommendations have been established for publicly-traded firms. Organizations, governments, and institutions urge companies to adopt these codes of best practice and to foster good governance mechanisms. Some public companies have adjusted to these suggestions and have begun implementing them for several good reasons. According to Monet and Newby (2001), “Equity buyers are increasingly basing investment decisions on companies’ records on corporate governance (as well as on projected real shareholder returns). The challenge for investors is to measure and reward good corporate governance practice as readily as they have criticized bad corporate governance in the past.” The 2002 Global Investor Opinion Survey by McKinsey & Company supports this finding. According to the study, an overwhelming majority of investors (more than 70 percent) are prepared to pay a premium for companies exhibiting high standards of corporate governance than for the shares of a company with similar financial performance but poorer governance practices. The premium investors would pay for a well-governed company varies by country and region. Premiums average 12-14% in North America and Western Europe, 20-25% in Asia and Latin America, and over 30% in Eastern Europe and Africa (McKinsey & Company, 2002).

The previous findings concern public firms with diluted ownership. However, private firms, which are not required to adopt these recommendations, nevertheless decide to
follow the example of their public counterparts and adopt stricter corporate governance standards. A recent survey by Robert Half Management Resources finds that “some 58% of CFOs at private companies with more than 20 employees said they were implementing stricter governance and accounting practices.” (Investor Relations Business, 2003). According to the survey, there are three main reasons for the adoption of stricter governance rules in private firms: first of all, to meet rating standards to get better access to financial capital, secondly to meet the requirements to go public, and, thirdly, to meet the standards to enter an alliance with a public firm. The following statement summarizes the context for private firms and, hence, introduces what is at stake for a private firm adopting stricter corporate governance rules: “[Private] companies have stakeholders to address, and a governance model can demonstrate to stakeholders that the management is sensitive to their stewardship.” (Investor Relations Business, 2003). It becomes clear in this respect that governance aims to improve firm performance. Performance is described as awareness to “the stewardship of a firm’s stakeholders”. For its shareholders, it could be translated as maximization of their returns on investments; but it could also stand for job security for employees and family members or social responsibility to the environment. As can be seen in this example, performance in general, and even more in family firms, can be interpreted in many different ways. Pettigrew et al. (1999) find that there are no universal solutions to what are the determinants of firm performance, no “magic bullets”. Therefore, the authors suggest a customization on a case-by-case basis.

As we can see from this section, a thorough and in-depth investigation of the impact of ‘best practice’ governance principles on firm performance has yet been established. Very few is known about how these principles affect firm performance in detail and what is the ultimate gain for family firms adopting these principles. Therefore, the following section will investigate what is our current level of knowledge on the link between family business governance and firm performance and what structural elements of the governance system play a pivotal role in this relationship.

**Research on the Link between Governance and Family Firm Performance**

Although the performance of family firms received average coverage by researchers in the field (Dyer and Sánchez, 1998), the actual link between governance and performance in family business is a barely investigated topic. The literature review revealed only a handful of studies that will shortly be described in the following section. Among these studies, one can differentiate between those studies focusing solely on issues of family ownership and performance and those linking the governance system as a whole to family firm performance. Let us start with the exploration of the ownership-performance link, shortly present the articles and describe their main findings.

Daily and Dollinger (1992) examined in their field survey the extent to which family-owned and -managed firms differ across structure, process, and performance dimensions from their professionally managed counterparts. They found evidence that family-owned and -managed firms exhibit performance advantages as a result of the unification of ownership and control.

Gallo and Vilaseca (1998) look at family firms with a family or non-family CFO. The principal findings of this research show that the family businesses with a family CFO are smaller, younger, and have a smaller market share than those in which the CFO is a non-
family member. No statistically significant differences are found in the performance levels (ROE) of the family businesses, whether or not a family member is CFO. However, when the CFO holds a high level position in the organization, or influences strategic decisions, the family businesses with a non-family member CFO achieve a higher ROE than those with a family member as the CFO.

Pooled, cross-sectional time series models in Kang (2000) indicate that family owners are positively associated with performance, and that there is a positive association with performance when a family member with some ownership stake is the non-CEO chairman of the board. According to Kang, that is because family owners have a credible threat of voice. In addition, in firms where the family is the single largest shareholder and a family member holds a non-CEO chairman position, there is a positive association with performance (measured as Return on assets (ROA) and Tobin’s Q). Kang concludes that family shareholders appear to shape organizational outcomes and that family owners are an important, but understudied organizational phenomenon in management academics.

Nagar, Petroni and Wolfenzon (2000) find that closely-held corporations have few owners, and that firm performance (net income scaled by total assets, or ROA, and operation income) is U-shaped in the ownership stake of the largest shareholder, with both diluted ownership firms and extremely concentrated ownership firms outperforming firms in which the largest shareholder is medium sized. The results suggest that dilution of ownership, which can be detrimental to firm performance in large public firms with a large number of shareholders, can actually be beneficial in closely-held corporations with few shareholders. “In this setting, dilution of ownership can actually be beneficial because it results in an ownership structure where shareholders are large enough not to surrender control to the manager, but do not have ownership rights to unilaterally control the firm and extract private benefits.” (Nagar, Petroni and Wolfenzon, 2000).

In their seminal and very in-depth study, Anderson and Reeb (2003) use the S&P 500 firms to explore the relation between founding-family ownership and firm performance in large public firms from 1992 to 1999. Besides the finding that more than 35% of the S&P 500 firms are family-controlled and that families hold on average 18% of the outstanding equity, the authors, contrary to their conjecture, come to the conclusion that family firms outperform their non-family counterparts. The further analysis of this over-performance reveals two particularly interesting facts: first of all, founding-family holdings and firm performance have a non-linear (non-monotonic) relationship: as family ownership increases, performance first increases as well; however, performance then decreases with raising levels of family ownership. The second point concerns active family participation. These firms where founders or their descendants occupy the CEO position exhibit better accounting profitability measures, whereas market performance tends to be better only in these cases where the founder him-/herself or an outsider is at the helm of the company (as CEO). Moreover, founder’s descendants occupying CEO chairs do not affect market performance. In other words, founder CEO’s and outside CEO’s account for the greatest value gains. The authors use Tobin’s Q as market measure and ROA as accounting measure for performance.

What we can see so far is that the outcomes concerning the relationship between ownership and performance in family firms point towards a positive relationship between family ownership and control on the one side and firm performance on the other. This positive relationship seems to be more evident for publicly listed family firms than for
private ones (i.e. Kang, 2000; Anderson and Reeb, 2003). Let us now turn to the studies dealing with broader issues of governance and family firm performance.

Gubitta and Gianecchini (2001) propose a taxonomy of different types of governance models in family-owned SMEs. According to the level of opening (this means the composition of governance structure) and the level of extension (of the decision making process), four different governance models emerge: rigid, familiar, managerial, and flexible. The analysis of data indicates a weak relation between the adopted governance model and organizational performance. However, the authors do not specify how performance is actually measured.

Mustakallio and Autio (2002) explore links between governance, entrepreneurial orientation, and performance in family firms. The authors come to the conclusion that the governance of family firms does influence their entrepreneurial orientation and that, in turn, this orientation constitutes a potential influence on their long-term performance (measured as the quality of strategic decisions and commitment to these decisions and in terms of profitability and growth).

Gnan and Montemelto (2001) look at the impact of both ownership and governance on firm performance (ownership is treated here separately from the governance system). They focus their research on relations between family business ownership, strategy, structure and functioning of governance systems and company performance in family business. Their main findings are that governance systems feature higher performances, in terms of functioning and effectiveness of existing governance bodies, in presence of outside partners, strategic alliances and numerous family members in top teams. On the contrary, they feature lower performance when the companies grow. Higher performance of governance systems, together with other factors related to ownership and strategy, determine higher company profitability. To measure economic performance, the authors looked at 1999 ROS, ROI and ROE.

Though the scarceness of studies on the link between governance and performance in family firms does not allow drawing much definitive conclusions, there is a common thread in the studies. The first finding is that there seems to be ample evidence of better performance of family-controlled firms, at least on the stock markets. The positive impact of the family relies not only on the fact that the family has stock ownership, but on the fact that the family takes a leadership role on the board (i.e. Kang, 2000; Anderson & Reeb, 2003). The second observation is that different levels of family involvement have different impacts on performance. The impact of the concentration of ownership in individual hands (i.e. Anderson & Reeb, 2003), or the impact of a non-family CFO (i.e. Gallo & Vilaseca, 1998) on performance indicate that unlimited family influence is not the panacea.
CONCLUSION AND RECOMMENDATIONS FOR FURTHER RESEARCH

The literature review of corporate governance in family firms has revealed several important findings: corporate governance in general is a vast topic in academic research and models of governance developed for large public corporations with dispersed ownership cannot be automatically applied to the family business context where the large variety of family firm configurations and the family system itself add further complexity. The literature review shows that the focus of research on family business governance has evolved over time, from an almost exclusive focus on individual governance bodies and structures, and mainly on the role of the board of directors in the family firm, to a different approach emphasizing the governance system as a whole. The review of the literature dealing with the link between governance and family firm performance indicates several limitations to the comparability of existing research, and a lack of documentation of the causality between best practices in corporate governance and firm performance. First of all, on the input side, governance can be regarded from several perspectives: there are multiple actors involved in the governance arena and it is difficult to isolate a particular element when wanting to explore corporate governance as a system of numerous structures and processes. Secondly, on the output side, the lack of consensus about the definition of performance (including a time frame discussion) further limits the comparability of research results. Last but not least, both governance practices and performance measures vary with economic sectors, firm size, and legal contexts.

In conclusion, the overriding finding of this review is that there is no universally accepted single theory or view that makes sense either in governance generally, nor in family firms in particular. There is a multiplicity of approaches and findings – and not even one single definition of governance. There is also generally very little justification of so-called ‘best practices’. If we come back to the leading question of the paper: “What do we know about governance in family firms?” and to the correlated question: “What can researchers, business owners and advisors get out of this discussion?”, there are both encouraging news and several important issues to note. One of the main issues is that the relationship between governance and performance still remains unanswered.

Interestingly for family businesses, families appear to bring an element of performance to businesses. Most research studies on performance point in that direction. The evidence seems stronger for traded businesses, where several studies, conducted in different countries, all conclude to the superior stock performance over the long term of family-controlled companies. Studies conducted on private businesses are less consistent in their conclusions, but a few in-depth studies also conclude to the better performance of family businesses in the private sector.

However, the second finding is that this element of performance is not unconditional, i.e. it depends on the degree and means of involvement of the family, as shown by the studies on the impact of ownership fragmentation, family Chairmen, and non-family CFOs. In other words, it seems that success of family businesses is due to the level of family influence in the different key governance structures. However, until present, the question about how and up to what degree of influence the family actually contributes to the performance of the firm still remains open.
On the other side, advisors to family firms should be cautious in recommending so-called ‘best practice’ governance principles to family firms. As we have seen previously, these recommendations lack empirical verification and what functions well for large non-family-controlled firms may not have the same impact for the family-influenced business.

But herein lay great opportunities for academics since these unanswered questions can trigger further research:

- The impact of ‘best practices’ on performance has yet to be empirically proved. Questions pertaining to the relevance of having a majority of outsiders on the board, single voting rights rather than dual classes of shares, etc. are not yet convincingly researched.
- The role effectively played by the family in different governance bodies has barely been addressed. Research on boards focused mainly on the role of outsiders, but generally ignored the key issue of the role of family members on the main business board, or on the holding board. Kang’s study on family chairmen of the board and Anderson and Reeb’s research on family CEO’s seem to be exceptions, but they make important contributions to a better understanding of the family’s role as an element of performance within the family-led firm. Other questions like the representation of family branches, or the relationship between the family council, the holding board and the company board are important and virtually absent from the current body of research.
- The absence of adequate performance measures for non-listed family businesses represents another potential field of research. Beside purely financial aspects, performance of a family-led firm is also about longevity and continuity of the family affair, job security for employees, reliability for customers, and social responsiveness to the environment. Therefore, rigorous research on performance measures for family firms should precede a more in-depth investigation of the governance-performance link.
- A case study approach looking at all dimensions of the family business system could contribute important insights to the discussion. The history and past crisis, the existence of family meetings, the family home, the acceptance of in-laws in different instances, the presence of outsiders in family meetings or boards, the identities of the chairperson and president, the presence and role of family members on the company board, the number of family owners, the presence of outside investors in the capital, the role of family and outsiders in management etc., knowledge about all these issues could contribute to a better understanding of governance in family firms and, hence, could provide valuable input to research and theory building alike.

In conclusion, the findings presented in this paper should help to enrich the research agenda for academics in family business, and, hopefully, will contribute to an in-depth investigation of unanswered questions in the field of family business governance.
REFERENCES


Huse, M. 2002a. Presentation at the 2nd International Doctoral Course on Governance in SMEs. Bocconi University, Milan, Italy.


APPENDIX 1: An Overview of Corporate Governance Definitions (cited from the Author(s); entries sorted in alphabetical order)

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Corporate Governance (CG) Definition</th>
<th>Comments (Scope and orientation)</th>
</tr>
</thead>
</table>
| Bain & Band (1996)            | “The essence of governance is found in the relationships between the various participants in determining the direction and performance of organizations. The primary groups involved are the shareholders, the board of directors, and the management. Other players are the customers, employees, suppliers, creditors, and the community.” | Broad; goal-oriented definition  
The central concern of governance is to add value to as many organizational stakeholders as is practicable. |
| Blair (1995)                  | “CG should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific assets.”                                                                 | Broad; task-oriented definition                                                              |
| Cadbury (1999)                | “CG is the system by which companies are directed and controlled.”                                                                                                                                                                 | Broad; task-oriented definition  
refers to the structures and to the ways of working of the different corporate bodies and, in general, to the system of rules defining structures, mechanisms and processes aiming at improving a firm’s performance. |
| Carlock & Florent-Treacy (2002) | “CG is an umbrella term that defines the processes, relationships, and interactions that develop between a firm’s senior management, its board of directors, and its shareholders. In simple terms, CG is a joint decision making process about the business’s strategy and policies.” | Narrow; task- and goal-oriented definition  
“The goal of CG varies based on the nature of the ownership group (private versus widely-traded) and the economic and cultural context in which the firm operates.” |
| Corbetta, Gnan & Montemerlo (2002) | “CG is defined as the way companies are directed and controlled; more comprehensive definitions make reference to the set of formal and informal relations between the board of directors, shareholders, top managers, and other relevant stakeholders.” | Broad; task-oriented definition  
Definition based on Cadbury (1999); points out formal and informal relationships among stakeholders. |
| Demb & Neubauer (1992)        | “CG is a process by which corporations are made responsive to the rights and wishes of their stakeholders.”                                                                                                                     | Broad; task-oriented definition                                                              |
| Hitt, Ireland & Hoskisson (1999) | “CG is a relationship among stakeholders that is used to determine and control the strategic direction and performance of organizations. At its core, CG is concerned with identifying ways to ensure that strategic decisions are made effectively.” | Broad; task-oriented definition  
Definition brings strategy and performance into the discussion; emphasizes the decision-making process. |
<p>| Huse (2000)                   | “CG can be defined as the interactions among internal and external stakeholders and the board of directors in directing a corporation.”                                                                                             | Broad; task-oriented definition                                                              |</p>
<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Definition</th>
<th>Scope</th>
<th>Type</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Huse &amp; Landström (2002)</td>
<td>„In general and very broad terms, CG deals with how external stakeholders, internal stakeholders and the board of directors contribute in directing an enterprise.”</td>
<td>Broad; task-oriented definition</td>
<td>This is a broad definition that also includes governance of other enterprises than large private business corporations. In other words, CG deals with the interactions among external and internal stakeholders and the board of directors in directing an enterprise.</td>
<td></td>
</tr>
<tr>
<td>Maher &amp; Andersson (1999)</td>
<td>“In its narrowest sense (shareholder model), CG often describes the formal system of accountability of senior management to shareholders. In its widest sense (stakeholder model), CG can be used to describe the network of formal and informal relations involving the corporation.”</td>
<td>No specific scope; task-oriented definition</td>
<td>“More recently, the stakeholder approach emphasizes contributions by stakeholders that can contribute to the long term performance of the firm and shareholder value, and the shareholder approach also recognizes that business ethics and stakeholder relations can also have an impact on the reputation and long term success of the corporation. Therefore, the difference between these two models is not as stark as it first seems, and it is instead a question of emphasis.”</td>
<td></td>
</tr>
<tr>
<td>Melin &amp; Nordqvist (2002)</td>
<td>“In a general sense, CG can be defined as how the owners’ interest is organized and exercised in order to influence in the strategy processes.”</td>
<td>Narrow; goal-oriented definition</td>
<td>“In the FB context, CG can be viewed as a system of structures and processes to direct, to control, and to account for companies.” (definition based on Cadbury, 1999)</td>
<td></td>
</tr>
<tr>
<td>Neubauer &amp; Lank (1998)</td>
<td>“CG is a system of structures and processes to direct and control corporations and to account for them.”</td>
<td>Broad; task-oriented definition, based on The Cadbury Report (1992)</td>
<td>“CG is a system of structures and processes to secure the economic viability as well as the legitimacy of the corporation.”</td>
<td></td>
</tr>
<tr>
<td>Nordqvist &amp; Melin (2002)</td>
<td>„CG is a system of structures and processes that arises as a result of the interaction between the owners, the board of directors and the top management team in directing and controlling the firm.”</td>
<td>Narrow; task-oriented definition</td>
<td>Definition based on Neubauer and Lank (1998) and Cadbury (1992). Aims at linking CG to the strategy process.</td>
<td></td>
</tr>
<tr>
<td>O’Sullivan (2000)</td>
<td>“A system of CG shapes who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed.”</td>
<td>No specific scope; task-oriented definition</td>
<td>“CG is concerned with the institutions that influence how business corporations allocate resources and returns.”</td>
<td></td>
</tr>
<tr>
<td>Author</td>
<td>Quote</td>
<td>Definition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------</td>
<td>-----------------------------------------------------------------------</td>
<td>----------------------------</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Tirole (2001) | “A good governance structure is one that selects the most able managers and makes them accountable to investors.” | Narrow; task-oriented definition  
              |                                                                 | Traditional focus on the conflict between outside investors and top management. |
| Vives (2000)  | “CG deals with the question ‘How to ensure that managers follow the interests of shareholders?’ CG refers to the design of institutions to make managers internalize the welfare of stakeholders in the firm.” | Broad; task-oriented definition |
| Witt (2002)   | “CG deals with the optimal organization of management and control in companies with the goal to balance the interests of all stakeholders.” | Broad; task- and goal-oriented definition |