

2 Research on family firms – Definition, theories, and performance

This chapter gives a brief overview of the main problems of family business research and offers basic information regarding family firms for a general understanding of the research field. One main issue is the question “What is a family business by definition?” In section 2.1, I briefly discuss alternative definitions of family firms that have been used in previous studies, and show how family firms are defined in this dissertation. Further, I present theories that help explain the differences between family and non-family firms (section 2.2). The chapter closes with a literature review of the performance differences between family and non-family firms and the related shortcomings (section 2.3).

2.1 Definition

How to define a family firm remains problematic in family firm research. Although many researchers have tried to develop a satisfactory definition¹⁷, there is still no consensus about a widely accepted definition.¹⁸ Although some studies in the finance literature identify any public company where a family or a founder owns more than 5 percent as a family firm¹⁹, other studies define firms only as family firms if the first succession into the second generation has taken place.²⁰ However, in most studies a family firm has been characterized as a firm that is controlled and usually managed by multiple family members, sometimes from multiple generations. For an overview of the different definitions used in performance studies, see Table 2-2 in section 2.3.

The use of different definitions is a major problem in family firm research. Although studies analyze related topics, the use of different family firm definitions makes the comparability of these results difficult. One of the biggest challenges of developing a general definition is the heterogeneity of family firms.²¹ Family firms are a unique group of organizations, but they also differ within this group. The involvement of the family in the management and ownership structure of the firm is unique to each family firm and thus it cannot be seen as constant factor.

In their review of the important trends in family firm research, Chrisman et al. (2005b) present two approaches of how family firms are defined in the reviewed literature. They distinguish between the components-of-involvement approach and the essence approach. Although the components-of-involvement approach treats family involvement as a sufficient condition in order to define a firm as a family firm, the essence approach treats it only as a necessary condition. Following the components-of-involvement approach, a firm can be defined as a family firm when a) a family is the owner, b) the firm is family-managed, or c) the firm is controlled by a family. If one of these three characteristics applies to a firm, it can be defined as a family firm. The essence approach is more restrictive and defines firms only

¹⁷ See Chua et al. (1999), Miller et al. (2007) for overviews of these definitions.

¹⁸ See Chrisman et al. (2005b).

¹⁹ See Anderson and Reeb (2003), Cronqvist and Nilsson (2003), Villalonga and Amit (2006).

²⁰ See Bennedsen et al. (2007), Pérez-González (2006).

²¹ See Arregle et al. (2007).

as family firms when family involvement leads to distinctiveness and specific behaviors. Four main characteristics constitute the essence approach: 1) a family's influence regarding the strategy of the firm, 2) a family's vision and intention to keep control and hand the firm over to the next generation, 3) family firm behavior, and 4) distinctive familiness. In order to identify a firm as a family firm these characteristics are required.

In this dissertation, I follow the essence approach by Chua et al. (1999, p. 25) in defining a family firm as “a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families.”

2.2 Theories about family firms

In this section, I present four theories – the resource-based view (RBV), social capital theory, agency theory, and stewardship theory – that are mostly used in family firm research in order to explain why family firms need to be examined differently compared with non-family firms. These theories underline the distinctiveness of family firms among organizational forms. Subsection 2.2.1 presents the RBV and its use in family firm research. In subsection 2.2.2, social capital theory and its particular importance for family firm research is explained. Agency and stewardship theory, two related theories, are then described in subsection 2.2.3.

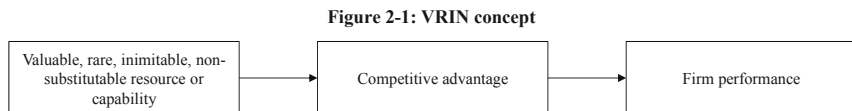
2.2.1 The Resource-based view

A major stream of research in strategic management has focused on competitive advantages and their sources. The RBV aims to answer the question of why some firms outperform other firms. The heterogeneity among firms within a particular industry and the success factors of the outperforming firms are the focus of this research stream. Beginning with the works of Penrose (1955, 1959) and her “theory of the growth of the firm,” the internal view of resources and capabilities as a source of competitive advantage has received a high degree of attention. By keeping external market conditions constant, research in this area analyzes the resources and capabilities within a firm. With the seminal works of Wernerfelt (1984) and Barney (1991), research on internal focus has been reinforced.

Barney (1991) developed a framework that is based on two central assumptions. First, firms within an industry are heterogeneous regarding their resources and, second, these resources are not moveable across firms. A firm's resources can “include all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness.”²² But not all resources have a positive impact on organizational outcomes. Firm resources that have the potential to generate a competitive advantage must have four characteristics. First, such resources have to be valuable, which means that a resource must have the potential to influence firm efficiency and effectiveness in a positive

²² Definition by Barney (1991), p.101.

way. Second, they must be unique and only available to one firm. Third, resources must be inimitable. Sustainable competitive advantages can only be generated if competitors cannot copy a resource or capability. The last attribute is the non-substitutability of a firm resource. In order to secure the strategy of a firm, resources must not be substitutable. When competing firms find a substitute for this resource, they have the possibility to implement a similar strategy and the competitive advantage will thus disappear. The so-called VRIN (valuable, rare, inimitable, and non-substitutable) concept has also been modified to become known as the VRIO concept, where the “O” stands for organization, i.e. that the organizational structure has to be ready and able to exploit resources or capabilities. Only resources or capabilities that possess all these characteristics have the potential to generate a sustainable competitive advantage and in turn increase firm performance. Figure 2-1 shows the VRIN concept as developed by Barney (1991).



(Source: Barney (1991))

The RBV has been used as an underlying theory by many studies in different fields of research. For example, Hitt et al. (2001b) show that human capital has an indirect and a direct effect on firm performance. Miller and Shamsie (1996) test the RBV and find evidence that in contrasting environments different types of resources (knowledge-based vs. property based) are the explanation of financial performance. In addition, family firm researchers have adopted the RBV to resolve family firm issues. The most widely known study using the RBV stems from Habbershon and Williams (1999, p. 1) who define “the bundle of resources that are distinctive to a firm as a result of family involvement [...] as the ‘familiness’ of the firm.” This unique bundle of resources can arise when a family impacts a business. The interaction between a family, its members, and the business are inimitable for each family firm. Sirmon and Hitt (2003) identify five family firm-specific resources and attributes that have the potential to provide competitive advantages for family firms. In their resource management process model, they argue that family firms evaluate, acquire, shed, bundle, and leverage these resources in a different way than do non-family firms, resulting in a potential competitive advantage. These resources are human capital, social capital, survivability capital, patient financial capital, and governance structure.

Human capital describes the acquired knowledge, skills, and capabilities of an individual.²³ In family firms, human capital can have both positive and negative effects. Although family members are often highly committed to the firm²⁴, relationships are warm and friendly²⁵ and the potential for deep firm-specific tacit knowledge is high, and thus the threat of employing suboptimal employees just because of the family affiliation may pose a

²³ See Coleman (1988).

²⁴ See Horton (1986).

²⁵ See Horton (1986).

problem.²⁶ In the context of innovations, human capital can be considered to be an important source of knowledge, which is not available in non-family firms. If successors of family members in the TMT are involved early in the family firm, deep levels of firm-specific tacit knowledge can be achieved, which may improve decision quality regarding innovations or other strategic decisions.

Social capital describes the relationships between individuals or between organizations.²⁷ This is further described in subsection 2.2.2.

Sirmon and Hitt (2003) define survivability capital as the integration of unique resource, namely “the pooled personal resources that family members are willing to loan, contribute and, or share for the benefit of the family business.”²⁸ These resources can take the forms of free labor, loaned labor, additionally equity investments, or monetary loans.²⁹ In the context of innovations, these personal resources may become an important source for long-term innovation projects such as radial innovations, which are associated with high risks and uncertainty. Survivability capital can function as a safety net in situations of unpredictable outcomes.

Patient financial capital differs from typical financial capital, because it is linked to a longer time of investments and not a threat of liquidation in the short-term.³⁰ As innovations are often long-term projects, family firms may benefit from their financial structures. This is supported by research suggesting that firms with patient financial capital are capable of pursuing more creative and innovative strategies.³¹

The governance structures of family firms are often associated with the discussion of agency costs. The question of whether the governance structures of family firms increase or decrease agency costs cannot be answered for the group of family firms in general. Carney (2005) identifies the system of corporate governance as a reason for family firms’ competitive advantages and analyses three family firm governance characteristics: parsimony, personalism, and particularism. He argues that these characteristics can lead to cost advantages, which in turn generate competitive advantages in scarce environments, help create and utilize social capital, and encourage opportunistic investment processes. But depending on the individual structure of each family firm and its context, agency costs can differ. Hence, innovations would benefit from decreased agency costs, but increased agency costs would hamper innovations. Subsection 2.2.3 presents different scenarios of agency conflicts in family firms and discusses agency costs in more detail.

In light of innovations, family firms offer unique resources that can improve new product performance. In particular, the human capital of the family and the ownership structures of family firms are unique resources that bring knowledge to create new ideas and

²⁶ See Dunn (1995).

²⁷ See Burt (1997).

²⁸ See Sirmon and Hitt (2003), p. 343.

²⁹ See Sirmon and Hitt (2003).

³⁰ See Dobrzynski (1993).

³¹ See Teece et al. (1997).

financial capital to develop these ideas into new products. For example in TMTs, family members can influence the innovation orientation of the team directly and in turn the innovation orientation of the firm. They further have the power to allocate financial resources to particular new product projects and the stamina that is needed to realize a new product project over a longer period. These resources may generate competitive advantages for a family firm and can lead to superior new product performance.

2.2.2 Social capital theory

Social capital theory is another common theory that has recently been used in family firm research.³² It addresses the importance of the interaction and exchange between individuals in a social network. Social capital can be defined as “the aggregate of the actual or potential resources which are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance or recognition [...]”.³³ Nahapiet and Ghoshal (1998) define three dimensions of social capital: structural, relational, and cognitive dimension. The structural dimension describes configurations and patterns of linkages between people. The beliefs, trust, norms, and obligations that connect people in a social network are described by the relational dimension. The cognitive dimension describes a shared language, interpretations, and systems of meanings within a social network. In family firms, each dimension is embedded in two ways, on one hand within the family and on the other hand with external stakeholders.³⁴ Research distinguishes between family social capital and a family firm’s organizational social capital.³⁵ Arregle et al. (2007, p. 77) describe family social capital as “one the most enduring and powerful forms of social capital.” The family represents a unique social network where each member can have social relationships, which are based on trust and a shared language, with other family members. Thus, family members can benefit from each other regarding information, influence, and relationships. Organizational social capital describes a resource that represents the character of social relationships within a firm.³⁶ It helps firms provide access to external resources³⁷ and facilitate internal coordination.³⁸ The existence and in turn connection of these two forms of social capital can increase positive firm outcomes.

For example, Adler and Kwon (2002) state that social capital may affect inter-unit and inter-firm resource exchange, the creation of intellectual capital, inter-firm learning, supplier interactions, product innovation, and entrepreneurship. Contributions can be derived from both inter- and intra-organizational relationships. Contributions from internal relationships include the reduction of transaction costs, facilitation of information flows, knowledge

³² See Arregle et al. (2007), Chrisman et al. (2005b).

³³ Definition by Bourdieu (1986), p. 51. For further definitions, see Adler and Kwon (2002).

³⁴ See Sirmon and Hitt (2003).

³⁵ See Arregle et al. (2007).

³⁶ See Leana and Van Buren (1999).

³⁷ See Hitt et al. (2002b).

³⁸ See Sirmon et al. (2007).

creation and accumulation, and improvement of creativity.³⁹ External contributions can be found in increasing success rates of alliances.⁴⁰ Both family social capital and family firm organizational capital are important resources that can provide information, technological knowledge, access to markets, and complimentary resources.⁴¹

In the context of innovations, the social capital of the family can be a decisive resource, which is unique to each family firm. Depending on the degree of family influence, social networks can be used in order to expand, for example, the in-depth knowledge of technologies from other family firms or suppliers. In particular, family social capital can be identified as a competitive advantage, because it is family and firm-internal. Hence, the effect on innovation outcomes may be positive. Social capital theory arguments are used in this dissertation for supporting hypotheses that indicate a positive effect of family influence on the relationship between TMT behaviors and innovation outcomes.

2.2.3 Agency theory and stewardship theory

Agency theory and stewardship theory are two interconnected theories that describe the relationship between two actors: the principal and the agent. Therefore, stewardship theory extends agency theory by integrating the views of other disciplines such as sociology and psychology.

Agency theory, which also appears as principal–agent theory in the literature, is theoretically based on divergent interests, opportunistic behavior, and asymmetric information, and deals with the conflict of interest between an agent, who acts as a representative of a principal, and a principal, who delegates work to an agent. In a situation, where the principal and agent have the same interests, no conflict of interest exists and no agency costs arise.⁴² In other situations, the principal and agent will have different interests. Typically, an agent will possess more or better information than will the principal about himself, the decision situation, or the consequences of actions.⁴³ As a result of asymmetric information, the literature distinguishes between two types of agency conflicts: adverse selection and moral hazard. Adverse selection describes a situation before contracting where the principal inadvertently chooses an agent who is less able, committed, and industrious than the principal expected. Moral hazard describes a situation after contracting where the agent acts in his or her own interests rather than in the interests of the principal. Complete contracts, which anticipate and provide for every eventuality, can only exist if information is perfect and costless and people are unbounded in their mental capabilities.⁴⁴ But this is often not the case in reality, where people have bounded rationality.⁴⁵ This leads to incomplete contracts between the principal and agent. In order to control the adverse selection and moral hazard

³⁹ See Arregle et al. (2007).

⁴⁰ See Ireland et al. (2002).

⁴¹ See Hitt et al. (2002a), Hitt et al. (2001a).

⁴² See Jensen and Meckling (1976).

⁴³ See Ross (1973).

⁴⁴ See Williamson (1975).

⁴⁵ See Simon (1957).

problems, principals have to invest in the recruiting process and align interests between themselves and agents. The costs related to the control of these agency problems are called agency costs.

In family firms, three different agency conflicts – family owner vs. external manager, family owner vs. external shareholder, and family owner vs. family manager – can occur.

Family owner vs. external manager

Family ownership is not necessarily an indicator of family management. A lot of family firms trust in external managers because capable and competent family members are missing or family members cannot come to an agreement about which member should lead the company. In order to overcome these problems, family firms employ external managers. In this case, the relationship between the principal (family owner) and the agent (external manager) seems to be similar to non-family firms. But the appearance is deceptive. Families are highly interested in the performance and future of the firm because most of their wealth is tied to it.⁴⁶ Although the family can be compared to a large shareholder in publicly traded firms, it is also a special investor type that is often weakly diversified. The strong interest of the family in the firm's success leads to a close monitoring of the external management. Demsetz and Lehn (1985) state that concentrated ownership, such as that in family firms, indicates a strong economic incentive to monitor external managers and reduce agency costs. The family, as a concentrated shareholder, has the power to appoint external managers and control important decisions. Because of the long involvement of a family in a firm, it has a good understanding of the operative processes and firm-specific knowledge, so external managers can be monitored more effectively. This limits, for example, the possibilities of external managers using firm resources for their own purposes and thereby affects firm performance and, in turn, the owners' interests negatively.⁴⁷ This close and more effective control of external managers can decrease information asymmetries between the family and external managers. In addition, the risk of the opportunistic behavior of external managers and the so-called "free-rider" problem⁴⁸ can be mitigated.

Family owner vs. external shareholder

An agency conflict can also exist between a dominant shareholder and a minority shareholder.⁴⁹ In publicly traded family firms, the family often holds large stakes while other shareholders hold only small stakes. In this case, information asymmetries and a conflict of interests may exist between the dominant shareholder and the minority shareholder. In particular, in family business groups where a family controls a large number of firms, minority shareholders can be disadvantaged. These family business groups often use a pyramidal structure in order to separate ownership from control. This means that a family

⁴⁶ See Andres (2008).

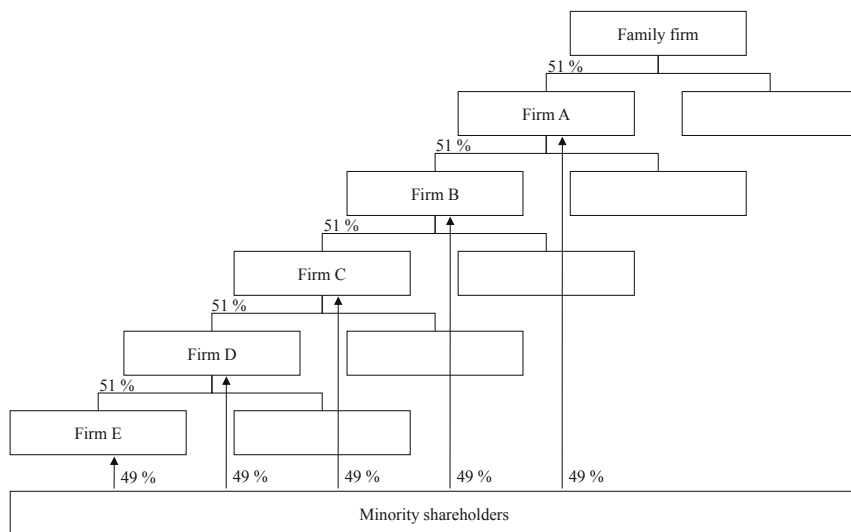
⁴⁷ See Ang et al. (2000).

⁴⁸ The "free-rider" problem often exists in widely held firms, where shareholders are not well informed and refrain from trying to receive more information. See Hölmstrom (1982) and Grossman and Hart (1980).

⁴⁹ See Claessens et al. (2002), Morck and Yeung (2003).

directly controls a firm, which in turn controls other firms, each of which control other firms and so on. Through this chain of ownership relations, the family achieves control over a large number of firms. Morck and Yeung (2003, p. 367) state that “such structures give rise to their own set of agency problems, as manager act for the controlling family, but not for shareholders in general.” Minority shareholders are used to bring in capital, but without receiving a majority of votes in one of the family business group’s firms. Figure 2-2 shows the pyramidal structure of a family business group. The family at the top of the pyramid can misappropriate minority shareholders’ wealth by “self-dealing”⁵⁰ or “tunneling.”⁵¹ Firms within the family business group often collaborate and supply products or services to each other. The buyer–seller relationship can thereby be manipulated by price settings. Low prices transfer profits to the buyer, high prices to the seller. The family may try to transfer profits from the firm on the lowest level of the pyramid (Firm E) to Firm A at the top as they receive 51 percent of the profits of Firm A. Thus, minority shareholders that take shares on lower leveled firms in the pyramid will be disadvantaged.

Figure 2-2: An example of a family business group’s pyramidal structure



(Source: Morck and Yeung (2003))

The conflict of interest increases when the family firm is managed by a family member. The information asymmetries between the family, as the dominant shareholder, and minority shareholders increase because the manager is a member of the family and shares

⁵⁰ Self-dealing transactions describe the behavior of a controlling shareholder, who transfers resources from the firm for his or her own benefit. For more information, see Johnson et al. (2000).

⁵¹ Tunneling describes the expropriation of minority shareholders. For more information, see Johnson et al. (2000).

more information with the family than he or she does with the external shareholders. Family management can lead to managerial entrenchment problems⁵², which describe a situation where a family manager possesses so much power that he or she can act in his or her own interests or in the interests of the controlling family. In this case, external or minority shareholders are disadvantaged again.

Family owner vs. family manager

Firms owned by a family are often managed by family members. In this case, agency costs may decrease, because there is no separation between ownership and control. Principal and agent are unified in the family manager, who ideally acts in the interests of the family. The identity of the goals and interests between the family owner and family manager may lead to lower agency costs.⁵³ In particular, family managers often have emotional relationships with their companies as their family's wealth, personal satisfaction, and the satisfaction of the family are tied to firm performance. Stewardship theory supports this view by describing family managers as stewards, who are intrinsically motivated by higher-level needs to act in the interests of the firm and/or the family.⁵⁴ Stewardship theory is based on a different model of man and a different behavior of individuals in comparison to agency theory. Table 2-1 compares the different characteristics of agency theory and stewardship theory. The behavior of stewards is driven by more than economic self-interest. They try to contribute to collective goals such as firm success instead of individual interests.⁵⁵

Table 2-1: Comparison of agency theory and stewardship theory

	Agency theory	Stewardship theory
<i>Model of man</i>	Economic man	Self-actualizing man
<i>Behavior</i>	Self-serving	Collective serving
Psychological Mechanisms		
<i>Motivation</i>	Lower order/economic needs (physiological, security, economic) Extrinsic	Higher order needs (growth, achievement, self-actualization) Intrinsic
<i>Social Comparison</i>	Other managers	Principal
<i>Identification</i>	Low value commitment	High value commitment
<i>Power</i>	Institutional (legitimate, coercive, reward)	Personal (expert, referent)
Situational Mechanisms		

⁵² "Managerial entrenchment occurs when managers gain so much power that they are able to use the firm to further their own interests rather than the interests of shareholders." Definition of "entrenchment" by Weisbach (1988), p. 435. For more information about managerial entrenchment problems, see Morck et al. (1988).

⁵³ See Fama and Jensen (1983a), Fama and Jensen (1983b).

⁵⁴ See Miller and Le Breton-Miller (2006).

⁵⁵ See Davis et al. (1997), Donaldson and Davis (1991).

	Agency theory	Stewardship theory
<i>Management Philosophy</i>	Control-oriented	Involvement-oriented
<i>Risk orientation</i>	Control mechanisms	Trust
<i>Timeframe</i>	Short-term	Long-term
<i>Objective</i>	Cost control	Performance Enhancement
<i>Cultural Differences</i>	Individualism High power distance	Collectivism

(Source: Davis et al. (1997))

Davis et al. (1997, p. 38) summarize the main differences between agency theory and stewardship theory as follows: “According to agency theory, people are individualistic, utility maximizers. According to stewardship theory, people are collective self-actualizers who achieve utility through organizational achievement.” Values such as trust, collectivism, and long-term orientation lead to the altruistic behavior of stewards. Altruism, in the context of religion and philosophy, describes a “moral value that leads individuals to act in the interests of others without the expectation of reward or positive reinforcement in return.”⁵⁶ From an economic perspective, altruism is a utility function that positively connects the welfare of one individual to those of others.⁵⁷ If altruism is reciprocal⁵⁸, namely the family owner and family manager act both altruistically and symmetrically, which means equally strongly, agency costs may be mitigated, but in some cases it can also increase agency costs. Problems include free-riding by family members, the entrenchment of ineffective family managers, and a biased parental perception of a child’s performance.⁵⁹ Depending on the involved individuals, altruism is a double-edged sword with increased agency costs on one side and decreased agency costs on the other.

Agency theory and stewardship theory also present different views about the involved actors. However, a generally accepted statement for the group of family firms in terms of agency costs cannot be given. It always depends on the type of agency conflicts and the involved individuals. In the context of innovations, the combination of family owner and family manager may be the most promising environment for the development of new products because long-term support for innovation projects is guaranteed. External managers may help increase knowledge in innovation projects, but they also increase the threat of opportunistic behavior, which is not present with family managers. In large family business groups, firms at a lower level may suffer from missing the support of the family, which may decrease innovation activities. Considering family members in the TMT as stewards rather than agents may help explain why family firms are innovative.

⁵⁶ See Karra et al. (2006), p. 863.

⁵⁷ See Bergstrom (1989), Schulze et al. (2003b).

⁵⁸ See Corbetta and Salvato (2004), Eddleston and Kellermanns (2007).

⁵⁹ See Schulze et al. (2001), Schulze et al. (2003b).

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