



**Trust in Governance**  
**The Competitive Advantage of Family Businesses**

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“Trust in governance” is a challenging statement to make after recent highly publicised corporate scandals that have diminished the bond of trust between shareholders and directors in public companies. The responses to these perceived breakdowns in corporate governance have predictably included demands for more rules to mitigate the type of opportunistic management behaviours that result in reduced shareholder returns.

Increased regulation, however, inevitably contributes to an overall increase in the atmosphere of “distrust”; if people could just be trusted to do the right thing, there would be less need for formal rules and elaborate control mechanisms. This problem of “distrust”, however, has not just been caused by recent events; it is in fact the dilemma that conventional UK corporate governance seeks to resolve.

Any business family who wants to govern their business based, to some extent, on loyalty, trust and informal obligations needs to be aware of this dimension of the PLC model of governance. Also, in order to mobilise trust in the governance of their business, the family needs to answer the deceptively simple question, “who do we trust?”

**“Distrust” in governance.**

The orthodox view is that if directors are given the power to use their own initiative, they will pursue their self-interests at the expense of the shareholders. Various well known “control mechanisms” are used to regulate what is called “the agency problem”, that you cannot expect another person (the agent) to look after your interests as well as you would do.

- Independent non-executive directors (NEDs) are appointed to monitor executive directors in the interests of investors.
- Board committees, populated by the NEDs, regulate particular areas where shareholders have concerns about the directors’ controlling decision making. For example, an audit committee to govern the relationship with the auditors; a nominations committee to plan board succession and recommend board appointments and a remuneration committee to ensure that the directors are provided with appropriate incentives to encourage enhanced performance.
- Share incentives are used to align the self-interest of the managers with the owners, the view being that this will reduce the risk of managers being tempted to enrich themselves at the owners’ expense.

It is important to acknowledge that conventional corporate governance is striving to resolve problems to do with the characteristics of companies whose shares are publicly traded. These are different from the challenges that arise in privately owned and closely controlled family businesses that have a very different governance profile, as summarised below.

**Comparison between conventional corporate governance and family businesses**

<u>Conventional Corporate Governance</u>	<u>Family Businesses</u>
Listed public companies	Mainly private companies
Dispersed ownership with many minorities	Concentrated family share ownership
Predominant role of the financial institutions	Predominant role of the owning family
Shareholder value is paramount	Family seek other returns on investment that are not entirely economic
Short term investor commitment	Long term family commitment
Short term performance measurement	Long term investment horizon
High financial leverage and creative accounting	Low financial leverage and cautious accounting

The rules, codes and guidelines for PLCs, administered by independent directors and a network of board committees, address the needs of companies in which ownership is dispersed among minorities and where financial institutions play a dominant role. Most family businesses, on the other hand, are private companies with concentrated family ownership and few outside minorities. Short-term investor commitment in public companies, where capital can readily migrate, makes shareholder value the paramount measure of success and leads to short-term performance measurement. In contrast, family businesses often have a generational investment horizon, the owners often have limited liquidity and many stakeholders' interests are taken into account in governance, including the next generation of owners, the wider family, employees and even the place where the business is located.

Attributes, or attitudes, like trust, loyalty and kinship do not feature in the PLC model of governance, but these have an intuitive appeal to many business families. This means that while the PLC model of governance has many things that family businesses can *adapt* and use, this model should not be *adopted* as a benchmark for privately owned family businesses.

### **Trust in family business governance – the competitive advantages**

There is a strong instinct towards trust-based relationships in most family businesses. An obvious example is marketing campaigns that emphasise, “you can trust us because we’re a family too”. However, governance based on trust can be the source of many other competitive business advantages.

### **Teamwork**

In a family business, responsibilities are often allocated among family members – and the “insiders” who are treated as “family” - based on trusting each other’s talents. They know each other well enough to know their respective strengths and weaknesses, and they trust each other to deliver. As a result, each business function is handled by the fewest number capable of doing so and responsibility is continuous over time and not intermittently reassigned. Hierarchical, top-down governance structures and excessive monitoring and reporting are replaced by horizontal relationships, openness and a commitment to teamwork.

### **Decision making and entrepreneurship**

This structure contributes to speedy decision-making. In place of elaborate rules and control mechanisms, decision making in family businesses is often marked by informality and pragmatism, including a willingness to waive rules in exceptional circumstances, especially where the right result has been achieved. When trust is high, people feel that they will be judged by the result rather than by whether or not they have followed the prescribed procedure, and, if necessary, they expect to receive the benefit of any doubt. This all helps to keep an entrepreneurial attitude to risk alive in the business.

### **Economic returns**

Family business owners who trust each other often feel a shared responsibility to protect the “family silver” and are willing to take a long-term view of their investment return, thereby giving the company the competitive advantage of cheap capital. The owners’ commitment can be reciprocated in long-term service by employees who are confident about their job security, leading to a pattern of long service that helps to build up know-how in the workplace and avoid the disruption and costs caused by high-levels of staff turnover.

### **Psychological returns**

Using trust in the governance of a business can also produce psychological returns. It generates goodwill among a group of stakeholders, (owners, employees, family and even wider communities with an interest in the business) who feel confident that they can rely on their colleagues to take the interests of each other into account. This encourages and reinforces personal qualities like empathy, sympathy and an awareness of the value of the greater good as distinct from a focus on personal gain.

### **The trust dilemma**

Having said all this it must also be acknowledged that trusting another person always tends to feel inherently risky to some extent. If a family wants to inject trust into governance of their business and seek the advantages mentioned above, they need to answer the key question, which is “who do we trust?”

### **Who do you trust?<sup>1</sup>**

Types X and Y mentioned below are different descriptions of a family’s basic attitude to trust. It is very important to stress that neither is better or worse than the other, they are just different. Knowing which is the more accurate description of a family’s attitude makes it far easier to build trust into governance in a way that “fits” with the family’s inherent views and feelings about who they can trust.

#### **Type X - “We trust people we know or who are like us.”**

This attitude to trust naturally limits the scope of who can be trusted to direct family and, in the absence of a familial relationship, might include “trusted” advisers, close friends and members of the same cultural, ethnic or social group as the family. In other words the family trusts people they know or who have something in common with them.

This approach to trust tends to generate an “insider” “outsider” mentality; insiders being those who can be trusted and outsiders being strangers who should not be admitted to positions of trust, unless they are very carefully vetted or can be controlled, and even then the family might still feel that there is a gap in trust that cannot quite be bridged.

This type of trust is usually slow to develop beyond immediate kith and kin because it is based largely on the personal experiences and social networks of family members. Bad experiences involving breaches of trust tend to be treated as set backs that make the family more wary. An “outsider” who is deemed to have breached the trust placed in him or her reminds the family of their innate feeling that “outsiders” should not be trusted in the first place. Violations by “insiders” may be punished by rejection and the breakdown of relationships; so an “insider” becomes an “outsider” and the overall attitude to trust among the insiders is reinforced.

#### **Type Y - “Treat others as you would wish to be treated by them.”**

This view describes people who believe that if they adopt a trusting attitude, it will be reciprocated rather than abused. Unlike Type X, it is not based primarily on personal experiences or relationships and is rather a belief or statement about how people ought to behave.

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<sup>1</sup> See *The Moral Foundations of Trust* by Eric M Uslaner, Cambridge University Press 2002

As a result, the group that can be trusted is wider and the family is likely to find it easier to contract with outsiders without the same level of checking or controls that would be needed to convince Type X that an outsider can be trusted.

The intrinsic optimism in Type Y usually means that setbacks are absorbed without sacrificing the view that people are generally trustworthy and that this is the right way to live and conduct the affairs of the family business.

### **The effect on governance**

For the purpose of comparing the effect of Types X and Y on family business governance it is worth mentioning a recent report from the European Confederation of Directors' Associations (ecoDA), called "*Corporate Governance Guidance and Principles for Unlisted Companies*". It is notable that this grouping of 10 national institutes of directors, including the UK Institute of Directors, believes that improved governance can promote growth and sustainability and underpin entrepreneurship in progressive unlisted companies. EcoDA also accepts that publicly listed and privately owned companies have different governance needs (see above) and that in family businesses, improved family governance is as important as improved corporate governance.

Principle 9 in the ecoDa document identifies the main components of good family governance as including a family assembly and policies in areas like employment of family members and transfer of shares. The question is how does a family's attitude to trust affect the detail of these best practice governance recommendations and the key issue of who is on the board?

### **Share ownership**

In Type X ownership will be tightly controlled. It would feel right to the family that ownership be restricted to bloodline family members because of their innate concern about trusting others, like spouses or non-family, to understand the family's values in relation to ownership and to use their powers responsibly. This might even extend to the feeling that ownership should be restricted to working owners, because of concerns that direct family who do not work in the business might develop a different ownership agenda and therefore are better not to be trusted with ownership.

Type Y ownership would be more open, with less concern about extending ownership to involve the wider family, including non-working owners and spouses or partners. Any feelings of this being risky might be mitigated by steps to educate and inform owners about their rights, the expectation then being that they can then be trusted to act responsibly.

The different attitudes to trust are likely to make it easier for Type Y to raise capital from outside equity investors and to use share based incentives to recruit and reward non-family employees, each of which are likely to be steps too far for Type X.

### **Board and management**

In Type X these positions will be dominated by family members and trusted insiders. The logic of this approach might extend to the family seeking in each generation to invest in businesses that exploit the talent in their lineage, because they will then feel they can innately trust the insider who is running the business. This will appeal as a better way of expanding the family's wealth than taking the risk of recruiting outsiders to run businesses that are not a good match for the talent and ability of the current generation.

In contrast, Type Y will readily engage talented outsiders to run their business. While Type X will always feel more comfortable with a business that is family owned and family run, Type Y will one day move with ease to become a business that is family owned, but not family run.

### **Employment policies**

It has become standard practice to recommend that a family business has a clear policy about how family members can enter and leave the business. It is equally important, although perhaps less understood, that the family's attitude to trust is reflected in this policy.

Type X should devise a policy that encourages family members to join and gives them every opportunity and advantage to do so, because ultimately the family will only be content if family members hold senior positions in the business.

Type Y on the other hand will favour a policy that promotes competence and ability over family relationships, and the policy will challenge family members to prove themselves worthy of the position. In Type Y the policy may even state categorically that there will be no advantage in being a family member.

### **Family Assembly**

In the governance of a family business there is always a forum where the interests and concerns of the family are discussed. In a small family these discussions will occur spontaneously, whenever needed, and often take place over dinner, at weekends or on holiday. However, as the family and its business both grow, the business of the family requires more thought and formality and this challenge is often met by creating a Family Assembly.

Type X will instinctively see the Assembly as an inner sanctum where the family can discuss issues that no-one else need know about. If they define insiders as bloodline family members, it would not feel right to invite outsiders like spouses, non-family directors or advisers to attend the Assembly. Type Y, in contrast, would be more likely to extend the Family Assembly constituency to involve these other stakeholders.

The different effect of Type X and Type Y on family business governance are summarised below and here it is worth reiterating some essential points:

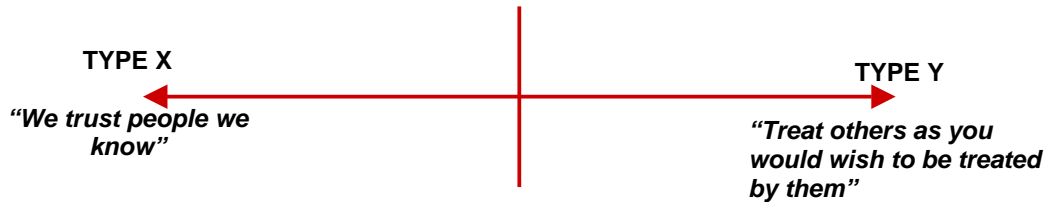
- Type X and Type Y are different.
- One is not *better* than the other although supporters of each view are likely to feel this because they are prone to compare the *advantages* of their view with the *disadvantages* of the other view.
- In family business governance it is essential to go with the flow of a family's innate values in relation to trust and families should resist any attempt to make them adopt practices that make them feel uncomfortable. There is no "ought to" in family business governance; that task is to discover what each family wants and is capable of delivering.

#### **Comparisons of Types X and Y in Governance**

<u><b>Type X</b></u>	<u><b>Type Y</b></u>
Share ownership restricted to "family insiders". Spouses and non-working owners may be excluded.	Ownership more open; could include spouses, managers, employees and outsider equity.
Board and management dominated by family and "insiders".	Ability and competence matters as much as "insider" status.
Employment policy promotes interests of family who can be trusted.	Employment policy challenges family members. Outsiders treated equally.
Family Assembly is inner sanctum restricted to bloodline.	Family Assembly open to outsiders participating.

### **An exercise - the Trust Spectrum**

If this approach to understanding the role of trust in family business governance is appealing, families can use the following simple exercise to identify if they are more Type X or Type Y and using the above information they can then start to work out the basic framework for governance of their business.



#### Tasks

1. Where are you on the trust spectrum?
2. Summarise the reasons for this view.
3. Start to work through the effect on how your family business needs to be governed

#### **What if we can't agree?**

This should not be considered unusual. If the family have divergent views on something as fundamental as "who do we trust?" this outcome should be accepted. The consequences are that the family is unlikely to thrive by continuing to be in business together. Building governance structures to help continue the family business is likely to bind in tension, which eventually will lead to future conflict. In practice it is interesting that the starkness of this outcome sometimes encourages families to continue their discussion in search of a workable compromise.

#### **The importance of a shared purpose in building trust**

One of the greatest strengths in a family business is a clear and strong sense of shared purpose among the owners, the wider family and the board. When this is clear each of these interested parties are far more likely to feel part of a collective endeavour and be willing to trust each other to translate the shared purpose into good governance and business practice.

On the other hand without a shared purpose, as time unfolds, there will just not be enough "glue" to bond the family, the owners and the board to each other and to their collective investment in the business. In the absence of this "glue", no amount of governance, or technical structures, will prevent things falling apart.

The family first has to decide who will participate in articulating the shared purpose. There is a lot of value in holding a family meeting of those over a certain age whose lives will be affected by the family business now and into the future. A family meeting for this purpose

needs careful planning and there might be a role for an external facilitator who can help make sure that there is a thorough debate in which everyone has an opportunity to express their views, so that the shared purpose is based on consensus and not the views of a dominant family member.

Other families might prefer to leave the decision to family members whose views are respected and who are trusted to do the right thing in the overall interests of all stakeholders. The choice will depend on each family's attitudes and beliefs, but what is important is that there is a clear shared purpose and the owners, family members and the board know what it is. Only then will these stakeholders be able to decide if they want to be involved in the family business. If, to the contrary someone feels that the shared purpose for the business could thwart their own aspirations, it is far better to find a way for them to exit gracefully rather than bind them reluctantly into structures that could cause much unhappiness.

Articulating a shared purpose means a family defining their version of "success". The returns on investment that families seek – their version of "success" - may be singularly financial or a combination of financial *and* emotional reasons. For example the shared purpose could include the following:

- Providing the desired level of financial security for a growing family; each family has their own ideas of "enough" and "too much".
- Preserving and extending a legacy of responsible and successful ownership to pass to the next generation.
- Providing career opportunities for family members.
- Attachment to a particular industry or geographical area.
- Putting something back through philanthropy.
- Keeping the family in touch and connected with each other through the business as individual family members grow up and grow apart.

After the shared purpose has been clarified, a series of questions follow that help everyone with a stake in the family business to understand how it affects family life, ownership and business practice. The question is, "if this is our Shared Purpose what does each interest in the family business *need to do or become* in order to ensure that it is fulfilled: -

- What do the current owners need to do or become.
- The wider family.
- The board of directors and senior management
- The business itself.

This approach to articulating a shared purpose and then expressing how it affects the key interests in the business helps clarify the norms of acceptable behaviour for key stakeholders. It should also mean that if any of them is ever in doubt about what action to

take, it should be possible to trust them to revert to the shared purpose and work out what is appropriate.

Knowing that there are different basic instincts in relation to trust – neither is right or wrong, just different – gives families an insight into how they can strategically mobilise trust in the governance of their family business. There is a lot to be gained by injecting trust into the governance of a family business, advantages that are beyond the reach of other businesses including those that denigrate the notion that trust is an effective way to build business relationships.

**Family Business Solutions Limited (FBS)**

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