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Governance and entrepreneurship in family firms: Agency, behavioral agency and resource-based comparisons

Isabelle Le Breton-Miller [a,b], Danny Miller [a,b,*], Franck Bares [a]

[a] HEC Montreal, Canada
[b] University of Alberta, Canada

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ABSTRACT

There remains a good deal of uncertainty as to whether and under which governance conditions family firms, even large, publicly traded ones, are entrepreneurial. We shall argue that agency theory, behavioral agency perspectives, and the resource-based view all posit both positive and negative influences regarding entrepreneurship in family firms, while empirical studies, collectively, are no less ambiguous in their findings. We use each of the above theories to propose various governance distinctions that can reconcile these contradictions and suggest when family firms will be most and least entrepreneurial.

Introduction

Family firms have been criticized in numerous quarters for their conservatism, their neglect of financial and growth objectives, and their unprofessional nature (Bertrand & Schoar, 2006; Bloom & Van Reenen, 2007; Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007). And yet, these firms are the dominant form of organization in the world, and account for a substantial proportion of publicly traded companies (Miller & Le Breton-Miller, 2005). Surely, given their share of the global economy, there must be some family firms that are entrepreneurial – that is capable of responsive product-market renewal (Schumpeter, 1942). Clearly, however, there are important differences within the breed. Indeed, it has been demonstrated that family firms vary greatly in their governance structures and this can have an important impact on their conduct and performance (Miller, Le Breton-Miller, Lester, & Cannella, 2007, Miller, Minichilli, & Corbetta, 2013; Villalonga & Amit, 2006). In short, it may matter to the extent of the entrepreneurial effort just who owns, governs and runs the business (Gomez-Mejia, Hoskisson, Makri, Sirmon, & Campbell, 2011).

Unfortunately, despite recent research and conceptualizing, we remain ignorant of under which circumstances family firms are most entrepreneurial. The theories that can best inform this domain – agency, behavioral agency, and resource-based theory – evoke conflicting insights, whereas the empirical findings remain inconclusive. We shall attempt to draw some fine-grained governance distinctions in an attempt to gain a better understanding of when family firms are most likely to be entrepreneurial. In doing so, we hope to condition the application of popular conceptual frameworks on family firm behavior to entrepreneurship among these organizations. Given the emphasis of much of the conceptual literature, our domain will be large, publicly traded companies, where issues such as agency and opportunism are most relevant.

We should make explicit a key assumption at the outset: We are not proposing that entrepreneurial behavior, particularly in its more active form, is always desirable. This very much depends on the capabilities and resources of the firm and the challenges and uncertainty in its environment (Thompson, 1967). However, given the pace of change in many industries, and the accompanying threat of relative stagnation, innovation, risk taking and proactive creativity, will be needed periodically to renew a firm. This is particularly true in family businesses that hope to remain evergreen to provide careers for next generation family members.

Although there have been numerous definitions of entrepreneurship, our focus will be on the well-known concept of entrepreneurial orientation (EO): that is, a firm's tendency to engage in ventures that are proactive, involve risk taking, and are innovative (Covin & Slevin, 1989; Miller, 1983, 2011). We are using Miller's (1983) interpretation of EO as actual, not merely desired or intended behavior. The rationale for the concept is that all three components are required, albeit in different measure, for behavior to be considered entrepreneurial. For example, innovation that

* Corresponding author at: HEC Montreal, 3000 Cote St. Catherine Road, Montreal, QC, Canada H3T 2A7. Tel.: +1 514 484 7768.
E-mail address: danny.miller@hec.ca (D. Miller).

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is reactive and involves little risk can hardly be considered venturesome. Thus most of the work on EO treats it as an integrated construct, and that is our own position (Covin & Wales, 2012; Miller, 1983, 2011). Moreover, although there has been debate over whether EO refers to an attitude of an entrepreneur or a set of behaviors of corporations, a significant body of research has favored the latter position, and that will be our emphasis here (see the reviews by Covin & Lumpkin, 2011; Covin & Wales, 2012; Wales, Gupta, & Mousa, 2013). Indeed, following Miller (1983), we shall use the terms EO and (corporate) entrepreneurship interchangeably.

Conceptual conflicts regarding family firm conduct

Family business scholars have relied in large part on three important theories to explain family firm strategic conduct: agency theory, behavioral agency theory – including that relating to socioemotional wealth preferences – and the resource-based view. As we shall see, each of these theories offers arguments both for and against entrepreneurship taking place in family firms.

Agency theory suggests that because in family firms, ownership and management incentives are aligned, or due to the superior monitoring capabilities of major owners, agency costs are low (Fama & Jensen, 1983). Where opportunism is reduced, it can be argued that there will be ample financial resources available for entrepreneurial initiatives. On the other hand, other scholars, again using an agency framework, claim that major family owners may use their power and knowledge to exploit minority shareholders, diverting resources required for innovation to parochial purposes (Shleifer & Vishny, 1997). That in turn might constrain entrepreneurship.

Behavioral agency scholars have taken a different tack. Based on work in behavioral economics, they argue that family business owners, given their existing endowment, will be risk averse, preferring to hold on to what they have rather than risking it on new ventures (Wiseman & Gomez-Mejia, 1998). That would constrain entrepreneurial behavior where the endowment considered relates to current family security, capital or income. Gomez-Mejia et al. (2007) elaborated on this theme in their notion of *socioemotional wealth* (SEW), arguing that family owners will use their business to satisfy socio-emotional needs such as providing jobs to offspring. Although this may drive conservatism, it could equally be argued that the intention of passing on a healthy business to later generation kin provides an incentive for entrepreneurial renewal (Miller & Le Breton-Miller, 2005). Again, a popular theory is ambiguous in its implications for family firm entrepreneurship.

Finally, we come to the *resource based view* (RBV). Some have argued that family firms will be restricted in their access to many of the resources required for entrepreneurship (Bertrand & Schoar, 2006). For example, the desire to keep family control over the firm restricts financing options, whereas nepotism and entrenchment may restrict the pool of competent managers (Bloom & Van Reenen, 2007; Mehrotra, Morck, Shim, & Wiwattanakantang, 2011). On the other hand, it has been argued that because of their long-time horizons, these firms are astute *stewards* of their human and intangible resources (Arregle et al., 2007; Habbershon, Williams, & MacMillan, 2003; Miller, Le Breton-Miller, & Scholnick, 2008).

In short, agency, behavioral agency (including SEW) and RBV perspectives surface both positive and negative factors regarding the relationship between family governance and entrepreneurship. We shall argue that variations in family firm governance may help determine which polarities of each of these theories apply, and therefore how entrepreneurial family firms can be.

Gaps in the empirical literature

This absence of conceptual resolution is accompanied by conflicting empirical findings. Some studies show family firms to be resistant to innovation and entrepreneurship. For example, research on family firm innovation – a component of entrepreneurship – has demonstrated family firms to be less innovative and less able to leverage their patents than non-family businesses (e.g., Block, 2012; Gomez-Mejia et al., 2011). Similarly, Miller and Le Breton-Miller (2011), in examining entrepreneurial orientation in large public family firms, found these firms to be far less entrepreneurial than their lone founder counterparts.[1] Other work has shown family businesses firms to innovate only when pressured by bankruptcy risk or under-performance (Chrisman & Patel, 2012).

However, other studies have found that families can be great sources of intergenerational entrepreneurship and incubators of nascent entrepreneurs (e.g., Discua Cruz et al., 2013; Miller et al., 2008; Schjoedt, Monsen, Pearson, Barnett, & Chrisman, 2013). Moreover, research on large, enduring family companies has shown some of these to be excellent deal makers and innovators, in part because of their willingness to invest in the future of an enterprise that sustains the family over generations (Miller & Le Breton-Miller, 2005).

Given these disparities, once again, a key insight toward resolution may lie in the details of governance. Not all family firms have the same preferences or capacities. *We shall argue that governance arrangements will provide insight into those critical elements that shape entrepreneurship in family firms*, and shall present propositions to that effect. Their contribution will be to reconcile conceptually the conflicting notions in the field.

Theory and propositions

We shall deal in turn with agency, behavioral agency (SEW) and resource based theories, attempting from the logics of each to discern more precisely the governance conditions under which family firms are most apt to be entrepreneurial.

Agency and governance

Traditional agency theory is concerned with information asymmetries between owners and their agents that allow the former to appropriate resources from the latter (Fama & Jensen, 1983). Agency scholars might argue that concentrated ownership would facilitate more effective monitoring given the power and information access of large owners. Under that logic, family firms, because they have lower agency costs, will monitor better, curb opportunism, and thus have more resources to pursue entrepreneurial ventures, which they will be motivated to undertake as they are required for the long-term robustness of the firm. Moreover, major owners due to their long-term objectives and knowledge of the business, will ensure that any such ventures are not manifestations of CEO hubris (Anderson & Reeb, 2003). According to those arguments, family firm ownership and vote control might positively influence entrepreneurial behavior.

However, more recent agency scholars have studied a second type of agency problem in which majority owners are able, given their power and knowledge, to appropriate resources from minority owners (Shleifer & Vishny, 1997). For example, large family owners may be in a position to exploit other owners by appropriating generous salaries and perquisites for offspring or

[1] This is not a surprising result – especially for founder firms that have become Fortune 1000 companies having no nepotism or socioemotional distractions to curb risk taking and innovation (Bertrand & Schoar, 2006; Gomez-Mejia et al., 2007).

cronies (Bertrand & Schoar, 2006). Indeed, some studies of publicly traded family firms have discovered that family firms underperform non family companies (Villalonga & Amit, 2006) and companies run by founders with no family involvement (Miller et al., 2007, 2013).

The rationale in this last case is simply that the family will use its power to enrich itself. Indeed, studies of family firms in countries other than the US, where holding company structures are in place, have shown that many engage in tunneling: channeling costs down the structure to firms of which they only own a small percentage and directing disproportionate revenues upwards toward the parent company (Morck, Wolfenzon, & Yeung, 2005). Given that many entrepreneurial initiatives are expensive, depleting firm financial resources can certainly act as a curb on entrepreneurial behavior.

Although these opposing agency arguments balance out in considering the impact of family ownership and directorships – they present both positive and negative arguments – they are clear about the need for objective monitoring by those with the knowledge and incentive to invest in the long term robustness of the business. What is critical is the ability of *non-family shareholders to monitor the firm* to ensure that appropriate conduct is practiced and that funds for profitable renewal ventures, and hence entrepreneurship, are available and invested properly.

Both agency rationales suggest monitoring be done by board members who are *not* merely cronies of those in power, and also expert about operations and the emerging challenges facing the firm. Thus, although we would not expect family control or ownership to necessarily suppress efforts at entrepreneurial renewal, problems in monitoring may well be indicated by very long board tenures (Vafeas, 2003; Westphal & Zajac, 1995). Such problems may involve both gaps in knowledge and parochial incentives. Our agency discussion enables us to draw several propositions.

First, we expect that the presence of family members on the board will be positively related to a firm's EO because they will have an *incentive* to monitor their investment to ensure that the firm remains robust via renewal and profitable in the long run. That will cause them to support efforts at innovation and generous long-term investment (James, 1999; Miller & Le Breton-Miller, 2005; Miller, Lee, Chang, & Le Breton-Miller, 2009). Indeed, they will feel a responsibility to other family members to ensure the soundness of the business.

Proposition 1. The presence of family owners on the board of directors will be positively related to a firm's EO.

Knowledge of the business at the board level is also required for board members to be effective. Thus, it will be important to have representation from company insiders – managers who have the most intimate knowledge of the business, its opportunities, and the competition it faces from rivals (Bloom & Van Reenen, 2007). Having insiders on the board who can serve as advocates for investing in new ventures may help to promote entrepreneurship (Miller, Minichilli & Corbetta, 2013). They can provide the expertise and arguments needed to convince other directors of the need to approve investments in projects of renewal.

Proposition 2. The presence of insiders from management on the board will be positively related to a firm's EO.

However, board *independence* and currency may also be critical to the entrepreneurial effort. Long tenured board members may be left in place because they are cronies of management or major owners – representing poor monitors against both types of agency problems. They may be left in place because they cooperate with those in power (Vafeas, 2003). Moreover, long-tenured board members may, on average, be more likely to lose touch with current developments in the market, and emerging opportunities for renewal. They may be more likely to be tied to old traditions and support the status quo (Westphal & Zajac, 1995). In short, they may lack both the incentive and the knowledge to sponsor entrepreneurship.

Proposition 3. High levels of tenure among board members will be inversely related to a firm's EO.

Behavioral agency theory expectations

As noted, the proponents of behavioral agency theory argue that owner preferences, especially those respecting risk taking, are influenced by existing endowments. Thus, owners who have significant endowments are reluctant to risk their loss (Lim, Lubatkin, & Wiseman, 2010; Wiseman & Gomez-Mejia, 1998).[2] Scholars of family business have adopted behavioral agency reasoning to argue that owners of family firms will wish to preserve, not simply their financial assets, but the socioemotional wealth (SEW) benefits that come from controlling those assets (Gomez-Mejia et al., 2007). Their research suggests that family firm owners, in trying to preserve control over their companies, avoid risk taking, even if their conservatism comes at the cost of profitability. That is, they will forego opportunities for enhanced returns if that might endanger their control – or the survival of their business. Gomez-Mejia et al. (2011) argued therefore that family firms would be less innovative – thus less entrepreneurial. Block (2012) confirmed this result, showing that family firms were less innovative than founder companies.

However, the socioemotional wealth perspective admits of a variety of family preferences, some relating quite positively to entrepreneurship (Miller & Le Breton-Miller, 2013). For example, the desire to keep the business in the family and pass it on to later generations may invoke the practice of regular firm renewal. Indeed, some research has found that in the attempt to be good stewards of the business and its stakeholders, to protect the family reputation, and to provide career opportunities for later generations, family firms are especially willing to invest in the future and to innovate to keep the business healthy (Miller & Le Breton-Miller, 2005; Miller et al., 2008, 2009).

In short, families may vary a good deal in their SEW preferences. Some may desire to have successful businesses that ensure careers for their children. Hence they will invest generously in renewing their firms through entrepreneurship (Miller, 2014; Miller & Le Breton-Miller, 2005; Miller et al., 2008, 2009). Other families may wish to enjoy current rewards from the business that have more to do with satisfying immediate family requirements rather than business needs.

As with agency theory, behavioral agency theory and its SEW variety, compel us to seek out the governance markers that might arbitrate between these divergent types of family preferences: For example, if the priority is to gratify current members of the family, that might be indicated by nepotism toward family members and the provision of high status jobs to kin, selected in large measure *because* they are family members (Bertrand & Schoar, 2006; Bloom & Van Reenen, 2007). Alternatively, if preferences are intended to ensure firm longevity and robustness, nepotism would be avoided, and outsiders would be recruited to fill the top jobs of major companies.

This argument will apply especially forcefully to entrepreneurship in large complex businesses, where choosing executives from

[2] Other have argued however that under conditions where there is a high chance of losing the asset, its owners will actually take higher risks to try to save it (cf., Chrisman & Patel, 2012).

a small family pool, rather than the far broader labor market from within or outside the company, can compromise a firm's ability to engage in complex entrepreneurial ventures (Mehrotra et al., 2011). Indeed, the administrative demands required to run a major company are far greater where the strategy is one of innovation and constant renewal, versus one that strives mainly to preserve the status quo. Thus:

Proposition 4. Entrepreneurship in major family firms will vary inversely with the presence of later generation CEOs and other executive positions.

Resource-based expectations

Some family business scholars argue that family firms, because of their psychological ownership of the firm and long time horizons, are especially apt to amass resources such as financial war chests, social capital, long-term relationships with commercial partners, and devoted human resources (Arregle et al., 2007; Habbershon et al., 2003; Miller et al., 2008, 2009; Sirmon & Hitt, 2003). Resource based view (RBV) scholars have pointed to the utility of such resources, not simply as sources of rent, but also as bases for firm renewal, innovation and entrepreneurship – which are critical capabilities. Indeed, financial capital, managerial and human capital, and productive relationships with partners, all can contribute to a firm's ability to engage in entrepreneurship (Sirmon & Hitt, 2003).

Other family business scholars point to a paucity of talent in family businesses: they argue that family conflicts may hamper decision making (Eddleston & Kellermanns, 2007), that family owners wanting dividends may drain capital (Bertrand & Schoar, 2006), and that managers drawn from a family pool rather than a wider market for talent will lack the competency to innovate (Bloom & Van Reenen, 2007; Mehrotra et al., 2011).

However, the emphasis now is not so much on the evils of nepotism (although that is also a concern) – but the lack of *entrepreneurial talent* – a key resource. It has been suggested that where an accomplished founder is present within a company – an individual with ample managerial experience and past success at venturing and business creation – that augurs well for entrepreneurship, especially where the founder remains in charge as CEO. Indeed, it has been demonstrated that founders of publicly listed companies, where still present after listing, make an important positive contribution to firm performance (Miller et al., 2007).

By contrast, as noted, where later generation family members become CEOs, they may lack the talent to engage in entrepreneurial projects. Again, this is especially likely to be the case in large, publicly listed family firms where entrepreneurial initiatives are often major and complex – involving significant allocations of human and capital resources in the face of a good deal of uncertainty (Bloom & Van Reenen, 2007).

Moreover, where a later generation of the family serves more broadly as officers and directors, their involvement in the company may sap other resources due to their demands for dividends; they may also bring family conflicts into the business, thereby impeding decisive resource commitments required for entrepreneurship. Thus our final proposition overlaps in part with our previous one:

Proposition 5. Entrepreneurship in family firms will be positively related to the presence of a founder, and negatively related to the involvement of later generation family members on the top team and board of directors.

Ample prior studies have established the connection between entrepreneurial orientation and financial performance – both in terms of market valuations and growth (Miller, 2011; Wiklund & Shepherd, 2003, 2005). Thus we expect that among family firms, those employing an entrepreneurial orientation will outperform others in their cohort in growth and profitability.

Conclusion

Certainly, each of the approaches to family firms and their entrepreneurial efforts have merit, and often are based on sound arguments and suggestive empirical evidence. It is interesting however that even when we follow the logic of each of these theories, they not only differ a good deal from one another in their expectations for family firm entrepreneurial performance, but more importantly, they each contain within themselves contradictory views in this regard. Our thesis in this paper is that their application very much depends on the fine grained aspects of governance that we have described. In no way are all family firms "created equal". They vary considerably in their governance structures and the emotional and resource advantages and disadvantages posed by those structures. Based on such distinctions, we have attempted to develop some propositions that may help to reconcile the rather different perspectives on the entrepreneurial behavior of family firms. We urge others in the field to ascertain the merit of these propositions by conducting empirical research on different types of family firms.

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