



# The role of professional management in family business governance

**FAMILY BUSINESS** IS STILL THE MOST IMPORTANT COMPONENT OF THE GLOBAL ECONOMY TODAY, AND ALSO THE MOST COMMON FORM OF ENTERPRISE IN THE WORLD. NOT ONLY IS IT VITAL TO THE FAMILY CLAN THAT OWNS AND CONTROLS IT, BUT IT ALSO PLAYS A PIVOTAL ROLE IN THE WHOLE SOCIO-ECONOMIC ORDER.

The remarkable achievements of quite a number of listed family businesses in the Far East are universally acclaimed. The author believes that if the management models of these corporations are further improved, they may become some of the best corporate governance models in the world and worthy of being emulated by the Western markets.

On the other hand however, a series of incidents or scandals concerning the corporate governance of Chinese family businesses that have occurred in recent years have made people ponder and reflect on the key factors for their success and failure.

According to the relevant literature, the popularity of family business is due to several factors. These include sustaining and enhancing the value of family assets (including intangibles such as credit standing, reputation, networking, government connections, etc.) and easier execution of ownership rights. Furthermore, business founders usually wish their management philosophy, values and satisfaction to be shared and succeeded by their trusted family members rather than outsiders. Concentrated ownership could also reduce outside influences and free-riding behaviour.

The major advantages of a family business are: lower agency and contact execution costs, aiming at longer-term returns, bonding family fate with corporate reputation, family members more active involvement in management, and more efficient decision making under a more centralized structure. However, there are also several disadvantages or limitations of a family business including over reliance on family networks, reservations on the appointment/retaining of outside senior executives, lower corporate transparency, less emphasis on governance structure, potential conflicts between family executives and minority shareholders, and overlooking succession issues.

Clearly family businesses have both strengths and weaknesses and it is important to integrate family management and professional governance. Major governance concerns include external financing sources, potential expropriation activities of controlling shareholders, independence of board and directors, chairman/CEO duality, relationships among family shareholders, family succession, and the role of professional executives in family businesses, etc. This article focuses on the last dimension of family business governance.

## Increased Involvement of Professional Management

Chinese entrepreneurs, who started their business from scratch, like the "hands-on" approach to management, and they even attend to every detail personally. In the West, by contrast, most family businesses adopt a "hands-off" approach, once they have gained a firm foothold and are running on the right track, the controlling shareholders tend to hire professional managers to take full charge of the day-to-day operations while retreating to the Board to assume advisory and supervising duties.

There are cases in the West in which the major shareholders still hold on to the management control power after the company is listed (e.g. Rupert Murdoch of News Corporation). However, the percentage of such cases is much smaller than in Asia.

Of course there would be certain advantages if family enterprises lost no time distributing the management control power to family members (70% of Hong Kong listed enterprises have family members as their CEOs). It is true that many high-level posts in family enterprises are held by family members, including the CEO, the GM, the CFO, the COO, etc.

However, if the entrepreneurs' children are not yet in a position to take over the family business due to a lack of experience, competence, interest or aptitude, the entrepreneurs can hire independent professional managers to undertake all or most of the high-level management work. This will also help foster the next generation of entrepreneurs to take over their own establishments in the future.

In fact, more and more enterprises are willing to hire professional managers to achieve the transformation from traditional family businesses to modern enterprises. For example, the Hong Kong industrial giant, Yip's Chemical Holdings Limited, has implemented a new management structure since 2003, with the Board of Directors being responsible for corporate decision-making while the Management Committee (MC) takes charge of business operations.

Yip's Executive Directors are mainly family members, whose responsibilities include making the long-term development plans and strategies, as well as supervising the operation of the MC, which consists mainly of independent professionals. This practice ensures that there is a clear-cut division of work and



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independence between decision-making and its execution, as well as straightening out the collaboration between them.

Furthermore, some founders of family businesses holding the post of general manager or CEO, attempt to leave their posts vacant for professionals to apply openly, with lucrative offers, showing their open-mindedness, broad vision and mettle. For example, in April 2007, the well-established Hong Kong Hysan Development Company Limited announced that its Managing Director, the heir to the founding Lee family, Michael Tze Hau Lee, after 17 years dedication to the company, was retiring from his current post at his own will. He retired right after the annual Board meeting in early May, to pursue his personal aspirations and goals, including more participation in serving the community, while remaining on the Board.

Hysan invited applications for the post of new Managing Director through a worldwide open recruitment, the first open recruitment for this post since the Company was listed in 1981. Indeed such cases are uncommon among the listed family-controlled companies in the region. The practice of openly recruiting a company CEO can reduce the company's family-tinted features, as well as help boost its image and efficiency in management.

As a matter of fact, the Hysan Development Company Ltd has actively carried out reforms in its management in recent years, and most of the directors on the Board are not from the Lee clan; therefore, the Board can achieve a better balance in its decision-making.

### Carefully Handling the Agency Cost of Professional Management

On the other hand, hiring outside professional managers can also lead to other management problems (or agency problems), which must be handled with care. The controlling shareholder (the Principal) takes full advantage of various monitoring and incentive mechanisms to prevent the senior managers (the Agent) from acting against the interest of the company or of the controlling shareholder. If monitoring devices fail, some professional executives would probably either squander or misappropriate the corporate property, or miss good opportunities for long-term investment because they are unwilling to take strategic risks or are concerned with securing only short-term income.

Moreover, when the managers become too powerful, the company or the Board of Directors may lose control over them and corporate bureaucracy will run rampant, thus doing great damage to the company's interest.

Take the famous brewery Huanghe Group in the Chinese mainland for example. It was founded by its president, Yang Ji Qiang, in 1985. His four sons served respectively as Chairman of the Board, General Manager (CEO), Manager and the like, in its subordinate listed company, Lanzhou Huanghe. After its listing, the company attempted to openly recruit senior professional managers. This was a practice considered very rare and bold in the Chinese mainland at that time. Eventually Wang Yan Yuan, an expert in media communication, was appointed as vice chairman of the Board and deputy general manager, mainly responsible for the company's listing.

However, Wang secretly set up his own business and power after joining the company and even transferred the company's benefits and interests to his own family enterprise. In the end he was held in detention on suspicion of violating regulations. As a result, the Huanghe Group called shareholders together for a general meeting, dismissing all the directors and top management personnel from their posts, and appointed Yang's sons to resume the post of vice chairman of the Board of Directors and the post of general manager, and re-elected other family members as board directors. Consequently, the company returned to the situation in which the family had complete control of the enterprise.

The so-called "Huanghe Incident" reflects the dilemma of family enterprises: on the one hand, they need to hire professional managers to provide assistance; on the other hand, the managers may not share the same interests with the family shareholders and may even go against the company's interest. In addition, due to the deficiency of the legislation and legal protection, some family enterprises often waver over hiring top professional managers, and sometimes even suffer from a loss of high-caliber talent.

In those family enterprises where the ownership rights and control rights are totally separate, there will also be similar agency problems. For example, several years ago, in the well-known American computer company, Hewlett-Packard (HP), the professional management once planned to merge with Compaq but could not get support from the heirs of the HP





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shareholding family. With the two sides opposing each other, the management later placed an advertisement in a number of American newspapers, quoting from one of the HP founders, Dave Packard: "To remain static is to lose ground", suggesting that if the two founders were still alive, they would also choose to change with the times and accept the merger.

However, David Packard, Dave Packard's son, fought back by quoting another of his father's sayings: "More companies die of indigestion than starvation", criticizing the management for quoting a wrong saying from his father. Bill Hewlett, son of the other HP founder, Walter Hewlett, made use of the media to refute the management's suggestion, regarding it as detrimental to the company as a whole. From these examples we can see that after the management has gained full control rights, it may go totally against the will of the shareholding family.

### Appointing Talent according to Merit

Sometimes professional managers may find themselves playing an awkward role in operating a family business; therefore, it is of great importance for them to handle the relationship with the family members effectively, and possess certain personal traits. In successful cases, the professional manager is often recognized as one of the family rather than a total outsider. In other words, in order to earn the family's trust, professional managers must get along well with the family, and be modest without losing their independent and professional stance. At the same time they must keep on offering advice in proper ways so that their own ideas can be brought into full play and their decisions fully supported.

Of course, the Chairman of the Board of Directors in a family enterprise will keep a constant watch on the independent CEO, and challenge him while providing guidance, encouragement and support. In other words, to the CEO, directors have a dual role as "a cop and a coach".

In any case, as family enterprises keep on growing, and are hiring more non-family managers, they need to establish a set of standards, and a fair and transparent system of appointment, assessment and reward, in order to motivate topnotch professionals. Family members of course can work

in a family business, but their role should be clear. When selecting a family member or an "outsider" to assume a high-level post, the overall interest of the company should be taken into consideration, i.e. to find the most suitable person to lead the company. Then, no matter how big a shareholder you are, if you are found incompetent or performing poorly through assessment, you will have to hand over your post to others.

On the other hand, no matter whether you are a family shareholder or not, as long as you are qualified and competent, you can always earn yourself a place in the company. The appointment should be made according to one's merits without avoidance of kinship, and competence and abilities should always be the yardstick in all matters. Family members cannot be excused their wrongdoings due to their special identity. Otherwise, this would make the management confused. If a professional manager has decision rights, other family members should respect their leadership.

It is supposed that, even if the appointed independent CEO is very loyal and capable, some families are still concerned that the cost of hiring professional managers is too high. However, in reality such concerns do not seem to be justified by research statistics. As a matter of fact, family enterprises are more likely to benefit from hiring professional managers than their non-family counterparts. According to recent research done by the author on the listed companies in Hong Kong, family enterprises pay much more on average to the CEO than non-family enterprises. Although professional CEOs (accounting for about 32% in number) receive a notably higher remuneration than the family member CEOs (about 68%) in the family business, the bonuses they receive have shown a remarkable correlation with the profits gained by the enterprise.

This also indicates that many family enterprises attach great importance to employing professional CEOs, and are willing to attract and encourage them with favorable packages. Some statistics also show that if the heirs of the founding family serve as CEOs in the family enterprise, they are likely to spend more on their material pursuits and comforts than the founding CEOs or professional CEOs.