Firms that are family owned but not managed by family members are often well managed, as family shareholders with large equity stakes carefully monitor those charged with managing the business (Bennedsen et al., 2006; Perez-Gonzalez, 2006; and Villalonga and Amit, 2006). However, management by the children of the founders typically adversely affects firm value (Claessens et al., 2002; Morck and Yeung, 2000). This may result from the limited pool of family members available for taking control of the business.

Succession is one of the most difficult challenges to resolve, with family-owned firms viewing succession as the transfer of ownership more than as a transfer of management. Problems arise from inadequate preparation of the younger generation of family members and the limited pool of potential successors who might not even have the talent or the interest to take over. For many such firms, the founder always made key decisions and other family members often did not have the opportunity to develop business acumen. In such firms, mid-level management expertise often resides among non-family members, who often leave due to perceived inequity in pay scales with family members and limited promotion opportunities. While some firms display an ability to overcome the challenges of succession, others look to sell the business (see Case Study 10–1). Unlike the case study at the beginning of the chapter, the owner lacked confidence that his existing management team had the level of sophistication to continue to grow the firm. Consequently, he looked to sell the firm, not only as a means of "cashing out" but also as a way of sustaining growth in the firm he had founded.

Case Study 10–1 Deb Ltd. Seeks an Exit Strategy

In late 2004, Barclay's Private Equity acquired slightly more than one half the equity in Deb Ltd. (Deb), valued at about \$250 million. The private equity arm of Britain's Barclay's bank outbid other suitors in an auction to acquire a controlling interest in the firm. PriceWaterhouseCooper had been hired by the Williamson family, the primary stockholder in the firm, to find a buyer.

The sale solved a dilemma for Nick Williamson, the firm's CEO and son of the founder, who had invented the firm's flagship product, Swarfega. The company had been founded some 60 years earlier based on a single product, a car cleaning agent. Since then, the Swarfega brand name had grown into a widely known brand associated with a broad array of cleaning products.

In 1990, the elder Williamson wanted to retire and his son Nick, along with business partner Roy Tillead, bought the business from his father. Since then, the business has continued to grow, and product development has accelerated. The company developed special Swarfega-dispensing cartridges that have applications in hospitals, clinics, and other medical faculties.

After 13 years of sustained growth, Williamson realized that some difficult decisions had to be made. He knew he did not have a natural successor to take over the company. He no longer believed the firm could be managed successfully by the same management team. It was now time to think seriously about succession planning. So in early 2004, he began to seek a buyer for the business. He preferably wanted somebody who could bring in new talents, ideas, and up-to-date management techniques to continue the firm's growth.

The terms of the agreement called for Williamson and Tillead to work with a new senior management team until Barclays decided to take the firm public. This was expected some time during the five-to-seven year period following the sale. At that point, Williamson would sell the remainder of his family's stock in the business (Goodman, 2005).

Continued

Case Study 10–1 Deb Ltd. Seeks an Exit Strategy — Cont'd

Discussion Questions

1. Succession planning issues are often a reason for family-owned businesses to sell. Why do you believe it may have been easier for Nick than his father to sell the business to a non-family member?
2. What other alternatives could Nick have pursued? Discuss the advantages and disadvantages of each.
3. What do you believe might be some of the unique challenges in valuing a family-owned business? Be specific.

Governance Issues in Privately Held and Family-Owned Firms

The approach taken to promote good governance in the Sarbanes–Oxley Act of 2002 (see Chapter 2) and under the market model of corporate governance (see Chapter 3) is to identify and apply "best practices." The focus on "best practices" has led to the development of generalized laundry lists, rather than specific actions leading to measurable results (Robinson 2002b). Moreover, what works for publicly traded companies may not be readily applicable to privately held or family-owed firms.

The market model relies on a large dispersed class of investors in which ownership and corporate control are largely separate. Moreover, the market model overlooks the fact that family owned firms often have different interests, time horizons, and strategies from investors in publicly owned firms. In many countries, family owned firms have been successful because of their shared interests and because investors place a higher value on the long-term health of the business rather than on short-term performance (Habersham and Williams, 1999; de Visscher, Aronoff, and Ward, 1995). Consequently, the control model of corporate governance discussed in Chapter 3 may be more applicable where ownership tends to be concentrated and the right to control the business is not fully separate from ownership.

Astrachan and Shanker (2003) conclude that the control model (or some variation) is more applicable to family-owned firms than the market model. The authors argue that director independence is less important for family-owned firms, since outside directors often can be swayed by various forms of compensation. A board consisting of owners focused on the long-term growth of the business for future generations of the family may be far more committed to the firm than outsiders. While the owners are ultimately responsible for strategic direction, the board must ensure that strategy formulated by management is consistent with the owners' desires.

Nevertheless, there is evidence that many private businesses are adopting many of the Sarbanes–Oxley procedures as part of their own internal governance practices. A 2004 survey conducted by Foley and Lardner found that more than 40 percent of the private firms surveyed voluntarily adopted the following SOX provisions: (1) executive certification of financial statements, (2) whistleblower initiatives, (3) board approval of nonaudit services provided by external auditors, and (4) adoption of corporate governance policy guidelines (Foley and Lardner, 2007).

Challenges of Valuing Privately Held Companies

The anonymity of many privately held firms, the potential for manipulation of information, problems specific to small firms, and the tendency of owners of private firms to manage in a way to minimize tax liabilities creates a number of significant valuation issues. The challenges