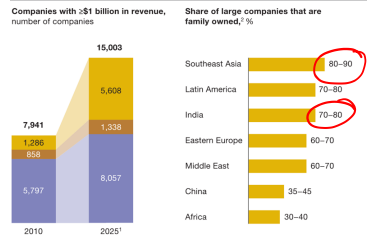


Family businesses are central to the global economy



¹ Projection based on city GDP forecasts.
² As of 2013 or closest available year, captured at headquarters location.

- Make up 35% of the companies in the Fortune Global 500 firms
- There are 5.5 million family businesses in the US
- Family-owned businesses contribute 57% of the US GDP, employ 63% of the workforce, and are responsible for 78% of all new job creation.

1

Family Business Definitions

- **Structural definitions** focus on the firm's ownership or management arrangements, e.g., "51% or more ownership by family members."
- **Process definitions** stress on how the family is involved in the business – its influence on company policy, its desire to perpetuate family control of the business

2

Why is the Industry Family Controlled?

New York Times.

- In the 1950s, over 70% of the 1785 daily newspapers in the US were family-owned
- All except one of the 12 largest newspapers in the US family controlled in 2006
- The 12 newspapers account for 50% of the circulation
- The desire to shape the news and hence public opinion
- "Preserving journalistic integrity"

**Private Benefit of Control
Or
Competitive Advantage**

3

Why is the Industry Family Controlled?

- Firms and industries are more likely to remain under family control when:
 - Their efficient scale and capital requirements are smaller
 - The environment is noisier
 - The investment horizons are longer

patient capital.

(Villalonga & Amit, 2010)

In a time of crises is family ownership good or bad?

4

How is Family Control Achieved?

1. Disproportionate board representation

- Representation on the board exceeding the voting stake

2. Dual class stock *US*

- Board control through voting rights

3. Voting agreements *FI*

- Agreement between family & institutional owners

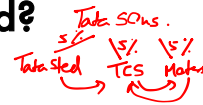
4. Pyramids

- Indirect ownership or cross-holding of stock

5. Trusts

- Pool the family's voting power and reduce taxes in intergenerational transfers

Family office



5

5

How is Family Control Achieved?

• Role of the Board

- Appoint, monitor and set compensation for top management
- As part of monitoring, it reviews and approves major corporate initiatives

• Shareholder Voting

- Major corporate initiatives that involve a structural or strategic change
 - Appointment of Board Members
 - Mergers and amalgamations;
 - Sales of undertakings;
 - Variations of shareholder rights;
 - Alterations in memoranda of association or articles of association;
 - Approval of audited financials and boards reports;
 - Declarations of dividends;
 - Reduction in capital;
 - Liquidation of the company.

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6

How is Family Control Achieved?

• Majority Voting System

- Nominees need more than half the votes cast to be elected
- Withholding a vote for a Director equivalent to voting against

• Plurality Voting System

- Nominees with the most "for" votes are elected.
- In contested elections, withheld votes do not count

- Withhold but not be identified
 - Fear of management retaliation

7

7

Morgan Stanley's Assault

• Overspending

- Boston Globe - \$1.1 Bn in 1993
- New HQ - \$600 Mn

• Stock repurchase

- \$3 Bn between 1997 & 2004 at Avg price of \$37

• Sulzberger's inaccessibility

• Corporate Governance

- Dual Class shares
- Excessive management compensation
- Entrenchment of management
- Conflict of Interest (Publisher vs Owner)

8

8

Morgan Stanley's Assault

- Company Perquisites
- Board, Family Council or Advisory Compensation
- Family Business Dividends
- Income from Job (inside or outside)
- Income from Investments outside the family business
- Inheritance & family gifts

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Sulzberger's Choices

- **Business:** Responsibility to readers for journalistic integrity
- **Owner:** Fiduciary duty to shareholders
- **Family:** Preserving the Socio-emotional wealth of the family

10

Sulzberger's Choices

In order to endure for generations in a sustainable manner, families need to grow their financial assets while maintaining unity and building talent. The three factors, Growth of Family Assets, Family Unity, and Family Talent, are vital for ongoing family success

JOHN A. DAVIS, 2014

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Evolution of Family Business Governance System

- Family firms start as **controlling owner**
 - Full ownership & control
 - Remains for one or two generations
 - Small advisory board instead of BoD
 - Paper Board with family members
 - Family council to prepare plans, policies, rules & agreements
- Intense family relationships
- The founder is impressive, builds a lot of value and is typically at the center of activity, often regarded as indispensable.

1

TERSICK, ET AL, GENERATION TO GENERATION, 1997

12

Evolution of Family Business Governance System

- **Sibling Partnership** stage
 - Usually lasts for one generation
 - Two or more siblings share ownership & control
 - Formalisation process starts
 - Historical rivalries due to lopsided distribution of power
 - Family relationships less connected as siblings create their own nuclear families
 - Sibling tension around power and fairness, balancing dividends with reinvestment, and building professional systems in the business are common issues at this stage.
 - Role of independent advisors critical

OWNERSHIP STAGES

Controlling Owner → Sibling Partnership → Cousin Consortium

Source: GERSICK, ET AL, GENERATION TO GENERATION, 1997

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Evolution of Family Business Governance System

- **Cousin Consortium** stage
 - The family is larger, diverse, and the business is larger and more complex
 - Bloated highly political boards
 - Annual family assembly of the entire family
 - Non-family members often manage the business, while the family gravitates to board roles

OWNERSHIP STAGES

Controlling Owner → Sibling Partnership → Cousin Consortium

Source: GERSICK, ET AL, GENERATION TO GENERATION, 1997

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Family Wealth Paths

- **Path 1: It declines.**
This is called the *Three-Generation Rule Path*, which follows the three-generation axiom.
- Wealth travels this path typically for two reasons:
 - The family consumes its assets faster than it generates assets; and
 - The business is in a maturing or declining stage in its industry, is not keeping pace with technological advancements and is not regenerated.

FAMILY WEALTH PATHS

1st Generation 2nd Generation 3rd Generation

Quick Descent, Three-Generation Rule Path, Regeneration

Source: JOHN A. DAVIS, 2013

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Family Wealth Paths

- **Path 2: It declines faster.**
This is called the *Quick Descent Path*, which happens for the same reasons as the *Three-Generation Rule Path*, and in addition:
 - The family makes a bad bet (or two) in overly risky investments that do not turn out well; and/or
 - Financial assets are divided due to family conflict, perhaps costly lawsuits, or divorce.
 - On this path, families lose a lot of money quickly.

FAMILY WEALTH PATHS

1st Generation 2nd Generation 3rd Generation

Quick Descent, Three-Generation Rule Path, Regeneration

Source: JOHN A. DAVIS, 2013

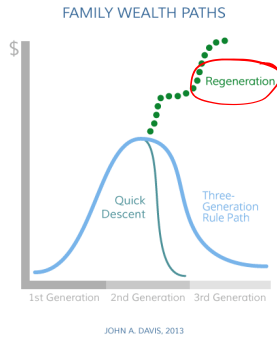
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Family Wealth Paths

• Path 3: It grows.

Families that do well financially over generations are on the *Regeneration Path*. These families follow several philosophies and practices to grow their wealth, such as:

- Have strong management talent running their operations
- Stay united as a family
- Stay focused on their family mission
- Control their lifestyle expenses
- Diversify at the right time
- Develop family talent, including—in every generation—grooming *wealth creators* who know how to make money for the family.



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Tradeoff between Control, Liquidity, & Growth

• Control is essential for founders and their families for:

• Economic Reasons

- Which business to enter or exit
- What to acquire or sell
- How much to invest
- Whom to hire and how much to pay them, Whom to fire
- Dividends

• Psychological Reasons

- Power, pride & prestige
- Emotional attachment

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Tradeoff between Control, Liquidity, & Growth

• Public Equity

- ↑ • Powerful incentive for employees
- Visibility to consumers
- ↓ • Required to disclose information
- Underpricing problem

• Private Equity

- Contacts
- Quality certifications
- Managerial expertise
- Better board supervision
- Professionalisation pressure
- Accountability

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Tradeoff between Control, Liquidity, & Growth

• Strategic Investor

- Operational Know-how
- Reputational rub-off
- Ability to attract & retain talent
- Relationships with customers & suppliers
- ↓ • Learning race
- Hold-up
- Adverse Selection
- Moral Hazard

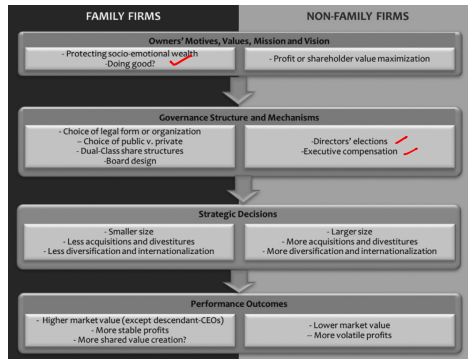
• Internal Capital Market

- Tax savings
- Lower cost of capital
- Efficient redeployment of resources

↓ • Tunnelling
 Tata → Tata → TCS ← dividends
 Motors ←

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Family vs non-family Firms



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The House of Tata

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Corporate Governance

- Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled.
- It involves balancing the interests of various stakeholders, including shareholders, management, customers, suppliers, financiers, government, and the community.
- Effective corporate governance ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders.

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Tata Group

- Started by Jamshedtji N Tata in 1868
- His sons Dorabji, Ratan and brother Ratanji set up Tata Sons as the family's investment arm
 - The family stake in various Tata firms was routed through Tata Sons
- Both Dorabji and Ratan bequeathed most of their inheritance and wealth, including shares in Tata Sons, to philanthropic charitable trusts.

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Tata Group

- JRD, the son of Ratan took control in 1938
- In the sixties, there was infighting among the siblings of JRD
- The Shapoorji Pallonji group took advantage and bought the shares of Tata Sons from the siblings.
 - Pallonji Mistry, the father of Cyrus Mistry had good relations with JRD as well as Ratan Tata
 - He was invited to the board on condition that he would not transfer his shares without board consent

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JRD

- Under JRD, the managers had total freedom
 - The Tata Group was like a commonwealth of enterprises, not an empire
 - Senior managers in the Tata Group were very powerful – Durbari Seth, Russi Modi, Nani Palkhivala
 - RNT was appointed as successor in 1992, coinciding with reforms

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Was Ratan Tata the right choice?

RNT

- RNT set the retirement age for executive directors at 65 and non-executive directors at 75
 - Capex in TISCO and TELCO to make them cost-competitive
 - TELCO forayed into the passenger car (risk appetite)
- Institutionalised group cohesion
 - Progressively increased Tata Sons' stake in group companies
 - Tata Sons undertook a rights issue - the group companies subscribed, using the money Tata Sons bought shares of group companies
 - Tata Brand Equity and Business Promotion Agreement (BEBP)

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RNT

- Group Executive Office
 - Restructured the business into seven sectors
 - Set up a Business Review Committee
 - Implemented the Tata Code of Conduct
 - Implemented the Tata Business Excellence Model
- In August 2010, Tata Sons announced the formation of a selection committee for next leader
 - In Nov 2011 Cyrus Mistry was announced as next Chairman

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Was Cyrus Mistry the right choice?

CM

- 60% of revenues from international business with overall PAT @ 10% and debt of \$26 billion
 - CM closed plants, divested businesses, shelved capex ||
 - Plans to turn around Tata Motors, Corus Steel and Telecom business backfired
 - In 2016, the Economist in a scathing review termed Mistry's performance as 'listless'

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October Shock

- On 24 Oct 2016, Nitin Nohria, Dean of HBS offered CM the choice to either resign voluntarily or be voted out by the board
 - CM refused, was kicked out, RNT returned
- CM counterclaims
 - He inherited a sick company
 - RNT acted as a super director
 - Shareholder democracy vs Corporate Governance

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Tata Saga

- In Oct 2016, Cyrus Mistry was abruptly removed as Chairman by the Board of Tata Sons and later removed from the Board by the shareholders
 - In 2018, the National Company Law Tribunal (NCLT) upheld the decisions
 - In Dec 2019, the National Company Law Appellate Tribunal (NCLAT) reinstated Cyrus Mistry as Executive Chairman of Tata Sons
 - Tata Sons filed an appeal in the Supreme Court of India, which stayed the NCLAT orders

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Board of Directors' Role and Independence

- The board of directors is central to corporate governance, responsible for overseeing the company's management and ensuring it acts in the best interests of the shareholders.
 - In the Tata-Mistry case, the board's role came under scrutiny when Cyrus Mistry was abruptly removed as chairman of Tata Sons by the board.
 - **Conflict:** The board's decision to remove Mistry raised questions about the independence and effectiveness of the board. Critics argued that the board acted under the influence of Ratan Tata, the previous chairman and a dominant figure in the Tata Group.
 - **Lesson:** This underscores the importance of having an independent and balanced board that can make decisions without undue influence from any single individual, ensuring decisions are made in the best interest of all stakeholders.

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Transparency and Disclosure

- Transparency in corporate governance involves the clear and timely disclosure of relevant information to stakeholders.
 - **Conflict:** Mistry accused the Tata Group of poor governance practices, including lack of transparency in decision-making processes and financial disclosures. He alleged that he was not provided with sufficient information regarding significant decisions.
 - **Lesson:** The dispute highlights the necessity for robust disclosure practices that ensure all board members and stakeholders are adequately informed about the company's operations and financial health.

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Shareholder Rights

- Shareholders' rights are a critical component of corporate governance, including their ability to vote on significant matters and access information about the company's performance.
 - **Conflict:** After his removal, Mistry raised concerns about the treatment of minority shareholders in the Tata Group companies. He claimed that their rights were being disregarded, particularly in the decision to remove him and in the governance practices followed.
 - **Lesson:** This situation emphasizes the need to protect minority shareholders' interests and ensure they have a voice in critical corporate decisions, promoting fair and equitable treatment for all shareholders.

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Ethical Conduct and Integrity

- Corporate governance also involves ensuring that the company's leadership adheres to high ethical standards and acts with integrity.
 - **Conflict:** The public feud between Tata and Mistry brought to light various allegations and counter-allegations, potentially damaging the reputation of the Tata Group, known for its high ethical standards.
 - **Lesson:** The case illustrates the importance of ethical conduct and maintaining integrity at all levels of corporate leadership to uphold the company's reputation and stakeholder trust.

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Leadership and Succession Planning

- Effective corporate governance requires a clear process for leadership succession to ensure stability and continuity.
 - **Conflict:** The sudden removal of Cyrus Mistry and the subsequent leadership vacuum indicated weaknesses in succession planning within the Tata Group.
 - **Lesson:** This underscores the importance of having a transparent and well-thought-out succession plan to manage leadership transitions smoothly and maintain organizational stability.

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Understanding Business Group

Advantages

- Resource Sharing and Synergies:** Business groups can share resources such as technology, knowledge, and managerial expertise across their subsidiaries. This can lead to cost savings, operational efficiencies, and enhanced innovation.
- Risk Diversification:** Business groups can diversify their risk by operating in multiple industries and markets. Financial stability is enhanced as losses in one sector may be offset by gains in another.
- Easier Access to Capital:** The business group's combined strength and reputation can facilitate easier financing access. Subsidiary companies may receive favourable borrowing terms and increased investment opportunities.
- Strategic Flexibility:** Business groups can strategically reallocate resources and assets among their entities to capitalise on market opportunities. This dynamic resource allocation can maximise returns and support struggling subsidiaries.
- Enhanced Governance Standards:** Well-governed business groups can implement consistent governance policies and high standards across their entities. Uniform governance practices promote transparency, accountability, and stakeholder trust.
- Economies of Scale:** Large business groups can achieve economies of scale in procurement, production, and marketing. This can lower costs and improve competitive positioning in the market.

Disadvantages

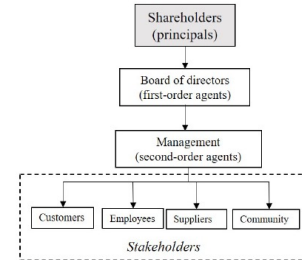
- Complex Ownership Structures:** The intricate and often opaque ownership structures, including cross-holdings and pyramids, can obscure true control and accountability. This complexity can make it difficult to monitor and regulate governance practices effectively.
- Conflict of Interest:** Conflicts of interest may arise when individuals hold multiple roles across different companies within the group. Decisions might favor one entity or group of stakeholders over the others, compromising overall governance quality.
- Minority Shareholder Rights:** Minority shareholders in subsidiary companies may have limited influence and protection. Their interests may be overlooked in favor of the controlling shareholders, leading to potential grievances and disputes.
- Transparency and Disclosure Issues:** Ensuring consistent and transparent disclosure across all entities within the business group can be challenging. Lack of transparency can result in information asymmetry, making it difficult for stakeholders to make informed decisions.
- Regulatory Compliance:** Operating across multiple jurisdictions entails navigating diverse and complex regulatory landscapes. This increases the risk of non-compliance, leading to potential legal and financial repercussions.
- Operational Silos:** Subsidiaries within a business group may operate in silos with limited coordination. This can lead to inefficiencies, duplication of efforts, and missed opportunities for synergy.

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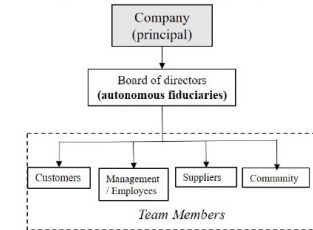
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Models of Corporate Governance

Shareholder-primacy model (Agency Theory)



Director-primacy model (Team Production Theory; Legal View)



(Adapted from Lan, L. L., & Hermalns, L. (2010). Rethinking agency theory: The view from law. *Academy of Management Review*, 35(2), 294-314)

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Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Conception of the company</u>	Companies are legal fiction representing a nexus of contracts.	Legal entity representing a nexus of firm-specific investments. Companies are legal constructs but are also economic and social organisms. A complex team production activity which involves the inputs of various stakeholders and the resulting output is neither separable nor attributable to contributions of individual stakeholders.

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Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Origins of the company</u>	Private agreement among property owners to pool and increase capital.	Created with the sanction of the lawmakers to encourage investment in long-term, large-scale projects needed by the society.

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Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Functions of company</u>	Maximize shareholder value. All corporations have this same objective function.	Multiple objectives – serve a need in the society; provide employment; drive innovation. The purpose of each of company is determined by the company's board independently.

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Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Shareholders</u>	Shareholders 'own' the corporation. Shareholders are principals who have authority over the conduct of the company. Shareholders are homogeneous. All shareholders are self-interested wealth maximizers	Shareholders are one of the stakeholders whose support is essential for team production in the company. Shareholders own the "equity shares" of the company with defined rights and obligations.

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Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Board of Directors</u>	Appointed by the shareholders as their 'agents'. Monitor conduct of the management with the objective of protecting shareholder interests. Agents of shareholders. Monitors management to protect the interests of shareholders.	Autonomous entity with fiduciary responsibility to the 'company'. Acts as a mediating hierarch—balances the often competing claims and interests of the various stakeholders who contribute to the team production process, makes decisions on the allocation of team surpluses, and is legally ultimately in control of a company's assets and key strategic decisions.

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