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Chapter 7

Analysis of Critical Incidents for the Design of the Governance System

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Abstract

This chapter focuses on governance as a key element of the safeguarding system of the family enterprise. The management is in charge of the company's performance in terms of profit and growth. The governance system is designed to secure value protection by designing a robust leadership system, monitoring and advising management, reviewing critical decisions, and providing fail-safe solutions in case of serious malfunctions of the management system. This chapter develops a typology of critical elements which could endanger the development of the company, including conflicts and disruptions among the owner group. Results of recent research on the root causes of the downfall of family enterprises are presented. Finally, a concept of a three-layer protection system is developed with the aim of providing stability for longevity.

Keywords: Governance; safeguarding system of the family enterprise; root causes of companies' disappearance; cohesion factors; separation factors; separation hurdles

7.1. Introduction

In an experimental reflection, we explore which analytical techniques and tools can improve the design of governance systems in family businesses. The model case for our analysis is the larger, older (third generation), wholly family-owned

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enterprise in the German legal environment. Governance is understood – in a broad sense – as the concepts for leading the leadership institutions (shareholders' group, Top Management Team). Governance serves to ensure the quality of the whole leadership system. It is assumed that the overriding objective is to secure the longevity of the family and its business.

In reality, however, this vision of longevity is the exception rather than the rule. We illustrate below the findings by Lantelme (2017), that within 40 years – little more than one generation – about half of the large family-owned companies disappear. Disappearance means ceased to exist as independent family companies: They were sold or went bankrupt. Although this is less than the rate of two-thirds of public companies which disappear in the same period, it is still a frightening rate of decay.[1]

It is therefore of utmost importance to explore ways and means to improve the longevity of companies. In all likelihood, this has to start with improvements in the quality of leadership. The governance system is designed to assist the owners and the organization to cope with disturbances in, and malfunctions of, the leadership system. In order to achieve that, it would be ideal to know which kind of disturbances and malfunctions are to be expected – specifically in areas critical for the survival of the family business.

With this aim in mind, we explore whether it might be useful to apply a concept technique such as Failure Mode and Event Analysis (FMEA) (VDA Band 14, 2008; VDA Band 4, 2009). Such techniques are standard in the design of mechanical systems today. They are essential in order to achieve a high level of reliability in modern transportation equipment (airplanes, motorcars, cable cars, railways) where failures would be critical for the users. In this effort, I am fully aware that there are limits to the extent one can transfer insights from mechanical systems to social systems. We cannot assume cause–effect relationships, we can only observe the feasibility of certain means for desired purposes. Even with this restriction, any improvement in the longevity of the social system "family business" would justify any effort.

7.2. The Broad Segments of Critical Incidents

In the system of family business, it is an established perspective of research to separate the three subsystems: the family, the ownership, and the business. These are distinct – albeit interacting – segments which in coevolution influence the family and its business.[2] Following this line of thinking, we distinguish as segments for critical incidents:

[1] This rate of downfall is similar to the rate of downfall reported by Ward (2011, p. 2). He counts 33% disappearance within 30 years. However, his sample includes also small businesses.

[2] As to the different interpretations of this model and its critical evaluation, see von Schlippe et al. (2017, p. 75 et seq.).

- Events concerning the composition of the ownership group by entry into the group, transfer of membership and rights, and exit.
- Events concerning the sustainability of the ownership group. The sustainability depends on
    - factors supporting the cohesion (Pieper, 2007),
    - factors working toward separation ("Trennungskräfte" according to Kalss, 2017), and
    - factors creating hurdles or even barriers to such separation forces (Kormann, 2017).
- Events originating in the spheres of the business which could affect the sustainability in various ways. Most important is the business development itself. A successful development of the business is "an effective glue for the ownership" (Miele & Zinkann, 2012). Conversely, the assessment of executives or assessments of strategies is a frequent source of potential conflicts among the shareholders. Fig. 7.1 illustrates the key critical elements.

7.3. Extant Research

Any research project in the realm of our topic has to be built on the stream of research on root causes leading to a crisis. In Germany, this body of research is connected with the works of Krystek (1987) and Hauschildt et al. (2000, 2006), for a comprehensive literature review, see Schulenburg (2008). Our specific interest is focused on the question of how the governance system should be designed in order to limit the risks resulting from such critical developments. A starting point for this inquiry is research on principles for designing effective contracts as we find it in Heussen and Pischel (2014) or Rehbinder (1993), or the textbooks of Aderhold

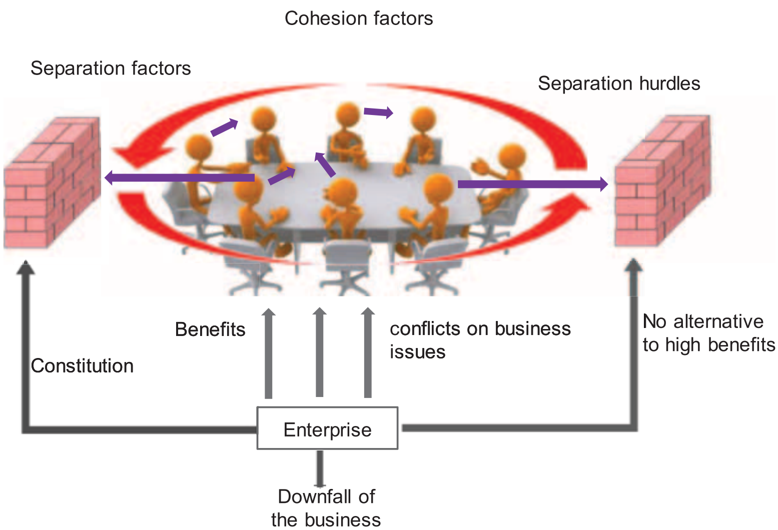

Fig. 7.1. Key Critical Elements.

et al. (2018) and Kunkel (2016). Here, the technique of "Störfallanalyse" (Analysis of disturbances and defaults) is developed. Until now, this research has only looked into procurement contracts, but not into shareholder agreements.

These catalogues of dangerous events which threaten the sustainability are based on the experience of the respective researcher. Complementary to these existing proposals in the relevant literature, we propose the use of a deductive approach to categorize all potentially critical incidents in a "mutually exclusive and comprehensively exhaustive" concept (Minto, 2009; Saunders et al., 2019). In a way, this aims to draw on the aforementioned "FMEA" which is a well-established practice in engineering design.

Standard chapters in the textbooks on corporation statutes and shareholder agreements elaborate on the stipulations which govern the composition of the shareholder group: entry, transfer, or exit of individuals in a shareholder position. In this, we find a variety of standard formulates. However, we seldom find a comprehensive evaluation of the standards according to the criteria of prolonging the longevity of the family business.

The literature on company statutes and shareholder agreements provides a rich source of critical factors which could lead to conflicts and separations among the shareholder group. We refer to Kirchdörfer and Kögel (2000), Lange (2005), Lohse (2005), Wimmer et al. (2018), Lutter (2010), May (2012), Kalss and Probst (2013), Ebel (2014), and Hennerkes and Kirchdörfer (2015). These authors enumerate the most frequent or most dangerous critical events in a shareholder relationship based on the consolidated experience of their professional activity as experts in the field. This stream of research is complemented by growing and well-grounded research on the legal aspects of conflicts in family businesses or – in legal terminology – of "companies with a closed circle of shareholders" (Wedemann, 2013). We refer to Lutz (2021), Bachmann et al. (2012), and Wedemann (2013). In this context, reference is to be made also to the sociological analysis of the typical conflict constellations in family businesses as documented in von Schlippe (2014) and Kormann (2018). An important contribution to the economic analysis of separation factors is the monograph by Redlefsen (2004) on the exit of shareholders from family businesses. He analyses the ramifications of the exit of shareholders from large family companies in Germany: the frequency, the root causes, and the consequences for the owners' group as well as for the businesses.

In summary, there is a broad basis of research on the negative factors jeopardizing the cohesion of the owners' group of family businesses. The major contributions are provided by the attorney's advice to shareholders and their companies.

More recently, there is a growing amount of research on the factors creating cohesion within the owners' group. Obviously, strengthening the cohesion is also important as a preventive measure for coping with conflicts. Pieper (2007) broke ground with his monograph "Mechanisms to Assure Long-Term Family Business Survival." Kormann (2018) elaborated on some of the instruments proposed by Pieper. With the research movement on Socioemotional Wealth (Gómez-Mejía et al., 2007), the aspect of cohesion between owners and their businesses as well as among the owners themselves became a central focus of research on family business.

Significant progress has been achieved in the analysis of the root causes for the downfall of companies by the work of Rindfleisch (2011). Rindfleisch does not focus on family enterprises, but the majority of the analyzed cases are medium-sized businesses which are typical for family enterprises too. A clear focus on the problems of family businesses is provided by Lantelme (2017) who looks at the frequency of downfalls of businesses, and Greussing (2017, see Lantelme et al., 2021) who illuminates the root causes of these downfalls.

We pursue a research project which first consolidates the "Hit-Lists" and other related insight embedded in extant literature. Furthermore, we try to identify those areas where increased research efforts seem promising. The aim is eventually an overarching description of all existence-threatening risks (Lantelme et al., 2021). This aim needs to be developed using a deductive approach. Ideally, we can construct a grid of relevant critical causes in a mutually exclusive and comprehensively exhaustive system. For this system, it is relevant how critical an effect is rather than how frequent it is, because existence-threatening risks are naturally comparatively rare. Still, it is wise to avoid deadly risks even when they seldom occur.

The relevance and the instruments of hurdles or barriers to separations remain an underresearched segment in the analysis at hand. The susceptibility of the various legal forms or corporations to exit is to be evaluated. For example, the shareholding company (Aktiengesellschaft) is a legal form which provides protection against termination of shareholdings. However, the listing of the shares seems to reduce the separation hurdle significantly. There is convincing empirical evidence that for listed family companies the influence of the founding owner's family diminishes continually over time (Klasa, 2007; Kormann & von Schlippe, 2017; Stotmeister, 2022, 2023).

Finally, the research on the downfall of companies due to strategy or management deficiencies is comparatively weak. There are infinitely more publications on "How to become successful…." than on "How to avoid a downfall," although the latter is more pertinent to a company's survival than the former.

7.4. Importance of the Factors

Research on family businesses has a certain bias toward the problems originating in the families. This might be a consequence of the fact that the researchers in the early periods came from the professions of psychological family therapy and of legal advisory. Both professions primarily deal with the problems in the owner group. This emphasis underrates the risks of the family business itself. Our research group tried to gain empirical evidence on the relative importance of critical incidents originating in the owners' group versus those originating in the business sphere – whether it be the management quality in general or specific strategic mistakes. In this quest for a certain population of companies (largest enterprises of 1971), the reasons for their disappearance within the following 40 years were analyzed. The first level of analysis was focused on the form of disappearance (Lantelme, 2017). Table 7.1 shows the relevant forms and causes of disappearance for family enterprises on the one side and public companies on the other side.[3]

[3]This is based on a plausible combination of two different analytical perspectives. This interpretation requires further research.

Table 7.1. Root Causes of Disappearance – Family-Owned Versus Public Enterprises.

	Family Enterprises	Non-Family Enterprises Listed	Non-Family Enterprises Non-listed
Survival	50%	49%	14%
Business-induced downfall	20%	6%	43%
Business-induced sale	–	25%	43%
Owner-induced sale	20%	20%	–
Owner-induced downfall	10%	–	–
Total	100%	100%	100%
	$N = 46$	$N = 35$	$N = 21$

Source: Authors' own table based on Lantelme (2017), Greussing (2017), and Frericks (2019); see Lantelme et al. (2021).

Note: Details of the break-down in Lantelme (2017, p. 68), and Lantelme et al. (2021, p. 165). The non-listed non-family enterprises include companies such as Aral AG, Edeka, Gedelfi, Baywa, Rewe, Ruhrgas, Steag. State-owned companies and subsidiaries of foreign parent companies are not included in this analysis.

In a subsequent analysis, the root causes of the disappearance of the family enterprises were further investigated and categorized (Greussing, 2017). This allocation indicates that business-related and family-related incidents have about equal importance.

In the context of our proceedings, the family-related issues are of specific relevance. However, the often-quoted conflicts in the family are a fairly rare decisive case. More often, the root causes are not conflicts among various members of the owner group, but just the specific requests of one member of the group. Likewise, it is identified in the survey by Redlefsen (2004) that "personal reasons" of an individual shareholder are the most often quoted reason for an exit.

In order to ensure a comprehensive list of critical factors, a deductive approach is required to complement and cross-check the inductive findings. This is the well-established practice in the critical event analysis in designing technical systems (FEMA).

7.5. Examples of Owner-Induced Critical Incidents

7.5.1. Critical Incidents in the Context of Entry Into and Exit from the System

> Entry of new members means a change in the composition of a group and a potentially new allocation of influence. Thus, the regulation of who can join which group under which conditions is a critical element in each shareholder agreement and family constitution (Kögel & Seemann, 2014).

An even more essential consideration than change is the exit:

- How can we allow that the exiting shareholder makes an auction of his shares? Surely, this would reinforce the rivalry among the remaining shareholders and create inequalities by enabling the acquiring shareholder to strengthen his power. A stipulation that the shares can be sold only to the company provides a safeguard, meaning that the relations among the remaining shareholders are not affected.
- Why do we so often see high discounts on the fair value of shares and rather short payment periods for the compensation of say 3 years? Why not just a 15 or 20% discount and a 7-year-payment period?

7.5.2. Analysis of Cohesion and Separation Factors and Separation Hurdles

As the next frame of critical events, I seek to analyze those factors which either strengthen or jeopardize the cooperation within a given shareholder group. These are the prerequisites for a lasting relationship in a profession or business or association for pursuing certain shared interests. To this end, there must be cohesion factors: separation factors cannot prevail. If these do gain a dangerous intensity, then there should separation barriers be in place. The lack or the destruction of these prerequisites is the critical incidents which need to be taken care of in preventive or at least curative actions or regulations for actions, respectively.

7.5.3. Cohesion Factors

The cohesion factors are described in a convincing concept together with rich examples by Pieper (2007), see Table 7.2 for a summary. Kormann (2018) expands on some aspects further, specifically concerning the financial benefits, the inheritance strategy, and the importance of the family and business history.

The critical factors destroying cohesion are – among others – the following (Pieper, 2007):

- Inequalities among shareholders create a wide area of principal–principal conflicts. There are numerous potentials for inequalities:
  - Majority rights and insufficient minority rights.
  - Wide differences in the portion of shareholding: 30% and 3%.
  - Unequal benefits between active and passive shareholders.
  - Unfair conditions for exit.
- Refusal of "Voice" for minority shareholders.
- Refusal of financial benefits such as profit distribution.
- Destruction of the good reputation of the enterprise or the owners' group and thereby diminishing or even destroying Socioemotional Wealth.

> Such factors degrade the loyalty to the family business. The latent question "Why should I belong to this group?" cannot be satisfyingly answered any more.

Table 7.2. Summary of the Cohesion Factors as Per Pieper (2007, p. 213).

Cohesion Dimension	Cohesion Enhancing Mechanisms
Dimension 1: Family Emotional Cohesion	Regular meeting
	Celebrating milestones and accomplishments
	Luxurious, interesting or exotic settings for family meetings
	Good parenting and familial relationships
	Interesting personalities
	Having fun together
	Birthday calendars
	Family history (written or video graphic)
	Photographic and video graphic albums etc.
	Family name
	Philanthropy
Dimension 2: Family Financial Cohesion	Money and other material objects
	Money for education
	Trust funds or other spending accounts
	Elevated lifestyle
	Intra-family lending
	Inheritances
	More explicit rules and precise application about how the resources are distributed (like education policies or family venturing policies)
Dimension 3: Business Financial Cohesion	Dividends
	Salaries in excess of market wages
	Perquisites
	Investing and business opportunities
	Pool contracts
	Shareholder agreements
Dimension 4: Business Emotional Cohesion	Newsletters and other regular communication between business and family
	Corporate news, corporate press releases
	Governance bodies as mediators for information between family and business
	Family gatherings around the business
	Celebration of special corporate anniversaries

Table 7.2. (*Continued*)

Cohesion Dimension	**Cohesion Enhancing Mechanisms**
	Next generation training and meetings
	Internships
	Plant tours
	Quality products
	Company name and logo
	Philanthropy
	Corporate Social Responsibility
	Archives, museums (business and other), monuments, portraits, busts, and movies
	Family business legacy

7.5.4. Separation Factors

We term "Separation Factors" (Table 7.3) those elements in the relationship among shareholders themselves and between shareholders and their business which could induce shareholders to exit the owners' group or to sell the whole business (Kormann & von Schlippe, 2023; Lantelme et al., 2021; von Schlippe & Kormann, 2023). Following Pieper's categorization of the origin of cohesion factors, we distinguish the following separation factors:

- Family Emotions
- Family Financials
- Business Financials
- Business Emotions

and we add the dimensions of conflicts of interest resulting from:

- principal–principal relation among shareholders
- principal–agent relation with a managing shareholder or even a non-family executive as the agent.

7.5.5. Separation Hurdles

Separation hurdles (Kormann, 2017, pp. 302 et seq., 523–524; Redlefsen, 2004, pp. 30–31) prevent or delay an otherwise intended separation. To these factors belong a wide variety of reasons:

- High taxes connected with a separation.

Table 7.3. List of Separation Factors.

Dimension of Separation Tendency	Exacerbating Factor
Family Emotion	Lack of family identity
	Personal rivalry
	Different lifestyles
	Different values
	Unequal parental affection
Family Finances	Unequally distributed inheritance
	Other personal interests (investments, philanthropy)
	Different perception of the need to grow
Business	No sufficient profit distribution
Financial	Concerns about sustainable strategy
Benefits	Different perception of need to grow
Business Emotion	Refusal of "Voice"
	Insufficient minority rights
	Overly restrictive contractual ties
	Damage to the good reputation of the enterprise = Destruction of Socioemotional Wealth
Principal – Principal Conflicts	Insufficient minority rights
	Wide difference in percentage of shares held
	Unfair exit conditions
Principal – Agent Conflicts	Doubts about qualification of agent
	Doubts about loyalty to family business concept

- High discounts versus the fair value of the shares in the sell-and-buy-agreements governing the exit.
- A legal form which does not provide the exit option such as a SE or AG, as long as the company is not listed.
- Long contract fixed duration periods (30 years).
- Excellent profits of the family business which could not be matched by another income alternative.

There are cases of hot conflicts active over decades where such hurdles prevented a separation. Even in cases where relevant provision could not ultimately prevent a separation, the hurdles' presence could help to gain time for the orchestration of an exit process favorable for the sustainability of the business.

7.6. Examples for Company-Induced Critical Incidents

Understanding which type of decisions could lead to critical events in the development of the business leads to governance rules which limit the authority of the executive directors of the company. In the context of our chapter, we can only provide examples for the potential approaches to listing the critical events (Kormann, 2018, p. 315 et seq.):

- Rigidity of the organization when adjusting to changing requirements in the environment. This requires the observation of the long-term trends in the development of critical indicators. Ideally, these indicators are not restricted to the end-effect "profitability" or "growth rate" only, but address the root causes of profitability and growth. For example, one could stipulate that the company is evaluated every 5 years to verify a reasonable value of the business and to assess the development versus the last valuation date.
- Decisions which cannot be corrected any more. Relevant examples are: forming Joint Ventures, long-term cooperation contracts, and the acquisition of companies which could not be sold again to other parties. Making a big mistake in these decisions can have existence-threatening consequences as they cannot be corrected any more.
- Decisions which are a "first time" event for the relevant company. Whatever is done first is an area in which the executive team does not yet have experience. This significantly increases the risk of making a wrong decision.
- Decisions which involve the investment of high amounts of money are inherently riskier than decisions about small sums of money.
- Decisions which significantly concern the personal interests of a member of the executive team (agency problem).
- Decisions which could be significantly affected by behavioral deficiencies of the executives, such as overconfidence.

All these categories require certain measures in the governance process to assure the quality of the decision-making process and limit the risk exposure. For the design of such regulations, there are basically two approaches. The conventional approach is to include in the Rules of Order for the executive team a list of transactions where the authority of the executives is limited and a governance institution (board, shareholder committee) must give their approval (Kormann, 2017, p. 225 et seq.). This specific enumeration has some disadvantages. Typically, only steps which are late in the planning phase or even in the implementation phase trigger the approval process. The other approach is simply to specify a general request: Any development or decision situation which can substantially affect the future development potential of the company has to be reported to the supervisory board (Kormann, 2017, p. 228).

7.7. The Downfall Protection Design

7.7.1. First Level: Performance System

Analogous to the design of engineering systems, one can differentiate three levels of damage protection.

The first level is the prevention of problems through a well-designed “Performance System”: A good business strategy and harmonious personal relationships are the basis. The formulation of a family strategy is an important “first line” of protection. These fundaments can only be created by sufficient leadership in the business and/or in the ownership group. In our understanding, the quality of the leadership is based primarily on the structure, the people, and the processes of the leadership institution itself, e.g., the Top Management Team.

7.7.2. Second Level: Monitoring System

The quality of the decision system has various aspects:

- Competence in identifying decision requirements, in analysis of relevant facts and in evaluation of facts, actions, and consequences.
- Alignment to valid targets and decision criteria.
- Decision-making processes and attitudes of the actors which ensure timely decisions. This also helps avoid delays or stalemate situations.
- Decision-making processes and attitudes of the actors which ensure cohesion. This requires avoiding counterproductive conflicts which jeopardize the implementation of any decision.

If one wants to increase the performance, then the quality of the management needs to be increased. This can be achieved by motivation, training, advising, or changing the composition and/or allocation of responsibilities. The quality improvement has to take place where the resources and their steering are located by the management. Deficiencies in the quality of management cannot be compensated for by other institutions in charge of supervision or audits or similar tasks.

Secondary protection comprises regular monitoring or even testing of the proper and safe functioning of the system. This is the realm of Governance.

The monitoring has three perspectives. First, the members of the governance institution may contribute to the monitoring of the business environment based on their involvement in the business activities of other companies. If appropriate they set “early warning signals” (Ansoff, 1975). Second, the monitoring follows variances in the performance of the system. The business development may necessitate additional resources such as a major capital investment program or an increase in the equity base. Such structural adjustments of the resources are typically to be approved by a governance institution (board, shareholder assembly). If dangerous deteriorations are noted, appropriate restructuring programs can be initiated. Such restructuring might include the disposal of an activity which is "beyond repair." Third, the monitoring of the activities of the management might lead to initiatives to ensure the quality of the management system:

- Impulses for the self-steering capability of the management, e.g., motivation, value orientation, incentives.
- Impulses for cooperative development of initiatives and decisions by advisory.
- Impulses for setting safeguarding context conditions for the decision process, e.g., rules for decision criteria, setting boundary conditions for limiting risk exposure.
- Limits to the authority of the management.
- Authority to give direct instruction to the management.
- If needed, the monitoring can lead to a removal of the executives and their replacement by new members.

The institution for the business governance, e.g., supervisory board, has a back-up in the form of the shareholders' assembly which monitors the activities of the business governance. If needed, the shareholders can upgrade the business governance by their own initiatives. Likewise, the shareholders have the right to change the composition of the governance board.

7.7.3. Third Level: Fail-Safe Back-Up System

Tertiary protection avoids a final downfall after the damaging event. This is the area in which the design of contracts is tested. The general protection routes are, for example, a fail-safe design, which secures a reduced but stable functionality for some time – time to develop remedies. Securing some minimum rights for minority shareholders might be an instrument of fail-safe design. The other option is to provide an emergency alternative. A board assuming to some extent the functions of a not-functioning shareholder assembly is a case in point.

In any case, the primary task of damage protection is "to stop the bleeding" and its root causes: The controlled exit of a shareholder might be necessary to stop the bleeding.

The ultimate layer of a fail-safe business system is to ensure the survival even following the downfall of *one* part of the business activity. "Survival" means maintaining the ability to pursue a strategy for business development. In general, this layer is formed by a diversification of wealth:

- Diversification of the activities of one enterprise.
- Ownership of two or more separate and autonomous enterprises in the ownership of one group of owners.
- Diversification of the wealth of the family by financial investments outside the enterprise.

These concepts of diversification are difficult to observe from the outside. Nevertheless, they do exist in many of the multigeneration business families.

Table 7.4 summarizes the important elements in each of the three levels.

Table 7.4. The Three Levels of Failure Protection.

The Three Levels of Failure Protection	
Primary Protection	Good structures, people
	Processes
	Good strategy
	Family strategy
Secondary Protection	Monitoring reliable functioning by Governance
Tertiary Protection	Contractual arrangements
	• Fail-safe-operation in conflict (at reduced functionality); minimal rights
	• Redundant design
	Exit options
	Diversification

7.8. The Basic Dilemma for Achieving "Ultra-Stability"[4]

In order to gain stability under known circumstances, clear and strict regulations are required in the shareholder agreements. However, the research on safety conditions provides a warning: Too many security measures to protect against disturbances and to secure stability lead to a rigidity which jeopardizes the safety in terms of adaptability. This adaptability is vital for securing sustainability under drastically changed external conditions. Perhaps the agreements under a "family constitution" are the proper place to provide for this flexibility – see Fig. 7.2.

7.9. The Decisive Role of the Legal Advisor in Identifying Critical Incidents

The legal advisor who designs the shareholder agreement has an enormous responsibility. He or she cannot only transfer the set intentions of the shareholders into a contract language. Designing their constitution is for the shareholders a unique decision. They haven't had the opportunity to accumulate experience. Only the legal advisor can act as a trusted person to transfer the experience of the cause–effect relationships to his or her clients. To accomplish this task, a holistic perspective is required. And there is more research and its consolidation in an interdisciplinary body of experience required in order to enable this holistic view.

[4]Ultrastability as the capability of a system to survive external shocks from arbitrary and unforeseen interferences (Ashby, 1956).

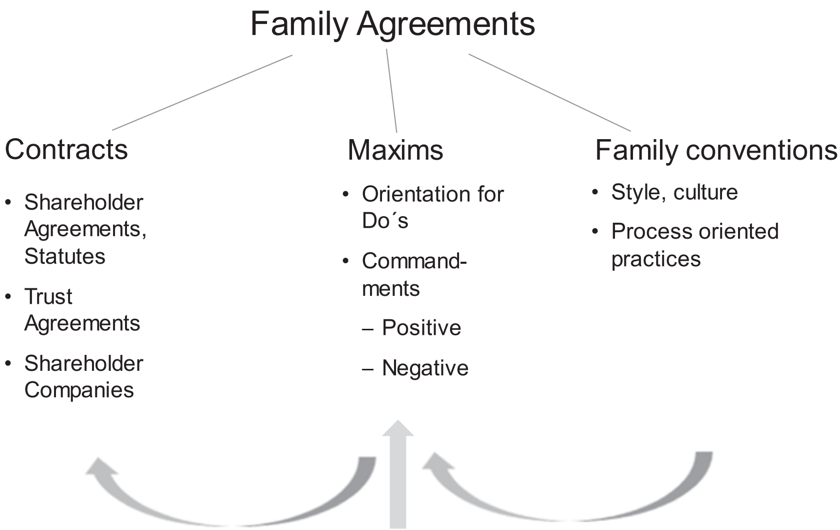

Fig. 7.2. Family Agreements as Elements of Governance.

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