The Economist

The downsides

All too human

How families can cause trouble for their firms

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TWO OF THE most successful television soap operas were about family businesses. “Dallas” told the story of J.R. Ewing’s struggles with his brothers, half-brothers and in-laws for control of Ewing Oil. “Dynasty” was a saga about another oil dynasty, the Carringtons, who “lived and sinned in a 48-room Denver mansion”. The producers understood that money and family together make the perfect stuff of drama.

Koch Industries, an oil, gas and commodities conglomerate based in Wichita, Kansas, makes “Dallas” look sedate by comparison. It has been a cockpit for family quarrels that have eaten up millions of dollars in legal bills and sometimes threatened to tear the company apart. It has also become toxic in some quarters because Charles and David Koch helped raise an estimated $400m in a bid to stop Barack Obama’s re-election in 2012 and fund organisations that promote libertarianism and climate-change scepticism. The firm was founded by Fred Koch, who had a genius for inventing ways of getting more petrol out of each gallon of oil. Fred's second son, Charles, eventually succeeded his father as the firm's CEO. David, a younger brother, acts as a loyal lieutenant. But this succession created huge tensions with two other brothers, Fred junior, the eldest, and in particular Bill, David's twin. Bill and Fred started bringing legal cases against "Prince Charles" and his sidekick. Lawyers sued and counter-sued. For nearly two decades the two Koch factions exchanged hardly a word that was not mediated by a lawyer. The brothers were finally reconciled in 2001, at least officially.

Such quarrels are nothing unusual among the world's biggest family businesses. Sumner Redstone, the majority shareholder of a clutch of media companies, CBS, Viacom and National Amusements, has a long history of feuding with his children, Brent and Shari, over succession. The Porsche and Piëch families, which control Porsche and Volkswagen respectively, have been fighting for decades even though they are related.

Some family companies thrive despite such quarrels. Koch Industries is a highly successful company with over 100,000 employees and an annual turnover of around $115 billion. Two of the world's leading shoe companies, Adidas and Puma, were founded by warring brothers, Adolf and Rudolf Dassler, who set up rival factories in their German home town of Herzogenaurach. But family quarrels also destroy or break up many family companies.

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Internal family rivalries often come to a head over the question of succession. Many family patriarchs are larger-than-life figures who are unwilling to make way for their successors. Haldor Topsoe remained an active chairman of his company until close to his death at almost 100. Arnold Maersk McKinney Moeller retired as boss of Maersk, the world's largest container shipping company, at 80, but continued to cast a long shadow over the company until he died in 2012, aged 98.

Family companies are more likely than other businesses to be thrown off balance by an unexpected death. Researchers who studied more than 5,000 family companies worldwide to see how vulnerable they were to health shocks among family members found that the unexpected death of a CEO could reduce performance by up to 30% and the death of a spouse or child by 10%. Even the hospitalisation of a family owner had an impact.

The biggest problem for family companies is the distinct possibility that the children or grandchildren of business founders may not match the founder for either brains or character. Warren Buffett, a veteran investor, once compared family succession to "choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners in the 2000 Olympics". A family grandee says that the biggest barrier to keeping the family show on the road is the "growing sloth of family members". And CEOs who bear the family name are far more difficult to sack than hired hands, even if they turn out to be useless. Francisco Perez-Gonzalez, of Stanford Business School, compared the returns of America's 500 largest firms in the three years before and after succession and found that returns of firms with non-family CEOs were about two percentage points higher than of those with relatives in the top job. Morten Bennedsen, of France's INSEAD business school, and Kasper Nielsen, of Copenhagen business school, conducted a study of succession in more than 5,300 private firms in Denmark and also found that relatives significantly underperformed outsiders.

Although family companies on the whole are trusted more than other firms, that advantage can quickly dissipate. Business founders will enjoy that trust no matter how rich they become, but their successors will lose some of it no matter how much they improve their companies. Billy Vanderbilt more than doubled his father's fortune in the seven years after "the Commodore's" death, but has since become a mere footnote in history.

The best family companies work hard to prevent this erosion of trust over time by holding themselves to higher standards than the rest. They force heirs to earn their entrepreneurial spurs, perhaps by conquering new regions or entering new industries. But these efforts fail as often as they succeed: the more mature a family company becomes, the more suspicion it faces.

Family companies also often suffer from a surfeit of bodies. If the family multiplies rapidly, ownership becomes more and more diluted. The Mulliez family, for example, has grown to 780 members, 600 of whom have ownership stakes in the family investment company. The Wendel family has more than 1,000 family members involved in Wendel Participations, the holding company that owns almost 40% of Wendel. Such dilution creates numerous problems. How do you decide who runs the company and who is just a passive shareholder? How do you ensure family harmony when different members have different levels of ownership and different degrees of control? Family members who are mere shareholders are likely to press for higher dividends, whereas those who remain in management will want reinvestment and growth. The bigger the family, the bigger the potential for conflict.

The Pritzker business empire, which included the Hyatt hotel chain, was broken up by the logic of numbers. The family patriarch left the empire to 11 cousins who all wanted very different things from their inheritance. The Pritzkers remain a powerful family; they include America's current commerce secretary, Penny, as well as numerous billionaires. But their business clout has been scattered to the winds.

A handful of families have the opposite problem: too few children. This seems to be particularly common in one of the world's most business-minded ethnic communities, the Parsees. Their number has fallen by about a tenth in each decade since the 1950s, and only about 61,000 of them are now left in India, three-quarters of them in Mumbai. They closed their maternity hospital in that city a decade ago. Nobody knows why they have so few children: some people point to their preference for late marriage, others say the reason may be genetic. But there is no doubt that it has a marked impact on business. The Tata family's repeated failure to produce offspring helps explain the structure and ownership of India's biggest company. When it ran out of direct heirs in the 1930s, the family handed control of the company to a trust. And because Ratan Tata, the chairman of Tata Group until 2012, has no children, the company's CEO is now called Mistry rather than Tata.