FOUNDERS’ APPROACH ON SUCCESSOR SELECTION: GAME THEORY ANALYSIS

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ABSTRACT

Family firms are vital in economies worldwide. However, only a small minority of these outlive their founders. The founder’s lack of a proactive approach towards the succession process has been pointed out as a key contributor to that reality. This paper employs game theory to study the impact of the founder’s approach on successor selection in family firms. The results obtained for a founder who adopts an activist approach and invites his preferred successor are compared to those where the founder just reacts to his children initiating the succession race. The findings provide analytical evidence of the importance of the founder being proactive to safeguard intergenerational continuity as well as increase the propensity of his/her preferred successor being appointed.

INTRODUCTION

Family firms are the oldest and most prevalent form of business in the world, representing 70 to 90 percent of the global Gross Domestic Product (GDP). Family firms worldwide range from micro and small firms to large conglomerates which dominate the global business panorama. Family firms is an area of research which has drawn rising interest given the impact and influence that such firms have on the economy worldwide. However, only 3 out of 10 family firms survive to the second generation and only 10% to 15% live on to the third (Kets de Vries, 1993). The challenge of management succession is the ultimate test that the founders of family firms face.

The founder is the first link between the family and the business dimensions of the family firm. The symbiosis which prevails of both these dimensions in the family firm justifies that founders of family firms pursue not only economic but also non-economic goals which affect their decision making process (Gómez-Mejia, Núñez-Nickel & Gutierrez, 2001; Klein & Kellermanns, 2008). The founder values the firm living on as his legacy (an important emotional benefit) but is also concerned in protecting family harmony (Friedman, 1991). The key emotional factors are firm intergenerational continuity and family harmony. The founder wants to secure the firm’s executive control staying in the family but also wants to protect the family from conflict.
The founder’s reluctance to move forward with the succession has been referred to as culprit of family firm’s high mortality rates (Harvey & Evans, 1994). This paper contributes by deepening the use of game theory to provide analytical evidence of the importance of the founder adopting a proactive stance towards the executive succession, focusing on successor selection. We contribute to the literature, by extending the succession game modeled by Jayantilal, Palacios & Jorge (2016). In their model they include, for the first time, the non-economical factors. They consider the emotional benefit of intergenerational continuity and the emotional costs related to conflict between family members. In their model they apply a game where the siblings simultaneously decide whether or not to pursue the successor position and then the founder makes his choice, in accordance to the firm’s cultural setting. Their results highlight the importance of cultural congruence to ensure both firm continuity and family harmony.

In order to study the impact of the founder’s approach on successor selection, we start by extending Jayantilal, Palacios & Jorge (2016) model to employ a sequential game where the founder, adopts an activist approach (Michael-Tsabari & Weiss, 2013), and actively moves forward with the succession by inviting his preferred successor. We then employ another sequential game where the founder is denoted as having a reactive approach, and only takes a stance after his children initiate the succession race. Our model’s novelty also resides in the comparison between the outcomes in both these games, taking into consideration the children’s career aspirations and, also, the father/child relationship, as these factors also play a role in terms of the chosen successor. For each case the payoffs of the games are ranked and subsequently the successor outcomes compared.

The findings demonstrate the importance of the founder assuming an activist approach to increase the propensity of his preferred child being appointed. The results collaborate that founders who are passive and simply do not assume the realms of the succession process have a greater risk of not ensuring intergenerational executive continuity of the firm.

In practical terms, we provide analytical evidence of the importance of founders’ approach to successor selection and hope this works as an added impetus for family firm intergenerational sustainability.

The paper begins with an introduction to family firms and successor selection. This is then followed by the presentation of the cases studied and the comparison of the results obtained. We finalize by reflecting on the impact of the findings, and suggest future avenues of research.

### FAMILY FIRMS

Family firms are said to be the beginning of any form of business activity (Wakefield, 1995). These organizations dominate the economic landscape of all the major economies. The European Commission (2009) indicates that family owned firms represent more than 65% of all organizations in the European Union and 40% to 50% of employment and are therefore considered to be “(...) crucially important for Europe (...)”, by the President of the European Commission (Barroso, 2007). In Australia, family firms account for more than 70% of all businesses and in Latin America 65% to 90% and over 95% in the US, contributing in 40% to the American Gross National Product (GNP). In the United Kingdom family firms account for 70% of all enterprises in the private sector responsible and for more 50% of the employment. In Portugal and Spain these firms account for 70% and 75%, respectively, of the total of firms
It is unquestionable that family firms play a pivotal role in the world economy not only due to their presence but, and more importantly, because of the impact they have on the macroeconomic variables. Studies, in different countries, acknowledge the vital contribution they make in terms of economic growth and employment generation (IFERA, 2003; Anderson & Reeb, 2003).

Various researchers have compared family and non-family firms to understand the differences that exist. Their findings show that family firms, in contrast to non-family firms, adopt a longer term orientation (Eddleston, Otondo & Kellermanns, 2008; Anderson & Reeb, 2003); are more conservative and risk adverse (Chrisman et al., 2010; McConaughy, Matthews, & Fialko, 2001) exhibiting greater resistance to change (Naldi et al., 2007; Zahra, 2005).

Family firms tend to be characterized by higher motivation, cohesiveness and commitment of the members comparatively to non-family members (Dunn, 1996; Donckels & Fröhlich, 1991; Lee, 2006). The strategic behaviour of family firms tends to be more inward oriented (Dunn, 1996; Fukuyama, 1995; Wong, McReynolds & Wong, 1992) and therefore exhibit reduced resource to debt (McConaughy, et al., 2001; Gallo & Vilaseca, 1996). The lower level of indebtedness reinforces the family firm’s orientation towards less risk to defend from loss of control (Zellweger, Meister & Fueglistaller, 2007; Blanco-Mazagatos, Quevedo-Puente & Castrillo, 2007) preferring internal sources and avoiding external long term debt (Upton & Petty, 2000; Davidson & Dutia, 1991). Family firms are inclined to reinvest profits due to their long term orientation and risk attitude (Vallejo, 2009; Gallo & Vilaseca, 1996; McConaughy, Henderson & Mishra, 1998; Poutziouris, 2001; Donckels & Fröhlick, 1991; Gallo, Tàpies, & Cappuyns, 2004).

The employees of family firms have higher levels of identification with the values of the family firm and are more involved, also due to the higher degree of loyalty in family firms in comparison to non-family firms (Adams, Taschian, & Shore, 1996; Kets de Vries, 1993; Ward, 1988; Neubauer & Lank, 1998; Tagiuri & Davis, 1996). Family firms, as a consequence of the higher levels of trust which exist between the members, are identified with better working atmosphere and greater levels of organizational commitment (Barnett & Kellermanns, 2006; Poza, Alfred & Maheshwari, 1997; Hosmer, 1995; Ward & Aronoff, 1991; Lee, 2006).

In terms of performance, however, the findings are not homogenous. Whilst some researchers defend that family firms lead to higher performance and valuation (Sraer & Thesmar, 2007; Fahlenbrach, 2009; Villalonga & Amit, 2006) others refer that gains in agency costs are offset by costs associated with problems such as parental altruism, nepotism, adverse selection, free riding of some members and negative spill over effects of tensions and conflicts of the family to the firm (Barnett, Eddleston & Kellermanns, 2009; Dyer, 2006; Anderson & Reeb, 2003; Burkart, Panunzi & Shleifer, 2003).

Confronting family firms with non family firms sheds light on key distinctive features of family firms yet, notwithstanding the importance of family firm worldwide, there is no consensus as to their definition (Neubauer & Lank, 1998). However, it is generally accepted that the singularity of such firms arises from the co-existence and interaction of the family and the business dimensions, as symbolically represented by Tagiuri & Davis (1996). The founders of family firms are the vertex between the family and the business dimension and play a central role in both (Sundaramurthy & Kreiner, 2008; Litz, 2008).
Founders have a fundamental influence over how the organization initially defines and solves its external adaptation and internal integration problems (Schein, 2004; Harvey & Evans, 1994). The founder defines the firm’s mission, choice of members and is in charge of its functioning (Dyer, 1986). In the earlier phase of the family firm, the founder has a unique and very privileged position to impose on the organization his/her values and beliefs, creating the basis of the organization’s identity. The values and beliefs of the firm are rooted in the founder’s education, life experience, family, and background (Arregle, Hitt, Srimon & Very, 2007). Thus, the founders have an important role in influencing the direction of the organization and its configuration (Handy, 1993). Their influence goes far beyond the earlier stages due to their long and active roles in management (Denison, Lief, & Ward, 2004) but also resulting from the role they play in ensuring the firm’s inter-generational sustainability.

Their centrality in both the family and the business explains why their decisions are driven by both economical factors (i.e. maximizing profits) but also non-economical factors (i.e. emotional factors) which are related to the family dimension (i.e. safeguarding from conflict; ensuring intergenerational continuity). As a result, their decision making process is driven to maximise the weighed sum of both economical and emotional factors (Klein & Kellermanns, 2008), by the relative importance they attribute to both the firm and family dimensions, respectively. One of the most strenuous decisions they face is the selection of their successor.

FAMILY FIRM SUCCESSION

Succession is undisputedly the most critical challenge that family firms face (Cabrera-Suárez, De Saá-Pérez & García-Almeida 2001). The succession process is described as a mutual role adjustment between the founder and the next-generation (Handler, 1990, 1992). It is a multistage and evolutionary course, characterized by the trade-off between the successor’s growing involvement and the reduction of involvement of the founder culminating in the transfer of the baton, as Dyck, Mauws, Starke and Mischke (2002) put it. Mutual respect and understanding between the generations is essential for the process to run smoothly (Cater & Justis, 2009).

This process encloses various steps including the selection, preparation, integration, and finally the transfer of power to the successor. Once the successor becomes the incumbent then the cycle repeats itself. Dyck et al. (2002) draw an analogy between the succession process and a relay race with success depending on sequence, timing, the passing of the baton and communication.

Succession planning refers to the dynamic process which requires the founder to plan the firm’s continuity and then implement the plan (Francis, 1993). The role and responsibilities of both the predecessor and the newly appointed CEO should be clear in the succession plan (Sharma, Chua & Chrisman, 2000). Some firms opt for succession plans which are carefully developed with contributions of accountants, bankers and other experts. Researchers have found that successful transitions can occur even if there is only an informal succession plan (Morris, Williams, Allen, & Avila, 1997).

However the numbers attest that a large majority of family firms do not outlive their founders. The founders are considered responsible for high mortality rates of family firms due to their lack of initiative in adopting a proactive approach to executive succession. Founders’ lack
of planning is directly linked to their resistance in leaving the top position in the family firm. The founder’s inability to let go has been cited as one of the major obstacles for succession (Sharma, Chrisman, Pablo & Chua, 2001). Founders often indefinitely postpone and neglect the succession due to their strong personal sense of attachment (Bruce & Picard, 2006; Le Breton-Miller et al., 2004; Dyer, 1986). Choosing a successor and kick starting the process translates, to many founders, as the beginning of the end. Many founders view leaving the firm and death, as one and the same (Barnes & Hershon, 1989). Consequently, to reflect on succession the founder has to accept his/her mortality, which can be strenuous (Lansberg, 1988). Additionally, the succession process, and in particular, the successor selection stage can ignite rivalries leading to conflict in the family and harmful effects in the firm (Friedman, 1991), which is also one of the reasons for many founders not adopting a proactive stance regarding successor selection.

The choice of the successor is a crucial step in the executive succession process, in the family firm. Different family relationships affect the way the issue of successor selection is addressed (Dyer, 1981). Beckhard and Dyer (1983) refer that the founder can have total and complete control over the succession process or can consult and/or involve family members and professional advisors. Depending on the prevailing culture, in-laws may or may not be considered for succession (Fiegener, Brown, Prince & File, 1994). Jayantilal, Jorge & Palacios (2016) highlighted the impact of cultural alignment on successful succession transfers.

A large majority of founders want the firm to live on and prosper at the realms of their descendants. The founder’s legacy and inter-generational continuity are key non-economic benefits (Chrisman, Chua, Pearson & Barnett, 2012). The choice of successor is dependent on various factors such as: availability (Sharma et al., 2000), gender (Haberman & Danes, 2007), ability (Brockhaus, 2004), culture and tradition (Ayres, 1990) to name but a few. When choosing a successor the most values attributes are his ability, commitment to the business and interpersonal skills (Motwani, Levenburg, Schwarz and Blanson, 2006). A founder, when selecting a successor, takes into consideration leadership skills (Waldman et al. 2006) and capacities in the fields of human and operational management (DeNoble, Ehrlich & Singh, 2007) allied to the power to motivate and inspire the workers (Waldman et al., 2006). In a family firm context, the founder also weighs in the successor’s family orientation (Lumpkin et al. 2008), i.e. the value the successor places on family involvement in the firm. As a result, the founder’s choice is influenced by the business dimension of the family firm but also by the family dimension. The founder is rational but different from non-family firm owners as he aims to maximise the sum of emotional and financial values. The trade-off will depend on the founder’s predisposition to value business performance or emotional value more. This predisposition will condition how he faces the challenge of family firm inter-generational continuity.

**THE ROLE OF THE FOUNDER**

The founder’s approach to the succession process is of fundamental importance to ensure that the firm’s executive control remains in the family. A founder who adopts a proactive stance and decides to move forward with the succession, by inviting one of his children to succeed him, is denoted as having an activist approach (Michael-Tsabari & Weiss, 2013). On the contrary, a founder who doesn’t take that initiative, as many times happens (Bruce & Picard, 2006), but
instead reacts when his children show interest in succeeding him we denote as having a reactive approach.

These approaches should be understood in the family setting where father and children communicate and express their views and desires. In this sense, when the father invites one of his children, it results from the father’s knowledge of his children’s abilities, personalities, interests and desires.

In the case of the founder who is more reluctant to address the succession process, his children can inform the father of their interest in heading the family firm. The child’s manifestation should be understood not as an isolated and abrupt stance but rather a step-by-step process. Progressively he/she acquires the necessary skills and competencies, through training experience and learning, to be able to head the family firm, at which point he/she can express that desire to his father. The other child can either pursue an alternative career path or express his/her desire to also head the family firm, in which case the father will need to choose between his competing children.

To analyze the impact of the founder’s role on successor selection in the family firm, we adopt to a game theoretic approach. We base our model on the game used by Jayantilal, Palacios & Jorge (2016). Our setup resorts to two sequential games, with three players: the founder (F), his elder child (E) and younger child (Y). The sequential games are of perfect and complete information where the players move in sequence and are fully aware of the strategies available to each one, and observe all the moves before making theirs. Each player knows exactly who has made what move before making a decision. These games are expressed in extensive form. The extensive form is represented by a game tree which summarizes all this information.

We start by presenting a founder who adopts an activist approach with regards to the succession selection. Figure 1 represents the three players and the two staged game, when the founder invites his preferred successor who can either pursue the top position in the family firm or not, and subsequently the other child decides whether to pursue the successor position. It is important to highlight that when the founder adopts a proactive approach he/she still faces the possibility that the child he invites might decline his invite and instead opt for a career outside the family firm. However, children who are more averse to going against their parents’ expressed wishes will find it more difficult to decline the invitation. This can be due to cultural reasons (Dyer, 1986) or higher affective commitment (Astrachan & Jaskiewicz, 2008).

In our second game, as opposed to a founder with an activist approach, the focus is now on the impact of a founder who does not want to take the initiative but instead adopts a more reactive role to his children’s efforts in pursuing the successor position. The game starts with the elder child who moves first and chooses whether or not to pursue to head the family firm. Subsequently the younger child decides if he wants to pursue and finally the founder is called to make his choice and appoint his successor. This game tree is represented in Figure 2.

We then use the rankings of the payoffs obtained from both games. The payoff of each child is the net benefit he/she obtains from the conjunction of his/her decisions with that of the other child, given the founder’s preference. The ranking of payoffs translates the preference for each strategic outcome for each child, being the most preferred 3 and 1 the least.

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We then find the equilibrium outcomes for both the games. As a sequential game is a sequence of subgames, the idea is to find the Nash equilibrium for each subgame, which refers to the set of strategies of best response for each player where there is no incentive for any player to deviate from that strategy (self-enforcing). To reach the subgame perfect Nash equilibrium (SPNE) solution in our sequential games with perfect information, backward induction was used. This technique warrants each player to look ahead and think backwards, before making his decision. The underlining logic is that each player should figure out how each of the others will react to his move, and how he will respond to that, and so on, as a result he should anticipate the different players’ reactions to his move and consider this when making his decision (Kreps, 1990). Finally, having obtained the SPNE outcomes for both games these are compared in order to contrast the role played by the founder’s approach on successor selection.

To study the impact that the founder’s approach has on successor selection there are five possible cases which can be studied. In this paper we present the ones in which adopting an activist vs. reactive approach by the founder makes a difference in successor outcomes. We presume that the founder, who knows both his children well, prefers to appoint the elder child as the successor. We consider the children’s interest in developing their career outside the family firm but also whether they are subservient towards their father’s expressed wishes.

Let’s start by considering the case of E being subservient and averse to going against his/her father, characteristics of what Miller et al. (2003) define as a conservative succession pattern. In other words, even though he/she might have preferred to follow his/her career path outside the family firm, he/she is unwilling to do so if that means going against his/her father’s expressed wishes.

Figure 1 represents the game when F adopts an activist approach and invites E to become his successor. The first node (also referred to as the root) represents the first move and refers to the elder child’s decision to pursue or not the successor position. Subsequently the younger child is called to play and decides whether he wants to pursue the CEO position or not. A path refers to the set of decisions that leads from the root to the terminal node (graphically the path leads from the root to the terminal node). The game has four possible outcomes, ensuing from four possible paths. Each player’s ranking of payoffs from the different paths is shown at the far right end of the tree. The first number corresponds to that of E and the second to that of Y.

Figure 1. SPNE for activist approach

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2 In the opposite case, identical conclusions may be achieved but with reference to the younger child.
Notice that for E, given his subservient nature, and that F invites him, then E’s most preferred outcome is to pursue (ranked 3) and not pursue is his least preferred (ranked 1).

To reach the SPNE backward induction is used. Starting on the upper part of the tree (when E has decided to pursue the position after having been invited by his/her father) then Y, given that he/she is rational and wants to maximize his/her wellbeing, will opt not to pursue. Now focusing on the node, where Y is called to play, given that E has decided to decline the founder’s invitation, then Y prefers to pursue (path 3 vs path 4) and will be appointed successor. This is his/her best response as it is better for him in comparison to all his other options and is marked with a bolder line in the game tree in Figure 1. Continuing to employ backward induction we arrive at the root (first node). At this point it is E who needs to respond to his father’s invitation. E anticipating Y’s choices will compare his outcomes from path 2 and 3 and will decide to pursue the successor position. This is his best response and is, also, marked with a bolder line in the tree in Figure 1.

As a result, the SPNE path\(^3\) is for E to pursue and for Y not to pursue the successor position, when the founder assumes an activist approach, and so E will be appointed successor. The equilibrium path is shown in the game tree, in Figure 1, and refers to the conjunction of the best responses of both players, marked with the bolder line, which links the root to the terminal node.

Figure 2. SPNE for reactive approach

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\(^3\) In this case the SPNE strategy, which refers the complete plan of action for each player for each contingency specifying what he/she will do when he/she is called to play is: Y – Not Pursue if E Pursue; Y – Pursue if E Not Pursue; and E: Pursue.
As opposed to a founder with an activist approach, the focus is now on the impact of a founder who does not want to take the initiative but instead adopts a more reactive role to his children’s efforts in running for the position. The game for this succession approach is also of perfect and complete information, where the founder maintains his preference for E but doesn’t proactively invite him. In this game E moves first and chooses whether or not to pursue to head the family firm. Subsequently the younger child decides if he/she wants to pursue.

To reach the SPNE again the backward induction technique is applied and the resulting equilibrium path is illustrated in Figure 2, with E not pursuing the position and Y pursuing the position, and so being appointed successor. Note that when E prefers a career outside the family firm and he/she is not conditioned he/she will opt out of the family firm.

Comparing the results it is apparent that by F inviting his preferred successor, in our case E, the founder increases the propensity of E being appointed successor. This is essentially due to the emotional costs the child faces of going against his father’s expressed wishes.

Figure 3 SPNE for activist and reactive approach
Now we study the case where Y’s career aspirations lay outside the family firm, whereas E’s preferences are maintained. Figure 3 illustrates the game tree for this case, for both a founder with an activist approach (left side of Figure 3) and one with a reactive approach (right side). Notice that E’s preferences, as illustrated by the rankings, remain the same as those presented before with regards to the different approaches that the founder can adopt (i.e. compare the rankings of E of the right plot of Figure 3 with Figure 1 and those of Figure 3 with Figure 2). Additionally, for a founder with a reactive type approach, the equilibrium paths for this case are also different to the one presented in Figure 2.

The SPNE outcomes, in this, case show that when the founder doesn’t assume an activist approach then there is a real possibility that the firm’s executive control will not stay in the family as the equilibrium path on the right side of Figure 3 illustrates. This case illustrates how the founder’s approach directly contributes to high mortality rates of family firms. When the founder does nothing and waits to react to his children’s actions he runs the risk of losing the opportunity to ensure that the family firm’s executive power stays in the family and that his legacy lives on. This case reinforces the differences, in terms of successor selection, which results from the founder being (or not) proactive and moving forward and inviting one of his children to succeed him.

Comparing the successor outcomes resulting from the founder’s approach, our findings emphasize the importance of the founder adopting an activist approach to increase the propensity of his preferred successor being appointed and ensure intergenerational firm continuity. The results highlight that if the founder doesn’t actively initiate the process then there is a higher propensity that the firm’s executive control will not stay in the family.
CONCLUSION

Various researchers have pointed to the founder’s passivity towards planning succession as the major culprit of the tragically high mortality rates registered in family firms. By resorting to the solid analytical foundations of game theory our results undisputedly illustrate the importance of the founder assuming an activist approach.

The founder by being more proactive places the onus on the child, making it more difficult for him to consider other career options. In other words, even when his preferred successor might desire to pursue his/her career outside the family firm, a founder who desires his preferred candidate to succeed him will be more successful if he takes a proactive stance. This is due to the emotional cost the children incur when they opt to go against their father’s expressed wishes. The more averse the children are to conflict with their father, then the greater the propensity of securing intergenerational succession. In families which are more cohesive and have higher degrees of emotional attachment and/or in cultural settings where younger generations are more submissive, the founder being more proactive will be fundamental to ensure his preferred candidate is appointed successor.

Comparing the results it is evident that the propensity of the founder’s preferred successor taking over the executive control of the firm is increased by the founder taking an activist approach. However, and more importantly, to ensure that the executive control of the firm remains in the family, our results stress that it is essential for the founder to be proactive. Our findings substantiate that the founder’s approach towards the succession process directly contributes to the continuity of the firms’ executive control remaining in the family.

For practitioners and consultants working with family firms the findings unequivocally demonstrate the importance of the founder adopting a proactive approach to successor selection. The results provide the analytical proof of the dangers that can arise jeopardizing the firm’s continuity as well as harm the family’s stability, and so should we hope to have contributed in providing an added motivation for founders to abandon their reluctance in addressing the issue of succession. An opportunity for future research would be to consider more complex games to include other family members and their influence on the founder’s successor selection, but also extend to include non-family possible successors.

REFERENCES


