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CORPORATE GOVERNANCE IN FAMILY- OWNED BUSINESSES IN INDIA: CONFRONTING THE CHALLENGES

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ABSTRACT

Family-owned businesses play a significant role in employment and backbone of India's economy, providing to innovation, and economic stability. Corporate governance in family-owned businesses involves the systems, processes, and practices that direct business decisions and control mechanisms. For family businesses, governance is integrated with family dynamics, which can complicate decision-making and impact the overall success of the enterprise and affect the economy. Family-owned businesses face unique corporate governance challenges such as nepotism, conflict of interest, weak internal controls and limited external oversight that can impact their continuance and sustainability. By confronting these challenges, family-owned businesses in India can improve their persistence and contribute to a sustainable economic future. This paper examines these challenges, analyse their implications, and examines the best practices for improving corporate governance including directors, independent directors, formalized management structures, and transparent decision-making processes also provide suggests to improve governance structures in family-owned businesses in India.

KEYWORDS: Family-owned Business, Sustainability, Economy, Transparency, Corporate Governance.

1. INTRODUCTION

Family-owned businesses is an important of India's economic aspects, accounting for a significant part of the country's Gross Domestic products and providing employment to millions of the people. These businesses often enjoy a deep-rooted heritage, strong community ties, and a unique corporate culture that sets them apart from non-family enterprises. Corporate governance refers to the mechanisms, processes, and relations by which corporations are managed, controlled and directed. These businesses create jobs, and contribute significantly to GDP. However, inherent structure which blends family and business dynamics, presents distinct challenges in corporate governance. Family run companies in India face challenges such as balancing the interests of owners with stakeholders and managing the relationship between professional managers and owners¹. Family-owned businesses often fight with corporate governance issues due to overlapping roles of family and business, succession complexities, and the potential for conflicts of interest. One third of Indian family-controlled companies experience corporate governance problems due to top management violating norms due to family loyalty or sibling rivalry, despite strong governance frameworks and legislation². This paper seeks to explore the corporate governance challenges faced by family-owned businesses in India. Examining the balance between maintaining family control and ensuring sound governance also family loyalty play significant roles in shaping governance practices. This paper aims to identify and analyse the corporate governance challenges that are unique to family-owned businesses in India and proposes solutions for sustainable growth and success.

2. IMPORTANCE OF FAMILY-OWNED BUSINESSES

Family-owned businesses represent a significant position of the Indian economy, encompassing a range of industries from manufacturing to services. It's often have deep roots in the aspects to serve and contribute to employment, regional development, and innovation.

Family-owned businesses are a cornerstone of the India's economy, playing an important role in various aspects such as 'economic growth' it contributes significantly to India's Gross Domestic products. The large part of the economic generate from family-run enterprises. It provides

¹ Swati Deva, *Corporate Governance of Family-Run Companies: Comparison of India and Hong Kong*, in THE INDIAN YEARBOOK OF COMPARATIVE LAW 2016 0 (Mahendra Pal Singh ed., 2018), <https://doi.org/10.1093/oso/9780199482139.003.0006> (last visited May 3, 2024).

² Vrajlal K. Sapovadia & Kandarp Patel, *Is Blood Thicker than Water? Appraising Adequacy of Indian Corporate Governance for Family Based Companies: A Case Study of Satyam Computers*, (2009), <https://papers.ssrn.com/abstract=1347868> (last visited May 7, 2024).

'employment' opportunities in both rural and urban areas. This employment opportunities fosters economic stability and helps to reduce poverty line and unemployment. These businesses are increasingly investing in research and development to drive 'innovation'. It's often a 'long-term perspective', looking towards the future for generations to come. This can lead to more stable decision-making and a focus on environment and economic sustainable practices. Its hold a unique and valuable position in India's economy. Enhanced gender diversity and sustained adherence to governance norms are needed in Indian family-run enterprises for better corporate governance practices³. By ensuring strong corporate governance practices, family-owned businesses can continue to play an important role in economics growth and country development while maintaining their unique cultural and familial characteristics.

3. LEGAL AND REGULATORY MECHANISM

Legal and regulatory frameworks aim to ensure accountability, transparency, and ethical conduct within businesses, while addressing the unique dynamics of family businesses. corporate governance regulations in India struggle to discipline dominant shareholders and protect minority interests⁴.

3.1 COMPANIES ACT, 2013

The Companies Act, 2013, is governing corporate governance in India. It governs to all companies, including family-owned businesses, and provide the roles and responsibilities of directors, Independent Directors, board structure and financial reporting requirements. Key provisions relevant to corporate governance in family-owned businesses such as composition of board along with appointment process, powers, rights, duties and liabilities of directors based on company size and type. Family-owned businesses that meet specific criteria must constitute corporate social responsibility committee for CSR activities, promoting social responsibility by mandating certain prescribed percentage of profits be used for social and environmental causes. Statutory audits, as mandated by the Companies Act, are a key mechanism for ensuring financial transparency and accountability. Companies must maintain proper internal controls to prevent fraud, mismanagement and financial irregularities. Companies to maintain proper records, conduct regular board meetings, and comply with other statutory requirements as per this Act.

³ Sanjeev Saxena et al., *Examining the Corporate Governance Strategies of Indian Family-Run Companies: Insights from Selected Enterprises*, 11 JOURNAL OF LAW AND SUSTAINABLE DEVELOPMENT e1713 (2023).

⁴ A Note on the Efficacy of the Current Corporate Governance Regulations in India by Santosh Pande, Valeed Ahmad Ansari :: SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2333023 (last visited May 9, 2024).

3.2 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI) REGULATIONS

SEBI regulations play an important role in corporate governance. SEBI's Listing Obligations and Disclosure Requirements (LODR) set out corporate governance standards, the listed companies must adhere to specific governance norms, including board independence, audit committees, and risk management strategies and policies. SEBI regulations mandate timely and accurate disclosure of financial and operational information to shareholders and all stakeholders. To protect shareholder interests, such as voting rights, related-party transactions, whistle blower mechanism and insider trading regulations.

Both the Companies Act and SEBI regulations affirm the importance of independent directors to ensure board performance, transparency and accountability. Independent directors are ensuring to act as unbiased guidance and act as external perspectives.

3.3 ENFORCEMENT AUTHORITY

The National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT) handle disputes and enforcement of corporate governance laws. These bodies play an important role in resolving conflicts and ensuring compliance with legal requirements.

3.4 COMPLIANCE WITH OTHER LAWS

Family-owned businesses must comply with various labour, employment and other laws, ensuring fair treatment of employees, adherence to minimum wage requirements, and proper working conditions. These laws contribute to corporate governance by promoting best business practices.

4. CHALLENGES

Family businesses provide many advantages, at the same time face challenges such as favouritism, succession planning and conflict of interest. Succession planning, professionalism, and access to funding are challenges faced by family-owned firms in India, preventing them from expanding and remaining viable⁵.

In 2009, Ramalinga Raju, co-founder of Satyam Computer Services, confessed to orchestrating a

⁵ Anjali Malik, *Challenges of Family-Owned Business in India: A Survey Based Analysis of Family Business Owners*,
⁶ INFORMATION TECHNOLOGY IN INDUSTRY (2018).

major corporate fraud, one of India's most prominent corporate fraud at the time. Founded in 1987, Satyam became a notable success, listing on the Bombay Stock Exchange in 1991 and Nasdaq in 1999, and generating over \$2 billion by 2008. However, discrepancies between actual profits and reported earnings led Raju to inflate the company's revenues, culminating in a scandal where 94% of reported income was fabricated. In 2015, Raju and nine others were jailed for their roles in the fraud. In 2013, Satyam was acquired by Tech Mahindra⁶.

Jet Airways, once India's second-largest airline with a 13.8% market share, ceased operations on April 18, 2019, due to financial insolvency, leaving over 15,000 employees jobless. The airline owed Rs. 8,500 crores to banks and an additional Rs. 25,000 crores to lessors, employees, and other firms. The collapse was attributed to corporate governance failures, particularly by Chairman Naresh Goyal, whose family held a majority share. The promoter-led board, criticized for being weak and compliant to Goyal, made financially imprudent decisions, including rejecting a crucial investment offer from the Tata Group. This rejection appeared to prioritize the promoter's interests over those of stakeholders and employees. Jet Airways' downfall is part of a broader pattern of governance issues in the Indian airline industry, as seen with previous failures like Kingfisher, Sahara, and Deccan⁷.

4.1 NEPOTISM AND FAVOURITISM

Generally, nepotism and favouritism are prevailing in family-owned businesses. Family relationships may create influence in business decisions. Emotions and disagreements may affect the business operations and prevent decision-making. Concentrated ownership within the family may lead to decisions that prioritize family interests over the company's well-being. Hiring and promoting family members based on familial ties irrespective of their qualifications and experience. This can lead to a lack of meritocracy, low employee spirit, and difficulty attracting top talent from outside the family and may create to resentment among non-family employees and prevent the business's ability to attract and retain top talent. Also, family conflicts, whether personal or business-related, can have a detrimental impact on governance and decision-making.

4.2 SUCCESSION PLANNING AND GENERATIONAL TRANSITION

Succession planning is a major challenge in Indian family-owned businesses. Identifying and

⁶ Lee Hoverd, *Tales of Turmoil: 10 Family Business Scandals*, THARAWAT MAGAZINE (Sep. 27, 2023), <https://www.tharawat-magazine.com/sustain/family-business-scandals/> (last visited Jun 17, 2024).

⁷ Kasmin Fernandes, *Biggest Corporate Governance Failures in India*, THE CSR JOURNAL (Apr. 20, 2021), <https://thecsrjournal.in/corporate-governance-failures-india/> (last visited Jun 17, 2024).

grooming the next generation for leadership can be complex due to family dynamics, differing expectations, and potential conflicts among heirs. A lack of clear succession plans may lead to instability during leadership transitions from one generation to the next. The absence of a clear succession plan can create power struggles and instability that damage the company's reputation and performance.

4.3 FAMILY ISSUES AND DISPUTES

Family issues can have a significant impact on corporate governance. Disagreements among family members over business decisions, ownership, or succession can escalate into major disputes. Such conflicts can damage business operations, prevent strategic planning and growth, affect employee confidence, and spoil the business's reputation.

4.4 CONFLICTS OF INTEREST

When family members are involved in the business, there is a high risk of conflicts of interest. Family members in leadership roles may prioritize personal gains over the company's well-being, damaging trust with stakeholders. Personal profit or gain might influence decision-making, harming the company's long-term interests and conflict with business goals. Decisions influenced by personal relationships can compromise the business's integrity and lead to unethical practices. These conflicts can also affect business growth.

4.5 INFORMAL BUSINESS PRACTICES

Family-Owned Business operates with informal structures, making it difficult to meet regulatory standards. This informality can lead to unclear and unethical decision-making processes, inconsistency in policies, and difficulties in resolving disputes. A lack of formal governance frameworks may create governance gaps and increase the risk of mismanagement.

4.6 LACK OF FORMALIZED STRUCTURES AND PROCESSES

Family-owned businesses often rely on informal decision-making processes, based on familial relationships and trust. While this can be beneficial in certain contexts, it can also lead to ambiguity and inconsistency in governance. A lack of formalized structures, such as clear organizational hierarchies, written policies, and established committees, can result in poor decision-making, operational inefficiencies, and business collapse.

4.7 RESISTANCE TO CHANGE

Family-owned businesses especially those with a long history, may resist change due to a strong attachment to tradition and established practices. This resistance can impede innovation and adaptation to new market conditions, regulatory environments and technological advancements. It can also may resist adopting modern governance practices. This resistance can prevent innovation, adaptability, and the ability to respond to changing market conditions. It can also limit the business's potential for growth and competitiveness.

4.8 WEAK INTERNAL CONTROLS

Many family businesses rely on informal controls that may not be sufficient for a growing company. It can expose them to financial risks and make them less attractive to investors. This can increase the risk of fraud and financial mismanagement.

4.9 LIMITED ROLE OF INDEPENDENT DIRECTORS

Corporate governance reforms in India face challenges such as lack of incentives, power of dominant shareholder, underdeveloped external monitoring systems, and shortage of qualified independent directors⁸. In India family-owned businesses, the boards of directors are often composed of family members or close associates, leading to limited diversity of thought and external expertise. The absence of independent directors can reduce accountability and prevent effective oversight, affecting the quality of governance decisions.

4.10 LACK OF EXTERNAL OVERSIGHT AND ACCOUNTABILITY

Many family-owned businesses are privately held, with limited external oversight and accountability mechanisms. This lack of transparency can lead to governance issues, such as financial mismanagement and unethical practices. It can also result in missed opportunities for strategic input and best practices from external advisors or independent directors.

4.12 EMOTIONAL ATTACHMENT

Family members may make business decisions based on emotions rather than rationality. Its affect the business growth.

⁸ Nandini Rajagopalan & Yan Zhang, *Corporate Governance Reforms in China and India: Challenges and Opportunities*, 51 BUSINESS HORIZONS 55 (2008).

4.13 PRESERVING FAMILY LEGACY

Families often prioritize legacy over profitability, impacting business growth.

4.14 LEGAL AND REGULATORY CHALLENGES

Family-owned businesses face various legal and regulatory challenges, including compliance with corporate laws, tax regulations, and labour laws. To manage this complex regulatory environment can be challenging, especially for smaller family businesses with limited legal and compliance resources. Small family-owned business face unique governance challenges, and achieving a proper balance between costs and benefits requires flexibility and an evolutionary approach to corporate governance implementation⁹.

4.15 FAMILY-CONTROLLED BOARDS

Boards in family-owned businesses often comprise family members, which can limit diversity of thought and experience. This can lead to "groupthink" and reduce the board's effectiveness in providing oversight and strategic guidance. Also, family-controlled boards may lack the independence needed to challenge leadership and hold it accountable. In India, family ownership positively impacts financial performance in traditional industries, while family CEOs negatively impact performance in new economy industries¹⁰.

Addressing these challenges by implementing strong corporate governance practices. Also focusing on good governance, family-owned businesses in India can ensure their long-term success and stability.

5. STRATEGIES FOR ENHANCING CORPORATE GOVERNANCE IN FAMILY-OWNED BUSINESSES

Corporate governance practices in India, such as board of directors, independent directors, and audit committees, are crucial for effective and efficient management of companies, but also face challenges and issues¹¹. Strategies should address the unique challenges that family businesses face while promoting transparency, accountability, and sound decision-making. Such as;

⁹ Philip M. Beattie, *Small Family-Owned Firms: The Challenges of Corporate Governance*, 99 CONTEMPORARY STUDIES IN ECONOMIC AND FINANCIAL ANALYSIS 1 (2018).

¹⁰ Rakesh Pandey, Dennis Taylor & Mahesh Joshi, *Governance of Large Family Companies in Traditional and New Economy Industries in India: Effects on Financial Performance*, 8 CORPORATE OWNERSHIP AND CONTROL 108 (2011).

¹¹ Surbhi Vyas -, *Corporate Governance Practices in India: Problems & Importance*, 5 IJFMR 2801 (2023).

5.1 STRONG CORPORATE GOVERNANCE

Implementing a well-defined corporate governance framework with clear lines of authority, an independent board of directors, and transparent decision-making processes is crucial.

5.2 NEED TO FOCUS LONG TERM SUCCESS

Ensuring a smooth transition from one generation to the next is an important for the long-term success of family businesses.

5.3 BALANCING FAMILY AND BUSINESS

Maintaining a healthy separation between family dynamics and professional decision-making.

5.4 ESTABLISH CLEAR GOVERNANCE STRUCTURES

Creating formal governance structures that define roles, responsibilities, and decision-making processes can help FOBs manage corporate governance challenges. Establish clear organizational hierarchies, setting up committees and implementing written policies. A well-defined structure reduces ambiguity and ensures consistent governance practices. Incorporating independent directors to bring objectivity and external oversight and ensure Independent Boards also evaluate business performance. Independent directors can provide guidance, challenge management decisions when necessary, and help mitigate conflicts of interest. This strategy also enhances accountability and fosters a more balanced decision-making process.

5.5 FORMALIZE SUCCESSION PROCESSES

To address succession challenges and establish clear policies for hiring, succession, identifies potential successors, outlines their roles, and conflict resolution also developing transition plans.

5.6 SEEK EXTERNAL GUIDANCE

for engage external consultants or advisors to facilitate succession planning. It can address key issues such as roles, succession, ownership rights, dispute resolution, and family values. Formalizing business practices, including recruitment, performance evaluations, and succession planning, promotes professionalism and reduces nepotism.

5.7 PROFESSIONAL DEVELOPMENT AND TRAINING

Investing in professional development and training for family members and non-family employees

with the necessary skills to contribute meaningfully to the business. Providing opportunities for skill development and leadership training ensures that the business has competent leaders and reduces reliance on nepotism. Also, training programs can foster a culture of continuous improvement and innovation.

5.8 INDEPENDENT BOARDS

Boards with independent directors can provide objective oversight, ensure adherence to regulations, and mitigate conflicts of interest.

5.9 EXTERNAL ADVISORS

Engaging external advisors can provide expertise in areas like legal compliance, risk management, and strategic planning.

5.10 INTERNAL CONTROLS

Implementing transparent financial practices and strong internal audit mechanisms can build trust with investors and stakeholders.

5.11 ENHANCING TRANSPARENCY AND ACCOUNTABILITY

Transparency and accountability are essential for effective corporate governance. Establishing regular financial and operational reporting to stakeholders and involving non-family stakeholders in key decisions to enhance accountability also promoting a culture of ethics and compliance throughout the organization. Clear communication also helps manage expectations and reduces the potential for misunderstandings.

5.12 ESTABLISH MECHANISMS FOR CONFLICT RESOLUTION

Family-owned businesses should have formal mechanisms to address and resolve conflicts among family members and stakeholders. This may include setting up a mediation process, appointing a family ombudsman, or engaging external advisors to help manage disputes. Effective conflict resolution strategies can prevent disputes from escalating and damaging the business.

5.13 IMPLEMENT RISK MANAGEMENT AND COMPLIANCE MEASURES

Develop robust risk management and compliance programs to ensure the business operates within legal and ethical boundaries. This involves assessing business risks, establishing internal controls,

and conducting regular audits to identify and mitigate potential issues. Strong risk management contributes to business resilience and protects against regulatory violations.

5.14 FOSTER A LONG-TERM VISION AND VALUES

Encourage a long-term vision for the business that aligns with family values and goals. This vision should guide business strategy and governance decisions, ensuring that short-term pressures do not undermine long-term sustainability. Emphasize the importance of social responsibility and community engagement to create a positive business reputation.

5.15 TRANSPARENCY AND COMMUNICATION

Open communication channels within the family and with external stakeholders foster trust and confidence in the company's governance.

By implementing these strategies, family-owned businesses can strengthen their corporate governance, enhance accountability, and ensure their continuity across generations. These strategies help to manage the complexities of family dynamics while promoting a robust governance framework that supports business success.

6. CONCLUSION AND RECOMMENDATIONS

Family-owned businesses are a pivotal component of India's economy, but they face unique corporate governance challenges due to family conflicts, nepotism, limited external oversight, resistance to change, succession planning, and regulatory compliance. Family-owned businesses contribute significantly to economic growth and employment generation, but governance and succession issues have been a concern in recent years. Corporate governance practices in Indian family-governed firms need improvement to enhance their economic growth and employment generation¹².

Addressing the inherent challenges requires a multi-faceted approach that includes clear governance structures, succession planning, and fostering transparency are key to overcoming these challenges. By implementing these strategies, FOBs can strengthen their corporate governance to ensure long-term sustainability and growth. Effective corporate governance requires a balanced approach that respects family values while promoting accountability,

¹² Amit Majumder, *Corporate Governance Practices of Family Enterprises: A Study on Some Selected Indian Family Governed Companies*, 8 IRA-INTERNATIONAL JOURNAL OF MANAGEMENT & SOCIAL SCIENCES (ISSN 2455-2267) 232 (2017).

transparency, and sound business practices. Legal and regulatory frameworks, such as the Companies Act, 2013 and SEBI regulations, play an important role in shaping governance standards for family-owned businesses. However, successful governance also depends on internal initiatives to professionalize management, implement formal structures, and encourage open communication.

