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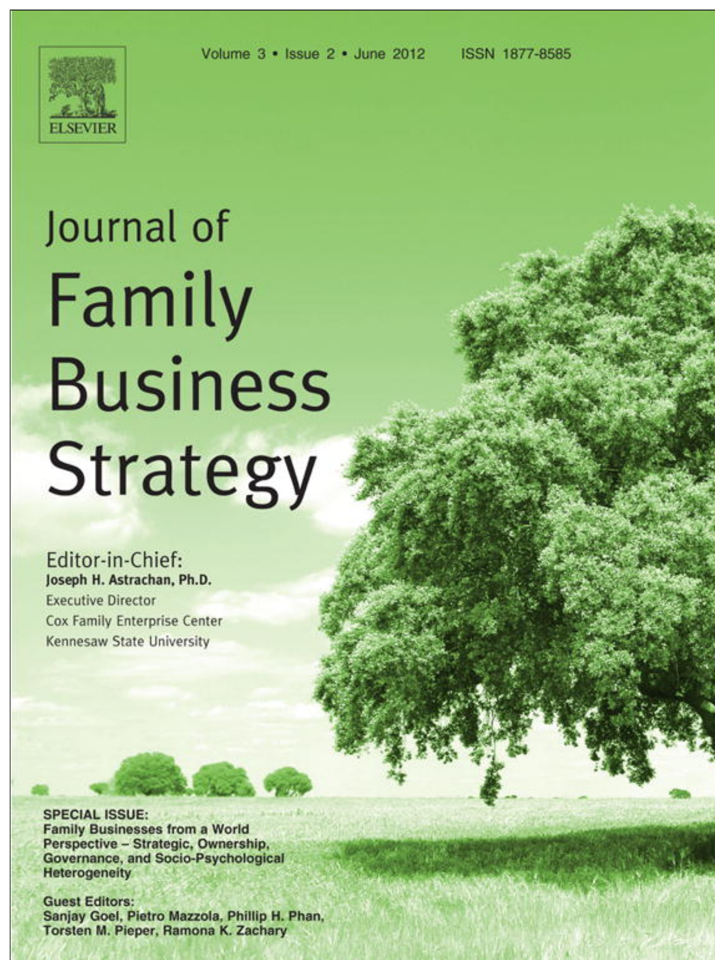

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Firm family firms: Current debates of corporate governance in family firms

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ABSTRACT

We reassess the effects of family ownership and strong family control on non-family minority and non-controlling shareholders. We argue that assumptions and interpretations regarding the cost and benefits of family ownership in the extant literature need to be understood relative to other firm governance arrangements. More specifically, we posit and examine the relevance of the private benefits of family control in two key circumstances: top executive succession and the nature of family business groups. Diverse outcomes are shown to be contingent on the national institutional settings where firms are located.

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1. Introduction

In this essay, we discuss repercussions of firm (strong) family control on corporate governance practices in largely family-owned firms. The common denominator of family firms, regardless of where they are located around the globe, is that they have high levels of ownership concentration. Families, therefore, seek to gain and sustain firm control over the firm. The simplest way for families to exert strong control of the firm is through the ownership and/or control of a large and significant number of shares. This trait in family firms allows strong control by family owners, involving them in the management of the firm, with the intent of retaining ownership and control throughout generations.

There are several important governance topics that have been introduced in extensive family business research, such as the outperformance of family firm owners compared to management-controlled non-family firms in Daily and Dollinger (1992), trans-generational entrepreneurship in Habbershon and Pistrui (2002), the broad view of the field of family business studies in Sharma (2004) and, more specifically, on the impact of family ownership on investment strategies such as R&D in Chen and Hsu (2009). We seek to add to this literature by revisiting some of its main assumptions and questioning its current validity. To start with, we define corporate governance more broadly as the structure of rights and responsibilities among the parties with a stake in the firm (Aguilera & Jackson, 2003). Firm governance dictates how benefits are created, maintained and distributed across different stakeholders (Aguilera, Filatotchev, Gospel, & Jackson, 2008). However, it is important to analyse how these relationships between the different participants in the firm are sustained, as well as how profits are managed in the context of family firms. In this essay, we focus on the corporate governance of family firms and specifically on the drivers of family control across generations. Comparing the corporate governance design in firms where there are no controlling shareholders, or in firms under non-family owners' control, we identify several dimensions of the governance of family firms that make family-controlled organisations potentially more competitive and resilient.

It is important to understand the landscape of family firms before discussing the underlying assumptions of this literature. It is an important fact that empirical research highlights the predominance of family-owned firms around the world, particularly in emerging markets, including the least restrictive definitions of family involvement in the firm (Sharma & Nordqvist, 2008). Based on our empirical research of recent data, in Table 1 we provide evidence on the relevance of family ownership that accounts for differences among countries and institutional environments in terms of the relevance of family ownership and the subsequent impact of governance structures on different company behavioural and strategic outcomes.

We hold that different owners (e.g., family, institutional investors, industrial firms, banks, state, employees, etc.) will have different interests in the firm, and therefore, each type of owner will use slightly different mechanisms to accomplish their unique

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Table 1
Relevance of family voting rights in selected studies.

Region	% Family voting rights
Europe [*]	17.0
Spain [1] [2]	19.9
France [1]	11.7
Germany [2]	12.0
UK [2]	3.6
Latin America [3]	22.0
Argentina [3]	18.5
Brazil [3]	21.8
Chile [3]	26.9
Colombia [3]	18.2
Mexico [3]	8.4
Peru [3]	27.0
Venezuela [3]	13.7

[*] is from Thomsen and Pedersen (2000), [1] refers to Desender et al. (in press), [2] data comes from Kabbach and Crespi-Cladera (2012) and [3] Aguilera et al. (2012). The data from Latin American countries on direct ownership has been adjusted according to the Faccio and Lang (2002) methodology.

strategic goals. The relative relevance of family ownership control, as shown in Table 1, or the proportion of firms controlled by family members, as reported in related papers, has an impact on the firm's governance practices. Agency theory asserts that family owners' monitoring practices differ from those of the institutional investors, for instance, due to differences in incentives. Schulze, Lubatkin, Dino, and Buchholtz (2001) and Schulze, Lubatkin, and Dino (2003) illustrate that family-managed firms deploy fewer formal monitoring and control mechanisms than firms dominated by other type of investors. As illustrated in the resource dependence literature, the monitoring abilities and advice capabilities also differ among different types of shareholders. These proposals are in line with our current empirical research, (Desender, Aguilera, Crespi-Cladera, & Garcia-Cestona, in press) demonstrating that family owners will rely less on external auditors to monitor managerial decisions and count on the internal role of the board relative to firms with dispersed ownership. Family firms are equipped with a set of internal control mechanisms, which we will discuss below.

Our findings in Aguilera, Kabbach, and Crespi-Cladera (2012) suggest that family owners tend to take bigger ownership stakes than other types of investors when (1) they are the largest shareholders and (2) they invest in emerging markets such as Latin America. We also find that family firms do not necessarily comply with the recommendations of codes for corporate governance as non-family controlled firms do (Kabbach & Crespi-Cladera, 2012). Instead, family firms tend to adapt their governance practices to the unique agency problem they face. In particular, Kabbach and Crespi-Cladera (2012) uncover a direct relationship between percentage of family ownership and non-compliance.

2. Private benefits of control

Family owners' preferences on how to control or manage firms (governance organisational form) and how to relate to the remaining stakeholders (mostly non-family owners) have received much attention in the governance literature. This interest stems in no small part because family ownership can lead to conflicts of interest due to the existence of private benefits of control. Private benefits of control refer to how rent owners maximise their interests, often at the expense of minority shareholders (Demsetz & Lehn, 1985). This misalignment between the firm's majority and minority owners also potentially holds when there is a concentration of control in the hands of investors who do not fully own the firm, as in the case of managers in widely dispersed firms. This agency conflict appears in family-owned firms when large family shareholders use their controlling position to extract private benefits at the expense of non-family shareholders (Villalonga & Amit, 2006) or of the remaining stakeholders as non-management family owners. Yet, we argue that the abusive/extractive side of this assumption is a debatable issue because actions that maximise benefits for family owners might also maximise benefits for the remaining minority shareholders in the family firm.

The appropriation of private benefits of control becomes salient in two key family firm decisions where families seek to assure their firm control: (1) succession and (2) the structure of firms around a family business group. Thus, we postulate that family firms' strategic behaviour in both decisions does not always necessarily harm the success of the firm or compromise the interests of the remaining stakeholders in the long run. On the contrary, it can bring a greater competitive edge and greater resilience in uncertain external environments.

Additionally, we assert that this assumption on the lack of impact on remaining shareholders' interests makes sense only under certain institutional environments. Private benefits of control, when institutional environments are weak, tend to arise from rent expropriation (from the overall society). Under these institutional settings, the negative effects of the political system or politically supported market power on the firm embedded in a weak institutional environment might result in rent expropriation (Khanna & Yafeh, 2007). These can be more severe than the rent expropriations that controlling family owners might exert on non-family shareholders. Family firms' divergence is contingent on the institutional environment in which they operate. We show that family firms in an emerging market like Latin America behave differently from family firms in Continental Europe (Aguilera et al., 2012).

Returning to the idea of an owner's preferences and creating different types of firm value, family firms encompass unique governance properties that grant them advantages in developing, sustaining, and appropriating the firm's value. This value, according to Gedajlovic and Carney (2010), comes from specific assets such as family culture or strong commitment to long-term firm survival, or as Gomez-Mejia, Cruz, Berrone, and De Castro (2011) assert, from the pursuit of nonfinancial utilities, referred to as a family's socio-emotional wealth. We add to these arguments the fact that corporate governance structures in family firms give high levels of discretionary power to the owner's managers, which the remaining shareholders and stakeholders tend to accept.

Our family firm setting under the agency theory perspective refers to the private benefits of control (Jensen & Meckling, 1976), as the utility of the family that comes at the expense of outside investors. We could also frame the issue of succession in the family firm around the "amenity potential" approach of Demsetz and Lehn (1985), referring to the non-pecuniary private benefits of control where the utility for the family would not come at the expense of profits. Our approach is that, under some institutional settings, the design of corporate governance structures and decisions in family firms are not necessarily harmful to the outside investors or stakeholders.

3. Succession

The literature on family business demonstrates that succession decisions are relevant for firm performance, success and survival (Anderson, Duru, & Reeb, 2009). The succession decision, in practice, is influenced by the preferences of controlling family managers and, in some cases, by the founder. A negative expected impact appears when controlling family managers do not plan the succession, postpone this inter-generational transition as much as possible, or put incompetent successors in place. Similarly, Le Bretton-Miller, Miller, and Steier's (2004) literature review

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identifies a number of important factors in the succession process of family-owned businesses.

When corporate control transfers from a highly able entrepreneur to a family manager of the next generation, Morck and Yeung (2003) assert that this heir is likely to be less able, and the heir's heir even less able, as a successor. Similar arguments are presented in Burkart, Pununzi, and Shleifer's (2003) theory that argues that the succession in the management of the family firm, with the strategic goal of keeping the firm inside the family's control by passing management to a family member, is less effective than the transfer of control to a professional manager. This "amenity potential" when a family member is preferred as a succeeding leading manager (CEO) over a non-familial manager may be based on his/her strong leadership or management capabilities that, in any case, should be determined by the needs of the firm.

We question the key assumption of superior managerial skills by professionals from outside the family and the systematic decrease in managerial abilities across generations. Agency theorists such as Schulze, Lubatkin, and Dino (2003) conceptualise family firms as ideal organisations where the interest alignment of owners and managers ensures effective decision making for the continuity of the firm. Specifically, we argue that the commitment of the family as shareholders and the high level of education and training of family managers are likely to overcome the costs of private benefits of control that can be exerted from non-family shareholders and stakeholders. For a sample of non-financial, non-utility U.S. firms, Pérez-González (2006) offers partial evidence supporting this view by showing that firms with a family CEO who did not attend a selective college dramatically underperformed; this does not hold true, however, for those family CEOs who attended selective colleges. Hence, we propose the following:

> Family firm management successions are not always necessarily better when staffed by professionals from outside the family as opposed to individuals from within the family. This succession selection is contingent on the abilities and training of the successor heirs.

4. Family business groups

In family firms, as in any other organisation, opportunities to set up new firms arise and new businesses are added over time (Faccio & Lang, 2002). Firms might choose to operate as business groups making some lines of business legally separate subsidiaries to exploit underutilised resources, adjust to corporate law, avoid the lack of product availability, build internal capital markets to overcome financial restrictions for tax advantages or to leverage decision-making control through pyramidal structures (Granovetter, 2005; Guillén, 2000; Khanna & Rivkin, 2001).

Family firms frequently decide to build pyramidal group structures. The existing literature does not provide satisfactory answers regarding the existence of business groups as control mechanisms. The evidence is inconclusive based on the effects of potential tunnelling activities. For example, while Bertrand, Mehta, and Mullainathan (2002) show that the value of Indian business groups is affected by the controlling families' tunnelling of resources, Gopalan, Nanda, and Seru (2006) examine intra-group loans in Indian business groups and find little evidence of tunnelling. A pertinent approach to this puzzle is through Khanna and Yafeh's (2007) inquiry: "why do investors continue to invest in situations where their investment is likely to be expropriated?" To investigate this issue, Almeida and Wolfenzon (2006) model business group structures against alternative ways of separation of the one share–one vote structure and conclude that the financing advantages offered by business group structures are a better explanation to why investors engage with these organisational forms rather than control mechanisms arguments. Yet, this finding is contingent on the country's investor protection environment. As Gedajlovic and Carney (2010) note, family business groups may represent an efficient organisational form for generating and sharing rents from family-specific assets such as family managers' commitment, founder's values and related socio-emotional wealth.

The concern for Morck and Yeung (2003) is that, in general, family managers do not act on behalf of all firm shareholders. The entrenchment of controlling families and the lack of transactional control between related companies in the business group (e.g., "tunnelling") may be detrimental to non-family investors. Self-dealing or tunnelling in business groups controlled by the same family may come from goods, services, or financing from each other in the normal course of business. At higher prices, the transfer is from the buyer to the seller and, similarly, artificially low prices transfer profits from the seller to the buyer's firm. Nevertheless, the existing literature does not provide conclusive evidence on whether these agency problems and the related private benefits of control are more relevant in family firms than those affecting widely-held firms.

We also point out that the principal–principal conflicts (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008) between controlling shareholders and minority shareholders, resulting from extensive family ownership and control or business group structures, need to be interpreted in light of the legal protection or the institutional setting in different countries. This is reflected in business literature (e.g., *The Economist*, 2011; Khanna, 2007) that describes, for example, that in the context of India's soft state, where courts can take years to come to a decision and contracts are difficult to enforce, we find complex business groups, with intricate chains of holding companies and subsidiaries that allow firms to build stakes in other firms without buying out all minority shareholders. To some extent, business groups, especially family business groups, are a response to market and institutional failures (institutional voids), especially in emerging markets. Thus, we propose the following:

> Family business groups may bear private benefits of control for the controlling family, and this is not necessarily as harmful for minority shareholders as for the structure of widely held firms or nonfamily-concentrated ownership firms.

5. Conclusion

We have presented arguments about why some of the conventional logic for poor governance in family firms might be flawed. In brief, we cannot assume that family owners' interests will always be in juxtaposition with those of non-family owners, as we discuss for the practices of succession and business groups. To conclude, we suggest new venues for future research. First, it is critical to further examine how different institutional contexts either enable or constrain the growth of family firms in terms of organic growth, internationalisation, and innovation. Second, more empirical evidence on the qualification and abilities of family heirs compared to standard professional managers to lead new generation management in firms is crucial to understand to what extent family nepotism is or is not a harmful practice for the non-family shareholders or stakeholders. Third, another interesting avenue of research would be to delve into empirical data illustrating how family firms organise their multiple corporate governance practices in a context of constrained resources but often with a longer view of the firm. In other words, how and who makes the ultimate important strategic firm decisions such as acquisitions, diversification, internationalisation, and leverage.

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Another line of research focuses on the problem from the family perspective rather than from our firm approach. The formal ownership by family members who share their ownership with other family members who are not in the business, for instance, or the power within the family remains understudied, as Danes (2011) recalls when referring to couple's interactions when conducting business. The effects of family unit dynamics in business ownership and governance, while related to traditional questions such as whether firm strategic decisions are made at the family table or at the boardroom table, is not our research focus. Yet, these are relevant issues necessary to complete our analysis. Unfortunately, one of the challenges in conducting family business governance research is the availability of reliable and insightful data, as most family-owned firms choose not to become public or retain control under a structure of private firms. The study of the structure of relationships between family and non-family owners is challenging, particularly when the mechanism to sustain corporate control is often by avoiding disclosure of too much information.

On a positive concluding note, there is no doubt that currently, further analysis of family-owned firms is tremendously interesting for multiple reasons. First, from developed countries to emerging markets, family-owned firms are becoming central global players in the shifting world balance of power (post-2008 financial crises). Second, family ownership has evolved to include other types of owners, such as foreign institutional investors or state ownership, and these relationships create new, unexplored dynamics. Finally, with recent widespread globalisation and liberalisation processes, family firms have entered a new competitive arena where, in general, they hold themselves quite well, partly thanks to their governance decision-making design and their intrinsic adaptability, which is one of their competitive advantages relative to other large, established firms.

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