CORPORATE GOVERNANCE IN FAMILY FIRMS

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Abstract

This paper reviews the theoretical and empirical literature on the corporate governance in family controlled firms. In particular, it discusses conflicts of interest between owner and manager (referred to as Agency Problem I) as well as between minority and large shareholders (referred to as Agency Problem II) among family firms under agency theory framework. It is widely believed that families are better monitors of managers than other types of large shareholders, suggesting that Agency Problem I are less prevalent in family than in non-family firms. On the other hand, it is also argued that controlling families may extract private benefits at the expense of minority shareholders. In addition, the governance literature indicates that several conventional governance tools for controlling Agency Problem are less effective in dealing with Agency Problem II. This implies that other internally determined governance mechanisms such as boards of directors may play a more significant and effective role in controlling Agency Problem II in family firms.

Keywords: Agency problems, corporate governance, family control, boards of directors

Major corporate collapses and scandals in 2001 and 2002 such as Enron, WorldCom and HealthSouth have intensified the issue of corporate governance. What is corporate governance? According to Shleifer and Vishny (1997, p. 737) "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting return on their investment." Alternatively, "corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" (La Porta et al., 2000, p.4). A similar concept is suggested by Denis and McConnell (2003, p. 2) who define corporate governance as "the set of mechanisms–both institutional and market-based–that induce the self-interest controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximise the value of the company to its owners (the suppliers of capital)." These various definitions, explicitly or implicitly, refer to the conflict of interest between shareholders and managers (i.e., agency problem) which arises from the separation of ownership and control (i.e., the principal-agent or finance perspective on corporate governance) (Hart, 1995; Keasey et al., 1997).

Firms, therefore, need some ways to control the conflicts interest between shareholders and managers (insiders). These controls are referred to as corporate governance mechanisms. Such mechanisms can be either external to the firm or internal (i.e., decided by external factors or by the firms). The external mechanisms are the market for corporate control (the takeover market), the legal system and large shareholders, whereas the main internal mechanism is boards of directors.

Extensive evidence shows that family controlled firms play a significant economic role in various countries around the world. Specifically, La Porta et al. (1999) claim that families are the predominant controlling shareholders of most privately-held and publicly traded firms in the world. In Western Europe and East Asia, about half of publicly traded firms are controlled by families (Claessens et al., 2002; Faccio and Lang, 2002). Even in the US, the role of family firms is not trivial. For example, Anderson and Reeb (2003a) observe that one third of the S&P 500 firms have founding family ownership, with families on average controlling 19 percent of the firm's shares.

Agency theory, however, provides a mixed perspective on moral hazard problems in family controlled firms. For example, some (e.g., Daily and Dollinger, 1992; Kang, 2000) have argued that family firms are one of the most efficient forms of organisational governance and serve as the zero agency cost base in finance research (Ang et al., 2000). Indeed, Jensen and Meckling (1976) imply that formal governance mechanisms in family firms are not necessary and that their expense may even detract from firm performance. In contrast, there is an argument that owner-manager agency conflicts in family firms are more complicated due to entrenched ownership and asymmetric altruism (Gomez-Mejia et al., 2001). In addition, extant research generally shows that families have powerful incentives to systematically expropriate wealth from minority shareholders, especially when family control is greater than its cash flow rights (Faccio et al., 2001).

Owner-Manager Agency Problems (Agency Problem I) in Family Firms

The notion that family firms need not incur significant agency costs stems from the theories of Jensen and Meckling's (1976) and Fama and Jensen's (1983). These theories argue that owner management should mitigate agency costs because it aligns with the owner-managers' interests. This alignment reduces their incentive to be opportunistic, preventing the maintenance of costly mechanisms for separating the management and control decisions. In addition, family ownership should reduce agency costs because property rights are largely restricted to internal decision agents whose personal involvement assures that managers will not expropriate shareholder wealth through the consumption of perquisites and the misallocation of resources. Family management could also further reduce agency costs because shares tend to be held by agents whose special relations with other decision agents allow agency problems to be controlled without separation of management and control decisions.

Agency theorists further suggest families have greater incentives to monitor managers than other types of large shareholders such as institutional investors, financial institutions or widely held corporations (e.g., Anderson and Reeb, 2003a; Gorton and Kahl, 1999). This notion is based on several assumptions. Families represent a unique class of shareholders that hold poorly diversified portfolios. For example, families in large U.S. firms have over 60 per cent of their wealth invested in their firms (Anderson and Reeb, 2003a). Since the family's wealth is so closely linked to firm performance, families have stronger incentives to monitor managers and minimise the free-rider problem encountered by dispersed shareholders. In addition, families are long-term investors (i.e., multiple generations) who generally maintain a long-term presence in their firms (Anderson et al., 2003). They perceive their firms as an asset to pass to family members or their descendents rather than wealth to be consumed during their lifetime. A firm's survival is thus an important concern for families, suggesting that relative to other blockholders, they are more likely to ensure that managers maximise firm value. Families also potentially provide superior oversight due to their lengthy tenure if monitoring requires knowledge of the firm's technology (Anderson and Reeb, 2003a) and help to improve business stability and long-term planning (Mi shra et al., 2001). Moreover, families are almost always involved in management of the firm to control agency problems (La Porta et al., 1999), resulting in greater alignment between the interests of shareholders and managers. The implicit contract among family members discourages managers from abusing their power as severe misconduct leads not only to the risk of dismissal from the job but also the risk of expulsion from the family (Fama and Jensen, 1983). Families also generally face a situation where their reputation is strictly related to that of the firm (Ellul et al., 2005).

In addition to the potentially lower agency costs as a result of the greater alignment between interests of owner and managers, family firms may also benefit from employment relationships based on altruism and trust (Randøy et al., 2003). For example, developing trust through mutual, reciprocal altruism may reduce the need for monitoring and incentive-based pay (Chami and Fullenkamp, 2002). Altruism within the family may also lead to the firm's superior employment contracts. That is, family firms can punish all family members if one of them is shirking, which makes it possible for family firms to pay lower compensation (De Paola and Scoppa, 2001).

There are, however, several counter arguments asserting that family firms actually incur higher agency costs compared to non-family firms. For example, the reluctance of families to fire incompetent family member managers may lead to higher agency costs. The family's role in selecting managers and directors can also create constraints for third parties in capturing control of the firm, suggesting greater nepotism and managerial entrenchment (Anderson and Reeb, 2003a). Consistent with this argument, Gomez-Mejia et al. (2001) report that family ownership and control in Spanish firms is associated with greater management entrenchment. Furthermore, Schulze et al. (2001) suggest that the agency problem in private family firms can be more difficult to manage because of self-control and other problems engendered by altruism. Specifically, they argue that since altruism partly stems from a parent's desire to enhance their own welfare, parents have an incentive to be generous even though that increased generosity causes their children to free-ride (e.g., squander their parent's money). This agency threat is likely to be more pronounced in family firms, because control over the firm's resources makes it possible for owner managers to be unusually generous to their children and relatives.

Empirical studies comparing the performance of family firms and non-family firms (as a proxy for agency costs) provide mixed results. Among large U.S. corporations, Holderness and Sheehan (1988) find that family firms have a lower Tobin's Q than non-family firms, while Anderson and Reeb (2003a, 2003b) and McConaughy et al. (1998) find the opposite. Villalonga and Amit (2006) indicate that family ownership only creates value when the founder serves as the CEO, or as its chairman with a hired CEO. Among Norwegian firms, Mishra et al. (2001) found that family control is positively associated with firm value. In contrast, Barth et al. (2005), using Norwegian firm data, found that family firms are less productive than non family firms. This productivity gap is, however, explained by differences in management regime. Particularly, family firms managed by a person hired outside the family are equally productive as non family firms, while family firms managed by the owner family are less productive. Gorris and Fumas (1996) found that family firms in Spain have higher productivity than non-family, but they did not find any difference in profitability. Meanwhile, Bartholomeusz and Tanewski (2006) document that family control creates agency costs in Australia.

Large-Minority Shareholder Agency Problems in Family Firms

The extant literature provides two broad theories of the benefits from a family preserving control. First, families are keen to preserve control due to significant non-pecuniary benefits of control called "amenity potential," and significant "reputational benefits" (Demsetz and Lehn, 1985). The second theory of family ownership suggests that the main reason for families desiring to maintain control is the possibility of expropriating the wealth of outside investors that comes with such control. Shleifer and Vishny (1997) argue that when large shareholders gain nearly full control of a corporation, they may extract private benefits at the expense of the minority shareholders. This begs the question whether families have the same incentives to extract private benefits from minority shareholders as other types of blockholders (i.e., institutional investors, widely held corporation and governments).

Anecdotal accounts and prior academic research (e.g., Anderson and Reeb, 2003b; Demsetz and Lehn, 1985, Faccio et al., 2001; Gomez-Mejia et al., 2001; Villalonga and Amit, 2006) generally indicate that families have powerful incentives to expropriate wealth systematically from minority shareholders, and that the incentives are strongest when family control is greater than its cash flow rights (Faccio et al., 2001). Any benefits extracted by financial institutions, mutual funds, widely-held corporations are likely to be divided among several shareholders, resulting in heavy dilution of such benefits (Ellul et al., 2005). However, Villalonga and Amit (2006) argue that the private benefits of control in family firms are not diluted among several independent owners, which suggests that families have greater incentives to expropriate wealth from minority shareholders than other types of blockholders. These arguments suggest that agency problems between large controlling and minority shareholders might be more prevalent in family controlled firms. Indeed, the separation of cash flow and voting rights can cause more severe agency problems between controlling shareholders and minority shareholders in family firms.

Consistent with these arguments, several empirical studies have documented that family shareholders in publicly listed firms extract rents via excessive compensation, special dividends and with related party transactions (e.g., DeAngelo and DeAngelo, 2000). In addition, Claessens et al. (2002) find that private benefits of control are a source of negative impact of family control on firm performance in East Asia. Similar evidence has been provided by Mayer (2001). The authors indicate that private benefits of control in East Asia, where corporate governance systems are poorly developed, can be seen in the form of empires, cronyism, corruption and crime through mechanisms such as zaibatsu firms in pre-war Japan, chaebols in Korea, excessive conglomeration in Indonesia, etc. In contrast, Anderson and Reeb (2003a, 2003b) find that among large U.S. corporations, family firms outperformed non-family firms, experienced less diversification than non-family firms, and use similar levels of debt as non-family firms. The authors argue that the results indicate that family ownership does not lead to minority shareholder wealth expropriation. In a follow up paper, however, Anderson and Reeb (2004) find that the superior performance of family firms found in Anderson and Reeb (2003a) is driven largely by family firms with more independent boards.

These mixed results can be explained by Morck and Yeung (2004). The authors argue that large shareholders can improve corporate governance in the U.S. or the U.K. because they have large wealth tied up in the firm and are keen to disallow mismanagement. In addition, strong investor protection laws in the U.S. and the U.K. allow these private benefits to shine through, while weaker protection in other countries permits the three types of agency problems (i.e., "other people's agency problem," "entrenchment agency problem" and "tunnelling") to be dominant.

Boards of Directors and Family Firm Performance

Boards of directors play an important role in mitigating agency problems between families and minority shareholders because corporate governance mechanisms in family firms are limited. Extant research indicates that several conventional corporate governance devices used to control owner-manager agency problems are less effective with family-minority shareholder conflicts. In particular, Gomez-Mejia et al. (2003), Kole (1997) and Shivdasani (1993) indicate that the takeover market, institutional investors, and incentive compensation are less common corporate governance mechanisms in family firms than in non-family firms. Westphal

(1998) suggests that boards of directors have a significant impact on firm performance when alternative governance mechanisms are limited.

Agency and stewardship theories both suggest that independent directors have a positive impact on firm performance. In agency theory, independent directors enhance firm performance through monitoring and control activities, whereas in the stewardship theory, independent directors create value through valuable advice and counsel. Anderson and Reeb (2004) find that independent director influence, on average, is associated with better performance in large U.S. family firms, and that without the presence of independent directors, firm performance is significantly worse than in non-family firms. This suggests that independent directors play a significant role in balancing the family's power and mitigating agency problems between the family and outside shareholders. To differentiate between agency and stewardship-theory-based explanations of their empirical results, Anderson and Reeb further examine the impact of affiliate directors on firm performance. Agency theory suggests that affiliate directors, due to their business relationship with the firm, tend to be less objective, are less effective monitors of the family than independent directors and provide few constraints to the family's opportunistic behaviour (Brickley et al., 1994; Klein, 1998). In contrast, stewardship theory assumes that families may not differentiate among directors based on their affiliation with or independence from the family. Instead, families place outside directors on the board based on their expertise and experience. Therefore, agency theory predicts that a negative relationship exists between affiliate directors and firm performance, whereas stewardship theory expects a positive association. Anderson and Reeb (2004) demonstrate that affiliate directors exhibit a negative impact on family firm performance, suggesting that these directors do not act as stewards. In addition, the result indicates that families may place affiliate directors on the board to facilitate the family's rent extraction.

Non-U.S. evidence on the relationship between board independence and firm performance in family firms has been provided by Klein et al. (2005) and Setia-Atmaja et al. (2007). Klein et al. examine a sample of Canadian firms and find a result that is in contrast to the results in Anderson and Reeb (2004). In particular, they found that for family firms, board independence is negatively correlated with firm performance, suggesting that a high level of board independence in family firms does not automatically lead to better performance. Meanwhile, Setia-Atmaja et al. found that the performance of family firms is positively associated with board independence. This is consistent with the argument that, in family firms, independent directors play a significant role in controlling agency costs (Faccio et al., 2001; Anderson and Reeb, 2004; Westphal, 1998)

With regard to the board size and family firm performance relationship, Mishra et al. (2001) found a stronger relationship exists between family CEOs and firm value among firms with smaller boards. This suggests that small board size might be a superior governance mechanism for firms managed by a founding family CEO, which is consistent with Yermack (1996). In contrast, Setia-Atmaja et al. (2007) found that board size is positively associated with the performance of family firms, which is consistent with stewardship argument (i.e., families benefit from having a greater number of directors). With respect to the board leadership and family firm performance relationship, Randøy et al. (2003) found that a descendant chair has a positive impact on firm performance, which is consistent with the notion that a descendant chairman could preserve the family's overall vision and long-term goals. Meanwhile, Villalonga and Amit (2006) found that family ownership creates value when the founder serves as chairman with a hired-CEO.

Conclusion

Agency theory provides mixed perspective on whether family control help to reduce or exacerbate moral hazard problems. The presence of family control helps to mitigate agency problems between owner and manager (Agency Problem I) as families have greater incentive to monitor managers than other types of blockholders. Indeed, families are almost always involved in firm's management. However, when families gain nearly full control of a corporation, they may extract private benefits at the expense of the minority shareholders (Agency Problem II). Controlling families have greater incentives for both monitoring and expropriation, and thereby Agency Problem II may overshadow Agency Problem I in family-controlled firms. It is also believed that several conventional corporate governance devices used to control Agency Problem I are less effective with family-minority shareholder conflicts. This implies that other types of governance tools such as boards of directors should play a more significant role in corporate governance in family firms. Empirical evidence on this issue, however, is far from unanimous. ■

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