Family Control of Ownership and Management of Family Business in Emerging Markets

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Abstract: In this study, we draw insights from agency and institutional economics perspectives to address the theoretical debate on whether family governance fills or abuses the void left by weaker market and legal institutions. We propose a dual focus on the pattern of family control and weak institutions to reconcile these opposed assessments. Based on a dataset consisting of all publicly listed firms in Taiwan between 1996 and 2005, we analyze how various combinations of family control over ownership, strategy, and operations yield different benefits and costs for the operational performance of firms in the absence of strong market and legal institutions.

We start this study by observing the paradoxical benefits and costs of family involvement in ownership and management of firms in emerging markets.

The emerging markets is often characterized by institutional voids, defined as the lack of market supporting institutions such as market intermediaries and legal protection of shareholders. In such contexts, agency costs caused by principal–agent (PA) conflicts and principal–principal (PP) conflicts would be even more serious than those in developed economies.

The PA problem means interest conflicts and moral hazard incurred when a principal hires an agent to perform specific duties. In emerging markets, owners of firms face significant difficulties in monitoring management (agents) because of the lack of market intermediaries, poor market discipline, and heightened uncertainties. Lacking quality information, owners cannot effectively compare their firms with industry peers to verify and assess how top management is doing. Rapid and simultaneous changes in regulations and markets also make it difficult to attribute cause and effect and hence to evaluate managerial efforts.

Thus, compared with nonfamily firms, family firms with combined ownership and strategic control suffer less from the monitoring difficulties and managerial opportunism due to the customary shareholding of the top family executive and, more importantly, the common family identity and family norms. The trust, goal alignment, and informal channels of communication based on family ties allow for the transmission of timely and high-quality information between family owners and top management. Compared with family firms with ownership control alone, firms where family members hold both ownership and strategic control also enjoy reduced PA conflicts and improved profitability. Although family owners are viewed as being more motivated to monitor management, because the family’s undiversified assets are concentrated in the firm, their ability to monitor management is severely constrained in emerging markets if family members do not participate in strategic management. The information asymmetry between family owners and outside executives can lead to managerial misbehavior and hurt firm performance. A case in point in Taiwan is Puteng Electronics: the nonfamily top executive pursued cost cutting without the owners’ knowledge, damaging the product quality and brand image that the family owners had built over five decades. When the family took back the leadership, it spent seven years restructuring the product lines to repair the damage.

However, family firms with ownership control and complete managerial control
(of strategy and operations both) are likely to suffer from heightened PP conflict that may well offset the gains from reduced PA conflict. Here, the PP conflict is defined as the goal incongruence among shareholder groups in a firm, particularly between the controlling and minority shareholders.

Under conditions of weak external governance, the presence of an outside executive as the chief operating officer inside the firm can serve as an important information mechanism to curtail the family’s self-dealing. The absence of such monitoring mechanism, the combination of family ownership and complete managerial control is the most vulnerable to family misbehavior because of the temptation for family members to collude, a lack of resistance at the execution stage, and the severe information constraint for outside investors. The PP conflict can derail firm performance, as family members seek their private benefits at the expense of the firm and minority investors, or the family is not scrutinized to seek improvement in firm efficiency. For example, one of the largest tunneling crimes in Taiwan’s recent history was committed by the Rebar Group, in which the family held 48.3% of all shares in 2005 and for which the top decision makers were the founder, You-theng Wang, and his son. Rebar was brought to court in 2007, where it was discovered to have illegally transferred 26.96 billion Taiwanese dollars (about US$900 million) of public shareholders’ money to the family’s pockets through faked long-term investments in unlisted firms over the period 1999 through 2006.

Even if the family does not deliberately expropriate other shareholders, the absence of monitoring by an outside top executive—when coupled with weak market discipline—means that the family may not be curbed when pursuing strategic actions that harm firm performance. Family executives have been found to be less likely to use formal control mechanisms (e.g., strategic plans) because such mechanisms may constrain their discretion and produce conflict among family members.

Given the weak external governance in emerging markets, independent directors can also be a valuable monitoring device in family-controlled firms, but the weak institutions make it challenging for them to play their monitoring role. They can strengthen the internal governance of family firms by providing information to outside investors and by limiting the family’s self-serving actions. However, the lack of information provided by market intermediaries means that independent directors must rely more on internal sources of the firm to play their monitoring role. Unlike the nonfamily executive who holds operational control, independent directors have no managerial authority and relatively less influence. This is particularly the case given the newness of this practice and the tradition in emerging markets that leadership roles are much more important than supervisory roles. The limited influence of independent directors is well illustrated in the famous case of Xinyi Science and Technology Company. The firm’s independent director, Chen-enKo (a renowned accounting professor), resigned before the firm’s illegal tunneling was brought to court. Ko was not able to stop the leaders from expropriating outside shareholders and did not want to continue his appointment. Given the power of family owners and executives, media reports in Taiwan have expressed grave concerns over whether independent directors can add value to family-controlled firms.

In light of the preceding arguments, we argue that having family members in both strategic and operational control is likely to generate the greatest PP conflict. When confronted with overwhelming family power, independent directors are less likely to counterbalance the family’s interests. In contrast, family firms with only ownership control may afford independent directors more structural autonomy to play their monitoring roles. Top executives from outside the family have less incentive to
constrain independent directors when they act on behalf of minority shareholders. Hence, we expect that the greater monitoring benefits of independent directors in family firms versus nonfamily firms are more likely to be realized in the type of family firm with only ownership control.

We find support for the above propositions when tested on a data set consisting of all publicly listed firms in Taiwan between 1996 and 2005. There are 4,482 firm-year observations pertaining to 631 unique firms in our sample. For most of these observations, the firm had existed for less than 40 years, which suggests that they were probably still in the control of first-generation leaders. We group the sample into five types of firms: family firms with ownership control alone (Type 1), family firms with strategic control but not operational control (Type 2a), family firms with operational control but not strategic control (Type 2b), family firms with complete management control (Type 3), and nonfamily firms (Type 4). Figure 1 illustrates performance effects of the different types of family firms and nonfamily firms.

![Figure 1 Industry-Adjusted ROA of Different Types of Family and Nonfamily With and Without Independent Directors](image)

In Figure 1, the industry-adjusted ROA refers to the difference between the firm’s ROA and the median ROA of its main industry. The comparison offered by the left-hand columns shows a rather notable difference—namely, Type 2a firms perform the best. The difference between the left and right columns is the contribution of independent directors for the specific types of firm: the left columns report values for firms without independent directors, and the right columns report values for firms with one standard deviation above the mean of the percentage of independent directors (14%; given the sample’s average board size of seven members, this corresponds to one independent director). Independent directors contribute most in Type 1 firms, followed by Type 2a firms. However, having independent directors makes little difference in Type 3 firms. Overall, the best performing governance structure is the combination of family ownership control, a family executive in charge of strategic control, an outside executive in charge of operational control, and independent directors.

Our study has strong managerial implicationsto design the corporate governance
structure and institutional order for family business under weak market. We establish that performance is enhanced (relative to nonfamily firms) under the combination of family ownership and strategic control, but not under other patterns. In other words, combined family ownership and strategic control fills the institutional void yet avoids abusing it, thus generating the best performance. In addition, through an analysis of industries with varying levels of market institutional development, we show that the performance premium of the combined family ownership and strategic control over the other patterns of family control is even more prominent in industries with weaker market institutions. Weak institutions not only shape agency costs but also accentuate the differences in various patterns of family control regarding agency conflicts and performance consequences. Meanwhile, independent directors contribute most to firm performance in family firms with ownership control alone, and they are less likely to provide a counterbalance when family power dominates.

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