Institutional Reforms and the Effects of Family Control on Corporate Governance

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Research Applied précis prepared by Andrew Hier, Cambridge Advisors to Family Enterprise

The authors of this study were interested in the effect of institutional transformation on family firm performance. Institutional transformation refers to the evolving impact of new or strengthened laws, governmental agencies, or domestic institutions such as banks or venture capital funds.

In emerging economies with less regulatory protections for minority investors in family businesses, it is typical to see a significant concentration of family ownership and a high degree of family control. This control can be direct or indirect, (i.e. through ownership of other entities that have shares in the company in question, and sometimes called pyramidal ownership). The downside costs of these arrangements include tunneling and excess appropriation of returns by the family group with concentrated ownership.

Concentrated family ownership and control of businesses can improve performance by having an aligned strategy, an efficient decision-making system, a longer-term view, and a motivated work force inspired by a feeling of connection to the ownership family. On the other hand, a governance system based upon concentrated family control without transparency and disclosure, often does not give protections needed to attract outside capital and can disadvantage the interests of minority family shareholders. Growth can be limited by the ability of the concentrated family ownership group to fund investments out of its own resources.

By studying data from publicly listed companies in Taiwan over the 14-year period from 1996 to 2009, the authors were able to compare the effects of a changing institutional environment on family business performance. This study gives a view of institutional transformation both before and after the Asia crisis of 1997-1998. Institutional transformation occurred in many ways over this time period, including, for example, regulatory requirements for transparency in financial reporting, full disclosure of indirect pyramidal control, and a governmental mandate for some independents on the board of directors of listed companies. This was the first study to involve a dynamic longitudinal analysis of transformation over time in one country, instead of comparing snapshots of different circumstances in different countries at one given time.

The authors concluded that:

1. Institutional reform strengthens the efficiency of governance in family-controlled firms in the emerging markets so as to enhance performance. Although the level of overall family control on the board diminished when the reforms were adopted, it appears that the concentration of family ownership increased; the institutional improvements increased their investment returns.
2. With the implementation of institutional reforms, the advantageous effects of family control on the firm are diminished, but may be substituted by newly strengthened external corporate governance.
3. External corporate governance can help restrain the negative effects of family pyramidal ownership on firm performance.

4. With institutional reforms, the dependence of external investors on informal social networks in emerging markets to find reliable investments can shift to investment decisions based, in part, on the safeguards of corporate governance.

In summary, the authors hope that institutional reforms which strengthen corporate governance will be appreciated by family business owners due to the increase in investment returns triggered by such stronger governance, even though such reforms may a) diminish the concentration of family ownership power by reducing family seats on the board; or b) expose family indirect control achieved through pyramidal ownership arrangements, which the ownership group might prefer to keep hidden.

Because the study was limited to listed companies, which by definition have non-family shareholders, it would be an extrapolation to apply all of the findings to those family businesses that have no external shareholders. However, practitioners should understand the importance of good governance in reducing agency costs (such as conflicts between controlling and non-controlling family shareholders and between owners and managers). For those families who do not seek external investors, practitioners should help their clients search for the right combination of governance that retains the advantages of family control and firm performance. For those families that seek external investors for growth capital, they will also need the right combination of governance that satisfies the concerns of the external investors while maintaining as much of the family control advantage as possible.

About the contributor

Andrew Hier is senior partner with Cambridge Advisors to Family Enterprise, specializing in family and business governance, shareholder relations, and succession issues. An FFI Fellow and faculty member for GEN 503: *The Professional's Toolbox: The what, why, and how of assessments in family businesses (offered as a pre-conference session in Miami)*, Andrew can be reached at ahier@cambridge-afe.com.