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Protected by the family? How closely held family firms protect minority shareholders

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Abstract

Most companies in the world are family-owned, and a majority of them operate in countries where the legal protection of minority shareholders is weak at best. In spite of previous arguments to the contrary, research shows that agency problems among owners actually increase in family-ownership situations, so family control by itself may not be an efficient substitute for the legal protection of minority investors. In this article we analyze successful strategies used by non-US business groups and firms to increase the satisfaction of their minority shareholders and to limit the incentives of the controlling shareholders to abuse them, and predict the outcomes of that protection. From these experiences we are able to suggest conditions needed to link family control and minority shareholder protection.

Keywords: Corporate governance; Family firms; Investor protection

1. Introduction

Family ties could provide bonds of trust and a sense of common purpose among members that can substitute those that are supposed to be provided by the legal system. This has led some authors (see, for example, Panunzi et al., 2002) to propose that family firms are more common in countries with weak protection of minority investors precisely because family ownership acts as substitute for the legal protection of minority investors. This is based on the assumptions that agency problems do not exist when the agent and the principal are members of the same family, and/or that the family has internal mechanisms to deal with such problems whenever they exist and create acceptable solutions. If, as Leon Tolstoy claimed, "all happy families are alike; each unhappy family is unhappy in its own way" our advice for a family firm would be simple: get a happy family.

Firm behavior can, indeed, replace legal protection. But rather than to invoke here moral reasoning even if it is present, we believe it has more to with competitive advantage: firms that protect their minority shareholders will have considerable advantages over those that do not. Accordingly, this paper consists of two main sections. First, we integrate the "political economy" of closely held FF (Morck, 2000; Morck and Yeung, 2001) together with the legal protection of minority shareholder into a matrix that describes four archetypical behaviors. We then present the model that results from their interaction, and conclude with suggestions for empirical testing of the model and further empirical research.

2. Combining family dynamics and investor protection: a typology of family firm environments

Here we combine family dynamics and legal investor protection to define four different types of environments (Fig.1). Family firms in each of them will be faced with specific challenges requiring different responses. Therefore, it is important for a family firm to identify in which of these categories it fits, and behave accordingly.

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	Relatively strong legal protection of minority shareholders	Relatively weak protection of minority shareholders
Good family dynamics	**Rules reinforce family**. Effective rules have been incorporated in the governance mechanisms of the company. The firm reaps the benefits by finding easy to retain current minority stakeholders and to attract new ones. BOMBARDIER INC (CANADA)	**Family replaces law:** Family ties substitute legal requirements, but their effectiveness diminishes as the ties become more diffuse. Stability is at risk during unusual events (successions, sale of assets, restructuring, etc) ELECTRODOMÉSTICOS MORAVIA (LATIN AMERICA)
Dysfunctional family	**Rules replace family**: Effective rules act as substitute of the law.The firm can still count on current minority shareholders (typically family members and members of top management team) but does not attract new ones. McCAIN (CANADA)	**Downhill**: Problems in the family are exacerbated by the legal framework. Minority shareholders can be abused, and, as a consequence, are not actively involved in the firm. EL PERIÓDICO DE HOY (LATIN AMERICA)

Fig. 1. Interaction between family dynamics and legal protection of minority shareholders.

2.1. Illustrative vignettes

We now illustrate each of these categories with a real life example.

3. Downhill: el periódico de hoy

El Periódico de Hoy (Today's Newspaper) is the leading newspaper company in a Latin American country. As it is the case with most Latin American newspapers, El Periódico is currently owned by brothers of a prominent family (second generation). But a family feud was extended into the management of the company, forcing the family to look for outside help to improve the corporate charter. This case illustrates two important ideas. First, it is clear that even though family ownership can be a substitute for the lack of legal protection to minority investors, this need not be the case. Indeed, family control can make the minority situation worse precisely because all shareholders are family. Therefore, we should not assume that family ownership is always an optimal solution to the lack of legal protection. In second place, we can predict that most family firms with similar problems will try to solve them sequentially rather than simultaneously: first, trying to improve corporate governance mechanisms, and then address the family problems. This is due to the fact that corporate governance can be dealt within a business setting, while family problems need to be solved in a more personal and perhaps not so rational level, where grievances and animosities can be profound.

4. Family reinforces rules: Electrodomésticos Moravia (ED)

ED is a Central American family-owned multinational company that sells a variety of household appliances. The controlling shareholder commanded an initiative to change the corporate charter, self-limiting his own ability to make decisions, in order to protect the interest of the minority in a hypothetical conflict of interest (through a shareholder agreement). The main goal of this decision, taken before any conflict had arisen, was to lock the commitment of some key members of the family with the future development of the company, principally with its geographic expansion. These family members had the abilities and capital required to turn the-up-to-that moment local firm into a multinational with operations in three countries, becoming in a short period of time one of the regional leaders in the industry.

There are two notable points in this example. First, the process was triggered by the expansion project, and the family members that were considered were those that could precisely contribute to its success. Not all the family members were included in the shareholder agreement. However, the agreement would not have been possible if the investors involved were not family members, since at the time the founder was very reluctant to share power. Second, the final result put the FF in a position where it can attract new minority investors from outside the family, if desired, since the protection in the charter is not limited to family members.

5. Rules replace family: McCain Foods limited

McCain Foods Ltd. (MFL) is the world's largest maker of French fries and related foodstuffs, invoicing roughly 6.5 billion US dollars (2003) in over 55 countries. In 1993 when Wallace and Harrison McCain, co-CEOs for nearly 40 years, disagreed on who should succeed them after their death or departures, the matter had to be resolved in court, which favored Harrison. Yet, in spite of the personal animosity, Wallace and his family retained at least 1/3 of all company shares, and never suffered any discrimination from his brothers. The family, once united, had become deeply divided, but the law was effective enough to avoid abuses of power from the majority shareholder, in spite of his feelings towards his brothers. In fact, MLF continued to grow after Wallace's departure, making Harrison and Wallace both very rich. So much so, in fact, that the magazine Forbes in 2004 listed Wallace McCain as being 30% richer than Harrison, to a large extent thanks to his shares in MFL.