While much of the research on family firms is carried out in mature markets, a small but burgeoning literature has examined the role of family businesses in emerging markets characterised by an institutional void. We examine publicly listed family firms in Taiwan to shed light on a key debate: is family control beneficial because it fills the institutional void or is it harmful because it abuses it.

One side of the debate holds that informal family norms, such as trust and obligation, substitute for weak formal institutions and hence reduce costs that stem from owner-management conflicts (i.e. PA agency cost). The other side of the debate argues that the lack of legal protection for minority shareholders gives the family more incentive and leverage to exploit minority shareholder wealth, which can lead to costs from conflicts between family owners and minority owners (i.e. PP agency cost). International organisations, like the IMF and World Bank, and emerging market governments tend to favour the latter view and have advocated or mandated the appointment of independent directors in order to provide checks and balances between family and minority shareholders.

Many of the institutional voids in emerging markets such as absence of laws protecting shareholders or difficulty in enforcing contracts, resulting in more opportunities to abuse shareholders, have corporate governance implications. Furthermore, the lack of trust between owners and professional managers is another serious governance issue with the latter not always working in the best interest of the former. Due to weaker market institutions, i.e. lack of sophisticated firms that help connect buyers and sellers, such as stock analysts, head hunters, market research firms, lack of monitoring and sophisticated information gathering, etc. there is a higher chance for professional managers to deceive owners or for family insiders to deceive external shareholders.

Different types of family firms

Under this setting, whether family governance fills or abuses the institutional void depends on the particular firm’s pattern of family control. Our approach underscores the importance of unpacking the heterogeneity within family firms, and of examining the performance implications. We look at the different types of family firms and analyse which one is the best configuration for the company: 1) family ownership control alone; 2) family ownership control plus control over strategy but not operation; 3) family control in ownership, strategy and operation.

Our finding is that there is an optimal pattern of family ownership and control that fills the institutional void and contributes to better business performance - the combination of family ownership and partial management control, i.e. the family
member is also the top executive, resulting in a better alignment of goals between the largest shareholders and top management.

Furthermore, the rigour of our study is highlighted by the fact that we also compare with publicly listed non-family firms and find that the family firms with this optimal pattern, tend to do better than non-family firms because they are able to fill the institutional void, especially in regards to the distrust between owners and managers, and between external shareholders and internal family owners.

We argue that because family affords this trust based on family relationships and informal channels of information gathering, so family owners tend to have more trust with family executives and have faster communication, resulting in better decision making for the business. Furthermore, the goals of owners and managers are better aligned. A case in point is Puteng Electronics in Taiwan, where the non-family top executive pursued cost cutting without the owners' knowledge, damaging the product quality and brand image that the family owners had build over five decades! When the family took back the leadership, it spend seven years restructuring the product lines to repair the damage. Firms with family ownership and strategic control enjoy a performance premium over firms with family ownership control alone due to reduced managerial misbehavior.

Non-family firms have more of a challenge in filling the institutional gaps because they don’t have that level of trust. In our analysis we compare a bank as the largest shareholder with professional top executive and find that indeed it does perform worse compared to a family firm that has a family top executive.

Finally, we find that family firms that have complete control (ownership, strategic and operational) suffer from heightened PP conflict i.e. problems between majority family insiders and minority shareholders, and under conditions of weak external governance, the presence of an outside executive who is in charge of operations inside the firm can serve as an important information mechanism to curtail the family’s self-dealing, which can derail the firm.

Corporate Governance Implications

In our study, we look at three major dimensions of family firms – shareholding or ownership; strategic control; and operational control. This mainly constitutes owners and managers, and we have not looked at board control, due to the reality in many emerging markets, including Taiwan, which is our empirical site, that the board has not become powerful or relevant enough yet to make a difference - at least not in the time period of our study 1996-2005. The board as a whole, to a large extent, has not played an independent function and so it wasn’t an important dimension in our focus.

However, in the second part of our paper, we look at a very important phenomena of corporate governance, and that is the role of the independent director in the firm. We find that the independent director has different levels of impact on the family firm’s performance, depending on the levels of family involvement.

Comparing the different types of family firms, we find that if the family control is too strong (ownership, strategic control and operational control), then the independent director is suppressed and essentially is considered a rubber
stamp, whereas when the family is not involved beyond ownership, the independent director’s impact is greatest for firm performance. The independent director also contributes to the performance of the optimal family business – which has ownership and strategic control, but hires a professional for operational control.

**Conclusions**

We establish that performance is enhanced (relative to non-family firms) under the combination of family ownership and strategic control but not under other patterns. In other words, combined family ownership and strategic controls fills the institutional void yet avoids abusing it, thus generating the best performance.

Taiwan is regarded as a relatively advanced emerging market, though during our study period, it was characterised by an important institutional void, which shaped the value of family governance. In emerging markets with even less developed market intermediaries and poor protection of investors, we may see a larger performance premium for family firms with strategic control in comparison to other family firms. In this particular context, then, strategic control by family is even more important for reducing the exploitation risks by outside management and the presence of an outside executive in operational control is even more instrumental to enhance monitoring over family owners. Our argument and results indicate similarly that, in markets with more advanced institutional development than Taiwan, we may not observe a significant performance advantage of family firms with strategic control over other types of family control.

Finally, our study throws light on a better understanding of a key corporate governance issue worldwide: the performance effects of independent directors. Research findings on their effectiveness are mixed, and this paper demonstrates an important contingency factor – the pattern of family governance in which independent directors operate and the various family control patterns shape the effectiveness of independent directors.

This implies that the push by many governments in emerging markets for adopting independent directors is unlikely to improve governance unless it affects the top family decision makers in firms with complete family control.

*Full publication available at:*


**INSEAD Working Paper No. 2012/20/EFE**

Organization Science: ISSN 1047-7039 (print) ISSN 1526-5455 (online)