Governance of Family Firms

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Abstract

We review what the financial economics literature has to say about the unique ways in which the following three classic agency problems manifest themselves in family firms: (*a*) shareholders versus managers, (*b*) controlling (family) shareholders versus noncontrolling shareholders, and (*c*) shareholders versus creditors. We also call attention to a fourth agency problem that is unique to family firms: the conflict of interest between family shareholders and the family at large, which can be thought of as the "superprincipal" in a multi-tier agency structure akin to those found in other concentrated ownership structures in which the controlling owner is the state, a bank, a corporation, or other institutions. We then discuss the solutions or corporate governance mechanisms that have been devised to address these problems and what research has taught us about these mechanisms' effectiveness at solving these four conflicts in family firms.

1. INTRODUCTION

Over the past 10–15 years, family firms have emerged as a leading research subject within financial economics and management. In fact, Anderson & Reeb (2003a) and Villalonga & Amit (2006) are each the single most cited article since 1999 in the *Journal of Finance* and the *Journal of Financial Economics*, respectively. In this article we review the subset of this literature that has received the greatest attention from financial economics: corporate governance in family firms. The dominant theoretical perspective has been agency theory; accordingly, we use this lens as the organizing framework for our article. We begin by discussing the agency problems that corporate governance seeks to address and what we have learned from existing research about the unique ways in which these problems manifest themselves in family firms. These problems are the conflicts of interest between (*a*) shareholders and managers, (*b*) controlling (family) shareholders and noncontrolling (e.g., minority) shareholders, (*c*) shareholders and creditors, and (*d*) family shareholders and family outsiders (nonshareholders, nonmanagers).

We then discuss the solutions or corporate governance mechanisms that have been devised to address these problems. Here we focus on the differences in how these solutions are applied in family firms as compared to nonfamily firms and on what research has taught us about these mechanisms' effectiveness in mitigating the four conflicts listed above. We conclude our review of the literature by distilling from it what we see as the most promising avenues for future research about corporate governance in family firms.

2. GOVERNANCE PROBLEMS IN FAMILY FIRMS

In order to capture the wider range of agency conflicts that are present in family firms relative to nonfamily firms, it is useful to adopt a relatively broad definition of corporate governance such as the one suggested by Becht, Bolton & Röell (2003, p. 3), who describe it as "the reconciliation of conflicts of interest between various corporate claimholders." Corporate governance research within financial economics has traditionally dealt with the first three of the four conflicts of interest listed above, namely: (*a*) shareholders versus managers, (*b*) controlling versus noncontrolling shareholders, and (*c*) shareholders versus creditors. In fact, the finance literature about family firms has more narrowly focused on the first two of these problems [which, following Villalonga & Amit (2006), are often labeled as Agency Problem I and Agency Problem II, respectively], whereas the third conflict (which we can label as Agency Problem III for consistency) has been largely absent from it.

Even more absent from this literature has been the consideration of the role of family outsiders with respect to the firm (nonshareholders, nonboard members, nonmanagers), who are significant stakeholders in the family firm and often exert a powerful influence over it. Yet, this group's objectives are not always aligned with those of family members who are insiders of some sort within the firm (controlling shareholders, board members, and/or managers). We refer to this conflict as Agency Problem IV to continue building the nomenclature.

The management literature on family firms does recognize this and other conflicts inherent to family firms. The three-circle model proposed by Tagiuri & Davis (1996) to represent the so-called family business system and its participants—family, owners, and employees—can be used as a framework to discuss the conflicts of interest among the seven groups defined by these three sets of stakeholders and their intersections.

In this article we propose a new conceptualization of the family business system and the family's role within it based on the agency perspective that has dominated financial economics research. Family firms are thus host to a multi-tier, concatenated agency structure in which managers (both family and nonfamily) act as agents for shareholders, including the controlling family shareholders

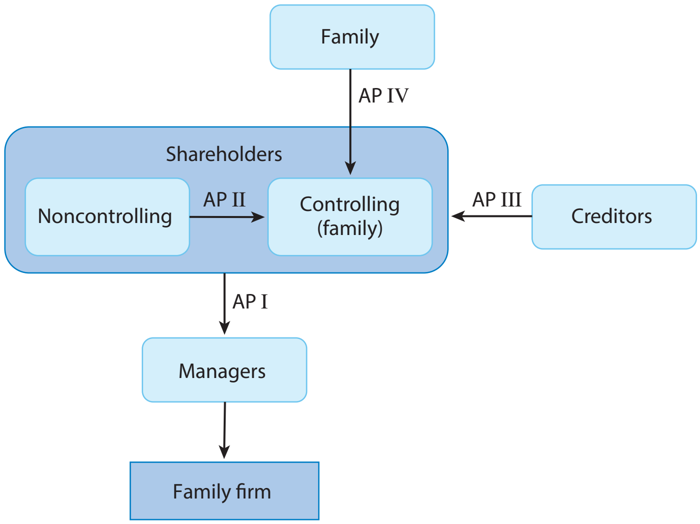

Figure 1

Agency problems (APs) in family firms.

who appoint them; shareholders, in turn, act as agents for the family whose interests they are meant to represent. **Figure 1** depicts the four agency problems, which we discuss below.

2.1. Agency Problem I: Conflict of Interest Between Owners and Managers

The conflict of interest between owners and managers (Agency Problem I) is the classic agency problem described by Jensen & Meckling (1976) and Fama & Jensen (1983), which results from the separation of ownership and control first denounced by Berle & Means (1932). The essence of the problem is that when a firm is not managed directly by its owners but by a manager hired to act on their behalf, the manager is likely to pursue his or her own interests, which are different from the principal's.

When ownership is concentrated in a single person or a small group, those owners will have the clout and the incentives to at least monitor the manager so that he or she does not deviate too much from the principal's objectives. Ownership concentration therefore serves as a mechanism to mitigate this agency problem (as discussed below), and family ownership is a particular case within it. Indeed, the corporate ownership literature (Claessens, Djankov & Lang 2000; Faccio & Lang 2002; La Porta, Lopez-De-Silanes & Shleifer 1999) documents families as the most prevalent type of concentrated owners around the world, more so than governments, banks, or other corporations. Several studies indicate that family firms represent over 33% of large publicly listed US firms (Anderson & Reeb 2003a, Jetha 1993, Shleifer & Vishny 1986, Villalonga & Amit 2006), over 55% of publicly listed firms if smaller firms are included (Villalonga & Amit 2010), and about 90% of all businesses in the US economy, including privately held firms (Astrachan & Shanker 2003, Shanker & Astrachan 1996). La Porta, Lopez-De-Silanes & Shleifer (1999) find that 30% of the 20 largest publicly traded firms in each of the 27 richest economies are family firms. When they use a sample of smaller firms and a less restrictive definition of control, the proportion rises to 53%. Using larger and more random samples, Claessens, Djankov & Lang (2000) and Faccio & Lang (2002) find those percentages to be over 66% and around 44% in East Asia and Western Europe, respectively (see Amit & Villalonga 2013 for a detailed review of family firms' prevalence).

Consistent with the notion that family ownership serves to mitigate Agency Problem I, McConaughy et al. (1998) and Anderson & Reeb (2003a) find that family businesses outperform nonfamily businesses. However, Holderness & Sheehan (1988) find the opposite result. Villalonga & Amit (2006) reconcile their findings by distinguishing among three elements in the definition of a family business: ownership, control (in excess of ownership), and management. They find that family ownership per se creates value and that family control in excess of ownership destroys value, although not enough to offset the positive effect of ownership. The performance effects of family management are large enough to overpower those of the other two elements, but their sign is entirely contingent on the CEO or chairman's generation: Relative to nonfamily businesses, founder-led firms outperform, whereas descendant-led firms underperform. As a result of these effects, the authors find that, just as with the issue of family firms' prevalence, the answer to the question of whether family firms are better or worse performers than nonfamily firms is contingent on how family businesses are defined.

After Villalonga & Amit (2006), dozens of studies of family firm performance have been published, often replicating their decomposition approach. Amit & Villalonga (2014) review the cumulative evidence from these studies and conclude that family firms significantly outperform their nonfamily peers, but they find considerable variation in results across studies. They attribute this variation to four key factors: family business definition, geographic location, industry affiliation, and intertemporal variation in economic conditions.

Individual and family shareholders are likely to be more dedicated principals and more effective monitors than other types of controlling shareholders, because their own wealth is at stake. In contrast, other types of concentrated owners such as the state, banks, corporations, or other institutions are only agents for their respective superprincipals, which dilutes their incentives to monitor the manager. Claessens et al. (2002) provide comparative evidence that is consistent with this argument: They find that the positive impact of controlling shareholder ownership on firm value in their sample is primarily driven by family shareholder ownership. Ownership by corporations or financial institutions has the same coefficient but lower statistical significance, whereas the effect of state ownership, while still positive, is not significant.

Within family firms, founding families are particularly likely to be dedicated and effective owners because their emotional ties to the firm give them an additional source of motivation. Villalonga & Amit (2009) provide evidence in support of this point: They find that the percentage difference between the Tobin's *q* of family firms and nonfamily firms in an industry (the industry's "family premium") averages 12% for founding family–owned firms but only 2% for nonfounding individuals and families. Because Tobin's *q* is a measure of value for the firm as a whole, these findings are also evidence that families' superior monitoring abilities attenuate the conflict of interest between shareholders and managers for the benefit of all shareholders, not just the family ones.

In most family firms, the conflict may be further attenuated or even eliminated by the fact that managers are significant owners themselves, or at least members of the controlling owner's family. La Porta, Lopez-De-Silanes & Shleifer (1999) find that 69% of the family firms among the largest 20 firms in each of 27 countries have a family member as CEO, chairman, honorary chairman, or vice-chairman. Claessens, Djankov & Lang (2000) find this percentage to be 57% in their large sample of Asian firms. Volpin (2002) finds that 50% of Italian family firms' top executives are family members. Anderson & Reeb (2003a) find that 45% of family firms' CEOs in the S&P 500 are family members. Villalonga & Amit (2006) find that 51% of Fortune 500 family firms have a family member as CEO and 66% as chairman or CEO. The fraction of family CEOs rises to 62% in Villalonga & Amit's (2009) sample of 2,110 US publicly listed firms, suggesting that, like family-owned and -controlled firms themselves, the proportion of those firms that are family managed is negatively correlated with firm size.

Family management thus, by reducing or eliminating the separation between owners and managers, has the potential to create value by nipping Agency Problem I at the bud. However, the agency benefits of family management have to be traded off against its costs if family managers owe their jobs to sheer nepotism as opposed to meritocracy and are of inferior quality than hired professionals, as modeled theoretically by Caselli & Gennaioli (2013) and Burkart, Panunzi & Shleifer (2003). The empirical evidence about the impact of family management on performance suggests that the aggregate balance of this trade-off is positive (see, e.g., Anderson & Reeb 2003a for the United States and Maury 2006 for Europe]. Upon careful inspection, however, the sign of this relationship has proven to be contingent on the manager's or family firm's generation relative to the founder. Consistent with the view that family management mitigates the classic agency problem, several authors (Adams, Almeida & Ferreira 2009; Fahlenbrach 2009; Morck, Shleifer & Vishny 1988; Palia, Ravid & Wang 2008; Villalonga & Amit 2006) find that US firms whose founder serves as CEO trade at a premium relative to other firms (both family and nonfamily). Subsequent studies have found similar results around the world.

In contrast, Villalonga & Amit (2006) find that US family firms whose CEO is a descendant of the founder underperform all other firms, and that this effect is entirely attributable to second-generation family firms. Consistent with this finding, Pérez-González (2006) and Smith & Amoako-Adu (1999) find that the stock market reacts negatively to the appointment of family heirs as managers and that operating performance subsequently declines. Cucculelli & Micucci (2008) find similar results for Italy. Barth, Gulbrandsen & Schøne (2005) find that Norwegian family-managed firms are less productive than nonfamily firms. Using a unique data set from Denmark that allows them to use the gender of departing CEOs' first-born children as an instrumental variable, Bennedsen et al. (2007) are further able to establish causality in the negative impact of family successions on firm performance.

Unlike the finding of the founder-CEO premium, the descendant-CEO discount has proven to be sensitive to the geographic location of the sample of firms studied. Barontini & Caprio (2006) find no such discount in Western Europe and neither do Andres (2008) in Germany and González et al. (2012) in Colombia. Sraer & Thesmar (2007) show that descendant-led firms in France largely outperform widely held corporations because of a more efficient use of labor. Mehrotra et al. (2013) analyze the unique Japanese practice of adopting sons-in-law and find that family firms run by this unusual type of heirs outperform those run by blood heirs, which in turn outperform those run by nonfamily-related managers. Amit et al. (2015) find that institutional development plays a critical role in explaining these differences in results: The net effect of descendant-CEOs on performance is negative when institutional efficiency is high but positive when institutional efficiency is low.

2.2. Agency Problem II: Conflict of Interest Between Controlling (Family) Shareholders and Noncontrolling Shareholders

Individual- and family-controlled firms are the foremost example of the corporation modeled by Shleifer & Vishny (1986), one with a large shareholder and a fringe of small shareholders. In such a corporation, ownership concentration alleviates the classic owner-manager conflict of interest (Agency Problem I), as described above. However, a second type of conflict of interest appears (Agency Problem II) because the large shareholder may use its controlling position in the firm to appropriate what Grossman & Hart (1980) label "private benefits of control" at the expense of the small shareholders.

Just like the benefits of ownership concentration are particularly pronounced when the controlling owner is a family, so are its costs. If the large shareholder is the state, a bank, a widely held corporation, or another institution, the private benefits of control are divided among several independent owners. As a result, the large shareholder's incentives for expropriating the smaller shareholders are diluted (just like its incentives for monitoring the manager). If, on the other hand, the large shareholder is an individual or a family, its incentives for both expropriation and monitoring are enhanced. Andres (2008), Caprio & Croci (2008), and Maury & Pajuste (2005) provide evidence of this comparative effect, although they reach opposite conclusions about the net effect of enhanced expropriation and enhanced monitoring. Whichever of these two effects dominates, the conclusion is the same: In family firms, more than in any other corporation with concentrated ownership, Agency Problem II is likely to overshadow Agency Problem I.

Evidence of the conflict of interest between controlling and noncontrolling shareholders can be classified into at least five types, discussed here from least to most incriminating. The first type of evidence consists of descriptive statistics of family ownership and/or controlling stakes. DeAngelo & DeAngelo (1985) find that corporate officers and their families hold a median 24.0% of equity but 56.9% of the votes. Claessens, Djankov & Lang (2000) report that the largest ultimate controlling shareholder (group) in East Asian firms on average owns 15.7% of the shares but has voting control over 19.77%. Faccio & Lang (2002) find these figures to be 34.64% and 38.48%, respectively, for Western European firms. Neither of these two studies reports these percentages specifically for families, but most controlling shareholders in their sample are families. Villalonga & Amit (2009) find that founding families in Fortune 500 firms own on average 15.3% of their firms' equity and 18.8% of the votes. Claessens & Yurtoglu (2013) survey corporate governance in emerging markets and highlight that families in the East Asian countries usually own about 50% of a firm's cash-flow rights, whereas in Latin America the ownership stake of the largest shareholder tends to be higher (more than 60% in Argentina and Brazil).

Families' presence in management further reinforces their ownership and voting control. Although such a presence can be beneficial insofar as it alleviates or eliminates Agency Problem I, it can also be seen as further enhancing Agency Problem II, particularly if the family manager owes his or her job to sheer nepotism. In that case, family management can be seen as a version of the managerial entrenchment problem discussed by Stulz (1988). González et al. (2014b) find evidence of family CEOs' entrenchment in their lower turnover but not in their turnover-to-performance sensitivity. Obviously, evidence of concentrated control in any of these forms is not evidence per se of a conflict of interest between controlling and noncontrolling shareholders, but it is a necessary condition for it.

A stronger form of evidence (still within the first type) lies in the difference or ratio between voting control and economic ownership (or between control rights and cash-flow rights) in any given firm—e.g., 4.07 percentage points or a 1.26 ratio in Claessens, Djankov & Lang's (2000) sample; 3.84 percentage points or a 1.11 ratio in Faccio & Lang (2002); and 3.5 percentage points or a 1.23 ratio in Villalonga & Amit (2009). A positive difference (or a ratio greater than one) provides evidence of another form of separation between ownership and control: In the context of Agency Problem I, "control" refers to management control, whereas in the context of Agency Problem II, it refers to voting (and/or sometimes to board control). This separation can be achieved through a variety of control-enhancing mechanisms. La Porta, Lopez-De-Silanes & Shleifer (1999) and subsequent studies, including Claessens et al. (2000) and Faccio & Lang (2002), analyze in detail the two most prevalent mechanisms in Asia and Europe, dual-class stock and pyramids, as well as cross shareholdings (although those prove to be less relevant). Villalonga & Amit (2009) add two more mechanisms to their study of ownership and control of US family firms: disproportionate board representation (the most common of all in the United States) and voting agreements between the controlling family and nonfamily shareholders.

The second type of evidence are empirical estimates of the control premium, which in turn come in one of two forms: (*a*) the block premium paid for a controlling block of shares, relative to the price paid in minority trades pre- or post-transaction (Barclay & Holderness 1989), and (*b*) the voting premiums or difference in stock price between two classes of shares that have different voting rights, after controlling for any possible differences in their cash-flow rights (Lease, McConnell & Mikkelson 1983; Zingales 1995). Both kinds of estimates are often interpreted as evidence of private benefits of control. A more conservative interpretation, however, is that they are simply estimates of the value of the benefits of control, including not just private benefits for the controlling shareholder but also the public benefits that such a shareholder can bring to other shareholders through his or her position of control. The most comprehensive empirical studies of control premiums are provided by Nenova (2003), who estimates average voting premiums in 18 countries, and Dyck & Zingales (2004), who provide evidence of average block premiums in 39 different countries. Caprio & Croci (2008) show that family firms exhibit particularly high voting premiums, suggesting that families are the type of controlling shareholders most likely to expropriate other shareholders. Moreover, DeAngelo & DeAngelo (1985) and Villalonga & Amit (2009) show that even in the United States, where dual-class stock is often portrayed as evidence of Agency Problem I, most dual-class companies are in fact family firms, suggesting that this type of structure and the resulting voting premium should be interpreted as evidence of Agency Problem II.

The third type of evidence comes from studies that find that the wedge between cash-flow and control rights has a negative impact on value. Claessens et al. (2002) find such an effect for all controlling shareholders, as do Gompers, Ishii & Metrick (2010) and Lins (2003) for all insiders. Villalonga & Amit (2006) document this effect specifically for family firms. Villalonga & Amit (2009) further show that the impact of the wedge between cash-flow and control rights varies depending on the mechanism(s) used to achieve this wedge: Dual-class stock has a negative impact, whereas pyramids and voting agreements have the opposite effect.

The fourth type of evidence and arguably the most direct comes from Bertrand, Mehta & Mullainathan's (2002) study of tunneling and other analyses that have followed their methodology. Tunneling is defined by Johnson et al. (2000, p. 22) as "the transfer of assets and profits out of firms for the benefit of those who control them." Bertrand, Mehta & Mullainathan (2002) find evidence of tunneling in Indian family business groups by measuring the differential sensitivity to profit shocks in group-affiliated firms relative to stand-alone firms. They do not examine, however, whether the stand-alone firms are also family controlled (although this is likely to be the case); thus, their results are more indicative of the costs of business groups as an ownership structure than of the costs of family control per se.

Villalonga & Amit (2010) apply Bertrand, Mehta & Mullainathan's (2002) methodology to test more precisely for the appropriation of private benefits by families in US firms, and they extend it to allow for asymmetric responses to positive and negative profit shocks. This extension allows them to test separately for the presence of tunneling and its reverse effect, which Friedman, Johnson & Mitton (2003) refer to as propping. Villalonga & Amit (2010) find that family firms are less sensitive than nonfamily firms to both positive and negative shocks, which is consistent with the notion that families are more prone to tunneling but also to propping. They further analyze the different responses of founding families versus nonfounding controlling families and individuals, which they find to be a critical factor in explaining family control of firms and industries: Founding families are more likely to retain control when doing so gives the firm a competitive advantage, thereby benefiting all shareholders. In contrast, nonfounding families are more likely to retain control when they can appropriate private benefits of control.

The fifth type of evidence, although less direct than the fourth, is perhaps the most severe criticism of the agency costs of concentrated ownership: the evidence of the macroeconomic magnitude and implications of the problem. Anderson & Reeb (2003a) and Villalonga & Amit (2006, 2010) show that entire industries (or a large fraction of some of them) are family controlled.

La Porta, Lopez-De-Silanes & Shleifer (1999) find that, on average, controlling families control 1.33 of the 20 largest firms in each of the 27 countries in their sample. Claessens, Djankov & Lang (2000) find this number to be as high as 4.09 in their East Asian sample (for Indonesia). They also report the fraction of each country's total market capitalization that is controlled by the top families: The most extreme case is the Philippines, where a single family controls 17% of the market through its business group. When the top 10 or 15 families are considered, however, Indonesia leads the region (with 57.7% and 61.7%, respectively). Faccio & Lang (2002) report similar statistics and find that, in Western Europe, the highest concentration of control of the stock market in a single family occurs in Switzerland (17.89%), whereas the highest concentration in the top 10 or 15 families happens in Portugal (34.23%) and Belgium (36.63%), respectively. However, Agnblad et al. (2001) report that the Wallenberg family controls about 50% of the Swedish stock market. Studies of politically connected firms around the world such as Faccio's (2006) suggest that the power of leading business families in each country may be further reinforced by their political connections.

In their literature review article, Morck, Wolfenzon & Yeung (2005, p. 655) argue that "if a few families control large swaths of an economy, such corporate governance problems can attain macroeconomic importance—affecting rates of innovation, economy wide resource allocation, and economic growth," a phenomenon they label as economic entrenchment. However, there is little and only very indirect evidence of the macroeconomic implications of family control. Morck, Stangeland & Yeung (2000) find that countries in which self-made billionaires' wealth is large relative to GDP grow faster than countries at similar levels of development, whereas countries in which inherited wealth is large relative to GDP grow slower. Morck & Yeung (2004) find that countries with a high incidence of family control over large firms have low compliance with tax laws, high official corruption, low judicial efficiency and integrity, inefficient bureaucrats with low autonomy, and high regulatory barriers to entry. Bertrand & Schoar (2006) document that countries with stronger family values have lower levels of per capita GDP, smaller firms, more self-employment, and smaller capital markets, and that a larger fraction of their total market capitalization is controlled by families. As they acknowledge, however, family values may be the consequence rather than the cause of economic development. Likewise, no causal direction can be inferred from the correlations reported by Morck, Stangeland & Yeung (2000) and Morck & Yeung (2004). Caselli & Gennaioli (2013), whose theoretical model focuses on the macroeconomic causes and consequences of dynastic management, use numerical simulations to show that the intergenerational transfer of control over corporate assets may be a substantial contributor to observed cross-country differences in productivity.

2.3. Agency Problem III: Conflict of Interest Between Shareholders and Creditors

From an agency theory perspective, debt has both benefits and costs. On the benefits side, debt can be used as a governance mechanism to attenuate Agency Problem I, as we discuss in Section 3. On the costs side, debt creates a new conflict of interest between shareholders and creditors (Agency Problem III). Fama & Miller (1972), Jensen & Meckling (1976), and Myers (1977) discuss the two forms this conflict of interest can take—the so-called asset substitution or risk shifting effect and the underinvestment that can result from debt overhang. Anticipating these situations, creditors will charge higher premiums and thus increase the firm's debt financing costs. [Readers are referred to Harris & Raviv (1991) and Myers (2003) for comprehensive reviews of the capital structure literature.]

In the family firms literature, Agency Problem III has received much less attention than Agency Problems I and II. Anderson, Mansi & Reeb (2003) argue that family shareholders' objectives such as ensuring the long-term survival of the firm, preserving the family's reputation, and keeping the firm in the family, together with the undiversified nature of their holdings in the firm that results from those objectives, make controlling families more likely to maximize firm value as a whole rather than shareholder value. Thus, the divergence of interests between shareholders and creditors will be less severe in family firms than in nonfamily firms. Consistent with this view, they find that founding family ownership is associated with significantly lower costs of debt. However, consistent with the findings in Villalonga & Amit (2006), they also find that this cost advantage is attenuated when the family firm is run by a descendant-CEO but not by a founder-CEO.

The amount of debt held by family firms relative to nonfamily firms—a necessary condition for the existence of Agency Problem III and another indication of the potential magnitude of the conflict—is unclear. On the one hand, families' desire to avoid dilution in their equity stake and their lower cost of debt would suggest they might have higher levels of debt relative to nonfamily firms. On the other hand, the same unique family objectives that make their incentives more aligned with those of creditors (concern with long-term survival and reluctance to share control with, or accountability to, outside capital providers in general—equity or debtholders) would suggest that they should be less leveraged. Perhaps not surprisingly, the evidence on this point is mixed: The survey of private family businesses by the MassMutual Financial Group (2003) shows that more than 25% of respondents report no debt other than payables, and another 30.3% have debt levels between 1% and 30% of (book) equity. Villalonga & Amit (2006) find that Fortune 500 family firms are significantly less leveraged than their peers. Anderson & Reeb (2003a,b) find that S&P 500 family firms are also less leveraged than their peers but not significantly so; Anderson, Mansi & Reeb (2003) find that they are more leveraged, but again not significantly so. Wiwattanakantang (1999) and Ugurlu (2000) find family firms to be relatively more leveraged in Thailand and Turkey, respectively. González et al. (2013) show that the family's participation in the board is negatively associated with debt levels in Colombia. Villalonga & Amit (2010) and González et al. (2013) find that debt levels are contingent on how families are involved in their firms. Ellul, Guntay & Lel (2007) find that family firms' cost of debt relative to nonfamily firms is negatively related to the degree of investor protection. D'Aurizio, Oliviero & Romano (2015) and Stacchini & Degasperi (2015) find that credit to Italian family firms during the 2007–2009 financial crisis contracted significantly less sharply than that to nonfamily firms, and that the ex-post performance of the (cheaper) loans extended to family firms is superior to that of their peers. Altogether, the empirical evidence about Agency Problem III in family firms suggests that family shareholders' incentives are better aligned with those of creditors than of other types of shareholders, which gives them better and cheaper access to credit.

It is worth noting that both Anderson, Mansi & Reeb (2003) and Ellul, Guntay & Lel (2007) find that nonfamily blockholdings have no significant impact on the agency cost of debt. This result confirms the evidence from studies of Agency Problems I and II (and of course Agency Problem IV) that families are a very unique type of controlling shareholder, with different objectives and behaviors compared to other types of shareholders, both large and small. As a result, there are important differences, both qualitative and quantitative, in these firms' exposure to agency problems relative to other firms.

2.4. Agency Problem IV: Conflict of Interest Between Family Shareholders and Family Outsiders

In addition to the three agency problems listed above, to which family firms are not immune, family firms are potentially subject to an additional conflict of interest between the family at large, which can be thought of as a superprincipal, and family shareholders, who in this case act as agents for them (Agency Problem IV). As agents of the family to which they belong, family shareholders are for instance entrusted with preserving and enhancing the family legacy (a key objective of the principals), given that the family firm, over which shareholders are delegated control by the family, is central to that legacy.

We conceptualize the family as the superprincipal in a multi-tier agency structure (versus, for instance, another stakeholder like customers or suppliers) for several reasons. First, such multi-tier agency structures commonly arise in concentrated ownership structures, not just in family firms. In state-owned firms, for instance, the government, as shareholder, is the manager's principal, but it is also, in turn, an agent for the public it is supposed to represent. In firms whose controlling owners are banks or other corporations, the ultimate shareholders of those banks or corporations are the superprincipals whose representatives (e.g., members of the firm's board of directors) are agents for them but principals with respect to the firm's managers. In firms whose ownership is concentrated in institutions such as mutual funds or private equity funds, the mutual fund managers (or the private equity fund's general partners) act as principals for the firm's managers but as agents for their respective groups of investors (the mutual fund's shareholders or the private equity fund's limited partners).

Second, just like shareholders have the power to appoint the managers who act as agents for them, it is the family that, subject to the limits of the law, appoints a subset of its members as shareholders to perform certain tasks on its behalf. This principal-agent relationship is perhaps most obvious for second- or later-generation family firms, in which the previous generation chooses which family members can and will be their successor shareholders through gifts, inheritance, sales, or other forms of transfer. But these transfers can also take place within a given generation, including the founder's (e.g., between spouses or siblings). It is also the family at large that, through various types of contracts (family constitutions, prenuptial agreements, wills, etc.), often decides who among its members and under what conditions will be excluded from the shareholder group. Thus, from the moment the transferee receives his or her shares, a contractual relationship is established—implicitly or explicitly—not just with the transferor but with the family at large.

Third, as in any agency relationship, the goals of principal and agent may diverge. The family's objective function often includes a wide range of goals such as preserving the family's legacy and reputation; implementing the family's values, mission, and vision; protecting the family name (which may be the same as the firm's); maintaining family unity and harmony; minimizing conflict; maximizing what Gómez-Mejía et al. (2007) call socioemotional wealth; preserving the corporate culture created by the founder; procuring employment for family members; helping out the community; protecting the environment; and other goals for which the family firm is instrumental. Family shareholders, being part of the larger family group, are likely to share some or all of their principal's objectives, but they are also likely to have some objectives of their own that may conflict with those of the family at large—e.g., maximizing financial returns, increasing distributions (which may limit firm growth), or having liquidity and exit options (perhaps at the expense of losing control of the family firm).

3. GOVERNANCE MECHANISMS IN FAMILY FIRMS

A wide range of governance mechanisms can be used to mitigate one or more of the traditional agency problems in corporations: ownership concentration, boards of directors, executive compensation, reduction of free cash flow through debt or dividends, corporate takeovers, dual-class unifications, and legal (or regulatory) investor protection. In addition, in family firms, a unique set of mechanisms exists to alleviate the agency problem between families and their representative shareholders: family assemblies, family councils, shareholders' or owners' councils, family constitutions, and shareholders' agreements. Although each of these mechanisms has been designed to address a specific agency problem among the four we have discussed, they often have an effect on one of more of the other three problems, as we discuss below.

3.1. Ownership Concentration

The literature on corporate governance has traditionally considered two versions of ownership concentration as a way to alleviate Agency Problem I: managerial ownership and outside blockholder ownership. Managerial ownership addresses the root cause of the problem by aligning the interests of the managers with those of their (fellow) owners. Outside blockholder ownership seeks to alleviate the problem through better monitoring of managers by large shareholders who, unlike small ones, have the incentives and ability to do so. As discussed in the previous section, both forms of ownership concentration are inherent to family firms, and hence we will not discuss them again as mechanisms. As explained in detail above, ownership concentration in general, and in the hands of family shareholders (and/or managers) in particular, alleviates two conflicts (Agency Problems I and III) at the expense of aggravating two others (Agency Problems II and IV).

One variation of this mechanism that merits further discussion, however, is the presence of multiple blockholders—nonfamily blockholders in the case of family firms. These blockholders have the power and incentives to monitor and discipline not only managers but also family shareholders, whose control they have the ability to contest. They can also form coalitions with the family to increase their joint control (e.g., above a majority threshold), which, as Bennedsen & Wolfenzon (2000) show theoretically, can be an optimal choice for founders. In Gomes & Novaes's (2005) model, the positive governance role of shared control stems not only from reduced ex-ante incentives to appropriate private benefits but also from ex-post bargaining problems among controlling shareholders that raise the cost of such behaviors. Through either channel, nonfamily blockholders in family firms can therefore mitigate both Agency Problems I and II. In doing so, however, they are likely to exacerbate Agency Problems III and IV, because they are likely to steer family shareholders away from their family's intrinsic objectives, many of which make family shareholders better aligned with debtholders.

Faccio, Lang & Young (2001) document that dividend rates are higher in Europe than in Asia, where there are multiple large shareholders, suggesting that they dampen small shareholder expropriation in Europe but exacerbate it in Asia. Villalonga (2011a) discusses the benefits and costs for family shareholders of sharing control with different types of equity partners such as private equity partners or joint venture partners. Several studies provide empirical evidence of the benefits of voting coalitions among large shareholders: Volpin (2002) and Gianfrate (2007) for Italy; Maury & Pajuste (2005) for Finland; Jara-Bertin, López-Iturriaga & López-de-Foronda (2008) for Europe; Attig, Guedhami & Mishra (2008) for Asia; Villalonga & Amit (2009) for the United States; and Carvalhal (2012) for Brazil. Only Maury & Pajuste (2005) and Villalonga & Amit (2009) have focused on families as a specific type of blockholders, though. Maury & Pajuste (2005) find that the contestability of control is particularly relevant in family firms, but its effect is contingent on the type of nonfamily blockholder: If the blockholder is another family, it has an incentive to collude with the largest shareholder and to expropriate minority shareholders. If it is an institutional investor, however, it has greater incentives for monitoring family shareholders.

Villalonga & Amit (2009) report on the identity and importance of nonfamily blockholders in US corporations and find that they have a negative impact on both family and nonfamily firms, which is particularly pronounced in founder-controlled firms. Voting agreements between family and nonfamily blockholders are uncommon (only 15 out of 210 family firms have one) but have a positive effect on firm performance.

3.2. Boards of Directors

The common apex of corporate governance systems is some form of board of directors (Fama & Jensen 1983). Although usually portrayed as a mechanism to mitigate Agency Problem I, a board can simultaneously alleviate other agency problems as well. Just like boards should protect shareholders from managerial power abuses by virtue of their ability and responsibility to monitor and discipline managers, they can protect noncontrolling shareholders from expropriation by controlling shareholders, thereby ameliorating Agency Problem II. (Of course, the latter requires that the board itself be not fully controlled by the controlling shareholder, which is why in many countries minority shareholders are legally entitled to some degree of board representation.) Moreover, in family firms, boards can ameliorate Agency Problem IV, because family board members can improve communication between family shareholders and outside family members (or their representative governance body, the family council) and help align the respective incentives of the two groups.

In spite of their potential to palliate agency problems, boards have received scant attention in the academic literature about family firms (Bettinelli 2011). Consistent with the view that boards can create value by balancing the power of family and nonfamily shareholders, Anderson & Reeb (2004) find a positive relation between board independence and firm performance in US family firms [however, Klein, Shapiro & Young (2005) find the opposite result in their Canadian sample]. Consistent with the view that boards can additionally solve other agency problems, González et al. (2012) find that both family directors and outside directors have a positive influence on firm performance. Andres (2008) also reports a positive impact of family directors; Barontini & Caprio (2006) find the same effect specifically for descendant directors, whereas Li & Srinivasan (2011) find it for founders. González et al. (2014b) find that boards dominated by families lead to longer CEO tenures, but CEO turnover shows greater sensitivity to performance, which suggests better supervision of management when family members serve on the board.

Villalonga & Amit (2009) find that in 60% of US family firms, the percentage of family members or family representatives on the board exceeds not only the family's economic ownership but also its voting control by an average difference of 10%. They find this disproportionate board representation to be the most common form of control enhancement in the United States, but one that has no significant impact on firm value. González et al. (2014a) find that families' disproportionate board representation significantly increases the amount and likelihood of dividend payments.

3.3. Executive Compensation

Executive compensation can be used as a mechanism to reduce Agency Problem I by offering well-designed contracts that align managers' interests with the owners' ex ante (Jensen & Murphy 1990). In family firms, compensation of family executives can also potentially reduce the risk of their entrenchment, and hence alleviate Agency Problem II as well.

Gómez-Mejía, Larraza-Kintana & Makri (2003) and Carrasco-Hernández & Sánchez-Marín (2007) find that family CEOs receive lower total pay than nonfamily managers but higher risk protection. Based on these findings, Combs et al. (2010) propose that family CEOs act like stewards, accepting lower pay in exchange for greater job security. This view is in line with Sraer & Thesmar's (2007) arguments and evidence from France showing that family-managed firms provide their workers with long-term implicit insurance contracts, which allow them to pay lower wages for better skills and thus attain higher levels of labor productivity. However, Combs et al. (2010) find that family CEO compensation is lower when multiple family members are involved but higher when the CEO is the lone family member. Using a sample from 14 European countries, Croci, Gonenc & Ozkan (2012) find further evidence that controlling family shareholders limit family CEOs' total compensation.

3.4. Debt

Debt can attenuate Agency Problem I through several channels. First, holding constant the dollar value of managerial holdings, the greater the firm's leverage, the greater the manager's share of equity and hence the greater the incentive to align with shareholders (Jensen & Meckling 1976). Second, higher levels of debt may induce greater effort by managers who want to avoid bankruptcy (Grossman & Hart 1980). Third, because of the commitments derived from debt contracts, which reduce or eliminate the free cash flow available to managers to undertake nonvalue-creating projects, debt financing serves as a useful device to discipline managers (Jensen 1986). Debt can also ameliorate Agency Problem IV by helping families retain control of their firms. Holding fixed the need to raise external capital, issuing debt lowers the need to raise equity, which dilutes the power of family shareholders and therefore of their family at large.

As reviewed before in our discussion of Agency Problem II, the evidence about the debt level of family firms relative to that of nonfamily firms is mixed, and it suggests that its use in family firms is limited by the families' desire to ensure the long-term survival of their firm. Villalonga (2011b) finds that family firms' financial conservatism served them well during the 2007–2009 crisis, when they fared better than nonfamily firms mainly for this reason.

3.5. Dividend Policy

Similar to debt, dividend policy can also be used as a mechanism to alleviate Agency Problem I by reducing the free cash flow under managers' control (Jensen 1986). Faccio, Lang & Young (2001) find that group-affiliated firms in Europe pay higher dividends than in Asia, dampening controlling shareholders' ability to expropriate noncontrolling shareholders. Villalonga & Amit (2006) and González et al. (2014a) find that family firms pay significantly lower dividends than nonfamily firms in the United States and Colombia, respectively. Michaely & Roberts (2012) find that listed firms and closely held firms with some level of ownership dispersion have higher payout ratios than wholly owned firms. Altogether, the empirical evidence suggests that families' desire to retain control of their firms weighs heavier in their objectives than liquidity and makes them prone to reinvest a large fraction of their earnings rather than paying them out as dividends. As a result, payout policy does not seem to play a significant role in mitigating agency problems in family firms.

3.6. The Market for Corporate Control

Manne (1965) argues that an active market for corporate control can serve as a disciplining mechanism for underperforming managers both ex post and ex ante (i.e., the mere threat of takeover would be sufficient to keep managers on their toes). However, several of the intrinsic characteristics of family firms we have reviewed insulate them to a large degree from the market's discipline: high ownership concentration, use of control-enhancing mechanisms, and managerial entrenchment.

Villalonga & Amit (2006) find that family firms fare better than nonfamily firms on Gompers, Ishii & Metrick's (2003) Governance Index, which is largely a count of antitakeover provisions. As Gompers, Ishii & Metrick (2010, p. 1052) note, however, their previous study and all subsequent ones based on their measure "have ignored the most extreme example of antitakeover protection: dual-class stock." As mentioned before, Villalonga & Amit (2009) show that most dual-class companies are in fact family firms and that, in large US corporations, founding families are the only blockholders whose control rights on average exceed cash-flow rights. Faccio & Lang (2002) report that 17.6% of family firms in their Western European sample have dual-class stock; the percentage is higher than 67% for Switzerland and Sweden. In line with Zingales's (1995) theory and evidence that the main driver of voting premiums is the likelihood of a control contest, the negative impact of dual-class stock on firm value can be attributed not only to the higher severity of Agency Problem II in dual-class firms but also to its obstruction of one of the main protection mechanisms against Agency Problem I. On the other hand, this insulation facilitates a greater alignment of interests between family shareholders and family outsiders, thereby reducing Agency Problem IV.

Caprio, Croci & Del Giudice (2011) find that ownership concentration limits the ability of family firms to participate in acquisitions as bidders and targets. Feldman, Amit & Villalonga (2014) find that family firms are less likely than nonfamily firms to undertake divestitures, especially when there is a family CEO, because such transactions may reflect negatively on, or even reverse, a predecessor's strategic decisions.

3.7. Dual-Class Unifications

Given that dual-class stock increases the likelihood of Agency Problems I and II, one obvious mechanism that can be used to counter both effects is to unify the multiple classes of stock (i.e., declassify the share structure in dual-class firms). Pajuste (2005) documents that these unifications have become increasingly common in continental Europe and finds that, as expected, firm value increases after the unification. Amoako-Adu & Smith (2001) and Arugaslan (2007) report similar findings from Canada and the United States, respectively.

However, because shares of the class(es) with superior voting or board control rights typically carry a control premium, besides the value increase that results from palliating agency problems there is likely to be a value transfer from the superior-class shareholders to the inferior-class shareholders. To make up for the value transfer, in companies that undergo these unifications the family or other insiders holding the superior-voting shares may load up on the inferior-voting ones before announcing the unification (Bigelli, Mehrotra & Rau 2007). Sometimes they are explicitly compensated for the value of their voting rights in cash, stock, or options (Hauser & Lauterbach 2004).

3.8. Legal Investor Protection

Shleifer & Vishny (1997, p. 769) argue that "if small investors are to be attracted to the business of financing companies, they . . . require some legal protection against expropriation by both the managers and the large investors." Coffee (1999) echoes their argument. There is significant empirical evidence for these claims (e.g., La Porta et al. 1997, 1998, 2002), although very little that is specific to family firms. Maury (2006) finds that family control intensifies conflicts between the family and minority shareholders when control is high and shareholder protection is low. Amit et al. (2015) find that the effects of family ownership, control, and management on firm value are contingent on the degree of institutional efficiency. The implications of this evidence are twofold: First, agency problems can be addressed to some degree by increasing legal protection of minority investors; second, as suggested by Enriques & Volpin (2007), the actual enforcement of the law may be the most effective tool to prevent specific forms of expropriation.

3.9. Family Governance Mechanisms

In addition to the governance mechanisms discussed above, which are available to family and nonfamily firms alike, business families use a range of mechanisms to govern themselves and their relationship with the family firm. These mechanisms serve to clarify the demands and rewards that arise from this relationship; articulate and communicate the family's mission, vision, values, and objectives; manage family conflict; and build trust and facilitate effective communication within the family and between the family and the firm (Davis 2007, Gersick & Feliu 2014). They also enable coordinated decision making about the broader family enterprise, which, in addition to the firm, may include other entities such as a family office or a family foundation, as well as other assets and activities shared by the family (Amit & Villalonga 2013, Davis 2007). Although the financial economics literature has taken no notice of these mechanisms so far, we introduce them briefly in this review because they can help mitigate agency conflicts in family firms.

The family assembly and the family council are the two main family governance bodies, akin in corporate governance to the annual shareholders' meeting and the board of directors, respectively. The family assembly is a forum that brings together all business family members over a certain age (e.g., 14 years old), regardless of their relationship to the firm. It usually meets once or twice a year and provides its members with information about the family and the business, sometimes accompanied by basic skills training to help them understand the latter (Davis 2007). The family assembly promotes constructive dialogue about shared family values, vision, and mission. Family assembly meetings often include social activities that build and strengthen family identity, cohesion, trust, and pride (Davis 2007), and they help the family preserve its heritage, culture, norms, and traditions (Amit & Villalonga 2013). Importantly, the family assembly is in charge of electing the family council from among its members and of reviewing and approving the work done by the council on its behalf (Davis 2007).

The family council is the representative work group that organizes meetings and education for the family; drafts rules, policies, and statements for discussion and approval by the family assembly; and is often delegated authority by the family to make decisions on its behalf (Davis 2007). The family council typically coordinates with the company's board to align the objectives of the family and of the shareholders, advising directors on an appropriate decision-making process that safeguards the family's values, needs, and wishes (Lansberg 1988), and subjecting to the board's approval decisions and policies that concern the firm—such as the employment and compensation of family members at the firm or the terms of credit issued by the firm to family members (perhaps secured with their equity). The council also offers a legitimate place to resolve internal family conflicts that may negatively affect a firm's competitiveness (Blumentritt, Keyt & Astrachan 2007). Therefore, the family council serves as the principal mechanism to alleviate Agency Problem IV, but it can also help mitigate Agency Problem II (e.g., by ensuring that only those family members who meet certain qualifications can work as managers in the firm) and Agency Problem I (e.g., by drafting an active ownership policy that limits share ownership to family members who are employed at the firm). It can also further alleviate Agency Problem III by establishing (fair) rules under which family members can act as creditors to the firm (which in the extreme would eliminate the distinction between shareholders and debtholders). Of course, if the board is weak and fails to counterbalance the interests of the family at large with those of the shareholders (family and nonfamily), family governance can worsen many of these problems by formalizing and legitimizing policies that may benefit family outsiders at the expense of the firm and its shareholders.

Instead of, or in addition to, the family council, some business families have a shareholders' or owner's council, which serves as a discussion forum and as the decision-making body regarding policies and agreements that are of sole concern to family shareholders, such as shareholders' agreements and dividend policies to be proposed to the board.

The family constitution is a written and morally binding agreement among family members that articulates the family's core values, mission, and vision for itself and the family enterprise (including the family firm), and which defines the policies, rules, and agreements that regulate how the family will relate to the firm—as employees, owners, and family members. The constitution is typically drafted by the family council or ad hoc task forces and is discussed and approved by the broader family assembly. Davis (2002) reviews the topics typically covered by a family constitution. To the extent that the firm and many nonfamily stakeholders are also affected by these rules and policies, many of these topics need to be reviewed and endorsed by the board of directors. Topics that restrict or relate to shareholders' legal property rights over their shares not only require board approval but are also frequently carved out into a separate document—the shareholders' agreement—which, unlike the constitution, is legally binding.

Amit & Perl (2012), Van der Heyden, Blondel & Carlock (2005), and Ward (2010) point out that the effectiveness of family governance mechanisms is critically dependent on the process, even more so than on the actual content, due to the importance of fairness perceptions among family members.

4. SUGGESTED AVENUES FOR FUTURE RESEARCH

Above we review the financial economics literature about the four agency problems to which family firms are exposed and the solutions to them. We find an important number of papers about the conflicts of interest between shareholders and managers and between controlling (family) shareholders and other shareholders, but much less research analyzing the conflict between shareholders and creditors, and nothing about the conflict between family shareholders and the family at large and about the family governance mechanisms that exist to mitigate this problem. We believe this problem and its solutions deserve more attention from the financial economics field and can bring much-needed rigor to its analysis. More generally, we suggest that future research about corporate governance mechanisms should adopt a holistic view of the agency problems to which family firms are exposed and analyze the repercussions of each mechanism on agency problems beyond the one they were originally designed to solve.

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