The Bright Side of Nepotism: Market Frictions and Managing Family Firms in Uncertain Environments

Ulya Tsolmon

Washington University in St. Louis

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Abstract

Using the market frictions logic, we examine how multi-unit family firms manage heterogeneous units by redeploying family managers to units with greater exposure to opportunism. We conceptualize how family managers can extend family control to units where familial relationships are an important resource. Using a novel data set of over 6,000 multi-unit family firms in 15 European countries, we find that diversified, partly owned, and geographically distant units are more likely to be allocated family managers, especially in regions where institutions are weak. We also find that firms are more likely to send family managers in response to exogenous shocks that increase frictions, especially where institutions are weak. We discuss the implications of our findings on how the contingency view of nepotism can shed light on the conditions under which family firms can gain a competitive advantage by leveraging familial relationships.

Introduction

Family firms, defined as entities owned, controlled, and managed by families, are a prevalent and reportedly the most common organizational form around the world (Anderson & Reeb, 2003; Feldman, Amit, & Villalonga, 2016). Nepotism—the hiring of family members within the top management teams—is a well-documented phenomenon in family firms (e.g., Chen, Chittoor, & Vissa, 2021; Chang & Shim, 2015; Miller, Minichilli, & Corbetta, 2012; Villalonga & Amit, 2006). Who to delegate to manage different units—family or non-family managers—is an important decision in family firms. However, whether family managers are a valuable resource and under what conditions remains an open question as the literature has not reached a theoretical or empirical consensus.

On the one hand, family managers are considered to be important for the management of family firms, because familial relationships and social capital can facilitate the development and transfer of tacit knowledge between family members (Le Breton-Miller & Miller, 2015), the development of long-term relationships with key family firm external stakeholders (Acquaah, 2012), and the extension of family's strategic and operational control (Luo & Chung, 2013). On the other hand, the literature also highlights the "dark side" of family management: family managers' inaptitude can negatively affect firm performance (Bloom & Van Reenen, 2007; Perez-Gonzalez, 2006), and family firms may prioritize the preservation of their socioemotional wealth (SEW)—the stock of non-economic utilities family owners derive from family's control, identity, and emotional ties—at the expense of financial gains when appointing family members as managers (Gomez-Mejia et al., 2007; Schulze et al., 2001).

The lack of consensus in the literature is largely due to a dearth of research on how family manager assignments are made (Firfiray et al., 2018; Jeong et al., 2022). Most studies on family managers have focused on CEO succession of family members (e.g., Chang & Shim, 2015; Calabro et al., 2018) and have largely overlooked the assignment of family-related managers to other top management roles and units. Also, studies have focused on external contingencies, such as emerging markets, industry characteristics, and external stakeholders, under which familial ties may or may not be valuable (e.g., Acquaah, 2012; Luo & Chung, 2005; 2013).

In this study, we open the black box of family manager assignments by examining *unit-level allocation* of family managers within multi-unit firms *across* institutional environments and focusing on *internal* contingencies. We use the market frictions logic to examine the conditions under which family managers can be valuable (Belenzon & Tsolmon, 2016; Mahoney & Qian, 2013). Internal frictions, such as asymmetric information and opportunism, can increase coordination, monitoring, and opportunity costs within multi-unit firms (Williamson, 1985). Hence, we propose that family managers can be valuable where familial relationships can alleviate internal frictions: in units more prone to imperfect and asymmetric information and where the risk of managerial opportunism is higher. Because internal frictions are expected to be accentuated in units operating in regions with weak institutions, we expect family managers to be allocated to these units.

We utilize cross-country data on 6,855 family firms and provide robust empirical evidence for the role of unit-level characteristics and institutional environment in jointly driving family manager appointments. We examine how family relationships are leveraged to increase family firms' control over units that are distant and more difficult to control especially in regions with weaker institutions, and how these relationships are utilized to manage environmental shocks that threaten the financial standing and control of the family. We find that family managers are most likely to be appointed to diversified, partly owned, and geographically distant units if they are operating in regions with weak institutions. Moreover, family firms tend to send their family managers to units hit by disruptions caused by labor disputes in their industry or technical and

natural disasters in the region. However, family managers are less likely to be deployed to regions that have experienced terrorist attacks, which points to the boundary conditions of family manager deployment as families are reluctant to send family managers in harm's way.

This study contributes to the following streams of work. First, it answers the call for understanding contingencies under which nepotism in the top management can provide advantages to family firms by developing a theory and empirically testing the predictions (Firfiray et al., 2018; Jeong et al., 2022). We build on Firfiray et al.'s (2018) proposal that to better understand whether nepotism can contribute to competitive advantage of family firms, it is important to unpack environmental and institutional contingencies under which family-related managerial resources can be valuable. Second, this study contributes with the data. We utilize cross-country data and track managerial assignments over time. We provide robust empirical evidence for how family firms respond to external shocks that increase uncertainty by deploying family managers to these units. Third, this study contributes to the managerial deployment literature by highlighting another dimension of how managers can contribute value—through their relationships, trustworthiness, and loyalty.

Theoretical Framework

Using the extant theory, we propose the following conceptual analysis of costs and benefits of allocating family managers to different units by strength on institutions.

Effects of Allocating Family Managers on Firm Performance		
	Weak Institutions	Strong Institutions
Units with Low Frictions	Formal controls are costly (+) Relationships are valuable: trust, social capital (+) Tunneling and corruption (-)	Stigma of nepotism (-)
Units with High Frictions	Formal controls are costly (++) Relationships are valuable: trust, social capital (++) Tunneling and corruption (-)	Relationships are valuable: trust, social capital (+) Stigma of nepotism (-)

Hypothesis 1: Units that have high internal frictions are more likely to have a family manager than units that have low internal frictions.

Hypothesis 2: The likelihood of units with high internal frictions to have a family manager is greater in regions with weak institutions than in regions with strong institutions.

Hypothesis 3: When environmental shocks increase internal frictions, units are likely to be allocated family managers in response to these shocks.

Data and Methods

We used Bureau van Dijk's (BvD) Amadeus database to extract information on top management, ownership, and financial data for both private and public family firms in 15 Western European countries

between 2002 and 2007.[1] BvD standardizes financial and management information across the different filing requirements of each country and provides comprehensive data on firms of different sizes. We define family firms using the common definition in the literature that is based on whether the family is the largest shareholder (e.g., Luo & Chung, 2013) or holds a controlling share of voting rights (20-50%) (e.g., Faccio & Lang, 2002).

We focused on family-owned corporate groups and managers of their affiliates. A common organizational structure in Europe, a corporate group is an organization composed of at least two legally independent firms controlled by the same ultimate shareholder (Almeida & Wolfenzon, 2006; Belenzon & Berkovitz, 2010). The legal definition of a corporate group in Europe relies on the concept of control, obtained through ownership or the majority voting rights and power required to appoint and remove the majority of a firm's administrative, management, and supervisory bodies (Seventh Council Directive 83/349/EEC). In this study, we examined the internal allocation of managers within corporate groups as multi-unit firms and between its affiliates as internal units.

Our estimation sample consisted of 24,629 firms belonging to 6,855 groups. There are two key advantages to using these data for our study. First, they provided detailed information on firms' internal structure and allowed us to track managerial moves between units. We could observe the firm's ownership structure, degree of diversification, geographic distance, and the institutional environments units in which they operate. Second, we could exploit between- and within-country variation in the institutional environment by identifying the quality of institutions and exogenous shocks to uncertainty by regions within countries.

Variable Definitions

Dependent Variables

Family Managers. Family managers are managers that have the same last name as the controlling family.

Family Manager Mobility. The probability of a unit receiving a family manager, conditional on redeployment. The indicator variable for each unit, *Family Manager Mobility*, equals 1 if a unit received a new family manager and 0 if the unit received only non-family manager(s).

Independent Variables

Diversification. We measured the diversification of a unit using a fraction of the group's sales generated in the same industry from the focal affiliate. An affiliate is considered diversified the greater the share of their group sales in a different three-digit SIC from the affiliate (excluding the focal affiliate's sales). The smaller the group's share of sales for the industry it is operating in (again, excluding the focal affiliate's sales), the more diversified a unit is.

Partial ownership. We identified a controlling shareholder in a private firm if the shareholder owns more than 50% of the firm's voting rights (excluding non-voting shares). Following La Porta et al. (1999) and Faccio and Lang (2002), we set this threshold at 20% for public firms since these firms usually have more dispersed ownership. We classified an affiliate as partly owned if non-controlling (minority) shareholders own some equity in the affiliate. Wholly owned affiliates are those that do not have minority shareholders. We constructed a Partial Ownership variable, which equals the share of equity held by minority shareholders. The higher the share, the less control a firm has over the unit.

[1] The countries are Austria, Belgium, Denmark, Germany, Finland, France, Great Britain, Greece, Ireland, Italy, Netherlands, Norway, Spain, Sweden, and Switzerland.

Geographic distance. We measured the geographic distance for each unit using log miles from the headquarters.

Governance quality. To measure the quality of formal institutions, we used the Worldwide Governance Indicators (WGIs) from the World Bank Group (Kaufmann, Kraay, & Mastruzzi, 2010). The indicators are based on the survey responses from many business information providers, non-governmental organizations, public sector providers, and households in over 200 countries. The indicators include six dimensions of governance for each country and year: government effectiveness, voice and accountability, political stability, regulatory quality, the rule of law, and control of corruption. We followed Zhou (2015) in constructing the WGI variable by taking the average values across the different dimensions of governance for the year 2002. Higher WGI values indicate better governance quality. We used measures for the strength of informal institutions as alternative measures for robustness checks.

External Shocks to Uncertainty

We exploited within-country and industry variations to determine whether firms deploy different managers when there are changes in environmental uncertainty. We examined the effects of industrial labor disputes on subsequent managerial deployment to those units. Analyses of technological accidents and disasters, natural disasters, and terrorist attacks can be found in the robustness section.

Labor disputes. The incidence of labor disputes in the industry may trigger a propensity in firms to send trusted managers to the unit to manage and prevent labor disputes (Jansen, 2014). Labor disputes in the industry can increase monitoring costs and heighten opportunism in the unit as incentives can diverge during disputes. Strikes are known to be contagious (Biggs, 2005; Jansen, Sluiter, & Akkerman, 2016), so any disputes in the industry must be managed even if a focal firm is not involved in labor disputes. Firms must renegotiate with unions and work councils, and the success of these negotiations hinges on employee-management relationships. Effective labor dispute prevention and management can have huge firm performance implications (Kleiner, Leonard, & Pilarski, 2002; Krueger & Mas, 2004).

We used data on strikes and lockouts from the International Labour Organization (ILO) of the United Nations, which collects annual statistics on industrial labor relations for over 100 countries at the industry level. The ILO defines an industrial labor dispute as "a state of disagreement over a particular issue or group of issues over which there is conflict between workers and employers." Specifically, we used data on strikes and lockouts: a strike is "a temporary work stoppage effected by one or more groups of workers with a view to enforcing or resisting demands or expressing grievances," and a lockout is "a total or partial temporary closure of one or more places of employment, or the hindering of the normal work activities of employees, by one or more employers with a view to enforcing or resisting demands or expressing grievances." For each industry at the two-digit SIC level, country, and year, we constructed a Labor Disputes variable by taking the natural logarithm of the number of strikes and lockouts, excluding the incidences involving the focal firm.

Control Variables

Our regressions control for firm-, industry-, and country-level characteristics that could affect the propensity of managers to move to different units.

Firm-level controls. We derived all firm-level controls from our data set. We controlled for affiliate and group characteristics. We controlled for the firm *Age* (year of incorporation), firm *Employment Size* (natural log of number of employees) and firm *Sales* (natural log of total annual sales). At the group level, we controlled for the total *Group Sales* (natural log of total annual sales of the group) and *Group Size* (the natural log of the number of affiliates in the group).

Industry-level controls. We included a full set of three-digit SIC indicators of the unit to account for industry-specific factors that might influence the propensity of firms to deploy managers.

Region- and country-level controls. We controlled for regional factors that may be correlated with the institutional environment and/or the propensity of managers to be deployed there. The within-country regions are identified at the two-digit NUTS level.[2] We included the Regional GDP and Population variables for each region. We also included country-level controls for the ultimate owner to account for cross-country variation in the propensity to deploy managers.

Empirical Specification

$$\Pr\left(FamilyManager_j\right) = F(\alpha_1 Unit\ Type_j + \alpha_2 GovernanceQuality_c + \alpha_3 Unit\ Type_j \times$$

$$GovernanceQuality_c + X_j'\alpha_4 + Z_g'\alpha_5 + \gamma_s + \varphi_i + c_g + \varepsilon_j. \qquad (1)$$

where j denotes the unit, g denotes the corporate group; s indexes regions; X is a vector of firm-level control variables (age, size, and sales) in the preceding year; Z is a vector of group-level control variables (sales and size); γ_s, φ_i, and c_g are complete sets of (respectively) regional, industry, and country dummies; and ε_j is an independent and identically distributed (i.i.d.) error term. $FamilyManager_j$ is an indicator variable that equals one if a unit has a family manager and zero if a unit does not have a family manager. $Unit\ Type_j$ is a continuous variable that represents different characteristics for unit j: *Diversification*, *Partial Ownership*, and *Geographic Distance*.

We expected units to be allocated family managers if they are diversified, partly owned, and geographically distant (Hypothesis 1), especially if they are located in regions with low levels of governance quality: $\hat{\alpha}_3 > 0$ (Hypothesis 2). The standard errors are clustered at the group level to allow the error term to be correlated across units and managers of the same corporate group.

$$\Pr\left(FamilyManagerMobility_{jt}\right) = F(\beta_1 Shock_{it} + \beta_2 Post_{jt} + \beta_3 Shock_{it} \times Post_{jt} + X_{jt-1}'\beta_4 + Z_{gt-1}'\beta_5 +$$

$$\gamma_s + \varphi_i + c_g + \tau_t + \varepsilon_{jt}\,, \qquad (2)$$

where j denotes the unit, g denotes the corporate group; s indexes regions; t denotes year; X is a vector of firm-level control variables (age, size, and sales) in the preceding year; Z is a vector of group-level control variables (age, sales and size) in the preceding year; γ_j, φ_j, c_j, and τ_t are complete sets of (respectively) regional, industry, country and year dummies; and ε_j is an independent and identically distributed (i.i.d.) error term. $FamilyManager_{jt}$ is an indicator variable that equals one if a unit j receives a redeployed manager and equals zero if the unit does not receive a redeployed manager. $Shock_{it}$ denotes any Labor Disputes in the industry i of unit j in the preceding year. $Post_{jt}$ is the period after the shock.

We expected $\hat{\beta}_3$ to be positive if family managers are sent to the units experiencing environmental uncertainty, and this effect should be even stronger in regions where institutions are weak (Hypothesis 3). The standard errors are clustered at the group level.

[2] The NUTS classification (Nomenclature of Territorial Units for Statistics) is a hierarchical system used to divide up the geographic territory of the European Union by major socio-economic regions (Eurostat, 2011). The classification of regions at the two-digit NUTS level is analogous to the Metropolitan Statistical Area (MSA) system in the United States.

Results

Table 1. Summary Statistics

Table 1. Summary Statistics and Correlations between Main Variables

		Mean	S.D.	1	2	3	4	5	6	6	8	9	10
1	Family Manager	0.292	0.455	1									
2	Diversification	0.300	0.356	0.021	1								
3	Partial Ownership	0.231	0.248	0.006	-0.032	1							
4	Geographic Distance (log)	4.843	3.527	-0.116	0.192	-0.040	1						
5	Governance Quality	1.277	0.171	0.119	-0.085	-0.142	-0.103	1					
6	Firm Age (log)	3.112	0.813	0.000	-0.05	-0.03	0.043	0.048	1				
7	Firm Employment (log)	2.711	1.326	-0.023	-0.102	0.048	0.191	-0.079	0.182	1			
8	Firm Sales (log)	7.861	1.395	-0.024	-0.139	0.074	0.198	-0.063	0.207	0.780	1		
9	Group sales (log)	9.336	2.052	-0.032	0.455	-0.027	0.431	-0.150	0.070	0.439	0.522	1	
10	Number of units (log)	1.298	0.904	-0.048	0.519	-0.078	0.468	-0.099	0.023	0.236	0.240	0.836	1

Notes: Correlations greater than |+/-0.005| are significant at the 0.05 level. N=24,629.

Table 2. Units with high frictions have family managers, especially where institutions are weak.

Dependent variable: Indicator for Unit Having a Family Manager. Linear Probability Model.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Hypothesis	H1		H2	H1		H2	H1		H2
Unit Characteristics	Diversified			Partially Owned			Geographical Distance		
Unit Type	0.080	0.085	0.819	0.008	0.039	0.290	-0.010	-0.009	0.042
st error	(0.013)	(0.013)	(0.075)	(0.013)	(0.013)	(0.094)	(0.002)	(0.002)	(0.010)
p-value	0.000	0.000	0.000	0.520	0.003	0.002	0.000	0.000	0.000
Governance Quality		0.353	0.517		0.347	0.377		0.281	0.462
st error		(0.021)	(0.024)		(0.021)	(0.024)		(0.030)	(0.047)
p-value		0.000	0.000		0.000	0.000		0.000	0.000
Unit Type x Governance Quality			-0.578			-0.199			-0.040
st error			(0.059)			(0.074)			(0.008)
p-value			0.000			0.007			0.000
Firm Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Regional Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.029	0.044	0.049	0.028	0.043	0.043	0.060	0.067	0.069
Observations	24,629	24,629	24,629	24,629	24,629	24,629	14,254	14,254	14,254

Notes: This table reports the results of linear probability regressions that examine the probability of a unit having a family managers. Firm controls include *Firm Age*, *Firm Employment Size*, *Firm Sales*, *Group Sales*, and *Group Size*. Regional Controls include *Regional GDP* and *Population*. Standard errors (in parentheses) are clustered at the group level.

The results reported in Table 2 suggest that family managers are likely to be allocated to diversified units (column 1), but no more likely to be allocated than non-family managers to partially owned units (column 2), and less likely to be allocated to geographically distant units (column 7). The results provide partial support to Hypothesis 1. However, in units located in region with weak institutions, family managers are more likely to be allocated to units that are diversified, partly owned, and geographically distance (columns 3, 6, and 9). These results provide support to Hypothesis 2.

Table 3. Units are more likely to receive a family manager after an environmental shock, especially in regions with weak institutions.

Dependent variable: Indicator for Family Manager Mobility. Linear Probability Model.			
	(1)	(2)	(3)
Hypothesis	H3	H3	H3
	All	Low WGI	High WGI
Shock x Post	0.015	0.018	0.003
st error	(0.002)	(0.003)	(0.003)
p-value	0.000	0.000	0.325
Shock	-0.001	-0.001	0.006
st error	(0.001)	(0.001)	(0.003)
p-value	0.329	0.804	0.074
Post	-0.014	-0.015	-0.001
st error	(0.001)	(0.001)	(0.007)
p-value	0.000	0.000	0.856
Firm Controls	Yes	Yes	Yes
Group fixed effects	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes
Country fixed effects	Yes	Yes	Yes
R^2	0.208	0.168	0.559
Observations	24,981	16,114	8,867

Notes: This table reports the results of linear probability regressions that examine the relationship between managerial mobility in response to environmental shocks. The estimation sample is a panel data. *Family Manager Mobility* is an indicator variable that equals one if a unit received a family manager, conditional on mobility, and equals zero if a unit received a non-family manager. *Shock* is a natural logarithm of the number of strikes and lockouts in the unit's industry and region that year, exlcuding the focal unit. Firm controls include Firm Age, *Firm Employment Size, Firm Sales, and Family Manager Presence*. Standard errors (in parentheses) are clustered at the group level.

The results reported in Table 3 suggest that units that are hit by exogenous shocks are more likely to be deployed family managers, especially if units are located in regions with weak institutions. These results provide support for Hypothesis 3.

When using natural and technical disasters as alternative measures of shock, we get similar results: family managers are deployed to the units in regions with weak institutions. However, when we use terrorist attacks as a chock in the region, we see the opposite result: family managers are less likely to be sent to units in regions hit by terrorist attacks especially if institutions there are weak. These results suggest the boundary conditions of family manager deployment. Family managers are not sent to where there is a chance of bodily harm.

Conclusion

This study examines the role of family managers in dealing with internal frictions stemming from asymmetric information and opportunism in multi-unit family firms. We examine how family relationships are leveraged to increase family firms' control over units that are distant and more difficult to control especially in regions with weaker institutions, and how these relationships are utilized to manage environmental shocks that threaten the financial standing and control of the family. We find that family managers are most likely to be appointed to diversified, partly owned, and geographically distant units if

they are operating in regions with weak institutions. Moreover, family firms tend to send their family managers to units hit by disruptions caused by labor disputes in their industry or technical and natural disasters in the region. However, family managers are less likely to be deployed to regions that have experienced terrorist attacks, which points to the boundary conditions of family manager deployment as families are reluctant to send family managers in harm's way. The study sheds light into the black box of family manager allocation and provides a conceptual framework and robust empirical evidence for conditions under which family managers may contribute most value.

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