Family Ties Help When Firms Go Bust

By Massimo Massa , The Rothschild Chaired Professor of Banking and Professor of Finance at INSEAD

When their business goes into distress, family firms have more than money at stake. Does this place them in a better position to manage their way out of trouble?

When General Growth Properties (GGP), the second largest U.S shopping-mall manager filed for bankruptcy in April 2009, after amassing US$27 billion in debt during an acquisition spree, its directors were faced with the choice between a US$10bn takeover offer from Simon Property Group, a leading competitor, and a US$2.6bn equity infusion from Brookfield Asset Management, a Canadian investment firm.

The board was split. While one half (controlled by descendants of the firm's founders) preferred an offer from the investment firm, the other half (controlled by hedge fund investors) favoured the offer from the strategic bidder. It was the setting, as real-estate analyst Jim Sullivan noted in the ***Wall Street Journal***, for some very interesting board discussions.

Anecdotal evidence like the one above suggests that different types of large shareholder blocks view bankruptcy proceedings very differently. Institutional investors and professional asset managers, motivated by the need for a purely financial resolution, are looking for ways to minimise their loss. Families, however, have a more complicated set of priorities. There are the emotional ties to consider (with the firm and its employees), as well as their reputation and family name and, in many situations, a larger proportion of personal wealth.

Influence and control

Because of their long-standing ties with the company, family blockholders tend to have closer relations with the management team giving them greater influence during bankruptcy proceedings, a time when most equity holders lose their ability to control the firm. They are also more likely to inject new equity capital during this period. Which raises the question, are family companies more incentivised and better positioned to achieve more effective, faster and hence less costly results? And, if so, is this recognised by minority shareholders, lenders and other stakeholders?

In search of answers, Alminas Zaldokas, Assistant Professor of Finance at the Hong Kong University for Science and Technology, and I looked at two alternative hypotheses in our paper **Bankrupt Family Firms**. The first being, that families are more effective at handling bankruptcy due to the combination of financial and non-financial motivations. Under this theory, purely financial (i.e. non family) block owners are seen as less likely to have an emotional attachment to the firm, and being more diversified, are less disturbed by the failure of one of their portfolio companies. They are also less concerned about retaining management of the company and may delay the bankruptcy process (and escalate the cost) by going "forum shopping" for a jurisdiction in the hope of a more favourable resolution that would help the value of the firm exceed the debt.

The contrasting posit proposes that families, by trying to retain control of an efficient firm, squander time and precious resources leading to a slower and less effective bankruptcy resolution and lower recovery rates for minority shareholders and lenders.

Well-recognised benefits of family control

We **tested** both hypotheses on a sample of public U.S. corporations between 2001 and 2008. The sample included family firms, institutional block-held firms and firms without a significant blockholder. The analysis revealed that family firms were, indeed, less engaged in “forum shopping”, emerged from bankruptcy faster and had higher recovery rates on debt. In fact, family block ownership was related to a 32 percent faster exit from bankruptcy (taking on average 446 days) and a 12 percent higher recovery rate for lenders (with an average recovery of 48 percent). An examination on whether this higher effectiveness in managing bankruptcy was linked to a higher probability of continuing ownership by the blockholder post-bankruptcy, found that the larger the family-holding, the higher the likelihood the company had of retaining ownership.

And it seems that minority shareholders and lenders appreciate this position. Following the bankruptcy announcement, the stock price of firms with large family control dropped less than other types of block ownership.

This has ramifications ex ante, with analysis suggesting that given the higher efficiency of family blockholders in bankruptcy procedures, debt holders are willing to lend at lower interest rates.

The double incentive

In general, block ownership is perceived negatively when it comes to bankruptcy, with controlling shareholders often seen as making decisions to minimise their own loss. However evidence suggests that the structure of the family firm and this double incentive (monetary and emotional) to stay out of bankruptcy place it in a better position to minimise loss.

In the case of GGP, the family shareholders won out and, despite the urging from institutional block investors, rejected the Simon bid, and finalised a deal with Brookfield Asset Management. Upon exiting bankruptcy in November 2010, a new restructuring plan provided a full recovery for GGP creditors and an allocation of US$5.2 billion equity to the firm’s 3,000 shareholders; a rare result for any bankruptcy re-organisation.

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