VARIANTS AND TRANSFORMATIONS OF AGENCY COSTS IN MANAGEMENT BUY-OUTS AND BUY-INS OF FAMILY FIRMS

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ABSTRACT

We compare the agency costs of family firms prior to a sale to outside parties with the agency costs after a management buy-out MBO or buy-in MBI by non-family investors. The agency costs of a family firm before a sale influence firm value and the potential changes in agency costs after a sale influence the ability of an MBO or MBI to improve firm profits. In transitions from family to non-family ownership, post-sale agency costs are path dependent and contingent. We present a framework and propositions detailing pre- and post-sale agency issues as they affect firm value and profits.

Keywords: Agency costs, Altruism, Family business, Management buy-outs, Management buy-ins, Owner-manager transitions.
VARIANTS AND TRANSFORMATIONS OF AGENCY COSTS IN MANAGEMENT BUY-OUTS AND BUY-INS OF FAMILY FIRMS

A firm may perish quickly or exist indefinitely, but all firms that survive for any length of time must eventually confront the challenges of ownership and management transitions (Steier, 2005; Wasserman, 2003). Such transitions are critical to a firm’s long-term survival and success but are particularly difficult because they require executives and organizational stakeholders to adjust to new strategies, roles, routines, and relationships (Steier, 2005). Management buy-outs (MBO) and management buy-ins (MBI), two types of these ownership and management transitions, focus on the purchase of a firm by a group of managers (Robbie & Wright, 1995). Generally assessed in terms of financial success or failure (Contardo & Angwin, 2002), the performance of a management buy-out or buy-in can be examined through the lens of agency theory (Jensen & Meckling, 1976), as performance may be influenced by the alignment of ownership and management. This paper builds upon earlier work to further examine how agency costs influence the financial performance of management buy-outs and buy-ins.

A management buy-out occurs when the incumbent management of a business acquires a majority stake, while a management buy-in occurs when external investors purchase the company and take over its management (Robbie & Wright, 1995; Wright, Thompson, Robbie, & Wong, 1995). Research on management buy-outs and buy-ins considers both publicly and privately held firms, but generally overlooks the purchase of family-owned businesses. However, family business transitions are an important area in which to examine management buy-outs and buy-ins, as an estimated 65-80% of all businesses are family businesses (Chua, Chrisman, & Chang, 2004; Gersick, Davis, Hampton, & Lansberg, 1997; Tagiuri & Davis, 1996). Owing to their management and ownership composition prior to a buy-out or buy-in,
family businesses offer an interesting avenue to assess the post-sale performance of management buy-outs and buy-ins.

Given that intra-family succession is considered the most important issue facing family firms and is the most researched family business topic (Chua, Chrisman, & Sharma, 2003), it is surprising that the primary alternative option – a sale of the firm to individuals outside the family – has not received more attention in the literature. However, only a very few studies have addressed MBOs and MBIs in a family firm context (Howorth, Westhead, & Wright, 2004; Howorth, Wright, & Westhead, 2007; Scholes, Wright, Westhead, Burrows & Bruining, 2007). Owing to the number and importance of family firms in most economies (Chrisman, Chua, & Steier, 2005), the fate of those that survive but do not remain under the control of the founding family is an issue of great theoretical and practical importance. Indeed, in some countries measures have been introduced to facilitate management buy-outs of family firms (Heuze, 1991). Such buy-outs account for upwards of 40% of the buy-out market and amount to several hundred transactions per year across Europe alone (CMBOR, 2008; Achleitner et al., 2008).

The success or failure of the firm both before and after the sale is dependent upon a number of factors such as environmental conditions, strategy, governance, and organizational structure, systems, and culture, and the extent to which stakeholders are able to appropriate rents (Coff, 1999; Porter, 1980). One of the most important of these factors is a firm’s agency costs (Meuleman, Amess, Wright, & Scholes, 2009). In this paper we focus on a comparison of the potential sources of agency costs of family-controlled firms before and after a sale to non-family owners through an MBO or MBI and how differences in agency costs influence performance, which is defined in this paper as return on investment (ROI). We focus on family firms because of their importance in the world economy (Chrisman et al., 2005) and because pre- and post-sale
agency issues are likely to diverge owing to the very different agency concerns of family and non-family firms (Chrisman, Chua, & Litz, 2004; Schulze, Lubatkin, Dino, & Buchholtz, 2001). Since these costs will materially affect expected and actual cash flows, they will influence valuations and the subsequent ability of a firm to cover its cost of capital (Jensen & Meckling, 1976). Thus, an appreciation of potential pre- and post-sale agency costs is of theoretical and practical importance in understanding and predicting when a family firm might be sold and for how much. Furthermore, neither family firms before a sale, nor non-family firms post-MBO or MBI, are likely to be homogeneous in terms of their ownership and management structures (Weir, Laing, & Wright, 2005). Thus, it will be useful to understand the various permutations and combinations of ownership and management that are possible.

This paper contributes to the literature by providing an accounting of the sources of agency costs in family firms prior to an outside sale as compared to the agency costs of the resulting non-family firms after an MBO or MBI. Propositions are developed on how different configurations of agency problems might influence firm performance after it is sold to non-family investors. By highlighting the “variants of agency contracts” pre- and post-sale (Steier, 2003) as well as the path dependencies that occur between the situations of the buyer and seller we gain a better appreciation of the complexities associated with MBOs and MBIs of family firms. Family and non-family firms are often treated as homogeneous populations in the literature with little within-group variations in agency costs. Through our agency cost accounting and classification we illustrate the fundamental fallacy of such an assumption.

In the following sections we briefly outline management buy-outs and buy-ins, followed by a discussion of the causes and types of agency problems as they apply to family firms and
MBOs and MBIs. We then apply these concepts to different owner-manager configurations prior to and following the sale of a family firm to outside parties.

**MBO/MBIs, AGENCY COSTS, AND FAMILY FIRMS**

Management buy-outs and buy-ins have become a popular form of organizational acquisition internationally over the past 30 years (Green, 1992). MBO/MBI teams can vary in size, but the average is estimated to be approximately four senior managers (Wright, 1986). Generally, the literature has focused on leveraged buy-outs of listed corporations (Cumming, Siegel & Wright, 2007; Kaplan, 1989; Renneboog, Simons & Wright, 2007), state owned firms (Wright, Chiplin, & Robbie, 1989) or divisions of large diversified companies (Wright, Wilson, Robbie, & Ennew, 1996; Stromberg, 2008). However, only a few studies have examined the purchase of smaller private family and non-family organizations (Howorth et al., 2004, 2007; Scholes et al., 2007).

When the owner-manager of a family firm decides to step down, decisions regarding ownership and management succession must be addressed. Typically, it is assumed in the literature that transitions will involve intra-family ownership and management succession. However, there are a variety of factors associated with the ability and intentions of individual family members, family relationships, strategic context, finances, and transition processes that might make intra-family succession impossible or undesirable (DeMassis, Chua, & Chrisman, 2008). Indeed, the conventional wisdom is that only about 30% of all family firms are successful in making the transition to the second generation and only about 10% make it to the third generation (Ward, 1997).

Assuming liquidation is out of the question, when the sale of a family firm becomes necessary or potentially desirable the issue becomes whether a buyer can be found who is willing
to pay a price that meets or exceeds the family’s estimate of the market value of the firm (Scholes et al., 2007) plus any premium the family might seek for foregoing the socio-emotional value of retaining family control (Gómez-Mejia, Hynes, Nuñez-Nickel, & Moyano-Fuentes, 2007). For a privately-owned family business, management buy-outs and management buy-ins are among the most important alternatives for selling a firm outside the family. Scholes et al. (2007) suggest that management buy-outs or buy-ins represent the sell-out options most likely to allow a family firm to retain some of its original identity after the sale. Fiegener (2009) has also noted that many firms retain at least a little ‘familiness’ even after substantial ownership has been transferred to outsiders. It is even possible that some family members may continue to be employed in the firm after an MBO or MBI (Howorth et al., 2004). In considering options for transitioning to new ownership, the likelihood of preserving some of the original firm identity and providing continuing employment for some family members may increase the desirability of buy-outs or buy-ins in comparison to other selling options such as trade sales or initial public offerings (Scholes et al., 2007).

One key question in the study of buy-outs and buy-ins is whether or not they will be successful (Contardo & Angwin, 2002). A good deal of the literature on MBO/MBI failure focuses specifically on leverage and the long term role that debt can play (Citron, Robbie, & Wright, 1997). However, the agency costs assumed by the management team after the purchase will also play an important role in determining whether or not the MBO/MBI will succeed or fail (Wright et al., 1996). As such, in order to examine the potential success of a buy-out/buy-in of a family firm, it is imperative to understand the agency costs that are specific to the family firm pre-sale and how these will affect the MBO or MBI after the sale.

**Agency Costs**
Agency problems can exist in any type of cooperative relationship among two or more individuals (Jensen & Meckling, 1976). However, agency theory is typically used to articulate the potential problems that occur between two parties who establish a contractual relationship that requires an agent to perform a set of tasks or behave in a certain way for a consideration, usually monetary, on behalf of a principal. Owing to bounded rationality, conflicts of interest, and information asymmetries, principals must guard against opportunistic behavior on the part of agents who may not always act in the principals’ interests. The costs of guarding against opportunistic behavior, as well as the cost of unpreventable opportunistic behavior, have been labeled agency costs (Jensen & Meckling, 1976). Agency problems between owners and managers have received the most attention in the literature (Eisenhardt, 1989), but those arising between borrowers and lenders (Myers, 1977) and between minority and majority owners (Morck, Shleifer, & Vishny, 1988) have also been studied.

Agency problems can be controlled by minimizing conflicts of interest between the principal and agents or by monitoring agents’ behavior. MBO/MBIs are usually expected to reduce the agency costs associated with diffuse ownership in listed corporations (Jensen, 1986) or in divisions of large complex organizations (Wright, 1986) because they realign owner and management. Significant equity ownership by managers, introduced as a result of the buy-out, provides incentives to reduce costs and seek profitable growth opportunities (Jensen, 1986). Tighter financial monitoring and control may occur, particularly when executives of active private equity firms make direct investments in the buy-out because such investors typically take board seats and require substantially more detailed and regular information than would be available to investors in a listed corporation. Private equity investors are also able to insert conditions in the shareholders’ agreement (or Articles of Association or Corporate Charter)
which gives them the power to veto or approve certain actions taken by management (e.g., capital expenditure above a certain level, acquisitions, disposals, etc.). Lenders may also insist on and monitor specific covenants relating to the provision of debt (e.g., minimum levels of cash flow/interest ratios), which constrain the behavior of managers who must focus on generating sufficient cash flow to pay down the debt and avoid bankruptcy (Citron et al., 1997; Citron, Wright, Ball & Rippington, 2003; Citron & Wright, 2008). The significant external funding required for the acquisition provides managers with the incentive to eliminate unprofitable operations in order to service debt and make fixed dividend payments (Thompson & Wright, 1995). In all, internal and external control systems to monitor behavior and incentives to align interests may come as a natural consequence of a move toward professionalization following an MBO/MBI. However, this does not always prevent agency costs. For example, Wright et al. (1996) found that monitoring did not significantly affect buy-out failure.

Furthermore, the typically presumed agency advantages of an MBO or MBI may not be as pronounced when family firms are purchased since family firms are already expected to have low agency costs. Indeed, the original conception of agency theory suggested that family firms should have few or no agency problems because of the shared interests of principals and agents (e.g., Jensen & Meckling, 1976). However, by applying theories from the household economics literature (e.g., Becker, 1981) to the family firm, Schulze, Lubatkin, Dino, and Buchholz (2001) show that agency problems can still occur under conditions of asymmetric altruism, a situation where a family principal acts in a manner that benefits a family agent at a cost to the business owing to an opportunistic lack of reciprocation from the family agent. Although altruism can benefit the family firm by creating loyalty and commitment among family employees, it can also cause problems of self-control on the part of the owner-manager who is often reluctant to
discipline family managers who shirk, free-ride, or consume prerequisites at the expense of the firm (Lubatkin, Schulze, Ling, & Dino, 2005). In addition, owner-manager, owner-owner, and borrower-lender agency problems also appear to be possible in family firms (Anderson, Mansi, & Reeb, 2003; Villalonga & Amit, 2006). Thus, family firms must potentially contend with agency issues arising from asymmetric altruism as well as the other agency issues found in non-family firms. Taken together, the results of the studies by Schulze et al. (2001), Schulze, Lubatkin, and Dino (2003a, 2003b), Chrisman et al. (2004) and Chrisman, Chua, Kellermanns, and Chang (2007) suggest that small and medium-size family firms have agency costs but these costs are generally lower than in privately held small and medium size non-family firms.

As with any MBO or MBI the potential agency problems that faced previous owners and managers of a family firm may be resolved by new ownership and management. However, the nature of the solution may be more difficult or less apparent because the use of relational contracts based on altruism and the pursuit of non-economic goals may lead to a greater reliance on informal rather than formal control mechanisms in family firms than non-family firms (Chua et al., 2009; Steier, 2003). When this is the case, it is possible, particularly in a MBI, for the new owner-managers to overlook some of the additional costs that will emerge in attempting to establish more formal systems to control agency costs. Therefore, the changes in agency costs prior to and following an MBO or MBI may be somewhat different and more difficult to resolve than what is suggested in the mainstream literature on the subject. Consequently, in the next section we attempt to specify the agency problems facing different types of family firms before exploring the implications of these situations for the MBO or MBI.

Family Ownership Pre-MBO/MBI
As shown in Table 1, family firm ownership can be concentrated, with shares held exclusively by the family owner-CEO or dispersed with shares distributed evenly or unevenly among family members as in sibling partnerships or cousin consortiums (Gersick, Davis, Hampton, & Lansberg, 1997). Mixed ownership of a family firm is also possible. In this case, the family holds majority ownership with one or more non-family members holding a minority interest. In terms of the firm’s management team, excluding the CEO who we assume to be a family member, the possibilities are family management (all managers are family members), non-family management (all managers are from outside the family), or a mix of family and non-family management.

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According to the precepts of agency theory as applied to family firms, asymmetric altruism is a possibility in any pre-MBO/MBI situation where there are both family owners and family managers since CEO-owners have control over the allocation of resources and perquisites and it is assumed that their altruistic tendencies extend only to family managers (Chua et al., 2009; Schulze et al., 2001). By contrast, owner-manager agency problems exist whenever ownership and management are separated (Jensen & Meckling, 1976). In Table 1 owner-manager separation is assumed to exist in every situation except when family ownership is concentrated in the hands of the CEO and the management team is composed entirely of family members. Thus, even when the business is wholly owned by family shareholders, owner-manager agency issues could arise if ownership is dispersed among family members not all of whom belong to the dominant management coalition. Owner-manager agency problems are also
possible in any situation where there are non-family managers and family owners, or non-family owners and either family managers, non-family managers, or mixed teams.

Similarly, whenever the dominant shareholder coalition excludes some shareholders, agency problems between owners such as entrenchment or hold-up (Gomez-Mejia, Nunez-Nickel, Gutierrez, 2001; Morck et al., 1988; Schulze et al., 2003a) can arise even if family members hold all the shares and have equal ownership percentages. It is well-known that when the firm is wholly owned by the family, but ownership is dispersed such as in sibling partnerships or cousin consortiums, conflicts may emerge over issues such as dividends, investments, and executive pay (Gersick et al., 1997). Likewise, owner-owner agency problems may also exist between majority and minority shareholders when ownership is held by a mix of family and non-family shareholders.

It should be noted that borrower-lender issues are not illustrated in the tables, as they may be present in any situation where debt is involved, although the debt structure will undoubtedly be different after an MBO or MBI (Cotter & Peck, 2001); we return to this point in the discussion section. Thus, with every combination of ownership and management pre-MBO/MBI, there are potential agency conflicts.

**A COMPARISON OF POTENTIAL AGENCY COSTS**

While agency costs will exist when the firm is held by the family, the number, size, and combination of these costs are expected to change after ownership passes from the family to the MBO/MBI team. In this section we use an accounting of agency costs approach (Chrisman et al., 2004) to compare the previously discussed agency problems in family firms with those that may emerge if the family decides to exit the business by selling out via an MBO or MBI. Our intention is to illustrate the path dependent and contingent nature of the sources of agency costs
of a family firm prior to and following an MBO/MBI and how variations in agency costs influence performance (ROI). Again, we assume for the purpose of exposition that (1) the CEO is the sole or principal owner of the firm, (2) the CEO of the family firm is a family member, and (3) the CEO following an MBO or MBI is unrelated to the original owning family.¹ We also refer to the managers reporting directly to the CEO as the management team, regardless of any ownership stakes and specify that the team is composed exclusively of family members, non-family members, or some mix of each.

**Non-Family Ownership Post MBO/MBI**

After the entire or majority interest of a family firm is sold to an MBO/MBI team there are agency challenges for the new owners of the firm (Barnes, Davidson, & Wright, 1996) and these may be substantially different from those that existed prior to the transfer of ownership. As shown in Table 2, there are six possible configurations of ownership and management following an MBO or MBI. The possible ownership combinations for the firm are: (1) concentrated non-family ownership by the new CEO; (2) dispersed non-family ownership among the CEO, management team, and/or private equity firm(s); and (3) mixed non-family and family ownership. The difference between mixed ownership before and after an MBO or MBI is that in the former the family has majority ownership while in the latter the family has minority ownership. Finally, the post-MBO/MBI management team may consist entirely of non-family managers or a mixture of non-family managers and managers from the family that originally owned the firm. We consider the possibility of the post-MBO/MBI management team being

¹ Deviations from these assumptions may have a material impact on agency costs pre- or post-MBO/MBI. For example, we assume that private equity firms might or might not be minority shareholders. However, there may be differences in agency costs depending on whether a private equity firm is a majority or minority holder, and these differences may be exacerbated if the investment is syndicated. However, while private equity firms tend to be majority owners for larger buyouts of listed corporations, this is less the case for buyouts involving family firms which generally tend to be smaller (CMBOR, 2008).
composed exclusively of managers from the previously owning family to be extremely unlikely, if not strictly infeasible.²

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**INSERT TABLE 2 HERE**

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It should also be noted that buy-outs, as opposed to buy-ins, can obviously only occur when the original family firm already has a non-family or mixed management team. Of course, after the sale non-family owners will dominate both ownership and management; otherwise it would be more appropriately considered a form of intra-family succession. While buy-outs by family managers are also possible, the resulting firm would still be family owned and managed, although by a different coalition of members of the same family. Furthermore, it is possible, that the buy-in team is another family. However, this would lead to replacing the agency costs associated with the ownership and management of one family with the agency costs associated with the ownership and management of a different family. This would, in effect, result in movement from one of the situations depicted in Table 1 to another, rather than a movement from a situation depicted in Table 1 to one portrayed in Table 2, which is the focus of this paper. Consequently, we do not deal with situations that involve intra-family buy-outs or buy-ins by the members of a different family in this paper.

**From Family Ownership to MBO/MBI**

Considering the possible combinations of ownership and management after the sale of the firm, the most noticeable difference in agency costs is that asymmetric altruism should no longer be possible. Using the understanding of asymmetric altruism as an agency cost in family firms, it follows that this source of agency costs is a direct result of the role the controlling owner(s)

² By definition, these are treated as development or replacement capital transactions as the existing family is essentially taking on new capital for expansion or reallocating its wealth portfolio by releasing some capital (in this case making the family a minority shareholder) and allowing in outside investors.
play in the firm and the family (Schulze et al., 2001). Assuming that family owner(s) act altruistically to all family managers, the agency costs associated with altruism should be higher in teams composed entirely of family members than in mixed teams of the same size. After the MBO/MBI, however, asymmetric altruism should be significantly reduced, if not completely eliminated, even if ownership is mixed among non-family and family shareholders since the former will hold the majority interest and will, by definition, be unrelated to members of the management team. The near or complete elimination of asymmetric altruism should improve the potential profit of the firm (the ROI numerator) after a buy-out or buy-in, because extra expenditures of resources for the benefit of family members and tolerance for shirking and free-riding will be seriously curtailed. This leads to the following propositions:

\[ P1a. \textit{MBO/MBI’s of family firms will reduce the costs associated with asymmetric altruism.} \]

\[ P1b. \textit{For family firms that undergo an MBO/MBI and reduce the costs of asymmetric altruism, there will be an increase in relative performance.} \]

The presence of altruism, whether asymmetric or reciprocal, is also an indication that family firm owners pursue non-economic goals and likely attach socio-emotional value to retaining family control (cf. Gomez-Mejia et al., 2007). However, unlike the agency cost of altruism, socio-emotional value should not vary between family firms with management teams composed of family members as opposed to those composed of both family and non-family managers because in either case intra-family succession and the sustainability of family control are viable. By contrast, the socio-emotional value attached to the family firm in situations where the management team is composed entirely of non-family managers is likely to be lower because this implies a diminished possibility of intra-family succession (DeMassis et al., 2008), thereby reducing the value of sustaining control of the firm across generations. Since non-family
managers have purchased the firm they may be more likely than family managers to see it as a tradable asset.

All else equal, owners that attach socio-emotional value to the continued control of the family firm could be expected to demand a higher price to sell the firm than otherwise would be the case. An inflated asking price will, assuming a sale is made, make it more difficult for the buyers to obtain a level of performance that covers their cost of capital. In other words, return on investment will be negatively affected after an MBO or MBI if socio-emotional value increases the investment (the ROI denominator) needed to purchase the firm.

Thus, the ROI of the firm after an MBO or MBI will be a function of both profits, which will be influenced by how much the agency costs associated with asymmetric altruism can be reduced, and investment, which will be influenced by size of the socio-emotional value premium paid by buyers. A reduction in altruism can improve profits, but the premium associated with socio-emotional value can increase the required investment and therefore reduce ROI.

P 2: The relative performance of a family firm after a buy-out or buy-in by non-family managers will depend upon the socio-emotional value premium paid by the buyer; a high socio-emotional value premium will decrease post buy-out performance.

While some buy-outs or buy-ins may lead to a reduction in agency costs, such costs may also be affected by the negotiation process. We reason that knowledge of the business and the valuation the family places on the business will have a greater influence on both the asking price and the price buyers are willing to pay than will actual market competition for the business, since small, private firms are not usually sold either in an open market with competitive bidding or in a restricted auction as in larger corporations (Boone & Mulherin, 2007). If family owner-managers have information advantages over incoming non-family management, they may be

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3 However, the amount of the premium may depend on whether the owner adopts a competitive bargaining position to maximize price or a more cooperative position (Howorth et al., 2004).
able to use it opportunistically to extract a price that exceeds the firm’s actual value. Alternatively, the new non-family management team may have better information, especially if the family has less managerial involvement (Howorth et al., 2004). For example, if non-family purchasers have a better understanding than family owners of the potential to reduce agency costs after the firm is acquired by instituting control mechanisms and professional management techniques, the possibility of consummating a transaction favorable to buyers increases. Such information advantages can, in fact, be doubly important because they may lead to obtaining a more favorable price (reducing the ROI denominator) and a better understanding of how profits can be increased after acquiring the firm (increasing the ROI numerator). In other words, information asymmetries about the presence and extent of agency costs in the firm can influence the selling price, as higher agency costs may decrease the present value of the firm under current ownership and management. But whether the sources of those agency costs are known and the causes understood by the new owners and managers may also influence the potential for improving profits after the firm is acquired.

In an MBO, managers that are already employed by the firm are involved in its purchase. Consequently the management team is kept largely intact; some family managers may even be retained. In this instance, the likelihood of information asymmetries is reduced (Scholes et al., 2007). In contrast, in an MBI, the purchasing managers do not have prior experience working within the firm. As such, in every case MBIs are at a disadvantage relative to MBOs owing to their lack of inside information (Meuleman et al., 2009; Wright et al., 1996).

Of course, the information advantage of MBOs over MBIs could exist in the purchase of non-family firms as well, but the size of the advantage that MBOs may have over MBIs in purchasing a family firm may be greater owing to the presence of altruism, non-economic goals,
and stewardship that can create firm idiosyncrasies (Carney, 2005). Such idiosyncrasies are likely to be more difficult for outsiders like a buy-in team to appreciate and, therefore more difficult to sustain when their effect is positive, and more difficult to eliminate when their effect is negative (Howorth et al., 2004, 2007).

P3. Management buy-outs of family firms should outperform management buy-ins because the probability of information asymmetries will: (a) reduce the probability of overpaying, and, (b) increase the ability to eliminate sources of agency costs after the family firm is purchased; this effect will be stronger in the acquisition of family firms as opposed to non-family firms.

Aside from the effects of agency costs induced by asymmetric altruism or information asymmetries between buyers and sellers, agency costs in the post-sale firm are anticipated to change as a result of the transition from a family firm to a non-family firm through an MBO or MBI. In Table 1 there are nine possible owner/manager combinations and five possible agency cost combinations for family firms. After an MBO or MBI, however, there are only six possible owner/manager combinations and two possible agency cost combinations (Table 2). However, as suggested above, even this elaboration of the agency issues facing different types of family and non-family firms is an over-simplification since the actual agency costs of firms with similar potential agency concerns in different cells of the matrices can vary substantially.4

Indeed, many configurations are possible. For example, firms with dispersed family or mixed family and non-family ownership and either family management or mixed management teams all have the potential for the same set of agency issues, it is not safe to assume that all agency costs will be the same for each scenario. Rather, interplay between the nature of the dispersion of ownership and management will affect agency costs. Thus, as opposed to situations of mixed family and non-family ownership, the lack of an outside voice in the dispersed family

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4 While it is beyond the scope of this paper, we recognize that the severity of the agency costs of firms with similar configurations can vary substantially and that more work needs to be done to identify the contingencies that cause these differences.
ownership situation may make it more difficult to reduce the negative effects of entrenchment, which create owner-owner agency costs (Anderson & Reeb, 2004). The presence of higher owner-owner agency costs when ownership is dispersed among family members in sibling partnerships or cousin consortiums may be advantageous for buyers who may be able to reduce or eliminate those costs.

On the other hand, when the firm employs both family and non-family managers, the potential for owner-manager conflicts may be exacerbated by altruistically induced favoritisms that cause inequities in the performance evaluations and remuneration of family managers in comparison to non-family managers (Chua, Chrisman, & Bergiel, 2009). This suggests that by eradicating the conditions that gave rise to those owner-manager agency costs in family firms with mixed teams as opposed to other management configurations, MBOs and MBIs may be able to affect firm performance in a more positive way. In both respects it should be understand that holding socio-emotional considerations constant, the value of the firm to the family is likely to be based on expectations of future profits that are rooted in an extrapolation of the firm’s potential given current ownership and management configuration. Therefore, owner-managers in an MBO or MBI could be able to purchase the firm at a price that does not fully reflect their potential to reduce the firm’s agency costs. This leads to the following propositions.

P4a. A dispersed family ownership structure will have reduced owner-owner agency costs compared to mixed family and non-family ownership structures.
P4b. The relative performance of an MBO or MBI will thus be higher in deals where there is a dispersed family ownership structure.

P5. Family firms with a mixed team of family and non-family managers will have a greater ability to reduce owner-manager agency costs compared to firms with teams composed entirely of family managers; the relative performance of an MBO or MBI will thus be higher when the family firm has a mixed team of family and non-family managers.
Although it is difficult to determine whether owner-manager or owner-owner agency costs will be more severe in privately held small and medium-sized family firms, Villalonga and Amit’s (2006) study of large publicly traded firms suggests that owner-manager agency costs generally reduce firm value more than agency costs between owners. This might occur for a number of reasons. For example, the interests of owners might be more aligned with that of other owners than with managers, or the behavior of owners that influence firm value is easier to monitor. In any case, since the family firm’s selling price should be negatively related to its agency costs, and, the potential to improve profits and cash flows after an MBO or MBI should be positively related to the family firm’s agency costs prior to the sale, we propose:

\[ P6. \text{The opportunity to reduce owner-manager agency costs will have a greater positive effect on the performance of an MBO or MBI than the opportunity to reduce owner-owner agency costs.} \]

Excepting for stipulations regarding the differences between buy-outs and buy-ins, it is possible to move from any family business configuration depicted in Table 1 to any of the MBO/MBI configurations shown in Table 2. This means that after an MBO or MBI the firm may have more or fewer sources of potential agency costs. As we have noted earlier, prior literature has suggested that MBOs may reduce agency costs (Amess, Brown, & Thompson, 2007) but this may not always be true when a family firm is purchased since ownership and management are already unified to a greater or lesser degree. However, MBOs or MBIs may still be advantageous in certain generic (as well as, of course, firm specific) situations. For example, when a family firm with dispersed family or mixed ownership prior to its sale becomes a firm with concentrated non-family ownership after its sale, the sources of agency costs decrease owing to a reduction in the number of owners. It is also more likely that family firms with dispersed ownership will contain owners who are not part of the management team, which
will not be the case in an MBO or MBI. In instances like these where ownership and management become more aligned, the agency costs might be expected to decrease in a manner similar to that of a buy-out of a diversified firm.

*P7. Management buy-outs and buy-ins that reduce the number of owners compared to the number in the family firm prior to the purchase will positively influence performance.*

Using an accounting of agency costs framework (Chrisman et al., 2004), it is also possible to consider MBO and MBIs in terms of the path dependencies of the agency costs prior to and following the sale. Shifts in ownership and management after an MBO or MBI are expected to alter the magnitude and occurrence of the different agency costs. Some cells in Tables 1 and 2 contain more types of potential agency costs than others. Assuming that the relative severities of the agency issues are equal (a reasonable assumption for large-scale analysis but one likely to breakdown when considering individual cases), it is clear that when a pre-MBO/MBI firm moves from a cell with more types of agency problems to one with fewer types, there is a potential for agency costs to decrease, and vice-versa. For example, the changes in agency costs for an MBI with dispersed non-family ownership with non-family management (5B) that acquires a family firm that is entirely owned and managed by family members (1A), will be different from the changes in agency costs if the acquisition involves a family firm with dispersed family ownership and family management (4A). In the former case the potential types of agency problems would increase from one to two. On the other hand, in the latter case the potential types of agency problems would decrease from three to two. Thus, all else equal, the potential performance of the firm after the transfer of ownership might be expected to decrease relative to what it was under family control along the first path and increase along the second path even though the ending situation is the same. Furthermore, because the purchase price is likely to be inversely related to the agency costs in the family firm prior to its sale, the potential
performance of an MBO or MBI is also path dependent upon the situation faced by the family firm even though they might have the same set of agency costs after the sale. Hence:

P8. The relative performance of MBOs and MBIs is dependent upon the agency costs of the family firm prior to the sale: the relative performance of MBO/MBIs that purchase a family firm with higher agency costs will be greater than MBO/MBIs that purchase a family firm with lower agency costs.

DISCUSSION

This paper has examined variants and transformations of agency costs in management buy-outs and buy-ins of family firms. We have noted that, while some paths will increase or decrease the potential number of agency issues, this does not always guarantee that total agency costs will go up or down. Taking into account the severities of the potential agency problems within the different ownership-management combinations also leads to contingencies. For example, consider an MBO/MBI that moves the business from mix ownership and non-family management (cell 8A in Table 1) to dispersed non-family ownership and non-family management (cell 5B in Table 2). In both situations the types and number of potential agency problems are identical. Based on previous work indicating that family stakeholders (1) are more likely to pursue non-economic goals (Chrisman et al., 2005), (2) have a longer term orientation (Sirmon & Hitt, 2003), and (3) are generally more risk adverse than non-family stakeholders (Ward, 1997), we may assume that the potential for conflicts of interest and information asymmetries between family stakeholders and non-family stakeholders is greater than what might arise among non-family stakeholders. This implies that the owner-manager and owner-owner agency problems in 8A may be more severe than those in 5B and that the relative performance of the firm will be higher after the MBO or MBI.5

5 In addition, the same sort of logic might suggest that an MBO-MBI that with mixed ownership and management (9B) could have considerably more difficulties in managing its agency issues than one with non-family ownership and management (5B).
However, as the cases studied by Howorth, et al. (2007) illustrate, MBOs and MBIs typically involve high leverage. Therefore, borrower-lender agency problems (which may potentially exist in any ownership/management combination) are likely to be more severe in 5B than in 8A following the buy-out or buy-in. On the other hand, as explained by Jensen and Meckling (1976), debt can have a mitigating effect on the owner-manager agency problem. Conceptually, there should be an optimal mix, but research is needed to help us understand what that mix would be.

When considering the configurations in Table 2 involving management teams composed entirely of non-family managers, owner-manager agency problems do not disappear. For example, non-family managers exercising MBOs or MBIs might be in a stronger position to implement professional management techniques designed to control agency costs (e.g., formalized structure, monitoring systems, incentives, etc.). However, this advantage may well be offset by the additional agency costs and risk associated with the need to secure large amounts of debt to finance the purchase, not to mention the difficulty in transforming the culture of the firm (Howorth et al., 2007). Family members interested in the fate of the firm after its disposal will consider these costs and risks in making their decisions, as will the non-family managers contemplating the purchase of a family firm.

From the tables, we can conclude that, holding all else equal, the likelihood of a family firm desiring to pursue the management buy-out or buy-in option increases as the situation moves further away from the one involving concentrated family ownership and family management because of higher agency costs and consequent reduction in profits and firm value. The ability to obtain a premium in compensation for a loss of socio-emotional value may also be greater if the purchasers see the ability to reduce agency costs and improve performance.
Additionally, the involvement of non-family owners or managers whose interests may be better served by management buy-outs or buy-ins can act as an additional spur. Finally, the interest of non-family managers to pursue the buy-out of a family firm should increase when current agency costs are especially high – as is the case when the management team is mixed and ownership is either dispersed among family members or a mix of family and non-family shareholders – since this situation appears ideal for obtaining a favorable price vis-à-vis the ability to reduce these costs and increase profits.

An important research question is whether there is a minimum and a maximum agency cost combination for a post-MBO/MBI. By type alone, situations exemplified by concentrated non-family ownership in Table 2 should have only one agency problem, whereas configurations exemplified by dispersed non-family ownership and mixed ownership each have two. Again, however, the severities of the agency problems must be taken into account before a full conceptualization of the contingent situations is possible. For example, MBOs and MBIs with mixed management teams, ownership groups, or both may have greater actual agency problems than those with more homogeneous configurations owing to potentially greater conflicts of interest and information asymmetries between family and non-family members even though the potential sources of agency costs are the same. Thus, when both the ownership group and management team include family and non-family stakeholders, as in the situation depicted by cell 9B, potential agency problems may be especially severe; conversely, the situation depicted by cell 2B where non-family ownership is concentrated and the management team is composed entirely of unrelated, professional managers may offer the most desirable scenario.

Of course, there is no one perfect transition from family to non-family ownership when it comes to reducing agency costs. In addition to accounting for costs, which should give a
preliminary indication of what agency costs a new ownership and management configuration will face, there are contingencies that must be considered for each agency cost. What will be ideal for one firm to reduce agency costs may not be the same for another. Using agency theory, we have framed what potential agency costs a firm will face, before and after a management buy-in or buy-out and developed propositions on the performance impacts of the situations depicted. Since intra-family succession is not always a viable or desired option, an understanding of the various alternatives to intra-family succession is important for family firm research, especially since initial conditions and subsequent configurations may have a material influence on performance and the ability to detect performance differences among firms.

**Further Considerations**

A possibility not discussed in this framework, though it may also be an adequate alternative for the family firm, is that of professionalization, which involves the transfer of management rather than ownership to non-family members. In this scenario, the CEO becomes a non-family member, while ownership remains with the family. This type of transition, like that of changing ownership, is expected to have its own unique agency combinations. For instance, when the firm is 100% family-owned and managed (1A), a potential agency cost that is expected is from altruism. If control is passed to a non-family member CEO, the opportunity for altruism is greatly reduced, if not eliminated, but in its place arise the classic owner-manager agency problem. The agency problem may actually be more complicated since owners will need to monitor the non-family CEO who will, in turn, be required to monitor the behavior of subordinate family managers, some of whom might be minority owners. However, in some situations where the family is not ready to sell the firm, but is also not able to manage it, this type
of succession may be preferable to a buy-out (Lee, Lim, & Lim, 2003) and as such, warrants further discussion and a more complete accounting of potential agency costs.

CONCLUSION

The comparison of the different agency problems before and after an MBO or MBI shows that performance may be higher or lower based on the number and types of agency issues encountered, owing to their affects on the potential selling price and the ability to increase profits. Thus, the prospects for high(er) performance following a sale of a family firm does not rely solely on the resultant ownership and management combination, but rather is path dependent. Furthermore, the relative severity of the different agency problems facing the firm after the buy-out or buy-in creates additional contingencies that influence performance.

This paper has only begun to identify and examine the complex configurations of agency costs that might exist before and after the sale of a family firm to non-family investors. Our propositions and the other implications of the frameworks presented in Tables 1 and 2 need to be tested. Indeed the potential sources of agency costs within each cell of the matrices, as well as a comparison of the actual agency costs between cells across the two frameworks before and after the sale of a family firm to outside investors all represent additional avenues for future research.

We envision that building datasets to test the propositions developed here is feasible. It is possible to identify large samples of MBOs and MBIs of family firms across different countries through databases such as CapitalIQ (Stromberg, 2008) or CMBOR (Scholes, et al., 2007). These can then be used as sampling frames to survey the MBOs and MBIs to ascertain the nature of ownership and family involvement before and after the buyout. In many cases, the financing and ownership structures after the acquisition are contained in these databases. In some jurisdictions,
such as in the UK and some other countries in Europe, it is feasible to obtain data on the performance of private firms both before and after the sale has occurred.

Reflecting an accounting of agency costs, it is argued that the number of agency costs post-sale may increase or decrease, depending upon the path and the contingencies involved in the ownership and management mix pursued by the MBO or MBI team. No one combination is necessarily optimal. Furthermore, implicit in our framework are other factors that have not been fully accounted for in this paper, such as the role of private equity firms and debt providers. Private equity firms and debt providers may contribute to the reduction of agency costs in buyouts but also may introduce new agency costs as a result of incomplete contracts and asymmetric information. The extent to which agency costs occur may be mitigated by the experience and expertise of these players (Meuleman et al., 2009). These factors also provide fertile ground for future research. For the family firm contemplating a transfer of ownership to non-family investors and for potential non-family investors assessing the purchase of a family firm, such research will be particularly valuable.
REFERENCES


Table 1: Potential Pre-MBO/MBI Agency Problems for Family Owned Firms

<table>
<thead>
<tr>
<th>MANAGEMENT TEAM OWNERSHIP</th>
<th>Pre-MBOI (with Family CEO-Owner)</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>Family Management (100% family managers)</td>
<td>Non-Family Management (100% non-family managers)</td>
</tr>
<tr>
<td>Concentrated Family (100% held by family CEO)</td>
<td>1A</td>
<td>2A</td>
</tr>
<tr>
<td></td>
<td>Altruism</td>
<td>Owner-Manager</td>
</tr>
<tr>
<td>Dispersed Family (100% held by various family owners)</td>
<td>4A</td>
<td>5A</td>
</tr>
<tr>
<td></td>
<td>Altruism</td>
<td>Owner-Manager</td>
</tr>
<tr>
<td></td>
<td>Owner-owner</td>
<td>Owner-owner</td>
</tr>
<tr>
<td>Mixed Family &amp; Non-Family (majority held by family owners; minority held by non-family owners)</td>
<td>7A</td>
<td>8A</td>
</tr>
<tr>
<td></td>
<td>Altruism</td>
<td>Owner-Manager</td>
</tr>
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<td></td>
<td>Owner-owner</td>
<td>Owner-owner</td>
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</tbody>
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Table 2: Potential Post-MBO/MBI Agency Problems

<table>
<thead>
<tr>
<th>MANAGEMENT TEAM OWNERSHIP</th>
<th>Post MBOI (with Non-Family CEO-Owner)</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Family Management (100% family managers)</td>
<td>Non-Family Management (100% non-family managers)</td>
</tr>
<tr>
<td>Concentrated Non-Family (100% held by non-family CEO)</td>
<td>1B</td>
<td>2B</td>
</tr>
<tr>
<td></td>
<td>Owner-Manager</td>
<td>Owner-Manager</td>
</tr>
<tr>
<td>Dispersed Non-Family (100% held by various non-family owners)</td>
<td>4B</td>
<td>5B</td>
</tr>
<tr>
<td></td>
<td>Owner-Manager</td>
<td>Owner-Manager</td>
</tr>
<tr>
<td></td>
<td>Owner-owner</td>
<td>Owner-owner</td>
</tr>
<tr>
<td>Mixed Non-Family and Family (majority held by non-family owners; minority held by family owners)</td>
<td>7B</td>
<td>8B</td>
</tr>
<tr>
<td></td>
<td>Owner-Manager</td>
<td>Owner-Manager</td>
</tr>
<tr>
<td></td>
<td>Owner-owner</td>
<td>Owner-owner</td>
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