

# The Theoretical Analysis of the Allocation of Family Control Rights Based on Guanxi in China

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Received 9 July 2014; revised 10 August 2014; accepted 2 September 2014

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## Abstract

With the development of the family businesses, family members are coming from diversified source. Under this circumstance, guanxi and potential conflicts between family members are becoming complicated. The allocation of control rights among the family members plays an important role. This paper proposes the allocation concept of the family guanxi-oriented control rights for the first time. On the basis of the review of classical theories about the control rights allocation, it builds a theoretical analysis framework of family control rights allocation embedding guanxi.

## Keywords

Family Members, Family Control Rights, Allocation, Guanxi, Theoretical Analysis

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## 1. Introduction

Family firms typically depict a complex, long-standing stakeholder structure that involves family members, top management, and a board of directors [1]. Traditionally, researchers have assumed that owner-managed firms will have either zero or insignificant agency cost [2]-[4]. The reason is that family members are expected to be altruistic toward each other as a result of kinship obligations. However, family firms are often plagued by conflict. Relationship conflict, an interpersonal conflict that is laden with negative emotions like resentment and animosity, harms the performance of family firm [5].

In recent years, the events about the scramble for control rights between family members happen occasionally. For instance, the infighting of Zhen Kung fu which is the magnate of the global Chinese fast food chains draws heat to discussion. The issue results from the divorce of the couple who are the founders of Zhen Kung fu. It leads to the break-up of kinship which sustains the family enterprise. Like a lot of family firms, Zhen Kung fu is established by the support of kinsfolk, but suffering the fight for the internal control rights between the family

members. The listing plan of Zhen Kung fu is stranded as the infighting. By now, we have not known what will happen to Zhen Kung fu with the conflict between the founders. Nonetheless, the scramble for control rights between family members raises the worry and lets them think about the effective control to the family firms. Furthermore, it also influences the allocation of family control rights. Especially, the control rights market and manager market in China are far from mature at the moment. The control mechanism based on guanxi plays an important role in the allocation of family control rights. How to allocate the family control rights effectively is an issue worthy of further research by the field of theory and practice.

Family control rights are defined as generalized control rights in this paper. It is a series of rights which is mastered by the controlling family to decide each main policy in the family listed companies, such as strategic decision making right, personnel remove right, investment right, finance dominating right, asset disposition right and other rights that don't set by the contract.

As the family control rights are a series of rights, every right can't be measured one by one. Family control rights mainly include two angles: the holdings of equity and the control of the managerial position. According to this, we classify the family control rights into two parts: family equity control and family managerial rights control. Family equity control means that the family controls the share of the listed companies. Family managerial rights control means that the family controls the board of directors and the managers of the listed companies.

## 2. The Analysis of Family Guanxi-Oriented Control Mechanism from a Listed Family Company

The separation of companies' ownership and control rights makes the allocation of control rights during the shareholders, board and management. The allocation of control rights between the three main parts and the balance relationship between them constitute the overall framework of companies' internal control rights allocation.

In the current China, the corporate control market and the manager market are far from mature. Different from the market-oriented control mechanism in British and American, the guanxi-oriented control mechanism is a significant feature in Chinese family business. When allocating the equity, arranging the board members and selecting the managers, the controlling family always prefers to choose people who have blood relationship, marriage relationship and quasi-family member relationship with them. The allocation of family control rights based on kinship is called family guanxi-oriented control rights allocation.

**Figure 1** is the family guanxi-oriented control structure of Busen Garments (SZ: 002569). Shou's family is the actual controller of Busen Garments. According to the Shou's family members' control relationship, Busen Garments is controlled by thirteen family members together. The kinship between the thirteen family members is complex. They may be brothers and sisters, parent and child, cousin, couples, brothers-in-law, nephew-aunty, nephew-uncle and so on.

In accordance with the La Porta's calculation method of ultimate control rights, the control rights of family ultimate controlling shareholder is the accumulation of the minimum shareholding percentage of each control chain. So the control rights of Shou's family are 84.9%. Shou's family absolutely controls the Busen Garments in the equity stake.

In addition, five family members are the directors of listed company's board. They account for half of the total number of the board of directors. One family member is the chairman of the board. Three ones are directors. And the other one is the board secretary. Moreover, four family members are the managers of the listed company. One family member is the general manager. The other three ones are vice-general manager. The Shou's family controls the board and managers of Busen Garments.

Above all, the control rights of the Busen Garments are allocated between Shou's family members. They are kinship.

## 3. The Literature Review

### 3.1. The Internal Conflicts and Agency Problems in Family Business

Recent researches about family business control rights all suppose that family members are acting in concert. The fundamental assumption in these papers is that all the family members have the same values and objectives, and they can act like one person when managing the family business to reduce the agency costs [6]. However, the assumption is challenged by the reality. Under the assumption that there will be different goals between

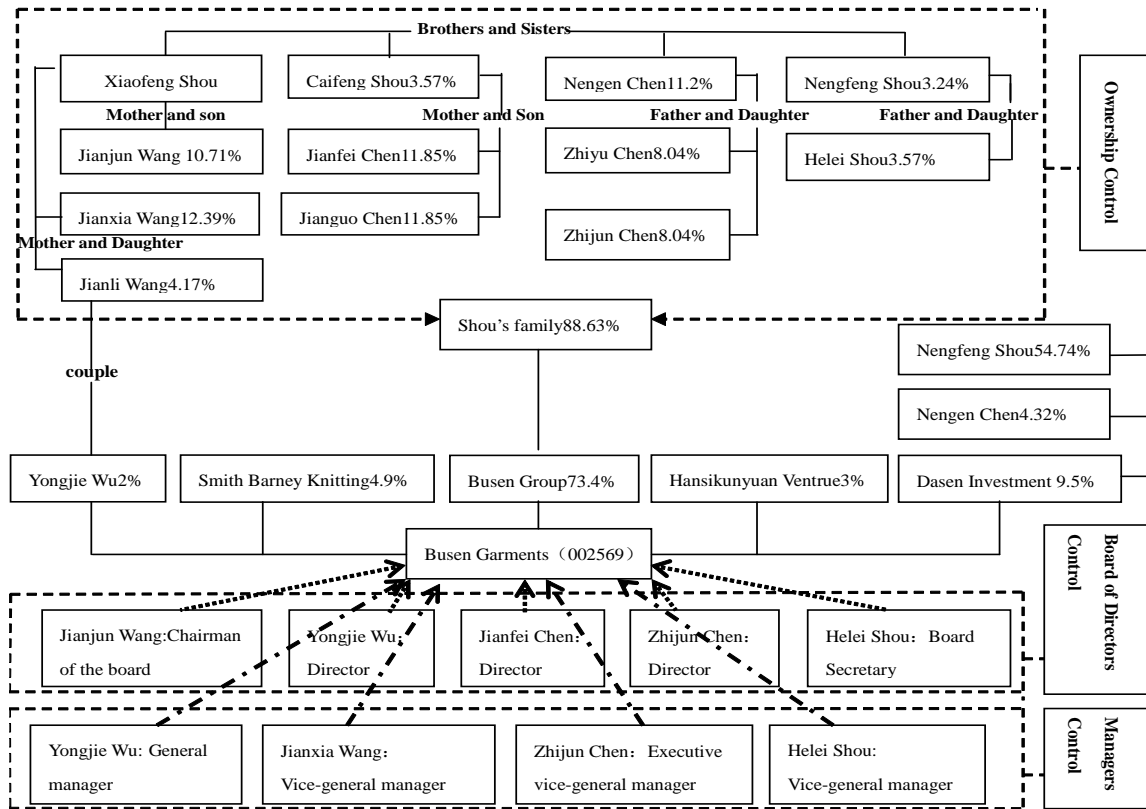


Figure 1. Family guanxi-oriented control structure figure of Busen Garments Data source: The initial public offering prospectus of Busen Garments (002569).

family members, some scholars start to pay attention to the allocation of the family internal rights which will influence the decision-making behavior of the enterprises.

Even the nuclear member of the family (immediate family) also can't guarantee the identical interests, let alone the pan-family [7]. The family members who participate in the production activities of family enterprise are agents too. Their goal and preference will not be identical. They are altruistic, but self-serving. They chase the maximal non-economic and economic utility for themselves [8]. Altruism can reduce the agency costs in the early stages of the family business development, but will increase the agency costs when the family business becomes large and mature [9].

If the family agents participate in the decision making, it may lead to suboptimal decisions [10]. The conflicts between the controller and the other family members will be determined by the allocation of the family internal equity [11]. The generational ownership dispersion will influence the family conflicts directly or indirectly [5]. The interpersonal conflict between the family members will bring negative influences to the corporate governance efficiency. The internal conflicts and the agency problems are discrepant between different combinations of family members [12].

### 3.2. The Allocation Mode of the Family Control Rights

Most research about the allocation of control rights start their discussion from the corporate angle. We can seldom find the research about the allocation of the family overall internal control rights. A few papers which concern the family authority and family agency problem may refer to the allocation of family equity, the managerial position occupied by the family members and so on.

The sustainable growth of the family business needs an authority. Sharing the control rights may lead the family members to scramble for the limited resources, and result in the demise of the family business [13]. In order to master the family firms by family members, a number of the family business owners tend to adopt management mode of family control. They won't let appointment to non-family members [14].

But Gersick *et al.* [15] find that the rights allocation in family firms varies greatly. In some family firms, rights are allocated to one controlling owner. In some other family firms, rights are allocated to several nuclear family members who are close kinship or distant family members. Moreover, in the process of competition and internationalization, it is a compromise governance mode for the family members and the professional managers to divide the ownership and managerial rights. In China, the proportion of the managerial rights which the family business owners allocate to non-family members is higher than the proportion of the family equity they allocate to [16].

### 3.3. The Factors Which Influence the Allocation of Family Control Rights

The scale of the family business is the most important factor which influences the allocation of family control right [17].

In current China, the capital market, the reputation market and the professional manager market are all imperfect. It is difficult for Chinese family business to transfer the control rights from the owner to the professional manager in short time [18].

If the family allocates the control rights inappropriately, it may hamper the development of the family enterprises. Trust and scale are the two factors which will influence the allocation of family control rights. Under the influence of Chinese traditional family culture, the allocation modes of family control rights are divided into two types: trust the internal people and trust the outside people. How to choose the allocation mode? It depends on the scale of family business. Before reaching a certain scale, it is better for the family business to choose the mode of trusting internal people. If the scale of the family business exceeds the certain scale, it is better to transfer the allocation mode from trusting internal people to trusting the outside people [19].

## 4. The Theoretical Analysis about the Family Guanxi-Oriented Control Rights Allocation

### 4.1. The Theoretical Background of the Allocation of Family Control Rights

The research about the allocation of corporate control rights started from the proposition that put forward by Berle and Means in 1932. In most public companies, the ownership is separated from the control rights.

The existing corporate control rights theories mainly develop from the transaction cost theory of Coase (1937), the vertical integration theory of Williamson (1985), the corporate organization theory of Klein *et al.* (1978), the team theory of Alchian and Demsetz (1972) and Aoki Masahiko (1994), the enterprise ownership structure and agency cost theory of Jensen and Meckling (1976) and Fama and Jensen (1983), the incomplete contracting theory of Grossman and Hart (1986) and Hart and Moore (1990), the enterprise control transfer theory of Aghion and Bolton (1992), indirect pricing theory of Yang and Ng (1995), and so on.

All these theories treat the relationship of corporation and market, and the allocation of the corporate internal rights from the perspective of transaction cost. They consider that market or corporation is the result of choice. When the market transaction costs are greater than the enterprise internal management costs, the enterprise will replace the market; otherwise, the transactions will implement in the market. Under such logic, the internal rights structure of the corporate also will follow the principle of saving the transaction costs. Who will master the control rights of the corporate, the material capital owner or the human capital owner? It depends on who can reduce the corporate internal transaction costs [20].

Following the way of transaction costs, the present corporate control theories take capital efficiency maximization into account only, but don't consider the guanxi factors between people [20]. In the cultural context and real life of China, guanxi is a distinctive characteristic [21]. All the trust and commercial relations are established on the kinship or kin-based pure personal relationship [22]. The interpersonal communication of Chinese people is a differential mode of the association. It to yourself as the center, like stones throw into the water, the ripples go out, the more pushing more far and thin [23].

In this differential mode of the association, kinship plays an important role in people's selection and decision. People always show a different degree of trust to others according to the guanxi between people and themselves. A lot of family enterprises are built on mutual trust between owners. Trust which is based on the blood, marriage, and region and so on is called guanxi-trust. Guanxi-trust restrains people behavior through the internalization of social code of ethics and repeated game in order to enhance the trust between people. In this trust mechanism, along with the increase of the number of the group member, the cost that people who want to keep cooperation

with other will increase too. Trust, as a kind of expectations, doesn't act on the allocation of corporate internal control rights directly. It affects on the allocation of corporate internal control rights by enhancing the expectations of cooperation to reduce the transaction costs [20].

In fact, trust reduces the transaction costs in social interaction through the way of reducing the uncertainty in the transaction. On the one hand, trust can improve the efficiency of the treatment of random events, and reduce the primary uncertainty; on the otherhand, trust can promote the information communication in the process of transaction, reduce the secondary uncertainty. In addition, trust can still improve the expectations of maintaining cooperation in both parties, and reduce the uncertainty of behavior.

Consequently, the allocation of Chinese family control rights doesn't fully comply with the classical theories. We must implant guanxi into the allocation of family control rights. As a result, we construct a theoretical analysis framework to study the paths of the allocation of family control rights. The main points are guanxi, trust, transaction costs and allocation of control rights.

### 4.2. The Theoretical Analysis about the Allocation Paths of the Family Control Rights

Follow the theoretical analysis framework, family control rights are allocated between family members and non-family members according to the kinship. Family equity is allocated between the family members. Family managerial control rights are allocated between the family and non-family members.

#### 1) The theoretical analysis about the allocation paths of family equity

Family equity is mainly allocated between the family members. The allocation paths of family equity are showed in Figure 2. If the guanxi between the actual controller and other family shareholder is closer, the actual controller will give he/she more trust. As a result, the internal transaction costs of the family will reduce. So, family equity should allocate between the family members who have the closer kinship with the actual controller.

#### 2) The theoretical analysis about the allocation paths of family managerial control rights

During the allocation of family managerial control rights, the controlling family can allocate the control rights to the family members, but also to the non-family members. Therefore, the transaction costs are divided into two parts: the transaction costs between the family members and the transaction costs between the family and non-family members. The allocation paths of family managerial control rights are showed in Figure 3.

If the family managerial control rights are allocated to non-family members, the actual controller will pay the lowest trust to them and the transaction costs will be the highest; if the family managerial control rights are allocated to the family members besides the actual controller, the trust that the actual controller will pay to them depending on the guanxi between the family members and the actual controller and the transaction costs will be changed with it; if the family managerial control rights are allocated to the actual controller himself, the trust is the highest and the transaction costs will be the lowest.

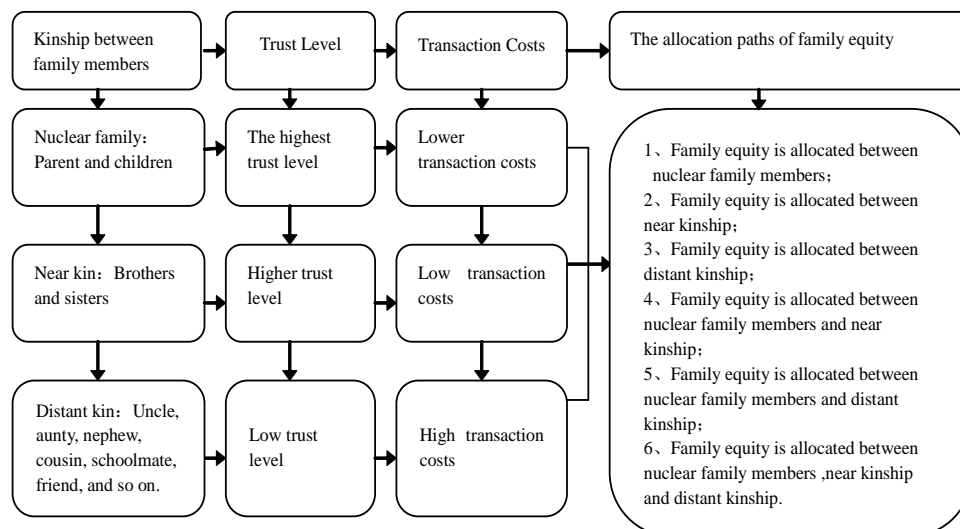
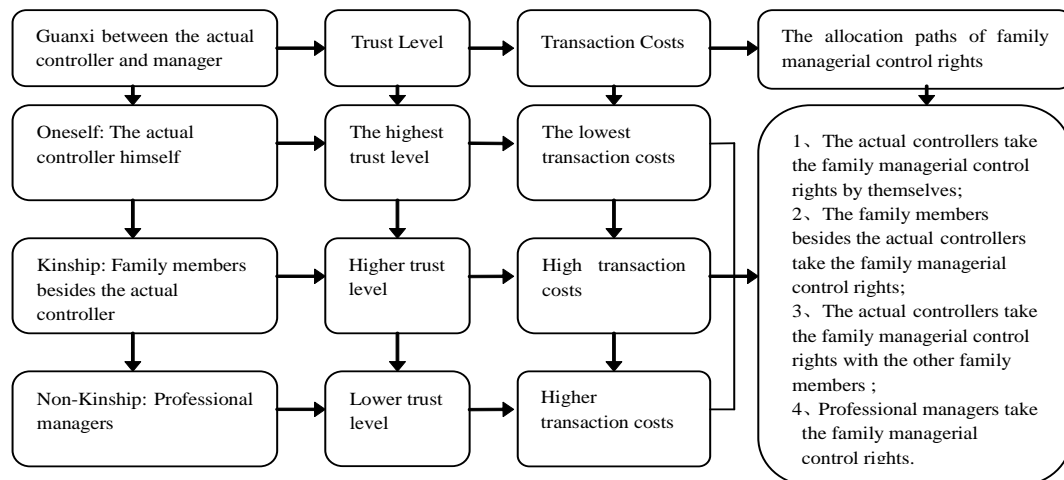


Figure2. The analysis of the allocation paths of family equity.



**Figure 3.** The analysis of the allocation paths of family managerial control rights.

## 5. Conclusions

This paper discusses the allocation of family control rights in Chinese family firms. We find that the allocation of family control rights is embedded by guanxi, especially the sibship. This distinguishing feature is related with the Chinese Confucian culture. Chinese culture shows the interpersonal relationship as distinction between inside and outside, and priority in rank. These principles are also applied in the allocation of family control rights. Different guanxi between family members influences the control rights he or she may have.

This paper proposes the allocation concept of the family guanxi-oriented control rights for the first time. Following the logic of guanxi → trust level → transaction cost → the allocation of family control rights, we construct two concept models about the allocation of family equity and managerial control rights. Different family may choose their own allocation path. The allocation of family control rights plays an important role in family firms, and sometimes may affect the survival of the firm. Therefore, how the different allocation path will impact the performance of the family firm needs to be further studied.

## Acknowledgements

This paper is supported by the Humanities and Social Sciences Planning Foundation of Ministry of Education of China (11YJA630171) and Zhejiang Gongshang University (X13-16).

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