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## **Blood is Not Always Thicker than Water: A Family Business Case Study**

Hai Ta

*Niagara University*, [hta@niagara.edu](mailto:hta@niagara.edu)

Todd M. Inouye

*University of Hawaii*, [todd.inouye@hawaii.edu](mailto:todd.inouye@hawaii.edu)

Shih-Jen Kathy Ho

*Niagara University*, [kh@niagara.edu](mailto:kh@niagara.edu)

Vincent Agnello

*Niagara University*, [agnello@niagara.edu](mailto:agnello@niagara.edu)

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### Cover Page Footnote

Works Cited Alderson, K. (2015). Conflict management and resolution in family-owned businesses. *Journal of Family Business Management*, 141-156. Aragon-Amonarriz, C., Arredondo, A. M., & Iturrioz-Landart, C. (2019). How can Responsible Family Ownership be Sustained Across Generations? A Family Social Capital Approach. *Journal of Business Ethics*, 161-185. Association of Certified Fraud Examiners. (2020). 2020 Report to the Nations. ACFE. (2020). Embezzlement in the Great Recession - National White Collar Crime. U.S. Dept. of Justice - Office of Juvenile Justice and Delinquency Prevention. Pedneault, S., & Peterson Kramer, B. K. (2015, May). Shattered Trust: Fraud in the Family. *Strategic Finance*, pp. 46-55. SCORE. (2018). Family-Owned Businesses Create 78% of New U.S. Jobs and Employ 60% of the Workforce. PRNewswire. Van der Heyden, B. C. (2005). Fair Process: Striving for Justice in Family Business. *Family Business Review*, 6. Wakefield Research. (2018). 2018 Hiscox Embezzlement Study. Hiscox.

## Introduction

Approximately 90% of all businesses in the United States are family-owned or family-controlled, and it is the economic engine that drives the economy. Family businesses employ 60% of the workforce and generate 64% of the GDP. Unfortunately, most family businesses face a succession problem in the United States. According to SCORE, only 30% survive the first transfer from the founder to the 2<sup>nd</sup> generation. Even more troublesome is that, of those companies, only 12% survive a second transfer to the 3<sup>rd</sup> generation or the founder's grandchildren.<sup>1</sup> The two leading causes for these dismal results are the lack of realistic succession planning and failing to address family conflicts as they arise. Both are evidence of poor management.<sup>2</sup> The protection of the company falls squarely on management. That includes ensuring the continuity of operations beyond the current management team. In addition, a succession plan should identify who will succeed the CEO, provide for necessary training and grooming of the successor, and ensure that employees are confident that the firm will remain solid and financially stable. The firm is destined to fail without proper planning and nurturing of succeeding generations.<sup>3</sup>

Before developing a succession plan, the family must address problem areas such as unfair apportionment of the workload, lack of accountability, and no-show jobs.<sup>4</sup> While proper management can resolve many of these issues, the desire to avoid family fights causes family managers to avoid addressing them.<sup>5</sup> When left unattended, feelings of jealousy are amplified and create a sense of entitlement. To level the actual or perceived imbalance, family members often feel justified in acting in their own best interests rather than the best interests of the company and

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<sup>1</sup> SCORE. (2018). Family-Owned Businesses Create 78% of New U.S. Jobs and Employ 60% of the workforce. PRNewswire. <https://www.prnewswire.com/news-releases/family-owned-businesses-create-78-of-new-us-jobs-and-employ-60-of-the-workforce-300613665.html> (accessed July 6, 2021).

<sup>2</sup> Van der Heyden, B. C. (2005). Fair Process: Striving for Justice in Family Business. *Family Business Review*, 6. <https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.976.6125&rep=rep1&type=pdf> (accessed July 7, 2021).

<sup>3</sup> Aragon-Amonarriz, C., Arredondo, A. M., & Iturrioz-Landart, C. (2019). How can Responsible Family Ownership be Sustained Across Generations? A Family Social Capital Approach. *Journal of Business Ethics*, 161-185.

<sup>4</sup> Alderson, K. (2015). Conflict management and resolution in family-owned businesses. *Journal of Family Business Management*, 141-156. <https://journals.sagepub.com/doi/full/10.1177/0894486519893223> (accessed July 7, 2021).

<sup>5</sup> Pedneault, S., & Peterson Kramer, B. K. (2015, May). Shattered Trust: Fraud in the Family. *Strategic Finance*, pp. 46-55. <https://sfmagazine.com/post-entry/may-2015-shattered-trust-fraud-in-the-family/> (accessed July 7, 2021).

the family.<sup>6</sup> In many cases, this early failure of management leads to theft and embezzlement.

A trusted employee or advisor may take wrongful advantage of an opportunity to misappropriate hard-earned dollars. If not caught early, it can cause bankruptcy. Unfortunately, of those businesses that do survive embezzlement, they often only barely do so. Added to the financial loss is the heartache and betrayal the embezzler caused when they breached that trust. In partnerships, it generally is the trusted partner, a lifelong friend. In a family-owned business, a trusted family member handles the finances. Faith in those individuals eventually leads to a relaxation of financial controls providing the opportunity to embezzle.<sup>7</sup>

When embezzlement happens, it is often devastating. Theft of money or property from a business can cause long-lasting severe financial hardship and sometimes lead to the business's demise. In the 2018 Embezzlement Study conducted for Hiscox Insurance, the average loss from embezzlement reported was \$357,650.<sup>8</sup> That report found that they perpetuated fraud in 85% of the reported cases. From 2005 to 2009, a time of economic upheaval, arrests for embezzlement ranged from 18,000 to 22,000 per year. In 2018, that number dropped to 13,500 arrests for embezzlement.<sup>9</sup> Unfortunately, these numbers are significantly underreported since many firms opt not to report the loss or file charges and, in many cases, no longer exist to report losses.

All businesses (and associated employees) affected by embezzlement are damaged financially and emotionally. Just as a mother protects her baby, managers are tasked to protect their business. To have embezzlement occur on their watch is emotionally devastating. In a family business, embezzlement is even more troublesome since it occurs by a family member or a trusted advisor who has been treated like family. According to the Association of Certified Fraud Examiners, the

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<sup>6</sup> Pedneault, S., & Peterson Kramer, B. K. (2015, May). Shattered Trust: Fraud in the Family. *Strategic Finance*, pp. 46-55. <https://sfmagazine.com/post-entry/may-2015-shattered-trust-fraud-in-the-family/> (accessed July 7, 2021).

<sup>7</sup> Pedneault, S., & Peterson Kramer, B. K. (2015, May). Shattered Trust: Fraud in the Family. *Strategic Finance*, pp. 46-55. <https://sfmagazine.com/post-entry/may-2015-shattered-trust-fraud-in-the-family/> (accessed July 7, 2021).

<sup>8</sup> Wakefield Research. (2018). *2018 Hiscox Embezzlement Study*. Hiscox. <https://www.hiscox.com/documents/2018-Hiscox-Embezzlement-Study.pdf> (accessed July 7, 2021).

<sup>9</sup> *Embezzlement in the Great Recession - National White Collar Crime 2020*. U.S. Dept. of Justice - Office of Juvenile Justice and Delinquency Prevention.

average amount embezzled in a family-owned business by a family member is \$600,000.<sup>10</sup>

This case study captures these issues faced by many family businesses. While it starts with a simple embezzlement case, it becomes more complicated when greed, jealousy, and a sense of entitlement are introduced. As the case progresses, the issue of succession arises. Participants are presented with the dilemma of whether succession should be based on equal shares to each family or whether the business should be transferred equally to everyone in the succeeding generation. Unfortunately, the issues in this case study are not fictional but are anonymized to protect the privacy of the parties involved. They represent a collection of actual decisions faced by a family business.

This case study has been used in undergraduate and MBA classes. It can be used as an in-class project or a case write-up homework assignment. In addition, a case analysis is available by email for instructors.

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<sup>10</sup> Association of Certified Fraud Examiners. (2020). *2020 Report to the Nations*. ACFE. <https://legacy.acfe.com/report-to-the-nations/2020/> (accessed July 7, 2021).

## **Blood is Not Always Thicker than Water: A Family Business Case Study**

In 1955, Marco and Maria Angelo immigrated to the United States from Italy to start an olive oil business. Marco grew up in an area known for its olive oil production. Before leaving his homeland, he contracted with farmers in his region to buy their olive oil. To Marco, this was a win-win proposition. He offered them a better price than what they were currently receiving while receiving an ample and stable supply to start his business of bottling and reselling the olive oil. Marco settled in Boston and used the money he inherited from his father's estate to create a company named Angelica Olive Oil. His business venture was an immediate success. His initial market was in and around the Boston area. His primary customers consisted of area grocery stores and small supermarket chains, but he also made direct sales to the public through a store attached to his factory.

Marco and Maria (his wife) had two children, Roberto and Salvatore. In the late 1960s, Roberto and Salvatore took over their father's business. Under their leadership, the company grew exponentially. They made a small public stock offering and raised enough money to fund a significant expansion. Even with this public offering, the family still owned 60% of Angelica Oil Company. To meet their needs, they began importing olive oil in large containers from Spain, Italy, and Greece to be repackaged into smaller consumer-sized bottles. Roberto and Salvatore successfully sold the oil to major supermarket chains throughout the northeast and had dreams of nationwide distribution.

Roberto married Isabella and had two children, Roberto, Jr. (Junior) and George. Salvatore married Anna and had a daughter Laura and sons, Joseph and Charles. All five of the children grew up in and around the family business. Junior attended a private university in Western New York and graduated with an MBA in Management and a BBA in Accounting. At the same time, George earned his M.S. in Business specializing in Supply Chain Management, from another university. After graduation, both joined the firm; Junior worked as a controller in the finance office, while George worked closely with his father in operations. Joseph decided against college, and upon graduation from high school, he joined the family firm and worked in the marketing department. Laura studied art and moved out to California to pursue her career as a graphic artist. Charles enjoyed fixing things and worked in the maintenance department of Angelica Olive Oil.

As the years progressed, Junior became the CFO (when the prior CFO, a trusted family friend, was caught embezzling funds from the firm). George was promoted to Vice President of Operations, Joseph the Vice President of Marketing, and Charles, the Manager of the Maintenance Department. Laura was given the title

of Vice President of Inspiration to keep family harmony, and each of the five children received the same salary. No salary adjustments were made when they received their promotions at the firm.

Junior's first task as CFO was to institute more robust financial controls. At this point, Junior was married and had two children under four. His father, Roberto and Uncle Salvatore were of the conservative mindset and thought it better to grow the business than to keep increasing salaries. Junior was financially stressed, having just purchased a new home in an exclusive neighborhood. His banker friend, Vincent, reluctantly agreed to finance the purchase of the house, knowing that the business was growing and Junior might soon have a higher income. Unfortunately, this mortgage violated bank policy because the loan-to-income ratio was not met. Knowing that no one at the bank would verify the financial statement, Vincent had Junior alter the income numbers on his financial statements and granted the mortgage loan request.

As Junior looked at redeveloping financial controls due to the previous embezzlement, he found himself with an opportunity to devise a scheme to embezzle money from the firm. He knew that no one would suspect him since he was charged with implementing financial controls to prevent any reoccurrence of fraud. He planned to have the Controller and Assistant Controller (or alternates if they are not available) sign off on the daily receipts of cash and checks. Then they would deliver the deposit slip and deposit bag to Junior. In their presence, Junior would record the Daily Cash Receipts Book. Unknown to the two employees, Junior recorded a lower amount each day in a separate Daily Cash Receipts Book. Junior took personal responsibility for delivering the daily deposit to Boston State Bank and advised his father, his uncle, the CPA firm, and the Board of Directors that this would ensure the complete safety of the deposit from possible fraud by any employee. Every one approved of this financial control policy. This policy allowed Junior to drive home, take the required cash out of the deposit bag to match what he wrote in the book, prepare a new deposit form, shred the old slips, and deposit the money.

The CPA firm auditing the company was happy that Junior instituted financial controls. It was something that the CPA firm complained about in the past, but it was never addressed until the Controller was caught embezzling funds. The CPA firm questioned Junior about the lack of signed deposit forms of the Controller who prepared the daily deposit. Junior reiterated that the family was thrilled that he took on this extra task. Keeping the signed slips was unnecessary because the amounts were recorded in the Daily Cash Receipts Book in front of the Controller. The Controller and Assistant Controller verified that Junior would immediately write the deposit amount in the book while they delivered the deposit to him. All appeared legitimate, and the CPA firm certified the financial statements each year.

Nervous about accumulating large amounts of cash at his home, Junior created a fictitious company and deposited extra money into another business bank account daily. To avoid suspicion, he opened this other account at 1<sup>st</sup> Street State Bank.

Junior's secret fell apart when Jillian, a teller at 1<sup>st</sup> Street State Bank, began dating Junior's brother George. Jillian was introduced to George through an arranged blind date set up by George's friend. On their first date, Jillian asked if he was related to Junior. When George confirmed that Junior was his brother, Jillian unknowingly dropped a bombshell. She asked him about Junior's business and his daily deposits. George was shocked, knowing Junior had no legitimate business other than Angelica Olive Oil.

George questioned his brother the following day. At first, Junior denied everything, but after unrelenting interrogation, he confessed. George demanded half of Junior's bank account to keep quiet. To ensure that George would not turn him over to the authorities, he plotted with George to expand the fraud scheme and launder the money through a legitimate but separate business enterprise.

Junior and George created a trucking company, Boston Transport, and ensured their names were not publicly connected to this business. As CFO and V.P. of Operations, they convinced their father, uncle, and the Board of Directors to switch transport companies by falsely reporting that the current company was missing customer deadlines. In addition, they said that although Boston Transport rates were higher, it had an excellent reputation for performance. The Board of Directors approved the Boston Transport contract without a background check taking the brothers' word.

One day, the 1<sup>st</sup> Street State Bank branch manager called Junior about a discrepancy between a deposit slip and the bank's recorded amount. Not able to reach Junior on his cell, the manager called Angelica Oil Company and asked for Roberto. The operator mistakenly transferred the call to Roberto, Sr. After confirming that he was talking to Roberto, the bank manager explained the problem with the deposit slip and that the deposit would be reduced by \$1,000. Roberto, Sr., was surprised that Angelica Oil Company was using another bank since the firm had been with Boston State Bank since its formation. Since Junior was not in the office, Roberto Sr. approached the Controller and inquired about the different bank accounts. The Controller said there were no new bank accounts and certainly none at 1<sup>st</sup> Street State Bank. Roberto, Sr., asked the Controller to call him each day with the deposit total for Boston State Bank, using the excuse that he was working on a long-term financing plan and needed actual deposit numbers. Roberto, Sr., then visited Boston State Bank and met the bank manager to get each day's deposit for Angelica Oil Company. When he compared the two, he confirmed his suspicions that Junior was embezzling from Angelica Oil deposits.



Roberto, Sr., decided to confront Junior and wanted his son George present. He called a meeting of his sons and confronted Junior. He was shocked when both Junior and George confessed their wrongdoing. They justified their actions by arguing that it was not fair that their cousin Laura was getting the same pay as each of them for a no-show job and that they were responsible for most of the work and profits for the Angelica Oil Company. Roberto decided not to expose his son's activities, worried they would likely receive jail time. Deep down, he also felt that his brother, his niece, and nephews did not pull their weight at the firm and eventually decided to join his sons in continuing this fraud. All three agreed to divide the profits among themselves equally.

The CPA firm had no idea that any of this fraud was occurring, but Barbara, the longtime assistant for Roberto, Sr., discovered the scam. While filing papers, she found a file out of place in the filing cabinet. It contained the incorporation papers for Boston Transport for Junior and George. She also found a written agreement signed by John Smith, CEO of Boston Transport, acknowledging that all shares in Boston Transport were being held in trust for Roberto, Sr., Junior, and George. Barbara, who writes the board minutes for Angelica Oil Company, was shocked that the new transport company was owned by Roberto, Sr., and his sons. This fact was never disclosed at the board meeting or to anyone at the firm.

Barbara became distraught. Roberto, Sr. was very good to her. She was well paid and had great benefits, including full tuition assistance for her son in medical school. While she did not work for Salvatore, she had a strong affinity for the entire family. She had watched the family grow the business and their children blossom into adulthood and be treated like family.

At family meetings, the topic of family succession always arose and ended up in a major argument. How should the family's portion be distributed from the 2<sup>nd</sup> to the 3<sup>rd</sup> generation? Roberto, Sr., and Isabella thought it should be an equal split between the two families, while Salvatore and Anna thought each 3<sup>rd</sup> generation child should get an equal 20% share (since there were five successors). They each sought professionals to help decide what was fair and best.

#### Case Questions:

1. If outside investors discover this fraud, whom can they sue? What would be the basis for their suit?
2. Are there restrictions on stockholder suits against one's corporation? How are stockholder suits handled?

3. Discuss each party's ethical lapses and legal culpability in this case study and the likelihood of success if investors file suit?
  1. George
  2. Roberto, Sr.
  3. Junior (Roberto, Jr.)
  4. Salvatore
  5. Controller and Assistant Controller
  6. CPA firm
  7. Audit Committee
  8. Board of Directors
  9. Bank Teller at 1st Street Bank
  10. Boston Bank Manager
  11. John Smith, CEO of Boston Transport
  12. Barbara, Administrative Assistant
4. Assuming the fraud is not discovered, how should the business interest be divided among family members? What should be in the succession plan?
5. Discuss if non-active family members, such as Laura, should receive any compensation. Be sure to provide clear reasons why or why not.
6. What accounting changes need to be made to prevent future embezzlement?
7. Identify and discuss the business management changes that need to be made.
8. Identify and discuss the family management changes that need to be made.

Exhibit 1: Angelo Family Tree

