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Principal-principal conflicts during crisis

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Abstract This paper explores principal-principal conflicts in corporate governance during times of economic crisis. We address the question: What external and internal governance mechanisms can best protect minority shareholders? Drawing on 877 publicly listed large corporations with concentrated ownership in seven Asian countries and regions, we compare different control structures between family firms and non-family firms during crisis. We find that family firms tend to choose certain control structures associated with potential principal-principal conflicts. However, these choices can be constrained by external and internal governance mechanisms. Specifically, legal institutions and presence of multiple blockholders serve as useful external and internal governance mechanisms, respectively, to constrain potential expropriation of minority shareholders.

Keywords Principal-principal conflicts · Crisis · Corporate governance · Family ownership

Instead of traditional principal-agent conflicts espoused in most research dealing with developed economies, principal-principal conflicts have been identified as a major concern of corporate governance in emerging economies (Young, Peng,

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Ahlstrom, Bruton, & Jiang, 2008). Principal-principal conflicts refer to conflicts between two groups of principals: controlling shareholders and minority shareholders. Young et al. (2008: 203) argue that these conflicts are likely to be especially severe when firms' ownership and control rights are concentrated in the hands of one large shareholder or one family of owners. Young et al. (2008: 208) further assert that tension for such conflicts may heighten during times of economic crisis, when controlling shareholders themselves suffer major losses and may have stronger motivation to expropriate minority shareholders. While empirical work on principal-principal conflicts is developing (Chen & Young, 2010; Peng & Jiang, 2010; Su, Xu, & Phan, 2008), more work is certainly necessary to deepen our understanding of these crucial conflicts in Asian firms. To further investigate principal-principal conflicts in general and to test Young et al.'s (2008) assertion about the severity of such conflicts during crisis, this paper studies control structures in firms during the 1997 Asian financial crisis. Specifically, we focus on the theme: What external and internal governance mechanisms can best protect minority shareholders in countries with potentially severe principal-principal conflicts during times of crisis?

The Asian financial crisis alerted investors to the region's weak corporate governance (Boubakri, Guedhami, & Mishra, 2010). Western advisors and media as well as international organizations such as the International Monetary Fund and the World Bank suggested that firms reduce ownership concentration and professionalize management. However, research finds that adopting Western-style board practices does not always improve the values of Asian companies (Nowland, 2008; Peng, 2004). These findings suggest more caution when drawing conclusions on corporate governance based on our understanding of Western practices. As a result, an institution-based view of corporate governance calls for more in-depth understanding of the institutions behind family ownership and control in Asia (Carney, Gedajlovic, & Yang, 2009; Peng & Jiang, 2010; Peng, Wang, & Jiang, 2008).

Responding to the call for more in-depth work on principal-principal conflicts issued by Young et al. (2008) and on institutions that may alleviate some of these conflicts issued by Peng et al. (2008), this paper investigates large public firms in the Asian financial crisis and contributes to the literature in two significant ways: (1) We explore control structures chosen by the largest shareholder, focusing on the potential conflicts between the largest shareholder and minority shareholders. (2) We provide suggestions on corporate governance reforms based upon an investigation of external and internal mechanisms that constrain certain control structures. Driven by an interest in minority shareholder protection, we address two specific questions: (1) What control structures do family owners tend to choose? (2) Are there external and internal governance mechanisms that constrain potential principal-principal conflicts?

Family ownership and control

In Asia, the vast majority of publicly traded firms have a family as the largest shareholder (Claessens, Djankov, & Lang, 2000; Heugens, van Essen, & van

Oosterhout, 2009; Steier, 2009). The identity of large owners often determines firms' control structures. Compared with bank, corporate, or state owners, family owners are more reluctant to draw equity from the stock market, fearing loss of control and family cohesiveness (Thomsen & Pedersen, 2000). These firms wish to maintain their business with an intrinsic character—the continued financial security of their families. As such, family owners are more likely to appoint a member of the family as CEO in order to strengthen the family's control.

Excess control rights over cash flow rights enable families to control multiple corporations, each becoming a member of an informal business group and sharing resources. Firms outside these networks may have a difficult time accessing these highly idiosyncratic and informal relationships (Meyer, Estrin, Bhaumik, & Peng, 2009; Peng, 2003; Zhou & Peng, 2010).

Principal-principal conflicts

The control structure adopted by families may become a problem in corporate governance when families use their control to protect their own interests at the expense of minority shareholders. Private benefits of control have been recognized as a major source of principal-principal conflicts (Young et al., 2008). Excess control rights over ownership rights may enable families to sell firm assets to themselves or related parties at below-market prices or spin off the most profitable part of a public firm, merging it with another of their privately held firms. When families appoint an owner CEO, they have an information advantage over minority shareholders (Anderson & Reeb, 2003). This information advantage can be leveraged by families to expropriate minority shareholders (Lemmon & Lins, 2003). High levels of equity ownership may insulate owner CEOs from external market discipline and facilitate collusion between family owners and the owner CEO to share the private benefits. When minority shareholders feel that their interests are not being protected, they may lose confidence in the firm, sell the stock, or refuse to invest (Boubakri et al., 2010; Young et al., 2008).

Expropriation of minority shareholders is not easily observed in an economic boom. However, in times of crisis, controlling shareholders may become more desperate to extract firm resources in an attempt to protect their own wealth (Young et al., 2008: 208). During the 1997 Asian financial crisis, even firms with a good reputation exploited their minority shareholders (Johnson, La Porta, Lopez-de-Silanes, & Schleifer, 2000). We suggest that family firms may maintain family control through excess control rights and family CEOs, which enable them to potentially expropriate minority shareholders in times of economic crisis. Specifically:

Hypothesis 1 Family firms are more likely to have higher excess control rights over cash flow rights than non-family firms. This facilitates potential expropriation of minority shareholders.

Hypothesis 2 Family firms are more likely to have an owner CEO than non-family firms. This facilitates potential expropriation of minority shareholders.

The external governance mechanism: Legal institutions

Are there governance mechanisms that constrain the control structures associated with potential principal-principal conflicts? Cross-country differences in the scale and scope of expropriation vary systematically according to the level of minority shareholder protection afforded by legal and regulatory institutions (Dyck & Zingales, 2004; Lee & Oh, 2007; Peng & Jiang, 2010). Legal and regulatory regimes may act as an external mechanism to protect minority shareholders (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998).

An institution-based view of corporate governance addresses the degree to which firms are embedded in a nexus of formal and informal institutions (Carney et al., 2009; Peng, Sun, Pinkham, & Chen, 2009). La Porta et al. (1998) argue that differences in shareholder protection can explain ownership and control structures around the world, indicating that institutional development imposes external mechanisms on a firm's choice of control structures.

Firms exhibit strategic behavior in response to both firm-level imperatives and country-level institutions (Heugens et al., 2009; Peng et al., 2009; Steier, 2009). Family owners choose control structures in response to the rules of the game (Peng & Jiang, 2010). Although having excess control rights and appointing owner CEOs are not illegal, such schemes may be more attractive in firms when the protection of outside investors is weaker. The rules that are more developed in protecting minority shareholders may limit the largest shareholder's ability to expropriate minority shareholders. Specifically:

Hypothesis 1a The positive relationship between excess control rights over cash flow rights and family firms (hypothesized in Hypothesis 1) is weaker in countries with more developed legal institutions.

Hypothesis 2a The positive relationship between an owner CEO and family firms (hypothesized in Hypothesis 2) is weaker in countries with more developed legal institutions.

The internal governance mechanism: Multiple blockholders

External governance mechanisms do not work perfectly, even in developed economies. In emerging economies with a more erratic institutional environment, less effective or nonexistent takeover markets, and poorly organized managerial labor markets, external governance mechanisms are likely to be even less effective (Young et al., 2008). In such environments, internal mechanisms may play a larger role in corporate governance (Peng et al., 2009: 68). Having multiple blockholders, rather than having just a single controlling shareholder, may be a useful internal mechanism to solve potentially devastating principal-principal problems.

Multiple blockholders combine industry knowledge or operating expertise with monitoring effort, which may enable them to effectively influence the largest owners. Multiple blockholders can form coalitions to take more efficient control than any of its individual members would. Other blockholders are not necessarily more competent than family owners. But if a family is the single blockholder, it will lack

supervision and balance. Having multiple blockholders makes it harder for the family to set up structures that grant itself more power to control the firm.

Governance mechanisms must both monitor decisions and provide resources as firms mature (Peng, 2004; Zahra & Filatotchev, 2004). A single family's ability to provide resources for the firm, especially during a financial crisis, may be limited. Other blockholders, such as governments or financial institutions, may possess a wider variety of resources (Thomsen & Pedersen, 2000). From a resource-based standpoint, multiple blockholders represent valuable, rare, and inimitable resources, which may limit a family owner's ability to obtain certain control structures likely to lead to severe principal-principal conflicts.

Hypothesis 1b The positive relationship between excess control rights over cash flow rights and family firms (hypothesized in Hypothesis 1) is weaker when firms have multiple blockholders.

Hypothesis 2b The positive relationship between an owner CEO and family firms (hypothesized in Hypothesis 2) is weaker when firms have multiple blockholders.

Methodology

Database

Our primary sources are (1) Datastream and (2) Asian Corporate Governance Archival Data Center (which primarily draws on Worldscope and World Bank data sources). Ownership and control data are collected for the year 1996, 1 year before the 1997 crisis. Ownership of each company is traced to its ultimate owner and the owner's cash flow rights share, as a percentage of total outstanding shares, is calculated (Claessens et al., 2000). A 5% control rights share cutoff is used to assure that the largest shareholder has concentrated ownership and control. Sufficient ownership data are provided since ultimate owners are traced. Firms in Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand are included. We have 877 observations.

Dependent variables

Excess control rights over cash flow rights (Excess control) This variable is measured as the difference between cash flow rights and control rights of the largest shareholder. Different from Lemmon and Lins (2003), who measure management excess control over cash flow with a dummy variable, we use a continuous variable that contains more information regarding the largest shareholder's excess control.

Owner CEO Firms with a CEO from the controlling shareholder's family are coded 1, and 0 otherwise.

Expropriation of minority shareholders (Stock return) Minority shareholder value is directly reflected in firms' stock market performance. Lower stock return harms minority shareholders' wealth, thus representing more expropriation. The 1997

Asian financial crisis was triggered in Thailand in July and spread over to other Asian countries very quickly (Lim, Das, & Das, 2009). We measure expropriation of minority shareholder by cumulative stock return (buy and hold return) during the crisis from July 1 to December 31, 1997 (or the last trading day of the year) to capture the immediate effect on minority shareholders.

Independent variables

Family firm Firms having a family as the largest shareholder are recognized as family firms (Thomsen & Pedersen, 2000). Firms with a family as the largest shareholder are coded 1, and 0 otherwise. A total of 641 firms in our sample are such family-owned firms.

Legal institutional development (Legal institutions) This is measured by La Porta et al.'s (1998) index for judicial efficiency, rule of law, and corruption, which runs on a 1–10 scale (10 being the best). La Porta et al.'s (1998) index has been widely used in cross-country studies (Dyck & Zingales, 2004; Peng & Jiang, 2010; Schneper & Guillen, 2004). Table 1 shows raw numbers for each country and the standardized numbers, which are aggregated to create a variable as the measure for institutional development. Singapore and Hong Kong have a relatively higher level of institutional development and Indonesia's score is relatively lower.

Multiple blockholders Firms that have more than one shareholder with more than 5% control rights are considered as firms with multiple blockholders. A total of 565 firms in our sample have multiple blockholders.

Control variables

Market-to-book ratio, debt-to-assets ratio, and firm age in 1996 are included. We also control for firm risk measured by beta, computed by regressing a firm's monthly stock return on the corresponding country index return in 1996.

Table 1 Country institutional development.

	Judicial efficiency Standardized value (raw score)	Rule of law Standardized value (raw score)	Corruption Standardized value (raw score)	Institutional development Standardized value*
Hong Kong	1.042 (10)	0.804 (8.22)	1.033 (8.52)	2.879
Indonesia	−1.390 (2.5)	−1.613 (3.98)	−1.839 (2.15)	−4.842
Malaysia	0.718 (9)	−0.017 (6.78)	0.519 (7.38)	1.22
Singapore	1.042 (10)	1.003 (8.57)	0.898 (8.22)	2.943
South Korea	−0.255 (6)	−0.832 (5.35)	−0.419 (5.3)	−1.506
Taiwan	−0.012 (6.75)	0.975 (8.52)	0.280 (6.85)	1.243
Thailand	−1.147 (3.25)	−0.319 (6.25)	−0.473 (5.18)	−1.939

* An equally weighted measure consisting of the three components of standardized value in previous columns.

Source: La Porta et al. (1998: 1142–1143).

In general, Asian firms with a listed American Depository Receipt (ADR) have higher disclosure quality. Thus, we include an ADR dummy to examine whether increasing accounting transparency leads to certain control structures. We also include 12 industry dummies and 7 country dummies.

Endogeneity of owner identity and control structure

Previous studies that link firm value with ownership and control have been criticized for not controlling endogeneity of control structures. Himmelberg, Hubbard, and Palia (1999) show that managerial ownership and control can be explained by key variables in the contracting environment. We use two stage least squares (2SLS) and control for unobserved firm characteristics associated with the identity of the largest owner, thus giving a consistent and efficient estimate of the effect of firm control structures. In the first stage, we use all of the exogenous variables to estimate two endogenous variables: "excess control" (ordinary least square [OLS] model) and "owner CEO" (logit regression model). In the second stage regression, we use the fitted values from the first stage as instruments and test expropriation of minority shareholders (OLS model).

In terms of econometric issues, multicollinearity does not appear to be a major problem, because the average variance inflation factor for each country is less than 10. Heteroskedasticity is corrected using robust (Huber/White/Sandwich) standard errors.

Findings

Tables 2, 3, and 4 show the correlations, first stage regression, and second stage regression, respectively. Family firm is positively related to excess control rights over cash flow rights in Model 1, and is positively related to owner CEO in Model 2. The chosen excess control and owner CEO are both negatively related to stock return in Models 3 and 4. We also use Hausman's test for the existence of endogeneity. The Hausman test is based on the difference between the OLS estimator and the instrumental variable (IV) estimator. We can reject the null hypothesis of no endogeneity at the 5% level, indicating that 2SLS model is efficient. In summary, Models 1–4 support Hypotheses 1 and 2, indicating that family firms are more like to choose certain control structures that relate to expropriation of minority shareholders.

Table 5 shows the moderating effects from external and internal governance mechanisms. Models 5 and 6 test the moderating effect of legal institutional development. The interaction of family firm and legal institutions is significant and negative in Model 5. The negative interaction term indicates that legal institutions have a negative effect on the relation between family firms and choice of excess control rights, supporting Hypothesis 1a. The interaction term is insignificant in Model 6, which means that Hypothesis 2a is not supported. The moderating effect on family firms' choice of owner CEO is not found.

Models 7 and 8 test the moderating effect of multiple blockholders. The interaction of family firm and multiple blockholders is significant and negative in both models. The negative interaction term indicates that multiple blockholders have a negative effect on the relationship between family firms and choice of control structures, supporting Hypotheses 1b and 2b.

Table 2 Descriptive statistics and correlations.

Variables	Mean	s.d.	1	2	3	4	5	6	7	8	9	10
1. Stock return	−40.4	33.2										
2. Family firm	0.7	0.4	−0.2***									
3. Excess control	5.1	7.8	−0.04	0.2***								
4. Owner CEO	0.7	0.5	−0.1**	0.5***	0.3***							
5. Legal institutions	0.8	2.5	0.2***	−0.1***	−0.1**	−0.1***						
6. Multiple blockholders	0.6	0.5	−0.00	−0.2***	−0.1**	0.02	−0.02					
7. Age	29.0	17.9	0.00	−0.0	0.04	−0.02	0.02	−0.1*				
8. Market to book	1.9	2.0	−0.1	−0.04	−0.02	−0.01	0.1*	0.1*	−0.04			
9. Debt to assets	28.3	20.7	−0.1***	0.08*	−0.05	0.02	−0.3***	0.04	−0.04	−0.1***		
10. Beta	0.9	0.9	−0.2***	0.03	−0.06	0.02	−0.1	0.01	0.03	−0.0	0.05	
11. ADR	0.1	0.3	0.1*	−0.03	−0.05	−0.1**	0.2***	−0.02	−0.01	−0.0	−0.1	−0.0

* $p < 0.05$.

** $p < 0.01$.

*** $p < 0.001$.

Table 3 First stage regression estimating excess control rights over cash flow rights and owner CEO.

	Excess control Model 1	Owner CEO Model 2
Family firm	**4.39***** (0.44)	**2.80***** (0.21)
Age	0.02 (0.02)	−0.00 (0.01)
Market-to-book	−0.08 (0.13)	−0.10* (0.05)
Debt-to-assets	−0.00 (0.01)	−0.00 (0.00)
Beta	−0.15 (0.30)	−0.05 (0.11)
ADR	−1.44 (0.98)	−0.32 (0.31)
Constant	2.33 (2.36)	−1.72* (0.81)
N	877	877
Prob > F, Prob > Ch^2	0.00	0.00
R^2	0.16	0.26

Standard errors are heteroskedasticity-consistent robust. Industry dummy variables and country dummy variables are included in the models but are not reported due to space constraints.

* $p < 0.05$.

** $p < 0.01$.

*** $p < 0.001$.

Table 4 Second stage regression analyzing expropriation of minority shareholders.

	Stock return Model 3	Stock return Model 4
Excess control	**−1.07*** (0.53)	
Owner CEO		**−9.12*** (4.48)
Age	0.07 (0.05)	0.05 (0.05)
Market-to-book	−0.95* (0.40)	−0.98* (0.42)
Debt-to-assets	−0.15* (0.07)	−0.15* (0.07)
Beta	−5.90*** (1.20)	−5.80*** (1.19)
ADR	4.32 (3.28)	5.35 (3.14)
Constant	−19.33 (12.87)	14.18 (10.87)
N	877	877
Prob > F	0.00	0.00
R^2	0.27	0.31

Standard errors are heteroskedasticity-consistent robust. Industry dummy variables and country dummy variables are included in the models but are not reported due to space constraints.

* $p < 0.05$.

** $p < 0.01$.

*** $p < 0.001$.

Table 5 Moderating effects of legal institutional development and multiple blockholders.

	Excess control Model 5	Owner CEO Model 6	Excess control Model 7	Owner CEO Model 8
Family firm	4.84*** (0.48)	2.76*** (0.23)	5.89*** (0.96)	4.23*** (0.53)
Legal institutions	0.12 (0.16)	0.03 (0.07)		
Multiple blockholders			1.12 (0.91)	1.62** (0.52)
Family firm × Legal institutions	**−0.39*** (0.19)	**0.05** (0.08)		
Family firm × Multiple blockholders			**−2.26*** (1.09)	**−1.75**** (0.56)
Age	0.02 (0.02)	−0.00 (0.01)	0.02 (0.02)	0.00 (0.01)
Market-to-book	−0.09 (0.13)	−0.09* (0.05)	−0.07 (0.13)	−0.09* (0.05)
Debt-to-assets	−0.00 (0.01)	−0.00 (0.00)	−0.00 (0.01)	−0.00 (0.00)
Beta	−0.18 (0.30)	−0.04 (0.11)	−0.18 (0.30)	−0.06 (0.11)
ADR	−1.46 (0.98)	−0.32 (0.31)	−1.47 (1.01)	−0.38 (0.32)
Constant	8.25*** (2.31)	−0.58 (0.74)	1.62 (2.44)	−1.48 (1.17)
N	877	877	877	877
Prob > F, Prob > Ch^2	0.00	0.00	0.00	0.00
R^2	0.16	0.27	0.16	0.28

Standard errors are heteroskedasticity-consistent robust. Industry dummy variables and country dummy variables are included in the models but are not reported due to space constraints.

* $p < 0.05$.

** $p < 0.01$.

*** $p < 0.001$.

Discussion

Our results indicate that family firms are indeed more likely to choose control structures with higher excess control rights and to appoint an owner CEO. Nonetheless, family owners do not choose these control structures without constraints. The external governance mechanism—legal institutional development—confines family owners who have excess control rights. The internal governance mechanism—multiple blockholders—also limits family owners' potential expropriation of minority shareholders.

Contributions

In our view, two contributions emerge. First, this paper has responded to the call for more in-depth research on principal-principal conflicts (Young et al., 2008) and for more probes into institutions behind family ownership and control (Peng et al., 2008). Given the disproportionate research attention to principal-agent conflicts, clearly, principal-principal conflicts deserve more research attention. We contribute to the literature by explicitly linking corporate governance mechanisms and control structures. Corporate governance development depends on a bundle of governance mechanisms (Young et al., 2008). Our study examines both the external and internal

governance mechanisms in constraining the choices of certain control structures that may lead to potential expropriation of minority shareholders.

Second, this paper continues the stream of recent empirical work on principal-principal conflicts (Chen & Young, 2010; Peng & Jiang, 2010; Su et al., 2008) by adding a finer-grained understanding of principal-principal conflicts during crisis. This paper examines the dominant principal in East Asian firms (family owners), and explores the source of principal-principal conflicts. Our findings of the relationship between control structures and governance mechanisms suggest that certain control structures associated with expropriation of minority shareholders can be constrained by legal institutional development and multiple blockholders. Our findings thus provide guidance for corporate governance reforms in these countries.

Limitations

In terms of limitations, this study uses a dummy variable for an owner CEO, while other studies focus on the fraction of shares owned by a firm's management (Demsetz & Lehn, 1985; Himmelberg et al., 1999). Whether the owner CEO belongs to the first (founding) generation of the firm may have a bearing on the valuation of the firm (Anderson & Reeb, 2003). Unfortunately, our data do not permit us to control for the generation effect of the owner CEO.

While the existence of multiple blockholders is an important governance mechanism, our study lacks exploration on the *identity* of the multiple blockholders. Are the governance mechanisms more effective when the other blockholders are the government, other companies, or another family? These questions will need to be addressed in future studies.

Writing in the middle of the 2008–2009 global economic crisis, we realize that every crisis may be "unprecedented." In addition to this paper, recent papers whose titles sport the word "crisis" all deal with the 1997 crisis (Boubakri et al., 2010; Chung, Lee, Beamish, & Isobe, 2010; Lim et al., 2009). Whether findings generated from this stream of work on the 1997 crisis can be generalized to the more recent 2008–2009 crisis remains to be seen in future research.

Conclusion

Resolving principal-principal conflicts in emerging economies requires creative solutions. An institution-based view of corporate governance suggests that individual countries will need to work out answers appropriate to their own particular institutional conditions (Carney et al., 2009; Peng et al., 2008, 2009; Peng & Jiang, 2010; Young et al., 2008). At present, abolishing concentrated ownership structures is not realistic, because the lack of supporting institutions (such as takeover markets, effective boards of directors, and laws and enforcement regimes) would create a governance vacuum. This paper adds to the existing literature on corporate governance reforms in Asia by examining concentrated family owners' choice of control structures and exploring two external and internal solutions for overcoming principal-principal conflicts.

Overall, to resolve principal-principal conflicts and combat expropriation of minority shareholders in Asia, our study highlights mechanisms that may constrain certain control structures associated with family firms. For policymakers engaged in the ongoing debate about the design of corporate control structure to protect minority shareholders and govern concentrated owners, our advice is twofold: (1) externally, strengthen legal institutions that protect minority shareholders and (2) internally, promote the presence of multiple blockholders who may provide checks, balances, and resources relative to the influence of a single dominant family in one firm.

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