# Principal–principal agency

**Article** *in* Academy of Management Annual Meeting Proceedings · August 2002

DOI: 10.5465/APBPP.2002.7516497



Michael N. Young
Hong Kong Baptist University



David Ahlstrom
The Chinese University of Hong Kong

JOURNAL OF MANAGEMENT STUDIES

*Journal of Management Studies* 45:1 January 2008
0022-2380

# Review Paper
# Corporate Governance in Emerging Economies: A Review of the Principal–Principal Perspective

**Michael N. Young, Mike W. Peng, David Ahlstrom, Garry D. Bruton and Yi Jiang**

*Hong Kong Baptist University; University of Texas at Dallas; The Chinese University of Hong Kong; Texas Christian University; California State University, East Bay*

ABSTRACT 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. Principal–principal conflicts between controlling shareholders and minority shareholders result from concentrated ownership, extensive family ownership and control, business group structures, and weak legal protection of minority shareholders. Such principal–principal conflicts alter the dynamics of the corporate governance process and, in turn, require remedies different from those that deal with principal–agent conflicts. This article reviews and synthesizes recent research from strategy, finance, and economics on principal–principal conflicts with an emphasis on their institutional antecedents and organizational consequences. The resulting integration provides a foundation upon which future research can continue to build.

## INTRODUCTION

Researchers increasingly realize that there is not a single agency model that adequately depicts corporate governance in all national contexts (La Porta et al., 1997, 1998; Lubatkin et al., 2005a). The predominant model of corporate governance is a product of developed economies (primarily the United States and United Kingdom), where the institutional context lends itself to relatively efficient enforcement of arm's-length agency contracts (Peng, 2003). In developed economies, because ownership and control are often separated and legal mechanisms protect owners' interests, the governance conflicts that receive the lion's share of attention are the principal–agent (PA) conflicts between owners (principals) and managers (agents) (Jensen and Meckling, 1976). However, in emerging economies, the institutional context makes the enforcement of agency contracts more costly and problematic (North, 1990; Wright et al., 2005). This results in the

*Address for reprints*: Michael N. Young, Department of Management, Hong Kong Baptist University, Kowloon Tong, Hong Kong (michaely@hkbu.edu.hk).

prevalence of concentrated firm ownership (Dharwadkar et al., 2000). Concentrated ownership, combined with an absence of effective external governance mechanisms, results in more frequent conflicts between controlling shareholders and minority shareholders (Morck et al., 2005). This has led to the development of a new perspective on corporate governance, which focuses on the conflicts between different sets of principals in the firm. This has come to be known as the *principal–principal* (PP) model of corporate governance, which centres on conflicts between the controlling and minority shareholders in a firm (cf. Dharwadkar et al., 2000).

PP conflicts are characterized by concentrated ownership and control, poor institutional protection of minority shareholders, and indicators of weak governance such as fewer publicly traded firms (La Porta et al., 1997), lower firm valuations (Claessens et al., 2002; La Porta et al., 2002; Lins, 2003), lower levels of dividends payout (La Porta et al., 2000), less information contained in stock prices (Morck et al., 2000), inefficient strategy (Filatotchev et al., 2003; Wurgler, 2000), less investment in innovation (Morck et al., 2005), and, in many cases, expropriation of minority shareholders (Claessens et al., 2000; Faccio et al., 2001; Johnson et al., 2000b; Mitton, 2002). In the last decade, researchers in finance and economics have increasingly realized that the traditional Jensen and Meckling (1976) conceptualization of PA conflicts does not account for the realities of PP conflicts that dominate emerging economies. In emerging economies, many firms experiencing PP conflicts can be characterized as 'threshold firms' that are near the point of transition from founder to professional management (Daily and Dalton, 1992). At the threshold, it may be in the best interest of the firm's continued development for founders (or the founding family) to yield control (Gedajlovic et al., 2004). However, failure to make the transition may worsen PP conflicts. Such a transition is always difficult for firms in both developed and emerging economies (Zahra and Filatotchev, 2004). Yet, a higher percentage of threshold firms in developed economies seem to have effectively managed this transition, while a majority of threshold firms in emerging economies have failed to do so. It seems interesting to explore why this is the case.

Strategy research (and the broader management research in general) has also begun to explore the institutional underpinnings of strategic behaviour including corporate governance, especially in emerging economies (Wright et al., 2005). While strategy research is influenced by the economic version of the institutional perspective (e.g. North, 1990), it has increasingly incorporated substantial elements of the sociological and behavioural insights from the institutional literature (Peng and Zhou, 2005; Scott, 1995). Thus, a wide range of different disciplines has begun to recognize PP conflicts and their impact on corporate governance.

This convergence of disciplines in their exploration of PP conflicts creates opportunities for further integration. Drawing on recent research in strategy, finance, and economics, this article brings PP conflicts in emerging economies into sharper focus. We review, integrate, and extend this growing literature, focusing on three main questions: (1) What is the nature of PP conflicts? (2) What are their institutional antecedents? (3) What are their organizational consequences? Overall, we endeavour to build a comprehensive and integrative model of PP conflicts to lay the foundation for future research.

## CORPORATE GOVERNANCE IN EMERGING ECONOMIES

Emerging economies are 'low-income, rapid-growth countries using economic liberalization as their primary engine of growth' (Hoskisson et al., 2000, p. 249). Institutional theory has become the predominant theory for analysing management in emerging economies (Hoskisson et al., 2000; Wright et al., 2005). As an example, seven of the eight papers published in a recent special issue of the *Journal of Management Studies* on strategy in emerging economies utilized institutional theory (Wright et al., 2005). Institutions affect organizational routines (Boyer and Hollingsworth, 1997; Feldman and Rafaeli, 2002) and help frame the strategic choices facing organizations (Peng, 2003; Peng et al., 2005; Powell, 1991). In short, institutions help to determine firm actions, which in turn determine the outcomes and effectiveness of organizations (e.g. He et al., 2007).

However, the institutions that impact such organizational actions in emerging economies are not stable. Furthermore, the formal institutions that do exist in emerging economies often do not promote mutually beneficial impersonal exchange between economic actors (North, 1990, 1994). As a result, organizations in emerging economies are to a greater extent guided by informal institutions (Peng and Heath, 1996). The theories used by researchers often implicitly assume that the institutional conditions found in developed economies are also present in emerging economies. Clearly, this is not the case in emerging economies and as a result the organizational activities can differ considerably from those found in developed economies (Wright et al., 2005).

To illustrate, in the case of corporate governance, emerging economies typically do not have an effective and predictable rule of law which, in turn, creates a 'weak governance' environment (Dharwadkar et al., 2000, p. 650; Mitton, 2002, p. 215). This is not to say that emerging economies have no laws dealing with corporate governance. In most cases, emerging economies have attempted to adopt legal frameworks of developed economies, in particular those of the Anglo-American system, either as a result of internally driven reforms (e.g. China, Russia) or as a response to international demands (e.g. South Korea, Thailand). However, formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent, inefficient, or do not operate as intended. Therefore, standard corporate governance mechanisms have relatively little institutional support in emerging economies (Peng, 2004; Peng et al., 2003). This results in informal institutions, such as relational ties, business groups, family connections, and government contacts, all playing a greater role in shaping corporate governance (Peng and Heath, 1996; Yeung, 2006).

For threshold firms, the transition to professional management is always difficult (Daily and Dalton, 1992). Yet it is even more difficult in emerging economies because of the weak institutional environment and it is common for even the largest firms to still be under the control of the founding family. In essence, these firms attempt to *appear* as having 'crossed the threshold' from founder control to professional management. But the founding family often retains control through other (often informal) means (Liu et al., 2006; Young et al., 2004). Indeed, publicly-listed firms in emerging economies have shareholders, boards of directors, and 'professional' managers, which compose the 'tripod' of modern corporate governance (Monks and Minnow, 2001). Thus, even the largest publicly-traded firms in an emerging economy may have adopted the appearance of corporate governance mechanisms from developed economies, but these mechanisms rarely function like their counterparts in developed economies.

In short, the corporate governance structures in emerging economies often resemble those of developed economies in form but not in substance (Backman, 1999; Peng, 2004). As a result, concentrated ownership and other informal mechanisms emerge to fill the corporate governance vacuum. While these *ad hoc* mechanisms may solve some problems, they create other, novel problems in the process. Each emerging economy has a corporate governance system that reflects its institutional conditions. However, there are a number of similarities among emerging economies as a group; conflicts between two categories of principals are a major issue. These PP conflicts are discussed in detail in the next section.

## THE NATURE OF PRINCIPAL–PRINCIPAL CONFLICTS

According to the Anglo-American variety of agency theory, the primary agency conflicts – PA conflicts – occur between dispersed shareholders and professional managers (although this is less pronounced in Japan and continental Europe). Accordingly, there are several governance mechanisms that may help align the interests of shareholders and managers. These include *internal* mechanisms such as boards of directors, concentrated ownership, executive compensation packages, and *external* governance mechanisms such as product market competition, the managerial labour market, and threat of takeover (Demsetz and Lehn, 1985; Fama and Jensen, 1983). The optimal combination of mechanisms adopted can be considered as a 'package' or an 'ensemble' where a particular mechanism's effectiveness depends on the effectiveness of others (Davis and Useem, 2002; Rediker and Seth, 1995). For example, if a board of directors is relatively ineffective, a takeover bid may be necessary to dislodge an entrenched CEO. Thus, governance mechanisms operate interdependently with overall effectiveness depending on the particular combination (Jensen, 1993). In other words, one mechanism may substitute for or complement another – if one or more mechanisms are less effective, then others will be relied on more heavily (Rediker and Seth, 1995; Suhomlinova, 2006).

While researchers have long maintained that the efficient design of a bundle of governance mechanisms varies systematically with the industry or the size of the firm (Fama and Jensen, 1983), it also is argued that the efficiency of a bundle of governance mechanisms varies systematically with the institutional structure at the *country* level (Guillen, 2000a, 2001; La Porta et al., 1997, 1998, 2002; Suhomlinova, 2006). Lubatkin et al. (2005a) explicitly address the impact of national institutions on corporate governance. Maintaining that traditional agency theory fails to accommodate differences in national culture, they build a cross-national governance model offering insight into why governance practices evolve differently in different institutional contexts. Put simply, it is likely that institutional structure at the country level impacts the bundle of internal and external governance mechanisms at the firm level.

The institutional setting in emerging economies calls for a different bundle of governance mechanisms since the corporate governance conflicts often occur between two categories of principals – controlling shareholders and minority shareholder. Of course,

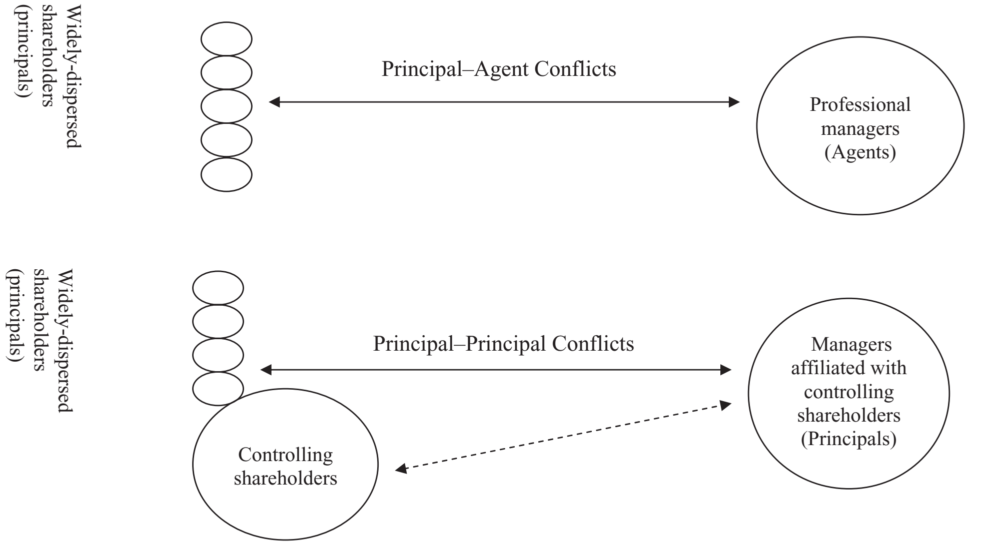


Figure 1. Principal–principal conflicts versus principal–agent conflicts

PP conflicts may exist in developed economies. For example, in developed economies, there has been an examination of the partial congruence between managerial interests and those of other stakeholders, such as debt holders (Dewatripont and Tirole, 1994; Hart and Moore, 1995). The PP model of corporate governance in emerging economies that we outline here differs from this research in that here we explicitly examine conflicts between two groups of principals. Figure 1 depicts this difference graphically. In the top panel of the figure, the solid arrow depicts the traditional PA conflicts that occur between fragmented shareholders and professional managers. In the bottom panel of Figure 1, note that the dashed arrow depicts the relationship between the controlling shareholders and their affiliated managers. These affiliated managers may be family members or associates who answer directly to the controlling shareholders. The solid line depicting the conflicts is drawn between the affiliated managers – who represent the controlling shareholders – and the minority shareholders. Hence the conflict actually is between the controlling shareholders on the one hand and fragmented, dispersed minority shareholders on the other hand.

This redrawing of the battle lines changes the dynamics of corporate governance in PP conflicts. For example, controlling shareholders can decide who is on the board of directors. This effectively nullifies a board's ability to oversee controlling shareholders. The recourse to the courts for the board not overseeing minority shareholders' interests is limited. In developed economies, concentrated ownership is widely promoted as a possible means of addressing traditional PA conflicts (Demsetz and Lehn, 1985; Grossman and Hart, 1986). But in emerging economies, since concentrated ownership is a *root cause* of PP conflicts, increasing ownership concentration cannot be a remedy and may, in fact, make things worse (Faccio et al., 2001).

This pitting of controlling shareholders against minority shareholders often results in the expropriation of the value from minority shareholders, which refers to the transfer of value from the minority shareholders to the majority or controlling shareholders (Shleifer and Vishny, 1997). Expropriation can take many forms – some legal, some illegal, and some in 'grey areas' (La Porta et al., 2000). Expropriation may be accomplished by: (1) putting less-than-qualified family members, friends, and cronies in key positions (Faccio et al., 2001); (2) purchasing supplies and materials at above-market prices or selling products and services at below-market prices to organizations owned by, or associated with, controlling shareholders (Chang and Hong, 2000; Khanna and Rivkin, 2001); and (3) engaging in strategies which advance personal, family, or political agendas at the expense of firm performance such as excessive diversification (Backman, 1999).

The differences between traditional PA conflicts and PP conflicts are outlined in Table I. Many differences are the result of differences in institutional context. For example, institutional protection of minority shareholders sets an upper bound on the potential for expropriation by majority shareholders in developed economies with well-founded market institutions, but such protection is usually lacking in emerging economies. Likewise, the market for corporate control is touted as the governance mechanism of last resort in developed economies, but it typically is inactive in emerging economies (Peng, 2006). All of these factors make the PP conflict substantially different from the stylized agency model that is touted in most research and textbooks.

## The Prevalence of Dominant Ownership

As mentioned in the previous section, dominant ownership is common among publicly-traded corporations in emerging economies and it is a root cause of PP conflicts. There are two reasons why dominant ownership is more prevalent in emerging economies. First, at the 'threshold' stage from founder to professional management (Daily and Dalton, 1992), giving up dominant ownership requires that the founders divulge sensitive information to outside investors. This has serious implications for building organizational knowledge and capabilities (Zahra and Filatotchev, 2004). Founder-managed firms may be reluctant to share strategically vital information with outsiders at a time when capabilities and core competencies are being conceived, assembled, or reconfigured. At this particular stage of development, leakage of sensitive information can undermine the very existence of an entrepreneurial threshold firm.

The sharing of sensitive information with professional managers and outside investors requires trust (Zahra and Filatotchev, 2004, p. 891). But trust among unfamiliar parties is less likely to occur in emerging economies because of the institutional environment (Bardhan, 2001; North, 1990; Skaperdas, 1992). As Barney and Hansen (1994)[1] point out, institutions may facilitate trust by putting in place legal safeguards that protect both parties. Since such institutions often are lacking or ineffective, firms in emerging economies typically hire only members of the in-group or family (Fukuyama, 1995; Yeung, 2006). This makes crossing the threshold from dominant to dispersed ownership more difficult in emerging economies.

Second, emerging economy firms may rely more heavily on dominant ownership for corporate governance reasons (Gedajlovic et al., 2004). As discussed earlier, corporate governance mechanisms consist of external mechanisms and internal mechanisms. The combination of governance mechanisms should be thought of as an 'ensemble' in which

Table I. Principal–agent conflicts versus principal–principal conflicts

| | ***PA conflicts*** *as depicted in Anglo-American variety of agency theory* | ***PP conflicts*** *that commonly occur in emerging economies* |
|---|---|---|
| Goal incongruence | Between fragmented, dispersed shareholders and professional managers | Between controlling shareholders and minority shareholders |
| Manifestations | Strategies that benefit entrenched managers at the expense of shareholders in general (e.g. shirking, pet projects, excessive compensation, and empire building) | Strategies that benefit controlling shareholders at the expense of minority shareholders (e.g. minority shareholder expropriation, nepotism, and cronyism) |
| Institutional protection of minority shareholders | Formal constraints (e.g. judicial reviews and courts) set an upper bound on potential expropriation by majority shareholders. Informal norms generally adhere to shareholder wealth maximization | Formal institutional protection is often lacking, corrupt, or un-enforced. Informal norms typically favour the interests of controlling shareholders over minority shareholders |
| Market for corporate control | Active as a governance mechanism 'of last resort' | Inactive even in principle. Concentrated ownership thwarts notions of takeover |
| Ownership pattern | Dispersed – holding 5–20% equity is considered 'concentrated ownership'. A shareholder with 5% equity stake is regarded as a 'blockholder' | Concentrated – often more than 50% of equity is held by controlling shareholder. Often structured as a 'pyramid' where cash flow rights are greater than ownership rights |
| Boards of directors | Legitimate legal and social institutions with fiduciary duty to safeguard shareholders' interests. Research focuses on factors that affect day-to-day operations such as insiders vs. outsiders, background of directors, committee structures, etc | In emerging economies, boards often have yet to establish institutional legitimacy and thus are ineffective. Research indicates they are often the 'rubber stamp' of controlling shareholders |
| Top management team | Professional managers who often have made their way up through the ranks or are hired from outside after extensive search and scrutiny of qualifications. Monitored internally by boards of directors and externally by managerial labour market | Typically family members or associates. Monitored mainly through family consensus or self-regulation adhering to 'gentlemen's agreements' |

internal and external mechanisms complement or substitute for each other to keep managerial opportunism in check (Rediker and Seth, 1995; Suhomlinova, 2006). In emerging economies, product markets, labour markets, takeover markets and other external factors are corrupted or ineffective and thus less effective in governing top managers (Djankov and Murrell, 2002; Groves et al., 1995; La Porta et al., 1998) and as a result, more emphasis is placed on internal control mechanisms (Peng and Heath, 1996). The primary internal governance mechanism in developed economies is the board of directors (Fama and Jensen, 1983). Yet, boards of directors are complex structures that need formal and informal institutional support to operate as intended (Aguilera and Jackson, 2003). As boards of directors in emerging economies lack this institutional support, they are less likely to play a strong monitoring and control role (Peng, 2004; Peng et al., 2003; Young et al., 2001). This means that firms in emerging economies are forced to rely on dominant ownership to keep potential managerial opportunism in check (Dharwadkar et al., 2000).

The result is that dominant ownership is the norm even in the largest corporations in emerging economies (La Porta et al., 1999). Not only is concentrated ownership more likely to occur, but controlling shareholders are likely to be *dominant* owners – holding more than 50 per cent of firm equity (Dharwadkar et al., 2000). In contrast, researchers working on US or UK samples often use a cut-off of 5 per cent equity to indicate the presence of 'blockholders', who exercise 'owner control' (Dharwadkar et al., 2000, p. 659). Based on our calculation using data reported by La Porta et al. (1998), the top three shareholders held 51 per cent equity of firms in 28 emerging economies on average, as opposed to 41 per cent in 21 developed economies. While the differences in percentages may not seem that dramatic, what they signify is an ownership-based control in emerging economies, which has a significant impact on how corporations are managed and run (Daily and Dalton, 1992).

## INSTITUTIONAL ANTECEDENTS

Figure 2 illustrates the antecedents and outcomes of the PP model of corporate governance. The institutional conditions in emerging economies create a climate that increases the costs of monitoring and enforcing contracts. Essentially, concentrated ownership is the most viable corporate governance alternative in this environment. The controlling shareholders are often associated with a family and/or business group. The controlling shareholders thus have the motive and means to exploit their positions. There are essentially two, often related, types of controlling shareholders, family owners and business groups, which are discussed next.

### Family Ownership

In emerging economies, controlling ownership is often in the hands of a family (Chen, 2001; Claessens et al., 2000; La Porta et al., 1999). Family ownership has an informal yet powerful influence on the way that organizations are run, with both positive and negative outcomes (Schulze et al., 2001, 2003). Family control may reduce agency costs by helping to align ownership with control (Fama and Jensen, 1983; Jensen and Meckling,

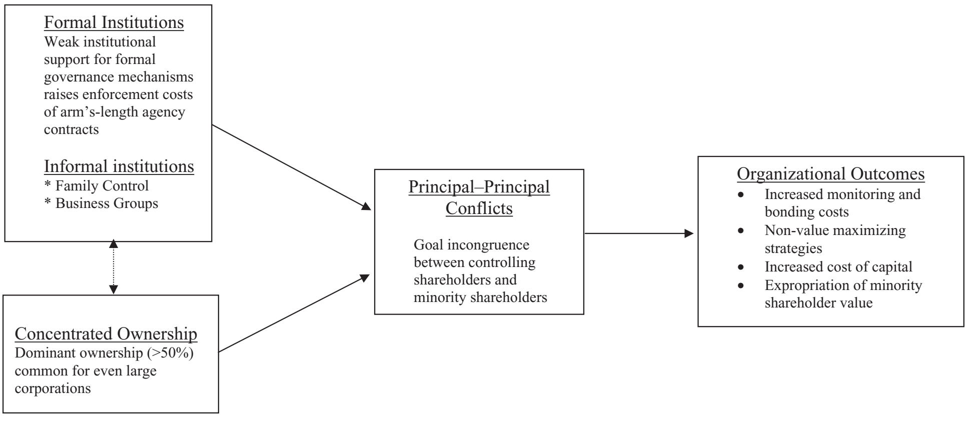


Figure 2. Antecedents and outcomes of principal–principal conflicts in emerging economies

1976). For example, Filatotchev et al. (2005) find that board independence from a founding family has a positive impact on firm performance. Family business scholars identify a number of underlying dimensions of the 'familiness' (e.g. goal congruence, trust) that assist family firms (Habbershon and Williams, 1999) and reduce monitoring costs (Lubatkin et al., 2005b). For example, Anderson and Reeb (2003) find that family ownership among US *Fortune* 500 firms is associated with increased performance.

On the other hand, family control may increase the likelihood of expropriation of non-family minority shareholders and can harm performance (Bloom and Van Reenen, 2006). Family owners may expropriate firm resources and appoint unqualified family members to key posts (Carney, 1998; Claessens et al., 2000). Sibling rivalry, generational envy, non-merit-based compensation, and 'irrational' strategic decisions can destroy firm value in family businesses (Gomez-Mejia et al., 2001). Along these lines, Schulze et al. find that family relations may make agency conflicts '*more* difficult' to resolve (2001, p. 102; italics in original), because relations between principals (family owners) and agents (family-member managers) are based on emotions, sentiments, and informal linkages, resulting in less effective monitoring of family managers. Whether family control ultimately helps performance depends upon a myriad of factors such as whether the family is willing to recruit managers from outside to develop a broader array of capabilities (Daily and Dalton, 1992; Gedajlovic et al., 2004; Tsui, 2004).

The net advantage or disadvantage of family control also depends upon the size and complexity of the organization. As Gedajlovic et al. (2004, p. 905) put it, '[Family-managed firms] are more likely to be born, grow, and thrive when the environment they face is characterized by low levels of munificence and complexity, but high levels of dynamism'. As the environment becomes more munificent or complex, the organization requires more formal and systematic control systems, and this is where family-managed firms run into problems (Gedajlovic et al., 2004).[2] Zahra and Filatotchev (2004) also recognize that different governance roles are called for at different stages of a firm's development. They argue that resource and knowledge roles of governance are important for entrepreneurial threshold firms but ownership structure and monitoring become more important as firms mature.

In emerging economies, the family business structure is a rational response to the institutional environment confronting firms (Redding, 1990; Yeung, 2006). The high costs of enforcing arm's-length contracts means that even large and complex firms often are staffed with family members (Backman, 1999). While this may solve some problems, it also creates new problems such as parents' altruism – defined in the family business literature by Schulze et al. (2003) as parents' inability to discipline under-performing adult children who serve in management positions in their firm. This is especially true for countries where the traditional culture places a high value on family ties (Bruton et al., 2003). For example, the Chairperson of the Securities Exchange Commission of the Philippines states that in Filipino corporations:

> [there often exists] a lack of transparency in board action and management [of family corporations] since families do not feel the need for public disclosure. As a result, minority shareholders are often kept in the dark as to the actual status of the corporations of which they are part-owners because the large shareholders dominate decision-making activities involving the company. (Bautista, 2002, p. 191)

Similarly, Backman (1999, p. 21) adds that in Asia, often 'the most anonymous of all outsiders – the minority shareholders in listed corporations – are treated the most derisorily of all'. Taken together, these statements illustrate the magnitude of PP conflicts in emerging economies.

## Business Groups

Another ubiquitous feature of corporate life in emerging economies is business groups (Ghemawat and Khanna, 1998; Peng and Delios, 2006). A business group is 'a collection of legally independent firms that are bound by economic (such as ownership, financial and commercial) and social (such as family, kinship and friendship) ties' (Yiu et al., 2005, pp. 183–206). Each member firm in a business group may be a distinct legal entity that publishes its own financial statements, has its own board of directors, and is responsible to its own shareholders. This is different from conglomerates in the USA, for example, where individual lines of business typically do not have any of these properties (Khanna and Rivkin, 2001, p. 48). Large family businesses often are organized around business groups, with different affiliated companies being run by various family members or branches (Biggart and Hamilton, 1992; Wilkinson, 1996). Business group networks, together with family structure, are some of the key institutions identified by Hamilton and Biggart (1988) as characterizing emerging economies. Cuervo-Cazurra (2006) makes the distinction between family-owned, widely held, and state-owned business groups, while noting that each type has a different set of actors, agency costs, and strategies. In business groups, informal ties – such as cross-holdings, board interlocks, and coordinated actions – are strong (Chung, 2006; Dieleman and Sachs, 2006).

While business groups exist throughout the world, they are relatively more prevalent in emerging economies (Peng et al., 2005; Yiu et al., 2005). Business groups can be further divided into those that emphasize vertical strategies versus those that emphasize horizontal strategies. Vertical strategies are primarily used to overcome product market and labour market failures, while horizontal strategies are more useful in overcoming capital market failures (Li et al., 2006). In general, business groups, especially those with high levels of horizontal product diversification, may provide more advantage in emerging economies (Chakrabarti et al., 2007; Khanna and Palepu, 2000b; Wan, 2005). This is primarily because they can substitute for weak institutional environments in capital, labour, and product markets, and this can provide certain competitive advantages (Guillen, 2000a; Li et al., 2006; Wan, 2005). For example, they facilitate technology transfer or inter-group capital allocation that otherwise might not be possible because of inadequate institutional infrastructure (Zhao et al., 2005).

While there are benefits to business groups, they can have certain disadvantages: they tend to be large cumbersome organizations that carry coordination and administration costs (Bae et al., 2002; Claessens et al., 2002; Ferris et al., 2003; Joh, 2003). Poor performance of business groups are in part due to problems in coordinating and allocating resources between the affiliated members (Isobe et al., 2006; Mursitama, 2006). More importantly for corporate governance reasons, the low transparency of such sprawling, loosely-affiliated business groups makes it difficult for minority shareholders to determine where control resides. It also makes it hard to identify and challenge unfair intra-group transactions (Chang, 2003) since such networks provide significant opportunity for collusion or other unethical transactions (Hoskisson et al., 2000; Woodruff, 1999). In short, business group affiliation provides a means by which controlling shareholders can expand control and thus increases the likelihood of expropriation of minority shareholders, which causes PP conflicts. Khanna and Rivkin (2001, p. 51) state:

> . . . secure in the embrace of the group, managers of the group firms may have weak incentives to run their businesses efficiently. They may also be obliged, or at least prone, to purchase inputs from sibling firms, efficient or not. Presumably groups include the firms whose decisions are most driven by considerations other than local economic gain. Social ties keep the firms bound to their groups despite economic costs, and poor performance can persist because selection pressures are modest.

Studying privatization in Central and Eastern Europe (CEE), Uhlenbruck et al. (2003) pointed out that participating in business groups facilitates organizational learning but inhibits economic transition. Before privatization, state-owned enterprises' (SOEs) primary source of information was state agencies. Privatization through market governance in CEE countries creates the possibility for corporate governance by private actors, but within a context with no established mechanisms to provide credible information to new owners (Spicer et al., 2000). Although participating in business groups is a key tool to acquire information about market environment, networks between former SOEs which reinforce non-market interaction may undermine effective transformation (Ericson, 1998).

In business groups, minority shareholders from a member firm are more likely to experience expropriation when the control rights of the controlling shareholders are greater than the cash flow rights – a practice referred to as 'pyramiding' (Bertrand et al., 2002; Claessens et al., 2002). A pyramid occurs when a controlling owner sits atop other member firms through a chain of ownership, controlling a particular corporation indirectly through other corporations. Through pyramid ownership, it is common for a firm's ultimate owners to have formal control rights that are greater than ownership (cash-flow) rights, and this increases the probability of expropriation of the firm. For instance, Faccio et al. (2001, p. 56) give an example of an investor, who owns 50 per cent of the shares of Company X, which owns 40 per cent of the shares of Company Y, which owns 30 per cent of the shares of Company Z. The investor ends up with 6 per cent (50% × 40% × 30%) of the ownership (cash-flow) rights of Z but 30 per cent of its control rights. In this case, the investor is *not* a majority shareholder of X, Y or Z, but is clearly a controlling shareholder of each of these companies. This creates a moral hazard situation, as the financial benefits from expropriation outweigh the financial costs for the ultimate owner.

In extreme cases, 'the controlling shareholders can extract high returns from projects that [actually yield] negative returns to the corporation' (Faccio et al., 2001, p. 54). Pyramid ownership schemes are widespread in emerging economies. Faccio et al. (2001, p. 59) find that the 22 largest East Asian business groups, through pyramiding, had 'ultimate control' of 31.2 per cent of *all* listed corporations in their economies. These ownership schemes increase the incentive and hence probability of minority shareholder expropriation as discussed earlier.

## ORGANIZATIONAL CONSEQUENCES

The organizational consequences of PP conflicts and their primary manifestation are multilevel. At the highest, *country level*, the consequences of PP conflicts involve inefficient capital allocation and lower standards of living (Morck et al., 2005; Wurgler, 2000). At the *intermediate level*, many nominally independent firms in emerging economies are informally organized and controlled as business groups (Whitley, 1992), which exhibit strategic behaviour in response to both country-level institutions as well as firm-level imperatives (Peng and Delios, 2006; Peng et al., 2005). At the lowest, *firm level*, how firms and their controlling shareholders and top executives choose certain governance structures and react to the existing structures can be conceptualized as strategic choices in response to the rules of the game (Peng, 2003). Consequences at the firm level include less than optimal strategic decisions and minority shareholder expropriation (Claessens et al., 2002; Lins, 2003; Morck et al., 2005; Wright, 1999). This section focuses on the impact on individual firms. These effects are principally twofold – monitoring costs and bonding costs, along with organizational strategy and competitiveness. Each will be discussed in turn.

### Monitoring and Bonding Costs of Principal–Principal Conflicts

According to Jensen and Meckling (1976, p. 308), total agency costs consist of: (1) monitoring costs – costs incurred by principals including measuring or observing the behaviour of agents; and (2) bonding costs – costs incurred by agents to guarantee they will not take actions to harm the principal. We use this conceptualization to examine PP conflicts.

The potential substitution of internal and external governance mechanisms suggests that concentrated ownership substitutes for poor external governance mechanisms in emerging economies to reduce traditional principal–agent monitoring conflicts. However, controlling shareholders differ from minority shareholders in terms of their monitoring role and their ability for expropriation – this difference creates monitoring costs of a different nature. There are three reasons why monitoring costs may actually be *higher* in emerging economy firms with PP conflicts. First, institutional structures are ambiguous (North, 1990; Peng, 2003). This makes the monitoring costs higher as it is more difficult to specify and measure the terms of contracts (Hill, 1995; Williamson, 1985). Second, since the agents (top managers) are also (or represent) the controlling shareholders, they are able to circumvent many of the traditional monitoring mechanisms, such as boards of directors (Dharwadkar et al., 2000). Finally, ownership concentration decreases the liquidity of stock markets, which results in less information content in share prices, reducing the monitoring capacity of capital markets (Holmstrom and Tirole, 1993; Morck et al., 2005). As such, for minority shareholders, the only viable recourse is to 'vote with their feet' by selling shares.

In addition, to attract minority shareholders, controlling shareholders may need to incur bonding costs as a type of implicit guarantee against expropriation. There are two types of bonding that may occur between controlling and minority shareholders. First, controlling shareholders may 'develop a reputation for treating minority shareholders well' (Gomes, 2000, p. 616). According to Gomes, if controlling shareholders undertake high levels of expropriation of minority shareholders, the market would discount the value of the remaining shares, causing a fall in the controlling shareholders' wealth. However, this type of assurance is based solely on reputation and the credibility of this implicit bonding arrangement needs to be constantly reinforced. There is always the suspicion that, in a crisis situation, controlling shareholders will resort to expropriation.[3] For example, even firms with good reputation exploited minority shareholders during the Asian crisis of 1997–98 (Johnson et al., 2000a).

If reputation alone does not adequately alleviate concerns of minority shareholders, firms with potential PP conflicts may issue American Depository Receipts (ADRs) on US stock exchanges. According to Doidge et al. (2004), Mitton (2002), and Reese and Weisbach (2002), one of the primary motivations of non-US firms for cross-listing ADRs in the United States is for the signalling effect that the firm will not expropriate minority shareholders. While these listings are costly and time-consuming, they invite the scrutiny of US SEC regulators and increase information disclosure. For example, of the 60 firms traded on the Russian Trading System (notorious for corporate governance problems) as of 2003, 95 per cent went through the trouble and expense of listing their shares on the NYSE through ADRs (McCarthy and Puffer, 2003, p. 401).

However, issuing ADRs as a signal is not without its complications – firms issue ADRs to *signal* that they are well-governed. Clearly, there is the possibility that the signal may be 'false'. For example, Russia's Gazprom had been trading with the use of ADRs for years, but it did not stop Gazprom's controlling shareholders from diverting firm resources to Florida-based Itera.[4] Future research that explores the benefits and costs of bonding utilized by controlling shareholders thus is crucial.

### Organizational Strategy and Competitiveness

While expropriation of minority shareholders arguably is unjust in its own right, PP conflicts also affect organizational performance and competitiveness by corrupting firm strategy (Filatotchev et al., 2001; Lins, 2003). Examples of actions that harm competitiveness include: (1) placing unqualified family members, friends, and cronies in key positions while overlooking better qualified candidates (Faccio et al., 2001); (2) purchasing supplies and materials at above-market prices or selling products and services at below-market prices to organizations owned by, or associated with, controlling shareholders (Chang and Hong, 2000; Khanna and Rivkin, 2001); (3) engaging in strategies which advance personal, family, or political agendas at the expense of firm performance such as excessive diversification (Backman, 1999); and (4) lower expenditure for innovation (Chen and Huang, 2006; Morck et al., 2005). Such actions are more likely to happen in emerging economies where legal and regulatory institutions are less developed.

Furthermore, PP conflicts are likely to increase the cost of capital, as firms with PP conflicts must pay higher dividends to attract investors (Bae et al., 2002; Ferris et al., 2003; Gomes, 2000; Lins, 2003). This partially explains why minority shareholders are willing to tolerate the risk of expropriation in exchange for higher dividends. These higher dividends can be thought of as a form of payoff that results in higher costs of capital and lower firm valuations (Faccio et al., 2001; Lins, 2003). Controlling shareholders may also prefer higher dividends – having a majority of wealth tied up in a particular firm makes retained corporate earnings increasingly risky for controlling shareholders (Carney and Gedajlovic, 2002). Along these lines, Faccio et al. (2001, p. 55) find that firms with at least 20 per cent of equity controlled by insiders paid significantly higher dividends. Potential PP conflicts also raise the cost of capital by under-pricing of public offering (Gomes, 2000). If investors are not convinced that controlling shareholders can credibly commit to foregoing expropriation, then a firm must rely on internal financing or pay a lot for external capital. Either of these options limits growth and hurts the performance of emerging economy firms.

As a result, firms in emerging economies tend to have lower market capitalization and rely less on external financing than firms in developed economies (La Porta et al., 1998, 2002). Ironically, this is the *opposite* of what one might expect in developed economies, where the conventional view is that large shareholders improve governance and *lower* the cost of capital (Demsetz and Lehn, 1985). In summary, PP conflicts may undermine firm competitiveness and discourage investor participation. This, in turn, increases the cost of capital through higher dividends and lower prices for equity offerings.

## IMPLICATIONS

An integrative and comprehensive view of PP conflicts in corporate governance has emerged from this review. At least three implications and extensions can be drawn from this synthesis. First, we extend earlier work by Hoskisson et al. (2000), Meyer and Peng (2005), Peng (2003, 2006), and Wright et al. (2005), by highlighting the central role that institutional theory has come to play in strategy research in general, and in research on emerging economies in particular. Institutional theory is particularly applicable in the case of emerging economies because of the variation in institutional contexts, and the effects that these contexts have on strategic choices (Peng, 2003). Studies conducted in these rich institutional contexts give us more insights into how institutions affect strategic management. As Scott (1995, p. 146) notes: 'it is difficult if not impossible to discern the effects of institutions on social structures and behaviors if all our cases are embedded in the same or very similar ones'. In this regard, as this review points out, research conducted in emerging economies can inform management scholarship and practice in developed economies.

Second, this article also informs the debate surrounding the potential convergence of institutions that support market capitalism (e.g. Guillen, 2001). Some scholars believe that a wide spectrum of economic and political institutions across countries is converging towards market capitalism as practiced in Western democracies (Fukuyama, 1992). Others propose that the institutions that are needed to support liberal markets and political systems are based on the broader underlying cultural foundations – in some cases dating back hundreds of years – which will maintain unique characteristics, perhaps indefinitely (Huntington, 1996). Corporate governance intersects organizations, markets, and political systems, and hence is a microcosm of the broader institutional environment. As such, it can serve as a barometer of the extent to which institutions are capable of converging across countries (Guillen, 2000b). For example, some scholars and practitioners argue that competitive pressures are forcing corporate governance systems around the world to converge towards the Anglo-American model (Rubach and Sebora, 1998). This is based on the idea that, if investors are willing to pay a premium for ownership in firms with transparent governance practices (Khanna and Palepu, 2000a, p. 288), this advantage will drive out the firms that do not conform to international norms (Wurgler, 2000). On the other hand, Guillen (2000b) and others argue that since corporate governance is so deeply embedded in a complex web of banking, labour, tax, and competition laws, any change in the governance system would require compensatory changes in numerous other areas. Along these lines, Faccio et al. (2001, p. 54) note that after the 1997 Asian financial crisis, 'the problems of East Asian corporate governance are, if anything, *more* severe and intractable than suggested by the commentators at the height of the financial crisis'. In essence, the debate on convergence has yet to be resolved and bears further observation (Young et al., 2004).

Third, until the convergence issue is resolved, researchers and practitioners need to be aware that corporate governance problems in emerging economies will require different solutions from those generated from a mainstream agency theory perspective, which 'assumes away' institutional differences (Lubatkin et al., 2005a). As Gedajlovic et al. (2004, p. 901) note, '[Agency theory] analysis of firm governance reduces relationships within firms to simple dyadic PA relationships between economically rational and motivated actors, and offers an arid and superficial portrayal'. Our review of the literature supports this view, and implies that using policies designed for developed economies may prove ineffective or even counterproductive in emerging economies. For example, increasing ownership concentration – a common agency solution – would not work in the case of PP conflicts, because giving more control to already powerful controlling shareholders may further enhance their ability for expropriation (Dharwadkar et al.,

Table II. Future research questions

| *Research areas* | *Questions* |
|---|---|
| Institutional differences and PP conflicts | • How do PP conflicts differ from one country (or region) to another?<br>• How do corporate governance mechanisms co-evolve with institutional transitions and strategic changes in emerging economies?<br>• What role do foreign institutional investors play in emerging economies? |
| Families, business groups, and PP conflicts | • Are there differences between concentrated ownership that consists of only a family and concentrated ownership that consists of a family along with other substantial investors?<br>• How does the portfolio of a family investment affect firm performance?<br>• What is the ownership identity of the firms participating in business groups?<br>• How does the structure of a business group affect PP conflicts?<br>• How can emerging economies better overcome the insider/outsider distinction?<br>• What are the main factors in overcoming mistrust of outsiders? |
| Addressing PP conflicts in emerging economies | • Is the German–Japanese model a more realistic model for governance reforms in emerging economies?<br>• Can the bank play a role in alleviating PP conflicts?<br>• How can various stakeholders from government, employees and creditors gain a foothold in an environment of low-trust with powerful business families?<br>• How many partners are needed to create an effective controlling coalition?<br>• How much stake does each coalition member hold?<br>• How to prevent the coalition members from colluding? |

2000). Yet abolishing concentrated ownership structures is not realistic, because the lack of supporting institutions (e.g. takeover markets, effective boards of directors, and laws and enforcement regimes) would create a governance vacuum that likely would result in unchecked managerial opportunism. Clearly, more research is warranted.

## SUGGESTIONS FOR FUTURE RESEARCH

While a considerable body of research on PP conflicts in emerging economies is developing, there is still much work to be done. This section offers a research agenda centred on the components of our review and the series of future research questions stemming out of our review (see Table II).

### Institutional Differences and PP Conflicts

Future researchers may wish to address the idiosyncratic cultural and regional differences across countries that affect PP conflicts. Although we have grouped emerging economies into a single category, future work needs to undertake a finer-grained approach in examining PP conflicts across various emerging economies (or regions). Although they may come from different starting points, institutional reforms have the same objective: to increase the effectiveness of corporate governance. Institutional differences means that the lessons from relatively more advanced emerging economies (e.g. Chile, Taiwan), while insightful, are not likely to be of equal importance to less developed ones (e.g. Belarus, Zimbabwe).

Second, understanding how institutional transitions and strategic responses *co-evolve* is essential (North, 2005; Peng, 2003, 2006; Suhomlinova, 2006; Yeung, 2006). It is generally accepted that institutions have a strong influence on the performance of economies (North, 1990), yet much less is known about the process by which efficient institutions evolve and take form (North, 2005). Although the efforts of governments, foreign advisors, and international organizations (e.g. the IMF, World Bank) may be one factor, this alone is insufficient. The development of corporate governance occurs through a complex, iterative, co-evolutionary process involving the formal and informal institutions of national contexts (North, 2005). Since institutional transitions and firm strategies co-evolve, corporate governance mechanisms are likely to be affected by various exogenous factors in the national contexts over time (Suhomlinova, 2006).

Furthermore, researchers may wish to examine the role that foreign institutional investors may play in this process of institutional reform. As emerging economies become more open, this exposure to outside ideas and influence will likely accelerate governance reforms. Foreign institutional investors are outside the domestic social networks from which the institutional norms of behaviour are generated, and they are therefore more likely to push for transparent deals and pressure governments to improve minority shareholder protection (Peng, 2003). In other words, they may be more pressure-resistant to locally-generated PP problems (Brickley et al., 1988; Kochhar and David, 1996; Tihanyi et al., 2003). Foreign investors may also have better monitoring capabilities, which can help firms to move away from an over-reliance on concentrated ownership (Khanna and Palepu, 2000a). For example, Djankov and Murrell (2002) find in their extensive survey of the research on transition economies that when investment funds, foreigners, and other outsiders become influential owners, *ten times* as much restructuring takes place in former SOEs than when the new owners are diffused shareholders. This is encouraging, and provides research opportunities concerning the process by which outsiders can make inroads.

## Families, Business Groups, and PP Conflicts

Numerous opportunities exist at the intersection of the literature on family businesses, business groups, and PP conflicts. In emerging economies, PP conflicts in family ownership involve family owners and non-family minority owners while PP conflicts in business groups involve in-group and out-group members. Areas of interest include: (1) concentrated ownership that consists of only a family versus concentrated ownership that consists of a family along with other substantial investors; (2) the impact of the portfolio of a family investment on firm performance; (3) the ownership identity of the firms participating in business groups; and (4) the structure of a business group (see Table II for questions).

Another potential avenue for research may involve examination of the factors that strengthen protection of founding families who wish to bring in outsiders. The prevalence of concentrated ownership in emerging economies is partly due to the difficulty that founding families have in trusting and monitoring people outside of a small circle of family and friends. Examining how corporate governance mechanisms work interdependently to complement and/or substitute for one another may be a good beginning point to study this transition (Rediker and Seth, 1995; Suhomlinova, 2006). Crossing the threshold from founding family management to professional management is difficult even in the best of circumstances (Daily and Dalton, 1992; Gedajlovic et al., 2004; Zahra and Filatotchev, 2004). This difficulty is exacerbated in emerging economies where difficult-to-enforce contracts make it risky for founders to turn the reins over to outsiders (Ahlstrom et al., 2004; Fukuyama, 1995). Yet, bringing in outsiders does happen. Taiwan is an example of an emerging economy where some concentrated owners have begun to dilute their holdings and are reducing their control by selling to institutional investors and bringing in outside management, albeit with mixed results (Filatotchev et al., 2005; Liu et al. 2006). Areas of interest in future work would include: (1) the insider/outsider distinction; and (2) mechanisms to overcome mistrust of outsiders (see Table II for questions). Simply put, insight is needed into how other corporate governance safeguards can more smoothly substitute for concentrated ownership in a weak institutional environment.

**Addressing PP Conflicts**

Future researchers may also wish to address PP conflicts in emerging economies by looking at the experience of organizations with concentrated ownership in developed economies. In particular, insight into the PP conflicts in emerging economies may potentially be drawn from the German–Japanese model of corporate governance as it more effectively accommodates concentrated ownership (Shleifer and Vishny, 1997, p. 773). German and Japanese corporate governance systems are often credited with reducing agency problems while avoiding the most egregious PP conflicts associated with concentrated ownership. This is often achieved through a strong network of owners, creditors, employees, and government. Is the German–Japanese model focusing on concentrated ownership a more realistic model for corporate governance reforms in emerging economies?

However, this arrangement is not without its share of problems. For example, a variant of PP conflicts may arise due to the common role of the bank as both a creditor and shareholder of the firm, whereby the bank is able to shift risk to minority shareholders (Chirinko and Elston, 2006). What role can banks play to alleviate PP conflicts? The German–Japanese-style stakeholder approach, as opposed to the shareholder maximization approach associated with the Anglo-American model, may be more applicable to the situation in emerging economies. Then remaining questions would concern: (1) the transplanting of the stakeholder culture to emerging economies; and (2) the management of various stakeholders in an environment of low-trust with powerful business families (see Table II for questions).

Another potentially promising avenue for examining how to address PP conflicts is the idea of controlling coalitions (Bennedsen and Wolfenzon, 2000). With controlling coalitions, ownership and control are distributed among several large owners and no individual shareholder is large enough to control the firm. This makes it much harder, for example, to divert funds from the corporation as such an action would require interaction (or collusion) among major coalitions. Advocates of coalitions maintain that controlling shareholders have incentive to set up such an arrangement as this creates a credible commitment (a form of bonding) that they will not undertake unilateral action to expropriate funds. Many questions remain to be answered with controlling coalitions, concerning: (1) the number of partners needed for an effective coalition; (2) the level of equity each coalition member holds; (3) the mechanisms to deal with issues such as one coalition member's withdrawal; and (4) to prevent the coalition members from colluding (see Table II for questions). Such an approach is a novel solution that deserves further examination.

## CONCLUSION

This article has reviewed research on corporate governance in emerging economies, which centres on the new but burgeoning idea of PP conflicts. First, we have integrated the literature and outlined the major ways that PP conflicts differ from the stylized principal–agent conflict. Then, we have presented a framework of the institutional antecedents and organizational outcomes of PP conflicts. Finally, this article has discussed implications of this new formulation, and suggested several potential avenues for future research.

Several contributions to the management literature emerge. To the best of our knowledge, this is the first systematic review to focus exclusively on PP conflicts and to outline specifically their characteristics and dynamics. In doing so, we explicitly connect the literature on corporate governance in emerging economies to the family business literature as well as the business group literature, which have amassed a considerable body of research largely in parallel of each other. We also extend management research to focus more on conditions outside of the Anglo-American mainstream in general and on emerging economies in particular (cf. Hoskisson et al., 2000; Wright et al., 2005). While PP conflicts clearly exist in developed economies, emerging economies exhibit the largest amount of institutional variance relative to that of developed economies (Scott, 1995). This focus on emerging economies, therefore, enables us to flesh out the significance of PP conflicts as an important but often overlooked problem in corporate governance.

We hope to create greater awareness of PP conflicts and their consequences and to reiterate the point that corporate governance in emerging economies does not closely resemble the stylized agency theory model centred on PA conflicts. We further stress that PP conflicts result in the unfair treatment of minority shareholders. But perhaps more importantly, PP conflicts do not promote strategies that are in the best interests of organizational performance. This is particularly unfortunate given the impoverished populations among which many of these firms operate. As such, resolving PP conflicts in emerging economies could improve the living standards for potentially millions of people (Morck et al., 2005).

In summary, resolving PP conflicts in emerging economies requires creative solutions beyond the standard approaches. Individual countries will likely need to work out solutions to their own particular institutional conditions (Young et al., 2004). We have laid a foundation here by outlining the institutional antecedents and organizational consequences. Future research needs to build on this foundation and expand our understanding of the crucial PP conflicts that affect so many firms, shareholders (both controlling and minority), and economies throughout emerging economies around the world.

## ACKNOWLEDGMENTS

The authors thank Jay Barney, Greg Dess, Peter Lane, Larry Lang, Chung-Ming Lau, Seung-Hyun Lee, Michael Lubatkin, Agnes Peng, Steven White, and Danqing Young for their helpful comments. We also appreciate the editorial guidance from Mike Wright, Steve Floyd, and three reviewers. Marc Ahlstrom, Donald Liu, Yuanyuan Zhou, and Xi Zou provided research assistance. This research was supported in part by the National Science Foundation (CAREER SES 0552089), Hong Kong Research Grants Council (Project # CUHK4047/99H and Project CUHK # 4650/06H), CUHK Faculty of Business Administration (Direct Grant # 2087) and Office of China Research and Development (Project # 6901218), TCU Entrepreneurship Center, and Ohio State CIBER. All content is the responsibility of the authors and does not necessarily represent the views of the funding organizations.

## NOTES

An earlier version of this paper was a finalist for the 2002 Carolyn Dexter Award for Outstanding Contribution to International Management at the Academy of Management Annual Meeting (Denver, August 2002) with a condensed version published in the *Best Papers Proceedings* that year. Earlier versions were presented at the AIB (Puerto Rico, June 2002), SMS (Baltimore, November 2003), and seminars at Ohio State and Virginia Tech (July 2002).

[1] Barney and Hansen (1994) identify three types of trust: (1) *weak form trust*, where there are limited opportunities for opportunism; (2) *semi-strong form trust*, which is trust induced by protection from opportunism in the form of governance mechanism; and (3) *strong from trust*, which is 'hard core trustworthiness' based on values, principles and standards of behaviour. In emerging economies, the institutional structure is such that semi-strong form trust is lacking. Thus organizational members must rely on strong form trust which is only possible with a small circle of family and in-group members.

[2] *Munificence* refers to the degree of resource abundance and investment opportunities. Family firms, with simple, organic control systems can succeed where other firms fail, in harsh, fragmented, price competitive markets, i.e. low munificence. *Complexity* refers to the heterogeneity and range of factors in various environmental segments. As environments become more complex, family firms find themselves unable to cope effectively because the control is organic rather than systematic. *Dynamism* is the rate of change and the degree of instability in the environment. Family firms are suited to high dynamism because authority, legitimacy and incentives that accrue to the founder promote entrepreneurial alertness. Furthermore, family managed firms operate under secrecy which also provides surprise (Dess and Beard, 1984; Gedajlovic et al., 2004).

[3] As an example of such suspicions, Asia's richest man, Li Ka-shing is called 'Superman' in Hong Kong for his business and investment prowess. Over the years, Li has gained a reputation for not exploiting minority shareholders. But this reputation may change after a series of recent deals in which Li appears to have personally gained at minority shareholders' expense. In one deal, Li purchased a relatively unknown software developer and then turned around and sold it 72 hours later at a large profit – essentially profiting strictly on his reputation. The local newspapers wrote: 'Investors had flocked to Vanda Systems and Communications Holdings in September 2003 with the hope that Hutchison [Li's controlled company] and Mr. Li's "Midas touch" would line their pockets with gold. The share price had soared 86% in three days. Hutchison simply cashed in on their expectations. In a city renowned for

dubious deals that turn a fast buck for those in the loop, shareholders believed that [Li] would deliver on the Li Ka-shing promise: that the tycoon would make them a lot of money, and that shareholder value and minority interests would not be an afterthought. It remains to be seen if Mr. Li's companies can still command the same investor appetite and trust when he next brings a deal to market' (*The South China Morning Post*, 2005. 'A case of Li magic or a cash grab?', 25 May, http://www.scmp.com).

[4] We thank Reviewer 1 for this example.

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