Principal-Principal Agency

Michael N. YOUNG
Mike. W. PENG
David AHLSTROM
Garry D. BRUTON

Printed by

Committee on China Research and Development
Faculty of Business Administration
The Chinese University of Hong Kong

http://www.baf.cuhk.edu.hk/ocrd/cmr.htm
PRINCIPAL-PRINCIPAL AGENCY

Michael N. YOUNG
Department of Management
The Chinese University of Hong Kong
michaely@baf.msmail.cuhk.edu.hk

Mike W. PENG
Fisher College of Business
The Ohio State University

David AHLSTROM
Department of Management
The Chinese University of Hong Kong

Garry D. BRUTON
Neeley School of Business
Texas Christian University

Abstract

Corporate governance research has largely focused on principal-agent conflicts while ignoring conflicts among other participants in the corporate governance process. However, in many corporations, particularly in emerging economies, the prevalence of dominant ownership structures along with weak legal protection of minority shareholders’ shifts the “center of gravity” of conflict in the corporate governance process away from the relationship between shareholders and managers towards the relationship between majority shareholders and minority shareholders. Yet little is known about the nature of these conflicts. This article outlines the primary causes and consequences of such “principal-principal agency” conflicts. We discuss the institutional setting for these conflicts, followed by propositions regarding their propensity, magnitude, and implications for firm competitiveness.

[Acknowledgment] Thanks to Kevin Au, Jay Barney, Greg Dess, Peter Lane, Larry Lang, Chung-Ming Lau, Seung-Hyun Lee, Michael Lubatkin, Agnes Peng, Denis Wang, Steven White, Danqing Young, and seminar participants at Ohio State University and Virginia Tech University. This research was supported in part by The Ohio State University Center for International Business Education and Research, Fisher College of Business Research Committee, Center for East Asian Studies, Center for Slavic and East European Studies, and Office of International Affairs; The Chinese University of Hong Kong Faculty of Business Administration (Direct Grant # 2087) and Office of China Research and Development (Project # 6901218); and the Research Grants Council of the Hong Kong Special Administrative Region (Project # CUHK4047/99H). An earlier version of this paper was nominated for the 2002 Carolyn Dexter award for Outstanding Contribution to International Management and a condensed version was published in the Best Paper Proceedings and presented at the Academy of Management Annual Meeting (Denver, August 2002).
1. Introduction

The assumption of the separation of corporate ownership and control, originating with Berle and Means (1933) and later embraced by Jensen and Meckling (1976) and others, has long been central to corporate governance research. This concept underpins agency theory-based corporate governance research, which assumes that widely dispersed corporate ownership creates a situation where conflicting goals between shareholders and managers is the primary source of conflict in corporate governance (Eisenhardt, 1989; Shleifer & Vishny, 1997). However, recent empirical research questions the notion of widely dispersed ownership, calling into question the centrality of shareholder-manager conflict in the corporate governance process. La Porta, Lopez-de-Salines and Schleifer (1999: 498) find that widely dispersed corporate ownership is most prevalent only in the United States and United Kingdom and “is actually an exception rather than the rule around the world,” and that “most corporations around the world are controlled by a family or the state, characterized by concentrated ownership.” Despite evidence to the contrary, the assumption of dispersed ownership, and hence shareholder-manager conflict, has remained pervasive in corporate governance research, causing it not to reflect the empirical realities around the world. As a result, more research is required on situations with concentrated ownership for corporate governance research to have relevance outside of the Anglo-American world (Morck, 2000).

For sure, some research has begun to probe the corporate governance consequences of concentrated ownership. For example, a German-Japanese model of corporate governance featuring more concentrated ownership has recently been developed (Charkham, 1994; Kim & Hoskisson, 1996; Thomas & Waring, 1999). However, Japan and Germany are wealthy, developed economies that share many institutional similarities with the US and UK (Buhner, et al., 1998). For this reason, Shleifer and Vishny (1997: 737-8) suggest that the differences between Germany/Japan versus the US/UK “are probably small relative to their differences from other countries.” Thus, there are likely large gains to be made by examining corporate governance in “other countries,” in particular, emerging economies, which have very different institutional settings. Emerging economies are “low-income, rapid-growth countries using economic liberalization as their primary engine of growth” (Hoskisson, Eden, Lau, & Wright, 2000: 249). Despite the increasing importance of emerging economies, they have received little attention of corporate governance researchers (Boyd, Carroll, & Howard, 1996; Guillen, 2000b; Low, 2002; Peng, 2000).

One recent exception to the lack of corporate governance research in emerging economies is the work of Dharwadkar, George, and Brandes (2000), who outline two widespread types of agency problems there. The first is the traditional principal-agent (PA) problem between shareholders and managers noted by mainstream corporate governance research. The second agency problem, they call the “principal-principal agency” (PPA) problem, and it centers on the conflict between two types of principals (majority shareholders and minority shareholders), and often results in expropriation of minority shareholder assets (Faccio, Lang, & Young, 2001). PPA problems are likely to be more pronounced in emerging economies than developed economies because of a relatively higher incidence of dominant ownership and inadequate protection for minority shareholders (Dharwadkar, et al, 2000; La Porta, Lopez-de-Silanes, & Shleifer, 1998; 1999). This is because when “large owners gain nearly full control of the corporation they prefer to generate private benefits of control that are not shared by minority shareholders” (Shleifer & Vishny, 1997: 759).
In general, the institutional context of emerging economies creates a situation where PPA problems are likely to occur with greater frequency and magnitude, giving researchers better opportunities to isolate and examine the phenomenon. In fact, the extensiveness of PPA conflicts in emerging economies lead Dharwadkar and colleagues (2000: 685) to urge researchers to focus on the PPA issue – both the formal control rights of majority shareholders as well as the informal relational ties that exacerbate PPA problems. Heeding this call, we extend the work of Dharwadkar and colleagues (2000) in three significant ways. First, while acknowledging the significance of the traditional PA problem, the theoretical basis for the PPA problem is developed. This focus is justified because in emerging economies, ownership concentration seems to be the norm, and minority shareholders have relatively less protection, which results in extensive PPA conflicts. Second, we elaborate the institutional conditions that lead to PPA conflicts with greater theoretical precision than has been done previously. Finally, we focus on family- and state-controlled firms, which are under-studied despite their ubiquity in emerging economies (La Porta et al., 1999).

1. THE CHARACTERISTICS OF PRINCIPAL-PRINCIPAL AGENCY PROBLEMS

Principal-agency theory (PA) examines problems of goal incongruence between principals and agents. Similarly, the principal-principal agency (PPA) variant of agency theory focuses on agency problems that result from principal-principal goal incongruence between majority shareholders and minority shareholders (Dharwadkar, et al., 2000). PPA problems are primarily manifest when majority owners abuse their ownership control to expropriate minority shareholders. Expropriation may occur legally, illegally, or in “gray areas” (Johnson, et al., 2000b). Economic mechanisms of expropriation include “related transactions,” whereby controlling owners sell firm assets or additional securities to themselves or to related parties at below market prices (Chang & Hong, 2000). Expropriation can occur through social mechanisms when large owners appoint family members to top management posts to further family interests at the expense of minority owners (Claessens, Djankov, & Lang, 2000). While such actions technically may be legal, they undermine firm competitiveness (Backman, 1999).

It should be noted that the distinction between PA problems and PPA problems is not always clear. Some examples of managerial opportunism are clearly PA (e.g., the manager who owns very little shares of stock and spends his time playing golf). Other examples of opportunism are clearly PPA (e.g., the family-dominated corporation with a family member as CEO in an emerging economy that purchases supplies from a family member at inflated prices). Others are gray areas (e.g., the CEO who owns a considerable portion of shares and uses that influence to obtain a corporate jet). However, the over-riding characteristic of PPA problems is the use of ownership control to expropriate minority shareholders.

Minority shareholder protection laws are intended to constrain majority shareholder opportunism, and they are relatively more successful in this task in countries with more highly developed market infrastructure such as the US (Holderness & Sheehan, 2000). In particular, minority shareholders may seek judicial reviews, and courts may act as a deterrent on majority shareholder opportunism through statutory dissolution. While these legal constraints are
intended to serve as an upper bound on expropriation in developed economies\(^1\), such protection often does not exist or is poorly enforced in emerging economies.

Standard corporate governance mechanisms may not be as effective in firms that suffer from PPA problems. In nearly all cases with dominant ownership structures, the majority of members is elected by the dominant owners, and thus is aligned with them. Furthermore, concentrated ownership, a possible solution to PA problems (e.g., Demsetz & Lehn, 1985), may be a root cause of PPA problems (Faccio, et al., 2001). In addition, in emerging economies, where PPA problems are particularly severe, the market for corporate control usually does not operate effectively due to a lack of market-supporting institutions (Peng, Lou & Sun, 2000). Table 1 compares and contrasts the various attributes of the PPA perspective with those of the more familiar PA perspective.

[Insert Table 1 about here]

The potential propensity and magnitude of PPA problems may be assessed by examining management and board structures (e.g., the percentage of family members), ownership patterns (e.g., concentration, pyramids, cross-holdings, and business groups), and strategic actions (e.g., related transactions) (Claessens, et al., 2000; Faccio, et al., 2001; Johnson, et al., 2000a, 2000b; La Porta, et al., 1997, 1998, 1999). While they are, in some ways, different from traditional agency problems, PPA problems may be just as harmful for firm competitiveness, particularly in emerging economies, and the causes and consequences of PPA are underdeveloped in the management literature (Dharwadkar et al, 2000: 685). In the next section, we outline the institutional context of corporate governance in emerging economies and why they are so ripe for PPA problems.

2. INSTITUTIONS AND CORPORATE GOVERNANCE IN EMERGING ECONOMIES

Emerging economies, because of their institutional uncertainty, are more conducive to PPA problems in corporate governance processes (Peng, 2000). Institutions as “the humanly devised constraints that structure human interaction” North (1990: 3), including formal rules (laws, regulations) and informal constraints (customs, norms, cultures). Similarly, Scott (1995: 33) defines institutions as “cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior.” Economy-wide institutions assert pressures to which organizations respond by, for example, complying, co-opting, or defying (DiMaggio & Powell, 1983; Oliver, 1997; Peng, 2002). Both the formal legal environment and the informal institutional constraints affect corporate governance (Ingram & Silverman, 2002; North, 1990). When formal institutions are weak, informal constraints have a more prominent effect on firm behavior (Peng & Heath, 1996; North, 1990; 1994).

In emerging economies, the term “corporate governance” was seldom encountered prior to

---

1. The recent scandals surrounding Enron, Global Crossing, Qwest, Tyco, WorldCom and others have raised questions about the legal protection of shareholders even in the US. However, even though shareholders may have faulty legal protection in developed economies, the lack of protection for minority shareholders is of a different nature, is more striking and has more devastating impacts in emerging economies (La Porta et al, 1997).
the 1990s. Yet the term has caught on rapidly. Many emerging economies have adopted formal legal frameworks, often modeled after the Anglo-American system, as a result of internally driven reforms (e.g., China, Russia) or as a response to international demands (e.g., South Korea, Thailand). As a result, nearly all listed firms in emerging economies have shareholders, boards of directors, and “professional” managers, which make up the “legs of the tripod” of modern corporate governance (Monks & Minnow, 2001). However, because of the rapid pace with which these corporate governance structures have come about, they often lack legitimacy. As a result, the similarities in corporate governance between emerging and developed economies are often more in form than in substance (Backman, 1999).

Table 2 compares some demographics of governance characteristics for various countries categorized by legal tradition (English common law, French civil law, German common law and Scandinavian common law) for developed versus emerging economies. According to La Porta and colleagues (1998), English common law countries provide the greatest formal institutional protection for minority shareholders, while French civil law countries provide the least, with German and Scandinavian common law countries falling somewhere in between. Note that on average, developed economies carry more formal institutional protection than do emerging economies for minority shareholders, including allowing vote on proxy by mail, not blocking shares before general shareholder meetings, cumulative voting/proportional representation on boards, and more effective minority shareholder protection.

In practice, formal institutional constraints may have less legitimacy and therefore carry less weight in emerging economies. Therefore, informal constraints, such as relational ties, family connections, and government contacts, may play a greater role in shaping corporate governance in emerging economies, leading to outcomes often at odds with what is anticipated based on the experience of developed economies (Peng, 2000; Low, 2002). For example, Young, Ahlstrom, Bruton, and Chan (2001) find that the service and control functions of boards of directors are less pronounced while the resource dependence role is more pronounced in Hong Kong and Taiwanese firms. In general, while firms in emerging economies may have adopted the formal corporate governance frameworks of developed economies, the informal institutions, and therefore the expected outcomes, are different. North (1994: 336) discusses why this occurs:

It is the admixture of formal rules, informal norms, and enforcement characteristics that shapes economic performance. While the rules may be changed overnight, the informal norms usually change only gradually. Since it is the norms that provide "legitimacy" to a set of rules, revolutionary change is never as revolutionary as its supporters desire, and performance will be different than anticipated. And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance.

2 La Porta, et al. (1998: 1122) define shares not blocked before meeting as: "Equals one if the company law or commercial code does not allow firms to require that shareholders deposit their shares prior to a general shareholders meeting, thus preventing them from selling those shares for a number of days, and zero otherwise."
3. THE CAUSES AND CONSEQUENCES OF PPA PROBLEMS

Figure 1 illustrates the conditions, causes and consequences of PPA corporate governance problems. As noted in the diagram, weak support of market institutions creates a need for dominant ownership structures to combat potentially severe PA problems. Dominant ownership structures are a necessary but not sufficient condition for PPA problems. Dominant ownership structures are more likely to lead to PPA problems if there is lack of protection for minority shareholders, family ownership, business groups or pyramid ownership structures, and/or state ownership. All of these conditions are commonly encountered in emerging economies. Note that three out of the four complicating factors outlined in Figure 1 can be classified as informal institutional constraints, namely, (1) family ownership, (2) business groups and pyramids, and (3) state ownership in transition. Only one of these factors, legal protection of minority shareholder rights, can be regarded a formal constraint, and the focus here is the lack of such formal protection. This is consistent with the institutional argument that informal constraints play a larger role in shaping corporate governance practices in emerging economies (North, 1994; Peng, 2000). Finally, note in Figure 1 that PPA problems are negatively correlated with firm performance by affecting strategy formulation and the cost of capital. In the sections that follow, each of the dimensions of the model will be investigated in more detail.

4.1 Dominant Ownership Structures

A prerequisite for PPA problems is dominant ownership. While dominant corporate ownership may arise for a variety of reasons, in emerging economies, they often arise to combat potentially ruinous PA problems that could result because of a weakness of other internal and external governance mechanisms (Dharwadkar et al, 2000; Ingram & Silverman, 2002). In corporations with diffuse shareholdings and information asymmetries, managers may not act in the interests of shareholders (Jensen & Meckling, 1976) and may engage in shirking (Alchian & Demsetz, 1972), excessive perquisite consumption (Jensen, 1986), and entrenchment (Walsh & Seward, 1990) to the detriment of shareholders and/or overall firm value. Furthermore, shareholders and managers may have different risk preferences and time horizons (Gray & Cannella, 1997).

According to agency theory, there are a variety of mechanisms that may help align the interests of shareholders and managers. These include internal mechanisms such as boards of directors (Jensen, 1993; Walsh & Seward, 1990), concentrated ownership (Ahmihud & Lev, 1981; Demsetz & Lehn, 1985), executive compensation packages (Jensen & Murphy, 1990) and external governance mechanisms such as product market competition (Jensen, 1993), the managerial labor market (Lambert, Larcker, & Weigelt, 1993), and threat of takeover (Jensen & Ruback, 1983; Manne, 1965). Further, from a theoretical perspective, it is likely that the effectiveness in controlling managerial opportunism depends on the efficiency of a bundle of governance mechanisms, and different governance mechanisms may substitute for one another (Rediker & Seth). The cost-benefit tradeoffs among governance mechanisms determine their use. The benefit of any mechanism is linked to its potential to mitigate managerial opportunism. A particular mechanism’s benefit depends on the effectiveness of other alternative governance mechanisms. If one or more mechanisms are ineffective, then others may have to increase to
keep the firm on track (Rediker & Seth, 1995). Furthermore, if the external mechanisms are strong, then the internal mechanisms may have less of a role (Rediker & Seth, 1995), while if internal mechanisms “fail,” then it is up to external mechanisms, such as the takeover market, to discipline managers (Jensen, 1993). For example, Rediker and Seth (1995: 87) suggest that: “a firm with high concentration is not likely to be taken over, and hence ownership concentration might be said to substitute for the threat of takeover as a governance device.”

Fama and Jensen (1983) hold that the design of the efficient bundle of governance mechanisms may vary systematically by industry or size of the firm, and, we might add, by institutional environment of the country as well. Even in developed economies, the external mechanisms, which include the market for corporate control, competition in product markets and the external labor market, do not act to perfectly align the interests of managers and shareholders (Rediker & Seth, 1995). If one takes into account that product markets in emerging economies are more likely to be restricted for reasons of political corruption (cite) that formal regulatory regimes are likely to be weak and ineffective (La Porta et al, 1998), and that takeover markets and managerial labor markets are ineffective or nonexistent (Groves, Hong, McMillan & Noughton, 1995; Peng, 2000) then it becomes clear that the burden of controlling managerial opportunism falls to the internal mechanisms.

A primary internal governance mechanism is the board of directors (Fama & Jensen, 1983; Jensen, 1993; Walsh & Seward, 1990). Yet policymakers in emerging economies often attempt to implement market policies in the absence of formal market-supporting institutions (Peng & Heath, 1996). This results in a lack of legitimacy and effectiveness of boards of directors, and creates a “weak governance” environment. If boards of directors lack legitimacy and authority, as is often the case in emerging economies, then concentrated ownership may prove the only way to solve potentially devastating PA problems (Dharwadkar et al, 2000). This situation also can be viewed similarly from the transaction cost perspective (Williamson, 1985). When a contract between two parties is difficult to specify or costly to enforce, then it may be optimal for one party to purchase all of the residual and control rights except for those that are easily specified and enforced (Grossman & Hart, 1986; Williamson, 1985). From this perspective, emerging economies can be viewed as having weak and/or volatile institutional structures, thus making contracts between shareholders and managers more costly to enforce than in their developed country counterparts. As a result, dominant ownership structures are more likely to prove optimal in those situations.

According to agency theory, large owners have greater incentive and means to monitor managers to control PA problems (Demsetz & Lehn, 1985; Jensen & Meckling, 1976). In developed economies, relatively low levels of concentrated ownership may improve governance. Empirical researchers often use 5% equity in the hands of an individual or organization to indicate owner-control, suggesting that in the context of “strong governance” in developed economies, even low levels of concentration (5-20%) can be effectively employed against PA problems (Dharwadkar, et al., 2000: 659). However, such low concentration levels are likely insufficient to combat PA problems in emerging economies. Other things equal, shareholders need larger equity stakes to exercise their control rights and effectively monitor managers (La Porta, et al., 1998: 1145). Dharwadkar, George & Brandes (2000) contend that it requires absolute “dominant” majority ownership – often greater than 50% ownership – to combat potentially severe PA problems. In addition, poorly protection for minority shareholders makes the shares unattractive for investors, indirectly leading to increased ownership concentration (La
As a result, over time, dominant majority ownership structures are likely to prevail across the corporate landscape in emerging economies – averaging 51% of equity held by top three shareholders in 28 emerging economies versus 41% in 21 developed economies (La Porta et al., 1998). Dominant ownership structures, though lacking in sophistication, may effectively control otherwise rampant PA problems and therefore become the rule rather than the exception in emerging economies with a typical dominant owner being a prominent, well-connected business family or the state (La Porta et al., 1999). For example, in less than a decade after privatization, the top 15 families in Russia controlled over 50% of GNP (Schroder, 1999). In East Asia, 68% of the listed firms have a single controlling shareholder (Claessens et al., 2000: 92). Overall, we suggest:

**Proposition 1:** Dominant ownership structures are associated with the need to combat potentially severe principal-agent (PA) problems.

Ironically, this solution to one set of agency problems sets the stage for another type of agency problems, because dominant ownership structure while effective in dispelling shareholder/manager conflict, may actually *provoke* majority/minority shareholder conflict (cite). This is because dominant ownership results in a *coupling* – as opposed to separation – of ownership and control. In such situations, the dominant owner installs a family member or associate as CEO and is able to reduce the likelihood or severity of traditional shareholder-manager conflicts. Yet this same CEO may then bestow preferential treatment on the dominant owners to the chagrin of minority shareholders. One could argue, in fact, that dominant ownership changes the theoretical dynamics of the corporate governance process because dispersed ownership, commonly assumed in traditional corporate governance research, does not exist. This shifts the center of conflict from shareholder/manager towards majority/minority shareholders. The dominant owners, who now have a direct line to the top management suite, may use their influence to benefit themselves personally at the expense of minority shareholders. According to Dharwadkar and colleagues (2000: 651), essentially, traditional agency problems based upon principal-agent (PA) goal incongruence often are supplanted by agency problems arising from principal-principal (PPA) goal incongruence. While conflicts between majority and minority owners are not inevitable, they are more likely to occur if there is weak protection of the minority shareholders, the topic to which we now turn.

### 4.2 Legal Protection of Minority Shareholders

Minority shareholder protection laws are intended to constrain majority shareholder opportunism (Holderness & Sheehan, 2000), and such laws differ across countries in terms of the degree of protection afforded. La Porta and colleagues (1998) ranked 49 countries (21 developed economies and 28 emerging economies) according to their legal tradition on several measures of minority shareholder protection (Columns 2-5 in Table 2). As discussed earlier, countries with an English common law tradition provide the best protection to outside investors, whereas French civil law countries have the least protection and German and Scandinavian civil law countries fall between. For example, common law countries most frequently (39%) allow

---

3. Countries with a civil law tradition likely provide less protection for minority shareholder rights, because of (1) higher standards of proof in conflict-of-interest situations, (2) greater responsiveness to (non-shareholder)
shareholders to vote by mail, never block shares for shareholder meetings (100%), and the have the highest percentage (94%) of laws protecting minority shareholders.

Since emerging economies have typically adopted legal systems from their former colonial mother countries, their protection of minority shareholders also varies, led by those adopting the English common law tradition, followed by those of the German civil law origin and finally those of the French civil law system (no emerging economy follows the Scandinavian origin). Among English common law countries, developed economies typically have better protection of minority shareholders than emerging economies. For example, while five (83%) of the six developed economies following a common law tradition allow shareholders to vote by mail, only two (17%) of the 12 emerging economies in the same group have such legal provisions. This contrasts sharply with the French civil law group, whereby only one developed economy (out of seven) and no emerging economy (out of 14) allows proxy vote by mail.

Interestingly, among the countries with French civil law protection the 14 emerging economies appear to have better minority shareholder protection than the seven developed economies. They have a higher percentage of shares not blocked before shareholder meetings (79%), allowing for cumulative voting or giving minorities a right of proportional board representation (36%), and enacting laws protecting minority owners (36%). This may be due to a substitution effect of alternative governance mechanisms (Rediker & Seth, 1995), with weak protection in one area leading to stronger protection in other areas. Or it may be because the tradition is less adhered to in the former colony compared to the original, or their enforcement may be lacking or questionable. As La Porta et al, 1998: 1141) point out: “the quality of law enforcement, unlike the legal rights themselves, improves sharply with the level of income.”

Overall, the level of expropriation is likely to be higher when there is (1) a lack of minority shareholder protection laws, (2) poorly drafted laws, and/or (3) poor enforcement of laws (Coffee, 2000; Gomes, 2000; World Bank, 2002). For developed economies, even for those in the French civil law group, while shortcomings of investor protection appear to have adverse consequences, their stronger legal tradition and higher levels of income may better ensure the enforcement of the laws that do exist (Faccio, et al., 2001; La Porta, et al., 1998). Thus we propose:

**Proposition 2:** Poor legal protection of minority shareholders is associated with principal-principal agency (PPA) problems.

### 4.3 Family Ownership and Control

Many corporations, particularly those in emerging economies, are controlled by families (Claessens, et al, 2000; La Porta, et al., 1999). Families assert informal yet powerful influence on corporate governance (Chen, 2001; Schulze, Lubatkin, & Dino, 2002; Shulze, Lubatkin, Dino, & Buchholtz, 2001), yet there is debate in the literature regarding the costs and benefits of this situation. On one hand, agency theorists argue that the alignment of ownership and control within a family leads to reduced monitoring costs (Fama & Jensen, 1983; Jensen & Meckling, 1976), and family business scholars identify a number of underlying dimensions of the “familiness” (e.g., goal congruence, trust) that provide competitive advantages to family firms stakeholder interests, and (3) greater reliance on statutes over fairness principles (La Porta, et al., 1998).
(Habbershon & Williams, 1999). Empirically, Daily and Dollinger (1992) report that relative to professionally managed firms, family-owned and -operated firms exhibit certain performance advantages due to their unified ownership and control.

On the other hand, there is family ownership structures may have unintended “costs”, such as sibling rivalry, generational envy, non-merit-based compensation, and “irrational” strategic decisions (Gomez-Mejia, Nunez-Nickel & Gutierrez, 2001: 82; Upton & Heck, 2000). For example, Schulze and colleagues (2001: 102) find that family relations make agency problems “more difficult” to resolve, because relations between principals (family owners) and agents (family-member managers) are likely based on emotions, sentiments, and informal linkages, which result in less effective monitoring of family managers. Schulze and colleagues (2002) identify two sources of governance problems in family businesses: (1) parents’ altruism often results in their inability to discipline under-performing children, and (2) the family advantage (e.g., goal congruence) disappears when second and third generations (often siblings, cousins, and their families), who have divergent interests and abilities, take over.

Because family ownership and control is so pervasive, particularly in emerging economies, a reconciliation of these two opposing views as crucial. We propose that whether the advantages outweigh the disadvantages of concentrated ownership and control in family firms basically depends on the size and complexity of the organization. When firm size is small and relatively noncomplex, it is likely, as noted by Daily and Dollinger (1992), Fama and Jensen (1983), and Habbershon and Williams (1999), that an organization can handle governance problems and attain competitive advantages. In fact, it may contribute to the economic take-off in many emerging economies. However, such practices are likely to yield increasingly lower net benefits for larger and more complex corporations. This argument is borne out by the evidence from developed economies, where simple structures tend to be more effective, and therefore more common, for smaller firms (Chrisman, Baurerscmidt, & Hofer, 1998). But beyond a certain size and complexity, firms can achieve a net gain by adopting a more sophisticated governance structure with more separated and specialized ownership and control (O’Neill, Poudar, & Buchholtz, 1998).

Yet, while relinquishing majority ownership and control may be a viable option for family firms in developed economies, it may not be viable in emerging economies because of the “weak governance” (Dharwadkar et al, 2000) and “low trust” (Fukuyama, 1996) that offers little protection against traditional agency problems. To deal with these issues, firms in emerging economies often staff key positions with family members even as the firm becomes large and complex. In other words, the family business structure is a rational response to the institutional environment facing firms in emerging economies (Chen, 2001). For example, 57% of the listed firms in East Asia have a CEO or chairman who is from the controlling family, and family ownership structures are the norm in even the largest and most complex corporations (Claessens et al, 2000: 92). Consequently, families and their businesses in emerging economies are often

---

4. Daily and Dollinger’s (1992) findings can be reinterpreted in this light as they only examine small firms (less than 500 employees, sales less than $30 million per year) with different ownership and control structures (p. 125). As a result, their results do not run counter to the size and complexity arguments outlined here.

5. In the United States, examples of family control of large, complex firms beyond the first generation, while not impossible (e.g., Ford Motor Company), is the exception. The opposite seems to exist in emerging economies.
indistinguishable (Chen, 2001).

In their seminal article, Fama and Jensen (1983: 307) allude to potential governance problems for family firms as they grow in size and complexity, arguing that only “small noncomplex organizations can efficiently control the agency problems caused by the combination of decision management and control.” Anticipating the potential PPA problems (although not using this term), they further note that separation of ownership and control “limits the power of individual decision agents to expropriate interests of residual claimants. The checks and balances of such decision systems have [agency] costs, but they also have important benefits” (Fama & Jensen, 1983: 309). Extending this reasoning, we argue that the combination of ownership and control in large, complex family corporations may lead to a situation where the expropriation costs (PPA costs) outweigh the savings in monitoring costs (traditional agency costs). While not every family firm will develop PPA problems, family ownership is more likely to foster an “us versus them” mentality forms between the family (who may view the firm as its property) and outside investors (who prefer to see the firm managed for the benefit of all shareholders). This may be particularly true in emerging economies, where the traditional culture places a higher value on family ties (Chen, 2001; Fukuyama, 1996).

Concentrated family ownership is more likely to lead to a situation where non-family members and associates are excluded from major top-level decisions and minority shareholders interests are neglected. Speaking of firms in Asia, Backman (1999: 21) notes that often “the most anonymous of all outsiders — the minority shareholders in listed corporations — are treated the most derisorily of all” (Backman, 1999: 21). These types of family business problems, as they relate to corporate governance, can be thought of as PPA problems and not as PA problems. Conceptually, in such cases, the dominant owner (family) uses its owner control power for personal benefit (e.g., employment of under performing family members) at the expense of overall firm performance (e.g., shirking or poor strategies). Therefore, we propose that family control of large complex firms may increase the likelihood of minority expropriation. Stated formally:

**Proposition 3:** Family ownership and control of corporations, particularly when an organization is large and complex, is positively associated with principal-principal agency (PPA) problems.

4.4 Pyramid Ownership Structures and Business Groups

Although not common in developed economies, may firms in emerging economies are owned and controlled through “pyramids” structures (Faccio, Lang & Young, 2001). Under a pyramid ownership structure, a group of shareholders owns and controls a corporation indirectly through another corporation. 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. For example, Faccio et al (2001: 56) give an example of an investor, who owns 50% of the shares of Company X, which owns 40% of the shares of Company Y, which owns 30% of the shares of Company Z. He or she ends up with 6% (50% x 40% x 30%) of the ownership (cash-flow) rights of Z but 30% of its control rights. Note that this creates a moral hazard situation, as the financial benefits from expropriation disproportionately outweigh the financial costs for the ultimate owners. In extreme cases, “the controlling shareholders can extract high returns from projects that yield negative returns to the corporation” (Faccio et al, 2001: 54). Pyramid ownership
schemes are widespread in emerging economies. For example, Faccio and colleagues (2001: 59) find that the 22 largest East Asian business groups (usually a prominent, well-connected family) had “ultimate control” of 31.2 % of the corporations from a sample of 2,603 through such schemes. These ownership schemes increase the incentive and hence probability of minority shareholder expropriation.

Another ubiquitous institutional feature of emerging economies is the “business group,” which is “a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action” (Khanna & Rivkin, 2001: 47; see also Granovetter, 1995; Guillen, 2000a). While these groups go by different names (e.g., the “business house” in India, the grupos in Latin America, the guanxi qiye in China, and the “financial-industrial group” in Russia), what distinguishes them from other organizational forms is that the groups are a community of firms without clear boundaries (Peng, 2000). Often in business groups, informal ties – such as cross-holdings, board interlocks, and coordinated actions – are stronger than formal ties. This, in turn, results in heavy intra-group activities and transactions, often at very favorable terms. The informal group ties often oblige majority owners of member firms to look after one another's interests, including bailing out member firms that are performing badly (Chang & Hong, 2000). Managers of member firms, consequently, may shirk their responsibilities knowing that other firms will assist them should they run into difficulties. According to Khanna and Rivkin (2001: 51):

… 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.

The low transparency of such sprawling, loosely-affiliated business groups makes it difficult for minority shareholders to determine where control resides, let alone identify and challenge unfair intra-group transactions. In short, business group affiliation may provide a means by which majority shareholders can expand control and thus increases the likelihood of minority shareholder expropriation (Backman, 1999; Ghemawat & Khanna, 1998). In short:

**Proposition 4A:** Pyramid ownership structures are positively associated with principal-principal agency (PPA) problems.

**Proposition 4B:** Business group structures are positively associated with principal-principal agency (PPA) problems.

### 4.5 State Ownership and State-Owned Enterprises (SOEs) in Transition

In addition to those controlled by families, many corporations in emerging economies are
owned and/or controlled by the state (La Porta, et al., 1999). From a corporate governance perspective, state-owned enterprises (SOEs) can be conceptualized as firms controlled by bureaucrats who command extremely concentrated control rights but who personally have no formal ownership rights. Although all citizens of a country, in theory, “own” the SOEs, in practice, ownership rights tend to rest with powerful ministries acting as de facto “majority shareholders.” As a result, while citizens pay taxes to establish, run, and subsidize SOEs, citizens end up assuming the role of de facto “minority shareholders” with practically no rights to govern these firms (Steinfeld, 1998). Viewed in this light, it is plausible to argue that the inefficiency of SOEs results from PPA problems, where minority shareholders are virtually powerless against a powerful majority owner (Shleifer & Vishny, 1997: 768). Because “state property belongs to all and to none” (Kornai, 1992: 75), the formal ideal of publicly-spirited officials running SOEs for the public good often is often replaced by utility-maximizing bureaucrats who enrich themselves at the expense of the public (Peng, 2000).

The widespread failure of SOEs has led to a privatization movement sweeping through formerly centralized economies (Ramamurti, 2000). However, many newly privatized firms continue to have poor governance and performance (Newman, 2000; Spicer, McDermott, & Kogut, 2000). In some cases, policy makers have experimented with partial privatization by selling minority positions in SOEs, while fear of instability often prompts them to retain majority ownership (Mar & Young, 2001). For example, in China, the largest emerging economy, an average of only 30-40% of the shares of publicly traded corporations are tradable/negotiable with the rest of the shares being controlled by the state. Only a very small percentage of firms have less than dominant ownership by the state. Therefore, nearly all Chinese investors have no choice but to become minority shareholders if they wish to participate in the stock market, with the state being the dominant majority owner (Young & McGuinness, 2001). As a result, the dispersed minority shareholders have virtually no say in how these corporations are run in the face of the dominant government owner – a situation ripe for PPA problems. In contrast to China, the reform of East European SOEs typically has been one of rapid, total privatization because of a different political environment. This also results in extensive insider control and inadequate protection of minority investors, and consequently severe PPA problems (Boycko, Shleifer, & Vishny, 1995; Estrin & Wright, 1999; World Bank, 2002).

As state ownership is privatized, powerful new owners may abuse their position for personal benefit during the transition. In an environment without formal institutional protection, decision makers must rely on informal networks whose members they can trust (Linz & Krueger, 1998; Peng & Heath, 1996). For example, in Russia, although non-management employees have become the largest shareholder group since the 1990s, they typically are very passive, unorganized minority shareholders. While the state typically retains substantial ownership stakes (approximately 9% of medium and large businesses), the state often remains passive, giving effective control to the managers – the second largest shareholder group of Russian corporate assets (Kuznetsova & Kuznetsova, 1999). Under these circumstances, it is not surprising that corporate assets are often transferred away from the publicly held firm to the hands of owner-managers (Johnson, et al., 2000b). During the Russian privatization in the early 1990s, firms sold for approximately $100 per employee, compared to market valuation of about $100,000 per employee for Western firms. Even controlling for differences in the cost of living, the Russian assets were still sold at a 99% discount (Shleifer & Vishny, 1997: 748). The low share prices likely reflected the likelihood that managers will expropriate outside investors (Johnson, et al., 2000b). Russian firms, consequently, have experienced great difficulties in accessing external
Proposition 5A: State ownership and control of corporate assets is positively associated with principal-principal agency (PPA) problems.

Proposition 5B: The extent to which ownership and control rest with insiders (especially owner-managers) at newly privatized (former SOE) firms is positively associated with principal-principal agency (PPA) problems.

4.6 Strategy and Competitive Outcomes from PPA Problems

While expropriation of minority shareholders is arguably unfair in its own right, PPA problems also affect organizational strategies and competitiveness. Firms with PPA problems are likely to embrace strategies that benefit the majority shareholders with relatively little regard for overall firm competitiveness. Examples of these actions include (1) placing family members (in family firms) or political friends and cronies (in SOEs) in key management positions while other candidates likely are more qualified (Faccio, et al., 2001; Steinfeld, 1998); (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, the dominant owners (Chang & Hong, 2000; Khanna & Rivkin, 2001); and (3) engaging in strategies which advance personal, family, or political agendas at the expense of firm performance (Backman, 1999). Beyond the poor treatment of minority shareholders, these are management issues that have important implications for the organizational competitiveness. Since PPA problems tend to be more extensive in emerging economies, they negatively affect the living standards and quality of life of often-impoverished populations.

PPA problems have further repercussions on firm performance by increasing the cost of capital. As Jensen and Meckling (1976: 313) point out: “prospective minority shareholders will realize that owner-managers’ interests will diverge somewhat from theirs, hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between manager’s interest and theirs.” Gomes (2000) concurs, noting that investors in emerging economies are able to recognize when owner-managers exploit minority shareholders and accordingly discount their equity. As a result, in order to attract investors, firms with potential PPA problems have to pay higher dividends in order to signal certain reputation for not expropriating minority shareholders as severely as other firms. This may explain why there are so many minority shareholders who invest in these firms, despite the obvious risks. Minority investors may believe that returns in dividends from certain (reputable) firms are high enough to outweigh the risks associated with potential expropriation (Gomes, 2000). This is a poor substitute for solid protection of minority shareholders, however, as even the most reputable firms may expropriate minority shareholder value under certain circumstances, such as the Asian financial crisis of 1997-98 (Johnson et al., 2000a).

Dominant shareholders also may favor a high dividend strategy (Carney & Gedajlovic, 2002). For majority owners with a large portion of wealth tied up in a particular firm, retaining corporate earnings may be seen as too risky. These individuals can reduce their risk by extracting dividends and reinvesting in other businesses. As a result, majority shareholders may also have a vested interest in paying more dividends, mostly to themselves anyway. For example, Faccio and colleagues (2001: 55) find that Asian firms with at least 20% of the equity controlled by insiders paid significantly higher dividends, which translates to higher costs of capital.
Ironically, this is the opposite of what might be expected in developed economies, where the conventional view is that large block owners improve governance and firm performance – corresponding to lower cost of capital (Demsetz & Lehn, 1985). In addition to higher dividends, firms with potential PPA problems may also suffer from higher cost of capital due to significant underpricing at the time of initial public offering (Gomes, 2000).

As a demonstration of the link between minority shareholder protection, capital market participation, and related cost of capital, La Porta and colleagues (1997: 1138) report a 60% ratio of minority shareholder equity to GNP for English common law countries, which have stronger protection of minority shareholders. This compares to a 21% ratio for French civil law countries, a 30% ratio for Scandinavian civil law countries, and a 46% ratio for German civil law countries. In cases where firms are unable to convince outside shareholders that dominant owners will not exploit them, firms have to either rely entirely on internal financing or to obtain external financing at very high costs, both of which hurt firm performance and limit growth opportunities in emerging economies. As a result, firms in developed economies rely to a greater extent on external financing than do firms in emerging economies, which has been associated with a higher capitalization and higher economic growth rates (Demirgüç-Kunt & Maksimovic, 1998). In summary, PPA conflicts undermine firm competitiveness and discourage investor participation. This, in turn, increases the cost of capital through higher dividends and lower prices for equity offerings. Thus the next propositions:

**Proposition 6A:** Principal-principal agency (PPA) problems are associated with strategies that benefit majority shareholders at the expense of overall organizational competitiveness and performance.

**Proposition 6B:** Principal-principal agency (PPA) problems are associated with higher costs of capital thereby negatively impacting organizational competitiveness and performance.

4. **RESOLVING PRINCIPAL-PRINCIPAL AGENCY PROBLEMS**

PPA conflicts are complex and multilevel, but there are potential remedies to reduce these problems. At the highest level, minority shareholder protection and corporate governance reform, whether in developed or emerging economies, are problems of political governance as well as corporate governance (Roe, 1994). Powerful families and individuals have a vested interest in maintaining the status quo, and can erect formidable barriers to governance reforms (Oliver, 1997; Rajan & Zingales, 2000). The question remains as to whether the political obstacles can be overcome to create market-supporting institutions fostering transparency and fair treatment for all shareholders.

In developed economies, this may be a matter of further “fine tuning” existing infrastructure, and this process has already begun. Such factors as prohibiting consulting by auditing firms, more transparency in boardrooms, greater independence of directors, facilitation of class action lawsuits by minority shareholders would be moves in the right direction. However, because the institutional context in emerging economies is particularly conducive to widespread and severe PPA, combating the problems there, will be more difficult, require more creative and far-reaching solutions. Abolishing dominant ownership structures presently is not an option because of the governance vacuum that would let managerial opportunism run rampant. Of course,
Principal-Principal Agency

In the short run, it is often necessary to educate minority investors in emerging economies who tend to be less sophisticated than their counterparts in developed countries concerning corporate governance. Without reform, the traditional solutions to corporate governance based on agency theory are not likely to solve PPA problems in emerging economies. For example, concentration of ownership – a principal-agency-based prescription intended for developed economies – will not limit the problem, but in fact may make it worse. This is because further ownership concentration will further increase the power of majority shareholders, leading to more PPA problems. Rather than increasing ownership concentration, what may be needed in such cases are limits to ownership concentration. Likewise, increasing board vigilance in and of itself may also miss the mark. Boards may be extra vigilant in looking after the interests of majority owners, who are also the top executives or family members. Thus, enhancing board vigilance may fail to address the PPA problems, unless measures are taken to ensure that boards of directors also represent the interests of minority investors as well as majority owners.

At present, although the Anglo-American model of corporate governance dominates the literature, there is no conclusive evidence whether this model is superior (Gedajlovic & Shapiro, 1998; Shleifer & Vishny, 1997). Relative to the Anglo-American model, the German-Japanese model, which accommodates concentrated ownership, has more in common with emerging economies. Therefore, it may be more realistic for emerging economies to model their corporate governance systems after those of Germany and Japan (Shleifer & Vishny, 1997: 773). Also, opening the economy to foreign institutional investors may accelerate corporate governance reforms. Because foreign investors are outside the domestic social networks, they are more likely to push for transparent deals and pressure governments to improve minority shareholder protection. Foreign investors may also have better monitoring capabilities, thus helping curtail the PPA problems and compelling firms to reach a higher level of performance (Khanna & Palepu, 2000). Of course, there is no guarantee that foreign investors will want to invest in emerging economies or that they will be successful in curtailing the PPA problems, but their presence is likely to be more helpful than their absence.

5. DISCUSSION

This article contributes to the literature by bringing to the attention of researchers a corporate governance problem that is largely overlooked in the management literature. In certain situations, particularly in emerging economies, dominant ownership structures and other factors...
shift the conflict in the corporate governance process away from the relationship between managers and shareholder and toward the relationship between majority and minority shareholders. While PPA problems certainly exist in developed economies, they are likely to be of relatively lower incidence and of less magnitude. Although PPA problems have received less attention in the management literature, they often have a detrimental effect on firm competitiveness, and hence the living standards of the populations in emerging economies where they are of greater incidence and magnitude. Extending agency theory research, we discuss the institutional structure, typical of emerging economies, that leads to PPA problems. Further we have highlighted other complicating factors that exacerbate PPA problems.

In emerging economies, PPA problems may not only harm firm-level performance, but they may also contribute to the macroeconomic instability that frequently occurs in emerging economies (Johnson, et al., 2000a). When a country experiences some loss of confidence (e.g., currency crisis, coup, riot, etc.), majority shareholders may step up expropriation in order to make up their “losses.” When the institutional norms are to expropriate minority shareholders, even some of the historically more reputable majority shareholders, facing drastic decreases in cash flow because of a crisis, may step up expropriation to maintain their income, despite the impact on reputation (Gomes, 2000; Johnson, et al., 2000a). Anticipating such increased expropriation, minority shareholders may sell shares en masse, thus causing a rapid fall in asset values and a worsening of the economic crises (Johnson, et al., 2000a). Recent crises in Argentina (2001), Asia (1997), Russia (1998), and Venezuela (2002) can serve as cases in point.

Future researchers need to be aware of the different nuances of pertaining to PPA problems and note that they may require different types of solutions from straight PA problems. Particularly in emerging economies, corporate governance mechanisms that are effective in developed economies with relatively dispersed ownership and solid protection for minority shareholders (especially the US and UK) may fail to address PPA problems that proliferate in emerging economies. The examination of emerging economies allows us to “vary institutional contexts” (Scott, 1995: 146). Otherwise, “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” (Scott, 1995: 146). As a first step, by utilizing an institutional environment outside the familiar Anglo-American world we are better able to isolate the PPA phenomenon.

There are a number of potential future research directions that may stem from this work. First, while North (1990, 1994) has argued that institutions determine the performance of economies, he acknowledges that less is known about what creates efficient institutions. Although the determination of governments, foreign advisors, and international organizations (e.g., IMF) may be one factor, this alone is not sufficient. Firms are not likely to be passive; instead they may delay or accelerate governance reforms (Ranjan & Zingales, 2000). The development of corporate governance occurs through a co-evolutionary process involving the formal and informal institutions of national contexts. Therefore, future work needs to explore in more detail how organizations influence institutions, shedding light on how these two co-evolve. Future research may want to also wish to address the idiosyncratic cultural and regional differences across countries and how they affect the PPA problems. National and regional cultures also generate idiosyncratic differences in corporate governance across countries (Gedajlovic & Shapiro, 1998). Thus, lessons from relatively more advanced emerging economies (e.g., Chile, Hong Kong), while insightful, are not likely to be of equal importance to less developed economies (e.g., Belarus, Indonesia).
REFERENCES


TABLE 1: The Principal-Agency Perspective versus the Principal-Principal Agency Perspective

<table>
<thead>
<tr>
<th></th>
<th>Principal–Agency</th>
<th>Principal–Principal Agency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major Goal Incongruence</td>
<td>Dispersed shareholders and professional managers</td>
<td>Majority shareholders – typically a prominent family or the state – and minority shareholders</td>
</tr>
<tr>
<td>Manifestations</td>
<td>Strategies that benefit entrenched managers at the expense of shareholders in general (e.g., shirking, pet projects, excessive compensation, over-diversification, etc.)</td>
<td>Strategies that benefit majority shareholders at the expense of minority shareholders (e.g., minority shareholder expropriation, nepotism, cronyism, empire building, etc.)</td>
</tr>
<tr>
<td>Institutional Protection of Minority Shareholders</td>
<td>Formal constraints (e.g., judicial reviews and courts) set an upper bound on potential expropriation by major shareholders. Informal norms promote shareholder wealth maximization</td>
<td>Formal institutional protection is often lacking, corrupted, or un-enforced. Informal norms typically hold the interests of major shareholders ahead of those of minority investors</td>
</tr>
<tr>
<td>Ownership Pattern</td>
<td>Dispersed – 5-20% is considered “concentrated ownership”</td>
<td>Concentrated – Often greater than 50% of equity is controlled by major shareholder</td>
</tr>
<tr>
<td>Boards of Directors</td>
<td>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.</td>
<td>Although similar in form to their developed-country counterparts, boards often have yet to establish institutional legitimacy and thus are ineffective. Research indicates they are often “rubber stamp” of the controlling shareholder</td>
</tr>
<tr>
<td>Top Management Team</td>
<td>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 market for corporate control</td>
<td>Typically family members or associates (if family is major shareholder) or political appointee (if the state is major shareholder). Monitored mainly through family consensus or government bureaucracy</td>
</tr>
<tr>
<td>Market for Corporate Control</td>
<td>Active, at least in principle as the “governance mechanism of last resort.” The threat of takeover theoretically encourages management teams to attempt actions that maximize shareholder wealth</td>
<td>Inactive even in principle. Emerging economies lack the institutional framework for outsiders to conduct takeovers. Concentrated ownership thwarts notions of takeover</td>
</tr>
</tbody>
</table>

1. For some demographic differences in corporate governance between developed economies and emerging economies, see Table 2. For more examples, see Claessens and colleagues (2000), Faccio and colleagues (2001), and La Porta and colleagues (1997, 1998, 1999).
TABLE 2: Ownership Concentration, Legal Tradition, and Minority Shareholder Protection

<table>
<thead>
<tr>
<th>(A) English common law origin (18 countries)</th>
<th>(1) Ownership by top 3 largest shareholders (mean)</th>
<th>(2) Proxy by mail allowed (1 = yes)</th>
<th>(3) Shares not blocked before meeting (1 = yes)</th>
<th>(4) Cumulative voting/ proportional representation on board (1 = yes)</th>
<th>(5) Oppressed minority protection (1 = yes)</th>
<th>(6) Average market capitalization of firms (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed economies (6)</td>
<td>0.43</td>
<td>0.39</td>
<td>1.00</td>
<td>0.28</td>
<td>0.94</td>
<td>6,586</td>
</tr>
<tr>
<td>-- Australia</td>
<td>0.28</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>5,943</td>
</tr>
<tr>
<td>-- Canada</td>
<td>0.40</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3,015</td>
</tr>
<tr>
<td>-- Ireland</td>
<td>0.39</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>944</td>
</tr>
<tr>
<td>-- New Zealand</td>
<td>0.48</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1,019</td>
</tr>
<tr>
<td>-- United Kingdom</td>
<td>0.19</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>18,511</td>
</tr>
<tr>
<td>-- United States</td>
<td>0.20</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>71,650</td>
</tr>
<tr>
<td>Emerging economies (12)</td>
<td>0.49</td>
<td>0.17</td>
<td>1.00</td>
<td>0.25</td>
<td>0.92</td>
<td>1,455</td>
</tr>
<tr>
<td>-- Hong Kong</td>
<td>0.54</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>4,282</td>
</tr>
<tr>
<td>-- India</td>
<td>0.40</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1,721</td>
</tr>
<tr>
<td>-- Israel</td>
<td>0.51</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>428</td>
</tr>
<tr>
<td>-- Kenya</td>
<td>na</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>27</td>
</tr>
<tr>
<td>-- Malaysia</td>
<td>0.54</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>2,013</td>
</tr>
<tr>
<td>-- Nigeria</td>
<td>0.40</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>39</td>
</tr>
<tr>
<td>-- Pakistan</td>
<td>0.37</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>49</td>
</tr>
<tr>
<td>-- Singapore</td>
<td>0.49</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1,637</td>
</tr>
<tr>
<td>-- South Africa</td>
<td>0.52</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>6,238</td>
</tr>
<tr>
<td>-- Sri Lanka</td>
<td>0.60</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>-- Thailand</td>
<td>0.47</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>996</td>
</tr>
<tr>
<td>-- Zimbabwe</td>
<td>0.55</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>28</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(B) French civil law origin (21 countries)</th>
<th>(1) Ownership by top 3 largest shareholders (mean)</th>
<th>(2) Proxy by mail allowed (1 = yes)</th>
<th>(3) Shares not blocked before meeting (1 = yes)</th>
<th>(4) Cumulative voting/ proportional representation on board (1 = yes)</th>
<th>(5) Oppressed minority protection (1 = yes)</th>
<th>(6) Average market capitalization of firms (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed economies (7)</td>
<td>0.51</td>
<td>0.14</td>
<td>0.14</td>
<td>0.14</td>
<td>0.14</td>
<td>3,371</td>
</tr>
<tr>
<td>-- Belgium</td>
<td>0.54</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3,467</td>
</tr>
<tr>
<td>-- France</td>
<td>0.34</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>8,914</td>
</tr>
<tr>
<td>-- Greece</td>
<td>0.67</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>163</td>
</tr>
<tr>
<td>-- Italy</td>
<td>0.58</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3,140</td>
</tr>
<tr>
<td>-- Netherlands</td>
<td>0.39</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>6,400</td>
</tr>
<tr>
<td>-- Portugal</td>
<td>0.52</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>259</td>
</tr>
<tr>
<td>-- Spain</td>
<td>0.51</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1,256</td>
</tr>
</tbody>
</table>
TABLE 2: Ownership Concentration, Legal Tradition, and Minority Shareholder Protection (continued)

<table>
<thead>
<tr>
<th></th>
<th>(1) Ownership by top 3 largest shareholders (mean)</th>
<th>(2) Proxy by mail allowed (1 = yes)</th>
<th>(3) Shares not blocked before meeting (1 = yes)</th>
<th>(4) Cumulative voting/proportional representation on board (1 = yes)</th>
<th>(5) Oppressed minority protection (1 = yes)</th>
<th>(6) Average market capitalization of firms (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Emerging economies (14)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-- Argentina</td>
<td>0.57</td>
<td>0</td>
<td>0.79</td>
<td>0.36</td>
<td>0.36</td>
<td>963</td>
</tr>
<tr>
<td>-- Brazil</td>
<td>0.53</td>
<td>0</td>
<td>0.79</td>
<td>0.36</td>
<td>0.36</td>
<td>2,185</td>
</tr>
<tr>
<td>-- Brazil</td>
<td>0.57</td>
<td>0</td>
<td>1</td>
<td>0.36</td>
<td>1</td>
<td>1,237</td>
</tr>
<tr>
<td>-- Chile</td>
<td>0.45</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>2,330</td>
</tr>
<tr>
<td>-- Colombia</td>
<td>0.63</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>457</td>
</tr>
<tr>
<td>-- Ecuador</td>
<td>na</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>na</td>
</tr>
<tr>
<td>-- Egypt</td>
<td>0.62</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>104</td>
</tr>
<tr>
<td>-- Indonesia</td>
<td>0.58</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>882</td>
</tr>
<tr>
<td>-- Jordan</td>
<td>na</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>63</td>
</tr>
<tr>
<td>-- Mexico</td>
<td>0.64</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2,984</td>
</tr>
<tr>
<td>-- Peru</td>
<td>0.56</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>154</td>
</tr>
<tr>
<td>-- Philippines</td>
<td>0.57</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>259</td>
</tr>
<tr>
<td>-- Turkey</td>
<td>0.59</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>477</td>
</tr>
<tr>
<td>-- Uruguay</td>
<td>na</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>na</td>
</tr>
<tr>
<td>-- Venezuela</td>
<td>0.51</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>423</td>
</tr>
<tr>
<td><strong>(C) German common law origin (6 countries)</strong></td>
<td>0.34</td>
<td>0.00</td>
<td>0.17</td>
<td>0.33</td>
<td>0.50</td>
<td>8,057</td>
</tr>
<tr>
<td><strong>Developed economies (4)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-- Austria</td>
<td>0.41</td>
<td>0</td>
<td>0.25</td>
<td>0.25</td>
<td>0.25</td>
<td>11,280</td>
</tr>
<tr>
<td>-- Germany</td>
<td>0.58</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>325</td>
</tr>
<tr>
<td>-- Japan</td>
<td>0.48</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>8,540</td>
</tr>
<tr>
<td>-- Switzerland</td>
<td>0.18</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>26,677</td>
</tr>
<tr>
<td><strong>Emerging economies (2)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-- South Korea</td>
<td>0.21</td>
<td>0</td>
<td>0</td>
<td>0.50</td>
<td>1</td>
<td>1,610</td>
</tr>
<tr>
<td>-- Taiwan</td>
<td>0.23</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1,034</td>
</tr>
<tr>
<td><strong>(D) Scandinavian common law origin (4 countries)</strong></td>
<td>0.37</td>
<td>0.25</td>
<td>1</td>
<td>0.00</td>
<td>0.00</td>
<td>2,644</td>
</tr>
<tr>
<td><strong>Developed economies (4)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-- Denmark</td>
<td>0.37</td>
<td>0.25</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>2,644</td>
</tr>
<tr>
<td>-- Finland</td>
<td>0.45</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1,273</td>
</tr>
<tr>
<td>-- Norway</td>
<td>0.37</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1,980</td>
</tr>
<tr>
<td>-- Sweden</td>
<td>0.36</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1,106</td>
</tr>
</tbody>
</table>
TABLE 2: Ownership Concentration, Legal Tradition, and Minority Shareholder Protection (continued)

<table>
<thead>
<tr>
<th></th>
<th>(1) Ownership by top 3 largest shareholders (mean)</th>
<th>(2) Proxy by mail allowed (1 = yes)</th>
<th>(3) Shares not blocked before meeting (1 = yes)</th>
<th>(4) Cumulative voting/proportional representation on board (1 = yes)</th>
<th>(5) Oppressed minority protection (1 = yes)</th>
<th>(6) Average market capitalization of firms (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(E) Average for 49 countries in the sample</td>
<td>0.46</td>
<td>0.18</td>
<td>0.71</td>
<td>0.27</td>
<td>0.53</td>
<td>4,521</td>
</tr>
<tr>
<td>Average for 21 developed economies</td>
<td>0.41</td>
<td>0.33</td>
<td>0.57</td>
<td>0.19</td>
<td>0.38</td>
<td>8,590</td>
</tr>
<tr>
<td>Average for 28 emerging economies</td>
<td>0.51</td>
<td>0.07</td>
<td>0.82</td>
<td>0.32</td>
<td>0.64</td>
<td>1,240</td>
</tr>
</tbody>
</table>

1. Results for developed and emerging economies are calculated by the authors based on raw data reported by La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1998: 1130, 1131, 1147, 1148). Raw data are from the early 1990s.
FIGURE 1: The Causes and Consequences of Principal-Principal Agency Problems

Weak Institutional Support of Corporate Governance Mechanisms
- Weak formal and informal institutional support of governance mechanisms creates potential for severe principal-agent problems

Dominant Ownership and Control (P1)

Principal-Principal Agency Problems
- Expropriation of minority shareholders

Firm Competitiveness
- Non-value maximizing strategies
- Increased cost of capital (P6)

Formal Institutional Constraints
- Weak protection for minority shareholders (P2)

Informal Institutional Constraints
- Family ownership and control (P3)
- Business groups and pyramids (P4)
- State ownership in transition (P5)