



## Corporate governance compliance of family and non-family listed firms in emerging markets: Evidence from Latin America

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### ABSTRACT

Based on agency theory, this study analyzes whether family firms are more compliant with corporate governance recommendations than non-family firms in the context of emerging markets. Using a unique sample of 826 observations of the highest ranked companies on the stock exchange indices of Argentina, Brazil, Chile and Mexico during the period 2004–2010, we hypothesize that family firms may adopt better corporate governance practices to substitute for the absence or inefficiency of a regulatory system and to mitigate the agency problem between majority and minority shareholders. Additionally, we propose a corporate governance compliance index considering the legal and institutional framework of the region. The empirical results indicate that family firms report a higher corporate governance index. We find that board composition (independence, size and COB-CEO duality) does not moderate corporate governance compliance of family firms but rather such variables have a direct effect on the corporate governance index.

### 1. Introduction

Family firms represent a major engine of economic growth and wealth creation and constitute an important form of business around the world (Spanos, Tshipouri, & Xanthakis, 2008). In emerging markets, family companies account for a significant proportion of the gross national product (Claessens et al., 2002) and are characterized by controlling family owner(s) and concentrated ownership (Lubatkin, Ling, & Schulze, 2007). In Latin America, most companies are controlled by its founders, and the involvement of family members in key executive positions is very common (Bertrand & Schoar, 2006). Similar to other emerging economies, Latin American listed firms are controlled by a family where corporate control is enhanced through various mechanisms such as pyramidal structures, dual class shares or multiple control chains, which might create an agency problem when their interests are not aligned to those of the firm (González et al., 2014).

Bammens, Voordeckers and Van Gils (2011) identified four main sources of agency problems in family firms: First, the extraction of firms' resources through special dividends, excessive compensation and tunneling activities (Anderson & Reeb, 2004; Setia-Atmaja et al., 2009); second, the misalignment of interest of the controlling family with the firm that results from non-financial aims such as the preservation of the firm for future generations (Gómez-Mejía et al., 2007; Jones et al., 2008; Voordeckers et al., 2007); third, altruism towards other family

members, such as setting up independent departments for each heir, rewarding employed family members equally regardless of effort and performance, and lavishing them with excessive perquisites and privileges (Schulze et al., 2001); fourth, intra-familial conflict, which creates rivalry among family members and results in underperformance (Schulze et al., 2003).

To mitigate agency problems, family firms have a strong incentive to increase compliance with corporate governance (hereafter CG) recommendations and promote board structures, which limit the expropriation of firms' wealth (Brunello et al., 2003). One important role of the board of directors as a monitor is to ensure that the company complies with applicable laws and regulations (Carter et al., 2010). Prior research indicates that independent members are included on the board of family firms as a response to pressures from non-family stakeholders, such as investors and banks, attempting to safeguard their financial interests (Fiegener et al., 2000). Therefore, family firms recognize the importance of good governance practices to retain investors' confidence and as a substitute for the weaknesses of the legal environment (Brenes, Madrigal, & Requena, 2011; Poletti-Hughes, 2009; Su & Lee, 2013).

Although family firms represent a significant part of publicly listed companies in Latin America, little research has been done on aspects of their CG. Most of the prior literature has been focused on Anglo-Saxon, European and Asian countries. A strand of literature has studied the

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relationship between family firms and CG as a strategic choice to explain performance differentials between family and non-family firms (Bartholomeusz & Tanewski, 2006; Goh, Rasli, & Khan, 2014; Klein, Shapiro, & Young, 2005; Lee, Cho, & Kang, 2011; van Essen, Carney, Gedajlovic, & Heugens, 2015).

In this paper, we consider the agency problem that arises from the relationship of controlling and minority shareholders and aim to study whether CG compliance is higher in family firms in comparison with non-family firms. We extend this research by investigating whether board characteristics (board size, board independence and COB-CEO duality) have an impact on CG compliance. The adoption of CG practices by family firms in markets where there is absence of a strong institutional system increases the confidence of external shareholders. Particularly, listed firms are highly visible and therefore are encouraged to increase transparency as bad practices may be broadly noticed and penalized (Baum & Powell, 1995). We hypothesize a moderating effect of board composition (size, independence and COB-CEO non-duality) on the relationship of family firms and CG compliance since the board of directors constitutes the linchpin of CG and one of its main functions is to ensure continuous CG compliance (Gillan, 2006). It is common that family members are involved in the management and board positions, and therefore, board structure might promote or limit CG compliance of family firms. The incidence of large family ownership and the incentives that the family have to benefit from control raises the question of whether the effectiveness of the board of directors might act as a mechanism to keep the family from expropriating minority shareholders' wealth (Anderson & Reeb, 2004). Therefore, consistent with agency theory, more independent and larger boards balance family board representation and consequently might enhance board monitoring and increase compliance with CG practices. To achieve our aim, we compiled a unique cross-country data of 826 non-financial firms of the four most important emerging countries in the Latin American region (Argentina, Brazil, Chile and Mexico) during the period 2004 and 2010.

This paper contributes in several ways to the family firm literature. First, we approach this study from the principal–principal agency conflict since Latin America is characterized by highly concentrated ownership structures where major shareholders may take advantage of weak shareholder protection to the detriment of minority investors. Second, we construct a unique regional CG rating (hereafter CGR) that reflects the regulatory and institutional framework of Latin America contributing to a better understanding of the CG of family firms. CG compliance may constitute a strategic tool to align the interests of controlling and minority shareholders; therefore, Latin American family firms may be more willing to increase CG ratings to increase market confidence. Third, as advocated by Kabbach de Castro, Crespi-Cladera, and Aguilera (2012), we provide empirical evidence on the relationship between family firms and CG compliance, and the effect of board composition on the CG compliance where research has been limited.

This paper is structured as follows. Section 2 develops the hypotheses. Section 3 describes the sample and empirical methods. Section 4 presents the empirical results. Section 5 presents the discussion and conclusions of this research.

## 2. Research hypotheses

### 2.1. Family-controlled firms and corporate governance compliance

In emerging economies, there is a strong link between CG structures and the institutional framework. Family ownership concentration is the response to the absence or inefficiency of the legal system and institutional weaknesses (Heugens, van Essen, & van Oosterhout, 2009; North, 2005; Peng et al., 2009). The institutional context promotes the effectiveness in monitoring and resource allocation in family firms (Li et al., 2006) and reduces the risk of wealth expropriation to minority shareholders (Barontini & Caprio, 2006). This conflict, better known as

type II agency problem, describes the use of controlling mechanisms by larger shareholders to expropriate minority shareholders (Villalonga & Amit, 2006). Family firms tend to maintain their wealth for several generations, investing their economic resources in a single firm or business group, and holding the strategic positions to pursue their private interests to the detriment of outside investors (Anderson & Reeb, 2004; Braun & Sharma, 2007; Gómez-Mejía et al., 2003). Schulze, Lubatkin and Dino (2003) state that family-owned firms could favor family interests over the firm's interests at a loss to minority shareholders and have incentives to be engaged in opportunistic behavior, as a response to family loyalty. Therefore, to preserve investors' confidence and as a signal of protection against expropriation to potential new investors, family firms might be encouraged to higher compliance with CG recommendations. Good governance practices in family firms aim to reconcile the interest of majority shareholders with minority investors in countries where the institutional system is weak. In this way, family firms may respond to institutional pressures in a more substantive manner to maintain a good reputation and project a positive family image (Liu, Valenti, & Chen, 2016).

CG in family firms aligns and organizes the ownership and management functions, through different mechanisms such as general meetings, board of directors, supporting committees and management teams (Brenes et al., 2011). As a consequence, good governance practices are critical in family firms to prosper in an environment of intense competition. According to Chrisman et al. (2007), family firms tend to monitor and provide incentives to management, which improves performance. The complexity of the family firm relationships, such as nepotism, free riding, and entrenchment, which dissuades the alignment of goals and strategies, can be solved through formal monitoring and controlling mechanisms (Chua, Chrisman, & Bergiel, 2009). In this context, it is expected that the principal–principal agency conflict of family firms is likely to lead to higher CG compliance in comparison to non-family firms, as family firms have incentives to protect not only the firms' reputation but also the wealth of the family. Thus, we set the following hypothesis.

*H1. Family-controlled firms show higher corporate governance compliance than non-family firms in Latin America.*

### 2.2. Effect of board composition on corporate governance compliance

In the context of family firms, the board of directors plays a relevant role in mitigating agency problems, not only between shareholders and managers (type I agency problem) but also between majority and minority shareholders (type II agency problem) (Acero & Alcalde, 2016). The board of directors constitutes an important control mechanism, as it is responsible for monitoring and preventing managers' opportunistic behavior in protection of minority shareholders (Cueto, 2013). According to Gillan (2006) and Carter et al. (2010), board monitoring includes overseeing continuous compliance with CG regulations. In markets where disclosure is voluntary, board structure complements or substitutes for other CG practices (Brown et al., 2011). Moreover, the board of directors serves as an advisor to the family firm, ensures fluent communication with all the company's stakeholders, maximizes corporate performance and lowers uncertainty (Jensen & Meckling, 1976; Su & Lee, 2013). We hypothesize that there is a differential in the monitoring activities from the boards of directors in family and non-family firms, which might have an impact on CG compliance. As described in Anderson and Reeb (2004), an effective board protects from resource expropriation by controllers. Therefore, the composition of the board of directors might alleviate the conflict between controlling and minority investors.

#### 2.2.1. Independent directors

According to agency theory, independent directors play a vital role in monitoring management performance and limiting managerial opportunism (Fama & Jensen, 1983). The presence of independent

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