CORPORATE GOVERNANCE OF BUSINESS GROUPS

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In, A.M. Colpan, T. Hikino, and J.R. Lincoln, Eds. (2010). *The Oxford Handbook of Business Groups*. Oxford University Press. ISBN 978-0-19-955286-3

CHAPTER 26

CORPORATE GOVERNANCE OF BUSINESS GROUPS

26.1. INTRODUCTION

Prior commentaries of research on business groups have highlighted two characteristics of work to date. First, business groups are a relatively underserved research topic, given their prominence in the global economy especially in emerging economies. Second, independent of the volume of research, studies of business groups have covered a limited range of topics (Granovetter, 1995; Yiu, Lu, Bruton & Hoskisson, 2007). Both of these limitations apply equally, if not more so, to the more focused domain of the corporate governance of business groups. While governance is a prominent topic in many disciplines, including management, finance, sociology, and other areas, there have been only a handful of articles which have addressed the intersection of governance and business groups.

The goal of this chapter is to offer an integrative framework for studying the governance of business groups. We begin with a brief summary of the studies focused on the governance of business groups. Next, we review key theoretical perspectives, including agency, resource dependence, institutional theory, and the rubber stamp model. This section will also examine how board roles may vary across groups in different nations. Next, we examine factors that affect how groups are organized, using the framework of horizontal and vertical connections proposed by Yiu and colleagues (2007).

Finally, we integrate these sections to lay out an agenda for future studies, including a series of promising research questions across levels of analysis including the governance of business groups types as well as member firms within the business group and institution differences and associated governance requirements.

26.2. GOVERNANCE AND BUSINESS GROUPS

What is corporate governance, and how does it relate to the effective management of business groups? While there are many definitions of corporate governance, most center around the role of boards of directors. Lorsch and MacIver (1989) characterized governance as the board's duty to govern the firm, with their primary role as exercising power over the top management team and employees. Stated more broadly and succinctly, Demb and Neubauer (1992) framed corporate governance as the accountability for firm performance. Charkham (1994) compared corporate governance to the set of checks and balances associated with different branches of government, and is the system that both directs and controls corporations. Typically, as noted, the focus of corporate governance is on boards of directors: the Cadbury governance code for U.K firms, for example, addressed the structure and responsibilities of corporate boards. While most definitions of corporate governance focus on boards of directors, other definitions are more broad, and include the firm's ownership structure as well (e.g., Denis & McConnell, 2003; Useem, 1996). Reporting and disclosure requirements – such as the Sarbanes Oxley Act in the United States – can also fall under the umbrella of corporate governance. For purposes of this chapter, we will focus primarily on the role of the board of directors as a governance mechanism.

By virtue of their complexity, and differences from nation to nation, business groups have been described as being almost invisible to academic researchers (Granovetter, 2005). Given the paucity of research on groups (Granovetter, 1995; Yiu, et al., 2007), it is not surprising that there is limited attention paid to governance issues among groups. Some studies that do address governance of groups focus on ownership issues versus the board of directors (e.g., Volpin, 2002). Other studies may collect samples in regions where business groups are pervasive, but not distinguish group and non-group firms in their analyses (e.g., Zona & Zattoni, 2007). Business groups in Chile represent an exception to this omission, with studies treating board characteristics as both a predictor and an outcome variable.

Some business groups are characterized by formal and explicit ties, which makes it relatively easy to identify group members. However, other groups, such as the Japanese keiretsu, have far more cloudy definitions of group membership. Khanna and Rivkin (2006) studied a variety of metrics to identify group membership in a sample of Chilean firms. Board interlocks were a prominent predictor of group membership, as were patterns of ownership and indirect equity ties. In contrast, family ties and direct equity links were less effective predictors of group membership. The authors concluded that the study of board ties is an important avenue for business group research.

A second Chilean study examined the performance implications of network connections. Silva, Majluf, and Paredes (2006) examined contingency effects of both family ties and board interlocks on performance. An important finding of their study was that family linkages were more consistently associated with performance than board ties. The latter finding is due to the potential for business groups to destroy, as well as

enhance, firm value (Chang, 2003). As shown by this review, little is known about the role of boards of directors in business groups. In the following section, we will explore different theories of governance, and how they may relate to the management of groups.

26.3. THEORETICAL PERSPECTIVES ON GOVERNANCE

To begin our review of theoretical perspectives that can be applied to the corporate governance of business groups, we begin with agency theory and resource dependence theory, which offer very different views on the primary function of boards of directors. Next, we examine institutional theory, which focuses on the role of social influences in shaping the board and its actions. Finally, we consider the rubber stamp perspective on corporate boards. While this is not a theoretical perspective, per se, this label has been used to describe boards which are relatively inert. We will identify key aspects of each perspective, as well as their particular relevance to business groups.

26.3.1. Agency model of corporate boards

Of the different theoretical perspectives used to study corporate governance, agency theory is the most prevalent in recent years: A recent content analysis found that the bulk of governance studies published in management journals were framed using agency theory (Boyd, Haynes & Zona, 2008). The central focus of agency theory lies in a separation of ownership from control, so that the firm's top executives have minimal or no equity in the companies they manage (Berle & Means, 1932; Fama & Jensen, 1983). An agency problem develops when managers and owners have divergent interests, such as competing preferences for risk. These competing interests become more problematic when there are information asymmetries between owners and agents, or when owners

have limited means of disciplining top managers. Consequently, the firm's board of directors is charged with monitoring management on behalf of the owners. While there is a wealth of studies linking governance characteristics to a variety of strategic and tactical outcomes (e.g., examples here), there are also a number of null and mixed findings regarding governance characteristics and firm performance (Dalton, Daily, Ellstrand, and Johnson, 1998).

One limitation of agency research is that the bulk of studies are based on US firms, or firms in other Anglo economies such as the United Kingdom. Since the norms for separation of ownership from control differ broadly outside the US and the UK, the relevance of a traditional agency view for many business groups is arguable (Morck, Wolfenzon & Yeung, 2005). In fact, one review concluded that the likelihood of managerial agency problems is minimal in many world economies, given the presence of controlling shareholders who have both the incentive and ability to discipline top executives (LaPorta, et al., 1999). However, these same conditions also give rise to a different type of agency problem, where dominant shareholders use their control to abuse minority investors. This is known in the management literature as principal-principal agency theory (Dharwadkar, George, & Brandes, 2000). For example, Bae and colleagues (2002) describe examples of two Korean business groups – LG Group and Samsung – that conducted acquisitions or other deals that provided uneven benefits to majority versus minority investors. Exploitation of minority investors has been linked with a variety of governance conditions, including legal protection, board composition, and other monitoring factors (Bae, et al., 2002; Volpin, 2002). In family-run business groups, there is also the potential for some family members to exploit other family owners

(Morck & Yeung, 2003). Overall, it has been argued that the potential for agency problems is more severe in family-based business groups than in freestanding firms (Chang, 2003: Morck, Wolfenzon, & Yeung, 2005). However, there is still very limited empirical analysis of the board's role and potential agency problems in business groups. It is also important to note that, while pyramidal group structures are often cited as being prime candidates for the abuse of minority investors, empirical evidence to date is inconclusive on this topic (Khanna, 2000).

26.3.2. Boards as a mechanism to manage external constraint

In recent years as noted above, research on corporate governance has been dominated by agency theory. This emphasis has overshadowed a longer running stream of research on boards as a mechanism to manage challenges and opportunities that emerge beyond the firm's boundaries. Influenced by general systems theory (Bertalanffy, 1968), management scholars began to develop theories to explain how firms interact with, and are affected by, their external environments. Resource dependence proposed that executives would respond to, and even proactively manage, their environments (Pfeffer & Salancik, 1978; Hillman & Dalziel, 2003). Boards of directors figure prominently in the firm's efforts to navigate its environment.

There is a sizeable research stream on the role of personal networks as a firm's conduit to crucial information and resources that are not available internally (Granovetter, 1985). One of the most important conduits is the web of external ties that are provided by the board of directors (Mizruchi, 1996). Board members are predominantly CEOs and executives of other firms, and typically serve on the boards of one or two other firms (Davis, 1996). These board seats bring executives into contact with other executive with

comparable ties, thus creating a broad, and complex, set of linkages to other firms. These patterns of board ties have been linked with many aspects of strategic change and adaptation (e.g., Useem, 1984; Haunschild, 1993; Carpenter & Westphal, 2001; Boyd, 1990). By recruiting prominent executives, the board of directors also helps to secure access to resources by bolstering the firm's legitimacy (Selznick, 1949). Finally, a board comprised of experienced directors can also offer valuable insight regarding both the framing and execution of a company's strategy (Lorsch & MacIver, 1989).

The resource dependence model has great relevance for business groups. In a recent review, Khanna and Yafeh (2007: 334) commented that "groups do not only respond to their environment, but also shape and influence it." If business groups do not shape it, they may be reshaped by other power players who are entering the market such as foreign institutional investors (Ahmadjian & Robbins, 2005). Historically, most business groups are created in response to inefficient markets, characterized by poor access to capital, resources, and market information. Groups attempt to overcome these constraints through varying combinations of diversification, vertical integration, and acquisition of financial institutions (Khanna & Yafeh, 2007). The boards of business groups have a potentially important role to play in managing group uncertainty, by serving as a connection to other members of the same group, entirely different business groups, and third-party organizations (Kim, Hoskisson, & Wan, 2004). Incidentally, Khanna and Yafeh note that statistical analysis of business groups and their environments "is almost absent." Consequently, there are many opportunities for research on how boards help business groups meet these external demands, which we will address in a subsequent section.

26.3.3. Boards as an institutional phenomenon

Both agency and resource dependence perspectives could be described as being performance oriented: Agency hypotheses typically address the prevention of adverse outcomes, while resource dependence looks for ways to optimally respond to external threats. Institutional theory takes a very different perspective on governance, as the focus is not on organizational efficiency. Instead, this perspective examines how organizational decisions are influenced by the social setting that the firm operates in.

Institutional theory proposes that firms in a given setting will gradually become more homogeneous with the passage of time. Firms adopt increasingly common processes and structures not necessarily because these attributes are competitively desirable, but because there are political and social pressures to conform to institutional norms (DiMaggio & Powell, 1983; Meyer & Rowan, 1983). Isomorphism is the process of increasing similarity, and can be normative, coercive, or mimetic. Normative isomorphism is associated with increasing professionalism. Trade groups, educators, socialization and other sources can lead to diffusion of a set of standard practices. For instance, a director might take a positive experience with a CEO assessment practice on one board to the other boards he or she serves on. As an example, interlocks among Chinese business group members are routinely used to share expertise (Lee & Kang, this Handbook). Coercive isomorphism exists when rules – ranging from legislation to voluntary guidelines – are imposed on organizations. Coercive isomorphism explains why many countries develop agency oriented regulations and governance codes, despite pressing evidence of agency abuses. As Granovetter (2005: 435) commented, the framing of many laws is rooted in agency theory. There is a widespread implicit

assumption that such framing is inherently desirable, such that "as countries advance, they will increasingly adopt similar legislation." A common example of this phenomenon is the widespread adoption of governance codes, such as Singapore, that emphasize board independence and CEO duality (Tsui-Auch & Yoshikawa, this Handbook). In general, these codes are based more on similar provisions made in foreign governance codes, versus specific incidents regarding CEO duality or board composition. Similarly, Brazil has adopted multiple tiers of voluntary governance practices (Aldrighi & Postali, this Handbook). Wholesale adoption of governance practices from other regions can be problematic, for two reasons: First, there is scant empirical evidence supporting many of the governance guidelines. Second, some practices may not be equally desirable from country to country (Finkelsten & Mooney, 2003; Finegold, Benson & Hecht, 2007; Norburn, Boyd, Fox & Muth, 2000). Turkey, for instance, is one of many countries that have followed global standards to improve governance by adding unaffiliated outside board members. However, faced with powerful family members who also serve on the board, and the relatively little knowledge held by these outsiders, these unaffiliated directors carry little influence regarding key decisions (Colpan, this Handbook).

A third type of imitation, mimetic isomorphism, occurs when firms adopt behaviors or processes solely through imitation of others. Mimetic behavior is usually based on high status firms – market leaders, high performers, or other highly prominent companies (Di Maggio & Powell, 1983). As an example of this process, in Germany, the adoption of stock options was originally contested, but as key Germany firms had "exposure to high-status institutional environments" in which this pay practice was

legitimate, they began to change and over time this practice became widely accepted (Sanders and Tuschke, 2007). Foreign firms are often prime candidates for imitation. Mimetic behavior is particularly relevant to the governance of business groups, for two reasons. First, mimetic behavior is more common in environments characterized by high uncertainty (Oliver, 1991). For instance, business groups in both China and Russia, for example, were established using horizontal keiretsu and chaebol groups as templates (Johnson, 2000; Keister, 2000). Therefore, the same market inefficiencies that gave rise to many business groups also create prime conditions for imitation. Imitation can be costly to the firm, because the process or behavior is not appropriate to the setting, or because the adopter does not have the absorptive capacity to implement it effectively. Consequently, adopted behaviors and methods might be inefficient, or even counterproductive, in the new setting (Newman, 2000).

26.3.4. Boards as a rubber stamp

The rubber stamp perspective, also labeled as managerial control, asserts that boards are powerless figureheads. The boards of many firms have been characterized as the organizational equivalent of an appendix – an organ which serves no useful purpose. Such boards provide little or no contribution in the way of oversight or strategy support, and perhaps minimal or no contribution to the firm's prestige as well. (Drucker, 1981; Mace, 1971). With a rubber stamp board, the power for all strategic decisions resides with the firm's top executives. While the board may provide some legitimacy, the simplest explanation for its presence is that most firms are legally required to create a board of directors. Rubber stamp boards can exist in a variety of settings, with varying implications. For instance, consider a smaller firm that is managed by its founder.

Having created the firm and holding a majority ownership stake, the CEO might see little need for monitoring, and possibly only limited advice regarding strategic direction. Consequently, the CEO might create a board populated by friends and family simply to conform to regulatory requirements. An inactive board in this setting might lead to lost opportunities, but the consequences may not be fatal to the organization. A more problematic case is the board of a large firm that is comprised of many fragmented owners. In this environment, top executives might create a weak board as a means to evade monitoring and pursue their own agendas. A third scenario is that of a firm that is legally an independent entity, but is essentially just a division of another firm. Kriger (1988), for instance, noted that the boards of many subsidiary companies are often characterized as "dummy" or "captive" boards. This could happen in many joint ventures firms which are dominated by two powerful owners, one of which may dominate with slightly more ownership.

The rubber stamp scenario has several implications for business groups. While it may be difficult to envision a situation where an inert board is actually desirable, the negative implications might vary substantially across settings. For example, some groups have very strong ownership of their subsidiaries, while others might hold only the minimal levels needed to establish control. The monitoring and control needs differ substantially in these two settings. Similarly, the potential for principal – principal conflicts, where dominant owners taking advantage of minority shareholders, will also vary depending on the ownership structure. Therefore, rubber stamp boards may be more problematic in settings that have greater potential for the abuse of minority investors. Cultural differences suggest that the potential for agency problems will vary substantially

for business groups in different regions. Self-maximization is a core assumption of agency theory. However, the likelihood of self-serving behavior can vary across nations. Hofstede (2001) found that the United States scored much higher on the "individualism" value index than other nations. Italy also reported a high ranking on individualism, particularly in regard to neighboring European nations. A strong proclivity to individualism creates greater temptation to maximize one's own benefit at the expense of the company. A second cultural characteristic related to agency problems is time orientation. Agency problems can arise when a manager has the opportunity to create an immediate personal benefit by sacrificing the firm's long-term interests. When a manager's mindset is oriented toward long-term outcomes, there is less potential for divergence between personal and company goals. Hofstede's data reveals systematic differences in time orientation across regions: Both the US and many European nations have fairly short time orientations. Brazil has a longer term outlook than the US, but is appreciably shorter than much of Asia. Also, it is important to note that regions are not monolithic in their values: Thailand, for example, reported a much shorter time orientation than either Hong Kong or Taiwan. As the needs for oversight will differ based on national characteristics, so will the implication of different governance structures. For example, CEO duality has a small, negative relationship with firm performance in the US (Boyd, 1995), and a modest, positive correlation with firm performance in many European firms, a finding attributed to cultural differences (Boyd, Howard & Carroll, 1997). Additionally, the effect differed by country in the study of European duality: the use of CEO – chairs was positively linked with return on investment in the UK sample, but nonsignificant for the Italian and Swiss samples.

Consequently, board monitoring may be more critical in business groups characterized by high levels of individualism (e.g., Italy), versus moderate (e.g., Brazil) or low (e.g., Thailand or Taiwan) levels.

Generally, most studies of governance topics are framed using a single theoretical perspective. However, as shown in this section, there are multiple perspectives on the role of the board of directors. Integrative frameworks offer the potential to improve our understanding of organizations, as they can test for both contradictions and points of overlap between different governance predictions (e.g., Boyd, 1995; Hillman & Dalziel, 2003). In the next section, we examine how Yiu and colleagues (2007) integrated agency and resource roles to deal with coordination challenges associated with business groups.

26.4. COORDINATION PROCESSES WITHIN BUSINESS GROUPS

Business groups are far from monolithic. Not only are there differences in the structure of business groups across countries, there can also be substantial variation in the manner that groups are configured within a single nation. For example, large business groups in China tend to be state-owned, while smaller groups are typically owned by families (Lee & Kang, this Handbook). In Taiwan, the degree of group diversification seems to be related to the extent of political ties among group members (Chung & Mahmoud, this Handbook). And, in Thailand, family-owned groups can be family managed, professionally managed, or use a combination of both approaches (Suehiro & Wailerdsak, this Handbook). In order to make prescriptions regarding the governance of business groups, it is necessary to understand the different ways that groups can be configured.

We focused on a framework offered by Yiu and colleagues (2007) because it offers four types of different groups which might require different governance arrangement and thereby allows us to suggest how these different types of groups might require different governance mechanisms for illustrative purposes.. Although Yiu and Colleagues (2007) describe only four ideal types or organizational forms, in practice it may be useful to think of these as four archetypes with many potential intermediate configurations. The first part of their model examines how four factors combine to shape business groups: market conditions, social setting, political and economic factors, and agency factors. As shown in Figure 1, these four elements will shape the need for different types of connectivity within a group. The first component, *external market conditions*, is rooted in transaction cost economics. Here, business groups emerge in response to underdeveloped market institutions. Mexico is an ideal example of these conditions, which included poor legal protection, lack of both human and financial capital, and a weak economy. Many of the groups in Chile were formed under similar conditions, as are the groups in many emerging economies. It is important to note that not all groups are affected by imperfect market conditions. In Thailand, for instance, many groups have been launched following the creation of the Thai Stock Exchange, which should presumably have eased access to capital through an improved market for equity capital. Similarly, many of the most powerful Israeli groups have formed in the last fifteen to twenty years, despite having fairly sophisticated market conditions. The *social setting* is another factor that can shape business groups. The rationale for this component is that organizational survival is rooted in alignment to the local social context. Consequently, the structure of groups will be influenced by local conditions. In

India, for instance, there is a norm of social solidarity, which leads to high degrees of trust and reciprocity. In contrast, Chilean groups have a reputation for being very guarded with strategic information (Lefort, This Volume) Consequently, among Chilean groups, it is common to keep ownership, board members, and even company information private within a group. The third component, *political and economic factors*, is related to efforts by host governments to advance national economic development (Keister, 1998). For instance, initial business groups in both China and Israel were state supported. Governments often take special initiatives to protect domestic groups, such as policies in Mexico to protect groups from foreign competition. As seen in Argentina, there can be considerable upheaval when a state decides to reduce its support for groups. Finally, *external monitoring and control* represents the potential for agency conflicts. Pyramidal holdings are common in many groups, including those in Argentina, Chile, Italy, Mexico, Taiwan, Thailand, and others. Different pyramids vary widely in the strength of their ownership chains, with corresponding variability in the potential for the abuse of minority investors.

Faced with these four sources of constraint, business groups respond with two types of internal coordination mechanisms: horizontal and vertical connections. Horizontal ties refer to connections among individual group firms, and can take many forms. Each member firm in a group usually has its own board of directors. Anecdotally, shared board ties, or interlocks, are common within member firms of a group – a point raised by many of the country chapters in this volume. While these interlocks can serve many purposes, including both resource provision and oversight, little research has been done to empirically assess the role of interlocks among group

members. Social ties among the board members are another type of horizontal connection, and can be considered a less formal counterpart to official board connections. Cross-shareholdings are a third type of horizontal connection, where group members hold reciprocal shares of other member firms. These equity links can serve as a monitoring mechanism, and also help to protect members from outsiders, such as takeover threats. A final type of horizontal connection is resource exchange between member firms. Groups that are vertically integrated or pursue related diversification will have higher levels of cross-firm transactions than groups that pursue unrelated diversification. Russian groups, as an example, rely heavily on vertical integration and scale economies as a source of competitive advantage. In contrast, groups in South Africa and Japan's horizontal (bank centered groups after World War II) have loose ties between members; for example, they have unobtrusive interaction to coordinate activities through integrative mechanisms such as a presidents' council.

Vertical ties are a chain of command that runs through a group hierarchically, often described as pyramids. Equity connections are the foundation of this command structure, and are often supplemented by placing loyal personnel such as family members, in key positions of subordinate group members (Yiu, et al., 2007). Some groups have virtually no vertical connectivity, such as groups with only lateral cross-holdings such as bank centered business groups in Japan (Granovetter, 1995). Other groups, in comparison, are characterized by strong one-way ownership ties. These vertical ties exist when there is a dominant owner, usually a family or a government. For groups with vertical connections, some will have very strong equity links (e.g., near total ownership of subordinate member firms), while others will maintain only the minimum

ownership level needed to maintain control, possibly through voting rights. These chains can include a mix of public and private firms as well. Both Zattoni (1999) and Volpin (2002) show simplified examples of Italian pyramids, while Morck and Yeung (2003) show the interplay of public and private equity in Canada's Brofman family group. While some nations may allow a combination of cross-holdings and pyramids (e.g., Thailand), other nations prohibit cross-holdings among pyramid members (e.g., Chile and Italy).

Insert Figures 1 & 2 about here

Owner involvement can take various forms in these vertical chains. Israel, for instance, has a very tight ownership chain accompanied by strict monitoring. Strategy development is often managed in these groups as a collaboration between owners and subordinate management (Kosenko & Yafeh, this Handbook). Korea, in comparison, exerts very strong control over the strategies of group members (Kim, this Handbook). Owner elites in pyramids can often enhance their control through mechanisms such as disproportionate voting rights or non-voting stock. Maman (1999) describes how Israeli groups enhance control through placement of managers in a variety of governance roles in subordinate firms, including board seats, executive committee, and chairman positions.

Yiu et al (2007) suggest the combination of horizontal and vertical connections yields four possible configurations of business groups, as shown in Figure 2: network (N-form), club (C-form), holding (H-form), and multidivisional (M-form) forms. The first, N-form groups, have strong horizontal connections but weak owner control. Such

groups are essentially networks, with potentially strong business transactions, social ties, and interlocks among member firms. These groups are often structured around a focal product, with group members comprising an analogue of a vertically integrated firm. A typical example of such types of business groups is the *guanxi qiye* in Taiwan, such as the Lin Yuan Group, where numerous enterprises are organized around a large corporation in hi-tech industries or industries focused on exporting their goods.

The second type, C-form, has relatively weak horizontal and vertical connections. As with the N-form, group members are not controlled by a dominant owner. Additionally, while group members coordinate with each other, the degree of exchange is weaker than for network groups. A typical example is the Japanese horizontal kieretsu. The third type are H-form groups, which have weak horizontal connections, but also have a dominant owner. These H-form groups are organized like a holding company with a portfolio of diversified subsidiaries. Examples of this type of business group can be seen among business groups in India, China and Singapore. Finally, the M-form business group is characterized by high levels of both horizontal and vertical connection. These M-form groups have a dominant owner that shapes the strategies of member firms. Additionally, group members will operate in either related industries or vertically integrated businesses, and are likely to have other forms of connection such as board interlocks or social ties. Large Korean chaebols, family business groups in Central Europe including Germany and Italy, and Belgian industrial business groups, for instance, fall into this category.

Both the role and degree of involvement of the board of directors is likely to vary widely across each of these four group forms. Agency and resource provision roles will

vary widely: Some groups will need primarily one role, while other group types will require that the board attend to both areas. Further, the intensity of the boards participation in a given role will vary as well. Given these complexities, board roles in business groups will not be a straightforward topic to analyze. In the next section, we develop a research agenda to help advance future studies on boards and business groups based on different levels of analysis.

26.5. STRUCTURAL CONFIGURATIONS AND GOVERNANCE ATTRIBUTES OF BUSINESS GROUPS

While there has been a shortage of studies on the governance of business groups, the reverse is true for future research opportunities. In this section, we identify a number of topic areas that could advance our understanding of how business groups are governed, as well as opportunities to help groups operate more efficiently. To discuss these opportunities we organize the rest of this chapter at different levels of complexity and evaluation.

Given their complex nature, governance issues in groups can be studied at multiple levels, as shown in Figure 3. The first level is the board of individual business group member firms. This level is comparable to the bulk of governance studies which examine samples of individual firms. These types of studies would treat governance characteristics of individual firms as either a predictor or outcome variable. For example, tunneling and other value-destroying tactics have been observed in many business groups (i.e., Chang, 2003). Agency theory could be used to determine what governance structures facilitate expropriation, and which other structures could prevent such

problems. Similarly, many aspects of board composition and process have been linked with firm performance. Consequently, are there board characteristics that explain why some members of a business group are more successful than others? Also, rubber stamp boards have been reported in many nations. Are rubber stamp boards more common in different types of groups, or at different vertical levels in a business group? And, do the performance implications of inert boards differ across settings as well? Given the complexity of these issues and the fact that this level is covered in standard governance research approaches, our focus emphasizes the group and institutional levels.

Insert Figure 3 about here

The next level of analysis is to study the entire governance network of a business group. Figure 3 shows two simplified business groups, each with very different structures: Group A is decentralized, with extensive lateral ties among members, possibly a N-form group. In contrast, Group B depicts a traditional hub-and-spoke configuration, with multiple hierarchical levels, possibly a C-form or a M-form group depending on the salience of the vertical ownership ties. Questions raised at this level could include the causes and consequences of different aspects of network structure, as well as the flow of information and resources across the network. For example, the framework developed by Yiu and colleagues (2007) would argue that network density would differ, on average, for N- versus C- or M-form organizations. Similarly, the resource dependence perspective would argue that the need for connections would differ depending on environmental conditions. Consequently, one would expect that network characteristics would change in response to increased uncertainty or competition. There are also opportunities for

multi-theoretic studies, such as assessing the relative importance of agency and resource dependence factors in shaping ties within a network. For instance, does the pattern of board ties among members of a group mirror ownership patterns, within group transactions, both, or neither? Finally, studies should examine how information and resources flow through a group network. Some business groups, for instance, use their board networks as a tool to identify and develop promising managers. Future studies could examine how high performing groups utilize their networks as human capital tools.

A third level of analysis concerns ties outside the business group network. As seen in Figure 3, these third-party ties could include links to other business groups (e.g., the single point of contact between A and B) as well as links to non-group entities (e.g., group A is connected to firm C, and group B is connected to firm D. Additionally, groups A and B also share an indirect connection via firms C and D. Anecdotally, cross-group ties are observed in some regions, while business groups in other areas might shun this type of connection. These connections will often be examined through the lens of institutional influences. For example, one promising research question is to assess how cultural and social factors that shape the use, or avoidance, or cross-group ties. A second research question examines how third-party ties are used to procure external resources, and how these resources are subsequently disseminated throughout a group. Belderbos and Sleuwagen (1996), for instance, noted that groups can benefit by sharing the expertise of member firms regarding foreign markets. As described elsewhere in this volume, Mexican groups leverage their regional expertise to facilitate expansion into other Latin American markets (Hoshino, this Handbook). A related opportunity is to examine the factors that shape the balance of within-group and third-party ties. While

business groups often maintain strong networks of internal ties, this process is far from monolithic, even within a geographic region. One study of Israeli business groups (Mama, 1999) reported marked differences in the composition of interlocks: Using a fifteen year window, one group was found to rely almost exclusively on within group ties. In contrast, two other groups reported a roughly even balance between within-group and external ties. Additionally, the balance of ties varied for each group over time. Therefore, more attention is needed on explaining why groups choose certain types of interlocks. To examine these levels of analysis in more depth, we examine first the business group level using the framework by Yiu et al. (2007) illustrated above and follow in the next subsection with suggestions for research at the institutional level.

26.5.1?2?Extending the Structural Configurations Framework to Governance Differences

Given the variety of business groups suggested by the Yiu and Colleagues (2007) archetypes, a significant opportunity that we take up in this section is to explore how the boards of different groups types might vary given the various organizing mechanism used to classify them and the potential roles boards might play. Drawing on Figure 2, we might expect systematic differences in board roles across the four archetypes. C-form groups are likely to have the weakest requirement for an active board: there is little interdependence between group members regarding strategy, and ownership influences are limited. As such, rubber stamp boards could be more relevant among C-form groups. These boards need some coordinating mechanism to manage the social ties. In C-form groups in Japan such as the bank centered horizontal keiretsu, a presidents' council might perform this role (Kim and Colleagues, 2004) In comparison, the N-form and H-form

groups will have greater needs of their boards of directors, albeit in different ways: N-form boards should emphasize resource exchange over monitoring, with the opposite balance for H-form groups.

N-form boards may lack an overall strategic focus given the lack of vertical relationships through ownership which could lead to a break-up through in-fighting and resource appropriation problems. Lorenzoni and Baden-Fuller (1995) identify the need for a "strategic center" in such business groups in order to manager the web of relationships. There may be either a super board such as a presidents' council or the board of a dominant firm which connects the firms through a critical set of centralized information links to facilitate efficient resource exchange and distribution as well as equitable distribution of rent generation. It may be that informal network cultural controls and threat of being ostracized will prevent problems normally associated with the lack of traditional monitoring.

Alternatively, H-form boards are likely to have strong resource distribution mechanisms, but monitoring may be inefficient. The may be two problems with such firms. Dominant firm boards may be overall controlling leading to inefficient leadership and management of members. In this case boards of member firms may be rubber stamps of the headquarter firm, which would be inefficient for the member firm needs. This could lead to tunneling as specified in previous research (Chang, 2003). As such, future research could example under what type business group archetype and associated governance arrangements tunneling is more or less likely to occur. Another type of problem would be too much decentralization among member firms with independent firms boards managing their own firms without a centralized board to coordinate among

members firms. This may create chaotic management approaches that would lead to possible cross purposes among controlling boards and thereby inefficiencies in monitoring. Of course, this may be less of a problem if the firms have little in common in regard to resource coordination as in an unrelated diversification strategy among member firms.

Finally, M-form groups will have needs for both monitoring and resource provision. Usually an M-form group would be more appropriate for firms where resource coordination between member firms would be more salient, such as in groups where vertical integration or more tightly related product diversification is pursue among member firms. Several types of problems might be studied among M-form groups. Usually, vertical integration and related diversification require more centralization (Hill and Hoskisson, 1987). Because each member firm has its own board of directors, the coordination among boards may be difficult without a mechanism to align the activities of all boards in the group. In other words, the subsidiary boards may create unnecessary bureaucracy which will hinder required centralization, given the strategy being implemented among member firms. Similarly, such redundant board might hinder resource distribution among member firms complicating resource transfer horizontally between member firms.

To study these issues, we suggest two types of studies which might be relevant for examining the question of differing roles across groups. First, comparative analyses could be used to test whether there are in fact differences in board roles across the four forms. These analyses could be based on surveys and interviews with directors (e.g., Zona & Zattoni, 2007; Ravasi & Zattoni, 2006). A second avenue for future study is to

examine the performance implications of these governance roles. This approach would argue that there is a contingency effect – i.e., some "matching" between the emphasis of different roles, specific organizational strategies and forms, and overall group and individual member firm performance.

A related research opportunity is to take a closer look at the characteristics of boards and individual directors, and how these factors relate to group structure and performance. A recent study of business group resources offers some insight on this question. A study of Chinese groups found that older groups and those whose executives came from government service suffered lower performance, while groups that cultivated the development of internal capabilities and international exposure had higher performance (Yiu, Bruton & Lu, 2005). In a similar vein, local market knowledge was identified as an important element in the survival of Argentinean groups (Carrera, Mesquita, Perkins & Vassolo, 2003). Extending these findings to business group boards, not all directors have the same access to resources and capabilities, and some skill sets will be more useful than others. A social capital perspective could help explain how groups acquire strategic resources that lay beyond the group's borders. Diversified groups, for instance, have broader and more complex decision environments. Correspondingly, a broad network of board ties is desirable in these settings (Geletkanycz, Boyd & Finkelstein, 2001). Thus, one opportunity would be to examine how direct and indirect board ties, as well as other connections, affect the effectiveness of acquisitions and diversification strategies. Chung (2006), for instance, examined how one form of social capital, personal ties, was used by groups to gain access to new market opportunities.

A similar research opportunity examines the board's role in shaping the type of diversification strategy pursued by a group. For Western economy firms, the pursuit of unrelated diversification is often seen as the sign of a governance failure (Amihud & Lev, 1982). However, there are mixed findings whether a 'diversification discount' exists for business groups as well. Some evidence suggests that group diversification is a sign of hedging, such as the emphasis on more stable profits versus higher profits. Alternately, though, unrelated diversification is also seen as an appropriate response to inefficient market conditions. Regardless of the performance effects, there is also evidence that many groups are engaged in substantial restructuring (e.g., Hoskisson, Johnson, Tihanyi, White, 2005; Carrera, et al, 2003; Choi, et al, 2007). How do group boards fit into the shifting emphasis on the type of diversification? For instance, are the changes in group diversification posture based on director experiences with other firms, as with acquisition activity in the United Stated (Haunschild, 1993)? If so, how might imitation patterns differ between groups? Given the differences in owner control, one might expect a more rapid change in diversification posture among H- and M-form groups than either C- or N-form.

Another set of studies could look at how restructuring affects governance of boards. If restructuring is triggered by excessive diversification and poor performance due to weak governance, are such oversights corrected after restructuring? As such, it would be important to heed Hoskisson and Turk's (1990) and Johnson's (1996) call to pay more attention to post-restructuring governance and how boards of business groups change over time. Similarly, it would be important to ask how issues such as currency shocks trigger the need for restructuring of business groups as they did in Korea; for

example, how do boards change to accommodate policy changes associated with such shocks.

A final recommendation for future research in this area concerns the basic strategic orientation of the firm. Strategic orientation is a construct developed by Shortell and Zajac (1990) that subsumes the Miles and Snow strategy typology into a continuum: prospectors and defenders as anchors, and analyzers as the midpoint. Does ownership structure cause some business groups boards to take a more conservative posture than others? Morck and Yeung (2003) suggest that family-based groups might try to block innovation, both within their own group and by competitors. Innovation leads to the potential loss of control for family owners and thus such control risk is pertinent for such owners (Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, in press). While creative destruction has the potential to enhance firm value in the long run, suppressing innovation may be in the financial interest of group owners. Also, second- and third-generation family members have the potential to be less skilled than founders, and the lack of turnover could cause group governance to become rigid and insulated from outside events. In Israel, older family groups have been eclipsed by a wave of technology entrepreneurs (Kosenko & Yafeh, This Volume), and might be considered as evidence for Morck and Yeung's argument. One opportunity for study would be to assess if the boards of H- and M-form groups have appreciably different strategic and thereby different governance orientations than the directors of C- and N-form groups. Next, we example institutional level issues.

26.5.2?3?Institutional processes

As noted earlier, an expectation of institutional theory is that organizations in a common setting will become increasingly similar over time. There is an open debate whether governance practices are converging worldwide, and whether this is a positive or negative development. Thus, one major opportunity for research on business groups centers on the potential for increasingly standardized governance, and the performance implications of this process.

There are several arguments favoring the notion of growing convergence in governance practices. Organizations such as the World Bank and the OECD advocate global governance practices. And, many of the country-specific guidelines emphasize similar issues, such as the need for more independent or non-executive directors, transparency, and the separation of CEO and Chairman positions (Norburn, et al., 2000). Additionally, evidence presented in several of this volume's chapters speak to both proactive and reactive governance changes in the pursuit of legitimacy. In Russia, the increased use of independent directors was intended to "send a strong signal that companies want to implement the best practices of corporate governance" (Guriev, this Handbook), in the hopes of boosting stock performance. Similarly, Korea instituted rules requiring a minimum number of outsiders following their economic crisis (Kim, this Handbook), and Turkey has been characterized as following pressure of global standards to create more balanced boards (Colpan, this Handbook). However, there are challenges to the notion of common governance systems, including incompatibilities and resistance in local areas (Coffee, 1999). A recent paper reviewed studies conducted at both the firm and country level, and concluded that convergence is less prevalent than widely believed (Yoshikawa & Rasheed, in press). Separately, there is limited evidence regarding the

effectiveness of many governance recommendations. For example, there is little empirical data to support the arguments that aspects of board composition or the separation of CEO and chairman positions are inherently desirable. Further, not only is the evidence inconclusive, but virtually none of these analyses have been done in countries in which most business groups operate.

There is also some support for the argument that boards are changing their governance practices solely as window dressing. In Brazil, for instance, the boards of business groups have chosen to follow new governance guidelines. The Sao Paolo stock exchange is relatively unique in that there are multiple tiers of voluntary governance compliance. The leading business groups on that exchange have chosen to follow the least stringent level of compliance (Aldrighi & Postali, this Handbook). As a second example, Korean firms began adding more outside directors to their boards in the aftermath of the Asian economic crisis. While both chaebol and non-chaebol firms added more outsiders, closer scrutiny revealed that many of the chaebol outsiders came from affiliated firms, or had other ties to the group. Consequently, chaebols could project an aura of board independence while still thwarting "the government's policy objective of improved monitoring of management (Choi, Park & Yoo, 2007: 955)."

More broadly, a recent study characterized two types of compliance in governance practices: de jure and de facto (Khanna, Kogan, & Palepu, 2006). De jure convergence exists when a region adopts a set of rules without accepting the underlying principles of those rules. De facto convergence occurs when firm behavior and attitudes adhere to the intent of those rules. Khanna and colleagues argued that there are three factors underlying potential discrepancies between rules and actual practice: A lack of

understanding of the implications of good governance, the absence of complementary institutions, or poor enforcement. In an empirical analysis, they found that there was greater convergence in governance rules for countries that were in geographic proximity or strong trading partners. Interestingly, they also found that US guidelines had no measurable influence on their own. Also, they found "virtually no evidence of de facto similarity (2006: 71)." Stated differently, there are major gaps between the adoption of governance rules and the actual practices used in different nations.

There are multiple opportunities to examine the intersection of institutional processes, governance codes, and business groups. While the role of mimetic behavior has been well documented among traditional boards (Haunschild, 1993), how does this translate to the boards of business groups? For example, what types of ties are the most influential: ties within the group, or external ties? Institutional theory would also argue that groups in developing economies are influenced by practices in western countries (Newman, 2000). Groups such as those found in Mexico have extensive alliances with foreign multinationals (Hoshino, this Handbook); do these connections carry special weight in shaping governance practices? Sanders and Tuschke (2007) provide evidence among developed economies that there is diffusion among some governance devices. But do these influences happen between developed and less developed economies where business groups with stronger social ties might resist or support such institutional influences. Also, how would such influences transfer between governance mechanisms in different emerging economies, both with business groups? Also, how might adoption influences vary for groups with differing levels of horizontal and vertical connectivity (Yiu, et al., 2007)?

There are also questions relating to governance adoption and firm performance. Many firms adopt governance practices solely for the legitimacy they infer to investors (Westphal and Zajac, 2001). Signaling theory offers a number of promising research questions. First, groups vary widely across region in the strength of equity ties across members. Is there a lesser need for market signals among groups with tight ownership connectivity? Second, many groups are often undervalued, reflecting the potential for agency abuse of minority investors. Does de jure acceptance of governance practices help to offset the group discount? If so, does de facto acceptance offer any additional benefit to the firm's performance? Third, it would be informative to compare whether high and low performing business groups differ in the gap between de facto and de jure use of leading governance practices. It may be that better performing business groups are those that adopt governance procedures that are more in accord with their own country or regions institutional pressures (Hoskisson, Yiu, & Kim, 2004). Finally, it would be useful to examine whether signaling benefits extend to operational performance and efficiency. In Korea, for example, the inclusion of outside directors is associated with better market valuation (Choi, et al., 2007), while in Scandanavia the presence of foreign directors has a comparable effect (Oxelheim & Randoy, 2003). For both studies, the presence of these directors is believed to be a signal of superior governance that is translated into a higher Tobins *q* score. What is not addressed, however, is whether these board characteristics translate into other metrics of firm performance, such as profitability, market share, growth rates, and so on. In the specific context of Korea, outside directors have been strongly criticized: "Due to a lack of monitoring skills and incentive to monitor CEOs actively, outside directors appear to be ineffective in

disciplining poorly performing CEOs (Chang & Shin, 2006: 86)." While these directors may provide some symbolic utility, the perception among Korean firms is that they provide little tangible value to the operation of the firm.

26.6. CONCLUSION

In summary, governance of business groups presents an important, but under researched area for future study. Although some research has been accomplished on this topic, there are many areas that need attention. In particular, we first need to understand the variation among business groups, both at the archetype level and at the institutional level. Different functional forms of business groups such as those introduced by Yiu, et al (2007) are likely to require different monitoring and resource provisions of their boards. Although there is a large body of research examining governance of independent firms, very little of this research is focused on firms within a business group. The business group itself is likely to affect member firms boards of directors and their governance procedures as well as be influenced by such member firms governance procedures. As such, business groups represent an important moderating or mediating effect of governance procedure among member firms. The nature of institutional country effects in which business groups are embedded is another important factor that shapes the governance of business groups and their member firms. Examining how such influences within countries as well as across countries facilitate change or inertia among governance procedures will provide an important agenda for future research.

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TABLE 1

RESEARCH QUESTIONS ON THE GOVERNANCE OF BUSINESS GROUPS

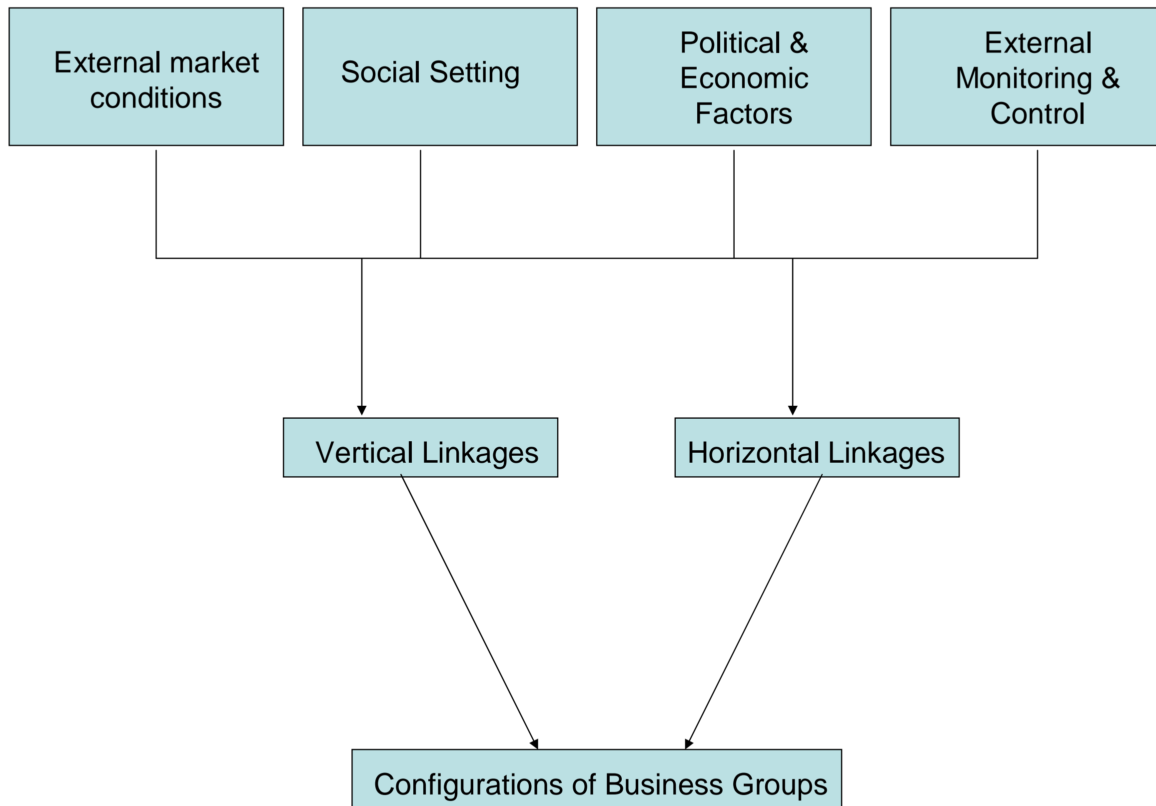
Topic	Potential research questions
Boards of individual members of a business group	➢ How do different needs for oversight and coordination affect aspects of board composition? ➢ What governance structures facilitate/hinder tunneling, expropriation, and other value-diluting activities? ➢ Are rubber stamp boards more or less prevalent in certain types of groups, or at different levels of a pyramid? ➢ How do the roles for inside and outside directors differ from group versus non-group firms?
Overall network of a business group	➢ Are interlocks, cross shareholdings, and informal ties substitutable? ➢ How does network density vary across different business group organizational forms? ➢ How do network characteristics change in response to new environmental conditions? ➢ What is the relative importance of agency and resource dependence factors in shaping the level of ties among members of a group? ➢ How can boards of a business group be used as a human capital assessment and development tool?
Ties outside of a business group	➢ Are there cultural or social factors that drive the use, or avoidance, or ties with other groups? ➢ How does knowledge and expertise acquired from third-party ties diffuse to other parts of a business group? ➢ What drives the balance of within-group versus external ties?
Adoption of governance practices	➢ How do horizontal and vertical connections affect adoption of practices? ➢ What is the relative importance of internal and external connections? ➢ How influential are practices of foreign alliances and joint venture partners?

TABLE 1 (continued)

Performance	➢ How does adherence to governance guidelines affect group valuation? ➢ What is the relative importance of de jure and de facto adoption? ➢ Is conforming to local or global norms more relevant to performance? ➢ Do high and low performing groups differ in the gap between formal rules and actual practice? ➢ How can signaling theory be applied to the boards of business groups? Do investors respond to governance stimuli in the same manner as for US firms?
Director Characteristics	➢ What role does director demography play in the execution of group strategies? ➢ How much emphasis is placed on director social capital when recruiting new business group member firm board members? ➢ Does director social capital affect the performance of business groups? ➢ Are mimetic processes driven more by director experiences based on within-group ties among member firms, or external ties? ➢ What role does director characteristics play in acquisition and divestiture decisions?
Diversification and divestment	➢ What strategic outcomes do business group directors associate with diversification at the group and affiliate firm levels? ➢ How do business group member firm boards engage in mimetic activity? ➢ What is the relative influence of internal versus external board ties in business groups? ➢ Is the diffusion process faster for some group types than others? ➢ What modifications do business group member firms make to their boards of directors following restructuring?

FIGURE 1

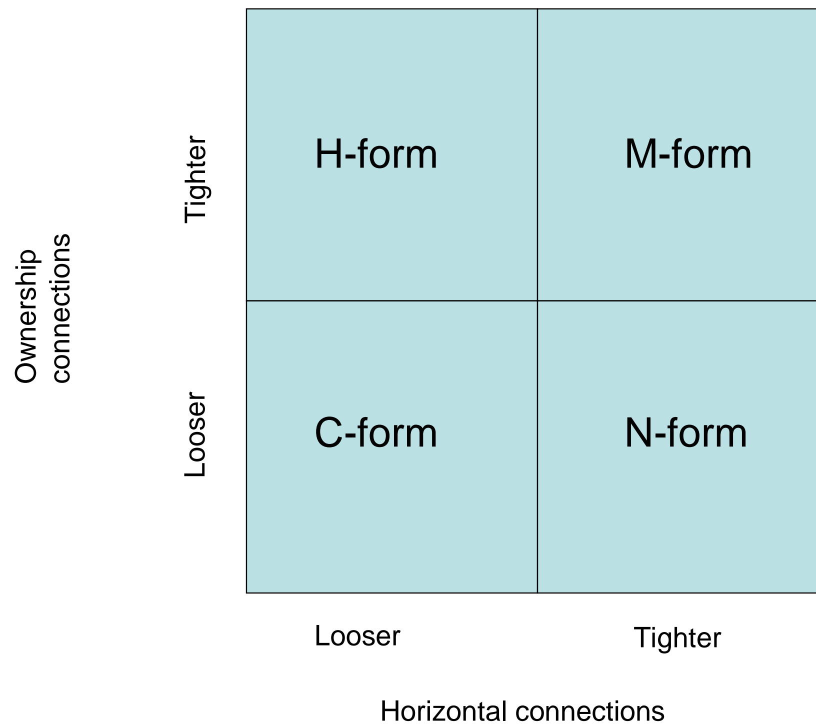
DETERMINANTS OF BUSINESS GROUP CONFIGURATION



Adapted from Yiu, et al, 2007, *Journal of Management Studies*

FIGURE 2

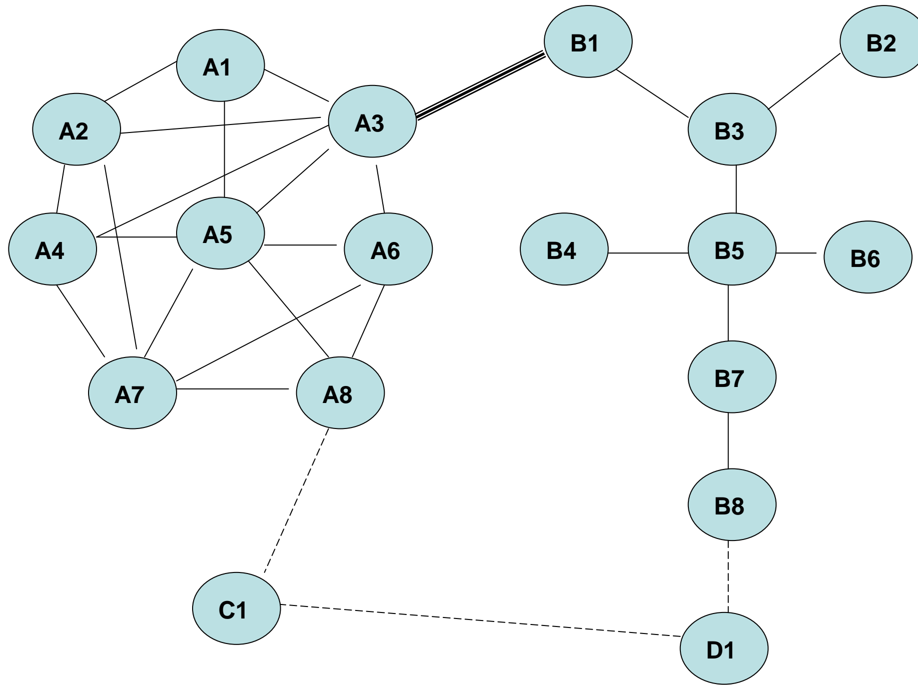
HORIZONTAL AND VERTICAL DIMENSIONS OF BUSINESS GROUPS



Adapted from Yiu, et al, 2007, *Journal of Management Studies*

FIGURE 3

POSSIBLE PATTERNS OF BOARD TIES FOR GROUPS WITH OTHER ENTITIES



Legend:

Solid lines: ties among members of a common group
Bold lines: ties to a different business group
Dashed lines: ties to freestanding firms