

RESEARCH NOTES AND COMMENTARIES

PRINCIPAL-PRINCIPAL CONFLICTS UNDER WEAK INSTITUTIONS: A STUDY OF CORPORATE TAKEOVERS IN CHINA

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The principal-principal perspective is tested and extended in the context of corporate takeovers of Chinese publicly listed firms from 1998 to 2007. The resistance of a target firm's controlling shareholder toward potential takeovers reflects the conflict between the principal and minority shareholders. It was found that this resistance weakens when target firms are located in regions with more institutional development, where the minority shareholders' interests are better protected. The resistance also decreases for target firms with CEOs who are politically connected, as these CEOs may be more interested in their own political careers than in representing the interests of the controlling shareholders. Copyright © 2012 John Wiley & Sons, Ltd.

INTRODUCTION

Corporate takeovers are widespread in developed economies where a market-based institutional framework for internal and external governance is well established (Dharwadkar, George, and Brandes, 2000; Peng and Heath, 1996). Over the past two decades, corporate takeovers have also become common in transition economies such as China's (Chen and Young, 2010; Xia, Tan, and Tan, 2008). The increasing research work in this area, however, has been focused on cross-border takeovers. Prior studies have investigated how multinational corporations (MNCs) use takeovers

as a strategy for penetrating transition economies and issues in post-acquisition integration (Cooke, 2006; Meyer and Tran, 2006; Rui and Yip, 2008; Xia *et al.*, 2008). Recent research has also examined the emerging phenomenon of cross-border takeovers by transition economy firms (Brouthers, O'Donnell, and Hadjimarcou, 2005; Chen and Young, 2010; Deng, 2009; Gubbi *et al.*, 2010).

Research on domestic takeovers within transition economies, however, is particularly underdeveloped. This study is designed to examine the influence of concentrated ownership on corporate takeovers in a transition economy, where there exist institutional voids, such as an underdeveloped capital market, unpredictable government regulations, and weak contract enforcement (Khanna and Palepu, 1997, 2000; Peng, Wang, and Jiang, 2008).

Concentrated ownership, together with weak institutions, has been identified as the 'root cause'

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of principal-principal (PP) conflicts, defined as the goal incongruence among shareholder groups in a firm, particularly between the controlling and minority shareholders (Dharwadkar *et al.*, 2000; Peng *et al.*, 2008; Su, Xu and Phan, 2008; Young *et al.*, 2008). In the PP conflict framework, top managers are expected to represent the interests of the controlling shareholder (Young *et al.*, 2008). Thus, the PP conflict can be considered as a differential in the principal-agent (PA) relationships. That is, the PA conflict with the majority shareholder is lower than the PA conflict with the minority shareholders. A recent survey of the strategy, finance, and economics literature found that although they are also present in developed economies (Johnson *et al.*, 2000), PP conflicts are a major concern surrounding corporate governance in transition economies where property rights are weakly enforced and there are but few rules and procedures to protect minority shareholders (Faccio, Lang, and Young, 2001; Su *et al.*, 2008; Young *et al.*, 2008). Such conflicts can potentially result in the controlling shareholder expropriating the minority shareholders by assuming control of the firm and depriving the minority owners of the returns due on their investments (Dharwadkar *et al.*, 2000; Johnson *et al.*, 2000; La Porta, Lopez-de-Silanes, and Shleifer, 1999). Expropriation may take various forms such as putting less qualified family members and friends in key positions, transferring assets to private holdings at below market value, and engaging the firm in non-value creating activities that advance personal agendas (Su *et al.*, 2008; Young *et al.*, 2008). The PP conflict perspective has important implications for corporate takeovers in transition economies, among which there is a strong tendency for the controlling shareholder to resist a potential takeover.

In particular, we study two conditions under which the resistance of the controlling shareholder toward a potential takeover can be mitigated. First, the resistance of the controlling owners is argued to be weakened for firms located in regions with more institutional development. In China, the level of institutional development varies substantially across regions (Wang, Wong, and Xia, 2008). For instance, in terms of legal development, the frequency of lawsuits and the efficiency of courts vary significantly across provinces (Fan and Wang, 2006). In regions with a higher level of institutional development, there are better contract enforcements and property rights protection,

mitigating the power of the controlling shareholders to expropriate minority shareholders for private benefits. The better institutional regulation of all PA relationships effectively reduces the ability of the agent to favor one principal over the others, mitigating the tendency to favor the powerful shareholders. This does not mean, however, that the controlling shareholder(s) do not intend to expropriate minority rights, only that they are constrained under the institutional regulations. This novel empirical context provides us an opportunity to directly test the effect of PP conflicts.

Second, in the context of China, chief executive officers (CEOs) who are politically connected may represent interests other than those of the controlling shareholders. When the CEOs of target firms are also politically connected, for example, with the local governments, they might pursue their own agenda to advance political careers (Cao *et al.*, 2009), which may often be incompatible with the objectives of the controlling shareholders. This will mitigate the resistance of the controlling shareholders to a potential takeover. In other words, the CEO independence increases the PA conflict between the CEO and the controlling shareholder(s), without necessarily changing the PA conflict between the CEO and the minority shareholders. Thus, this study also provides us an opportunity to extend the PP perspective by examining the key assumption that the top managers represent the interests of the controlling shareholders. Figure 1 depicts our extension of the PP conflict perspective from the work by Young *et al.* (2008).

By addressing these two mitigating factors, this study intends to contribute to the corporate governance and takeover literature in transition economies in the following aspects. First, we develop a context-specific perspective of corporate takeovers in China's transition economy. Because of the weak institutions and the existence of PP conflicts (Allen, Qian, and Qian, 2005; Peng and Heath, 1996), controlling owners are able to enjoy the benefits of private control and thus are more likely to resist corporate takeovers. Second, we test and provide empirical evidence in the takeover context that the effect of PP conflicts will be weakened as the institutions develop. Our research design takes advantage of the heterogeneities in institutional development across regions in China. This study is one of the first to provide a direct empirical test of this PP perspective across

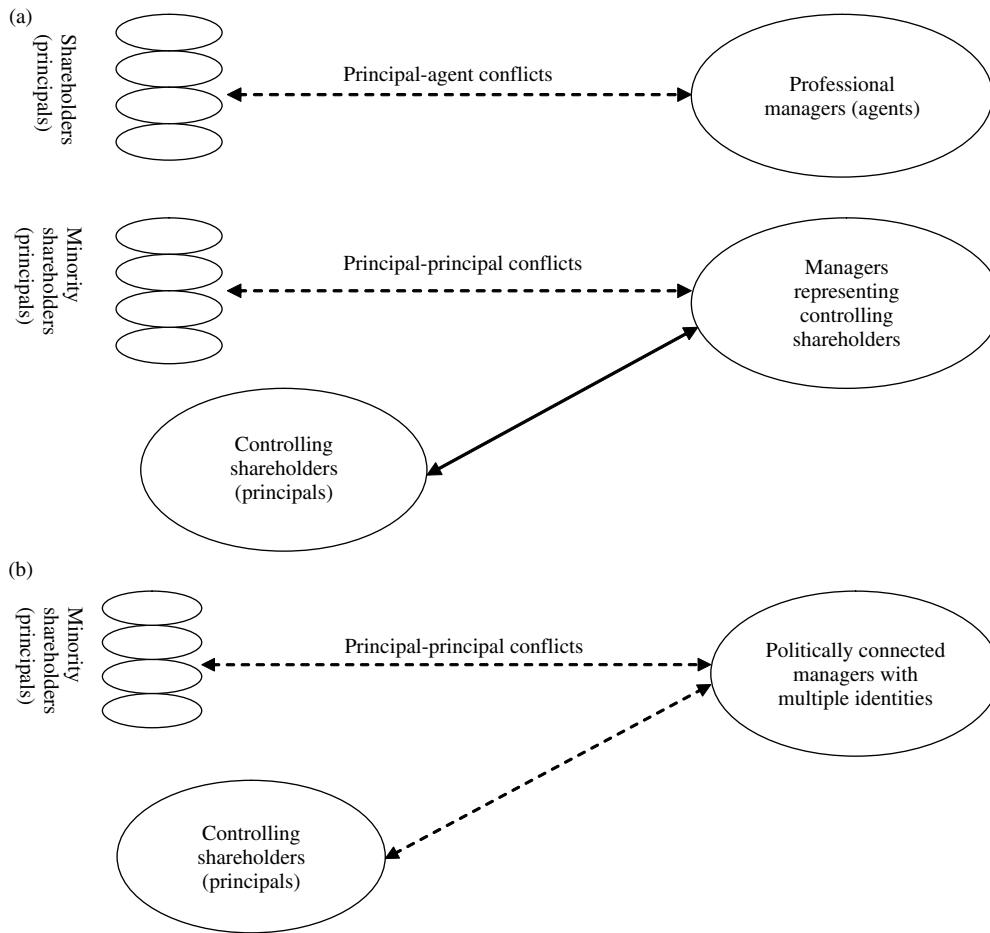


Figure 1. Principal-principal conflicts versus principal-agent conflicts (adapted from Young *et al.*, 2008: 200); (b) An extension of the principal-principal conflicts framework with politically connected managers in a transition economy

subregions of a transition economy with wide variations of institutional development. The research on the PP conflict between the controlling and minority shareholders complements the prior focus of the literature on the PA conflict between shareholders and managers. Third, by demonstrating that politically connected agents can have multiple identities rather than the single identity of representing the controlling shareholders, this study refines and extends the PP conflict perspective, by defining the boundary conditions of one of its key assumptions. In a nutshell, transition economies such as China's offer a promising new context in which to explore the relationship between governance mechanisms, ownership structures and strategic choices (Peng and Luo, 2000), and to examine the generalizability of key theoretical perspectives (Wright *et al.*, 2005).

These relationships were examined using a longitudinal dataset describing companies listed on China's two stock exchanges (in Shanghai and Shenzhen) from 1998 to 2007.

HYPOTHESIS DEVELOPMENT

PP conflicts and the resistance of the target firm's controlling owner

In transition economies where the institutional and legal systems that protect minority shareholders have not been fully developed (Peng and Heath, 1996), there could be significant goal incongruence between the controlling and minority shareholders, resulting in PP conflicts (Su *et al.*, 2008; Young *et al.*, 2008). The poor enforcement of property rights can obviously tempt a controlling

shareholder to exploit minority shareholders by extracting private benefits from the firm (Dharwadkar *et al.*, 2000; Dyck and Zingales, 2004). These benefits can be pecuniary (e.g., excess salary for the controlling shareholder) but also nonpecuniary (e.g., prestige and social status for the controlling shareholder, or pursuit of social and political goals detrimental to the firm) (He, Zhang, and Zhu, 2008; Holderness, 2003). And indeed, prior empirical studies have found evidence that controlling shareholders do extract private benefits from companies, particularly in less developed economies (Faccio *et al.*, 2001; He *et al.*, 2008; Su *et al.*, 2008).

The controlling shareholder can be powerful because large share ownership allows direct involvement in the firm's operations (Wang, 2003). The imbalance of power between the controlling and other shareholders and the underdeveloped legal institutions could provide controlling owners with an opportunity for related party transactions, defined as transactions between a firm and its controlling or major shareholders, branches, or affiliates, involving perhaps the purchasing of assets, transferring of shares, leasing of assets, borrowing funds, or providing credit and debit guarantees (Cai and Chen, 2004; Faccio *et al.*, 2001; Xiao and Ma, 2006). Such transactions are often covert, and sometimes at irrational cost. In such transactions, significant company assets and interests may be transferred to the controlling shareholders. A recent study using a sample of Chinese listed firms found that the average private value of control represented a premium of about 18.5 percent, measured as the price difference paid in control versus non-control transactions (He *et al.*, 2008). Because of the potential for private benefits, controlling shareholders are more likely to resist corporate takeovers.

If the largest shareholder has a high level of equity ownership and can thus extract more private benefits from the firm, he/she will have more to lose if control changes, giving the largest owner a greater incentive to resist any potential takeover. As La Porta's group has pointed out, '[I]n countries with poor protection of minority shareholders, losing control involuntarily and thus becoming a minority shareholder may be such a costly proposition in terms of surrendering the private benefits of control that the controlling shareholders would do everything to keep control.' (La Porta *et al.*, 1999: 473). Thus, the greater the percentage of

equity ownership by the largest shareholder in a target firm, the more difficult it will be, all else being equal, for a potential acquirer to take it over.

The regional institutional development and PP conflicts

Although China has made great progress during its market transition since 1978, the progress of institutional development among different regions is far from being equal (Fan and Wang, 2006). Firms in different regions face dramatically different operational environments in terms of policies set by local governments, consumer markets, competitive situation, market intermediaries, and legal environment. In regions with more developed institutions, we expect the resistance of the controlling owners to takeovers to be lower as it is more difficult to expropriate the minority shareholders. The relatively developed institutional support and formal infrastructures provide firms with a better environment for market-based competition: the market institutions will be more effective, and the property rights more likely protected (Cull and Xu, 2005). The developed markets are more likely to be able to provide efficient intermediary institutions and reliable market information, developed capital markets, effective mechanisms to enforce contracts, and decreased state intervention in business operations (Hoskisson *et al.*, 2000; Peng and Heath, 1996). Related party transactions may be avoided with legal contracts that can be enforced quickly and reliably. Therefore, it is more difficult for the controlling owners to extract private benefits from the minority shareholders.

In contrast, in regions with less developed institutions, the legal systems that protect minority shareholders have not been fully developed (Fan and Wang, 2006). Also, there is insufficient institutional support and formal infrastructures. Capital and factor markets are not fully developed and information flow is slower. PP conflicts are more likely to dominate firms in those regions. As the protection of minority shareholders is weaker, there are more opportunities for the controlling owners to pursue private benefits. The resistance of the controlling owners towards being taken over is therefore higher in those regions.

Hypothesis 1: The resistance of the largest shareholder to a corporate takeover will be weakened for target firms located in regions with a higher level of institutional development.

Politically connected CEOs and PP conflicts

One of the key assumptions of the PP conflict perspective is that the top managers are the agents of and answer directly to the controlling shareholders, rather than to all shareholders. Those managers are typically the family members or associates of the controlling shareholders (Young *et al.*, 2008). However, unlike the rest of Asia, the ownership structure of listed companies in China is characterized by the absence of families as significant shareholders or managers (Peng, 2004). Thus, the assumption that top managers represent the interests of the controlling shareholders may not hold in the Chinese context especially when top managers have multiple roles such as when they are politically connected, for example, with the local governments. Political connections exist between a firm and the government when the firm has a CEO who is currently serving as or was formerly a government bureaucrat (i.e., a current or former officer of the central or local governments) (Fan, Wong, and Zhang, 2007). Such connections are quite common in China. For instance, in a survey of 19 listed firms in highways and transportation, 17 of them have CEOs who were former directors of the transportation bureau of the local government (*First Financial Daily*, 2011). This is not limited to state-owned firms; private firms may also have CEOs with strong political backgrounds. The interests between controlling owners and politically connected CEOs may not be aligned, and thus the resistance of controlling owners to takeovers could be weakened when target CEOs are politically connected. There are several reasons for this argument. First, politically connected CEOs value their own political careers. In the eyes of these CEOs, the firms may be 'stepping stones along career paths through the Party and State bureaucracy' (Fan *et al.*, 2009: 12). CEOs with political ambitions have incentives to improve their own political record for future promotion (*zhengji* in Chinese), increasing the chance of their deviating from their assumed role as the agents for the controlling shareholders under the PP perspective, for example, in collaborating with the controlling shareholders in expropriating the minority shareholders. For instance, during the acquisition of Chinese state-owned enterprises (SOEs) by MNCs, some officials may be eager to establish their own performance record and therefore deliberately make

it easier for the MNCs to acquire the target SOEs (Cooke, 2006).

Second, in the western context, corporate control is defined as the right to determine the management of corporate resources, such as the right to hire, fire, and set the compensation of top managers (Jensen and Ruback, 1983). Corporate takeovers often result in some of the current managers losing their jobs and with that, their firm-specific human resource investments (Cotter, Shivdasani, and Zenner, 1997). However, CEOs with political connections will be at less risk of losing their jobs at the will of the controlling shareholders, as political connections can serve as an important buffer and resource in the institutional context of China. Compared with top managers without any political backgrounds, politically connected CEOs will have more discretion and protection in pursuing their own interests, which may not be consistent with those of the controlling owners. Different from the western context, politically connected CEOs in the Chinese context may receive additional protection from the government. In sum, when the CEOs are politically connected, the assumption under the PP perspective that they will only represent the interests of the controlling owners will likely be violated. Thus, we predict:

Hypothesis 2: The resistance of the largest shareholder to a corporate takeover will be weakened for target firms with CEOs who are politically connected.

METHODS

Sample

This study covered all publicly listed firms in China during the period 1998–2007. Most of China's publicly listed firms were formerly SOEs before the mid-1980s. The SOEs were transformed into profit centers without radical changes in the ownership structure (Qi, Wu, and Zhang, 2000). The establishment of two stock exchanges in the early 1990s (the Shanghai and Shenzhen stock exchanges) and the China Securities Regulatory Commission (CSRC) in 1991 was part of the market reform program. There were about 1,548 companies listed on either the Shanghai or Shenzhen stock exchange at the end of 2007.

The main data source was the China Center for Economic Research (CCER), which provides corporate financial and ownership structure data, governance information, and control change records. Company annual reports provide information of CEOs' political connections. The National Economic Research Institute (NERI) provides information on provincial institutional development.¹ To allow for updating the time-varying independent variables, each firm's history was divided into annual spells from 1998 to 2007. All of the independent and control variables were lagged by one year, thus 9,377 year-observations were included in the final analysis.

Variables

Dependent variable

The dependent variable was the hazard rate of a firm experiencing a takeover in a particular year. A takeover (the event) was defined as a change in a firm's controlling shareholder where the new owner was not the state.² Firms that were not subjected to a takeover by the end of the study period were considered right-censored. Consistent with the methods of previous studies (e.g., that of Davis and Stout, 1992), if a firm had more than one takeover during the study period, we focused on the first event. Thus, 231 events met the criterion and were included in the final analysis. The dependent variable was coded as '1' if a firm experienced a takeover in a particular year, and as '0' otherwise.

Independent variables

Equity share of the largest shareholder was measured by the percentage of shares held by the

largest owner. We have two moderating variables. The first, *regional institutional development*, was assessed using the institutional index developed by the NERI (Fan and Wang, 2006). Appraisals of the regional institutions are made along several dimensions, namely, the relationship between the government and the market, the development of the non-state sector, the factor markets, and the product markets, and the development of market intermediaries and legal environment. Along these dimensions, the NERI provided each of the 31 provinces, municipalities, and autonomous regions a score that captured the progress of institutional development. A higher score means better institutional development.³ The second moderator, *CEO political connection*, was assessed using information disclosed in corporate annual reports. Like previous research on the political connections of Chinese listed firms (Fan *et al.*, 2007; Li, Meng, and Zhang, 2006; Li *et al.*, 2008), we used the CEO's affiliation with the local government as an indication of political connections. *CEO political connection* is a dummy variable coded as '1' if the CEO is a current or former government officer, or a member of People's Congress or Political Consultative Conference,⁴ and '0' otherwise.

Control variables

Firm age, size, performance, debt ratio, cash flow, state ownership, and top management team (TMT) compensation were controlled for. Older firms are more likely to be acquired (Davis and Stout, 1992). *Firm age* was measured as the logarithm of the number of years since founding. Small and poorly performing firms make attractive takeover targets. *Firm size* was measured by the logarithm of a firm's total assets. *Return on equity (ROE)* was calculated as the firm's net income divided by owners' equity, adjusted by the relevant industry mean. *Debt ratio* was

¹ With the continued development of China's economy and its institutions, the disclosure quality of Chinese publicly listed firms has also improved. As a result, a growing number of recent studies in accounting (Wang *et al.*, 2008), finance (Allen *et al.*, 2005; Fan *et al.*, 2007), and management (Peng, 2004; Su *et al.*, 2008) have used data on Chinese publicly listed firms.

² The control of publicly listed companies can be changed either through transfers between government owners or group companies (usually without payment), or through share transfers with compensation between unrelated parties (Cai and Chen, 2004). Transfers without compensation usually occurred between government agencies and SOEs 'belonging to' the same level of government, or between SOEs held in the same group acting as the controller of state assets (e.g., state asset management bureaus). Such uncompensated, administrative transfers were excluded from this study.

³ The index was, however, only updated to year 2005. Since the rankings based on the scores were relatively stable across years, we used the year 2005 score for year 2006 also. In addition, as a robustness check, we used gross domestic product (GDP) per capita to measure the regional development (Gao and Kling, 2008). As the correlation between GDP per capita and the NERI score was 0.837, the results remained largely the same.

⁴ People's Congress and Chinese People's Political Consultative Conference are the two most important political councils in China. The two together are often called the 'Two Meetings' signifying their importance as the key means through which business leaders can participate in the government affairs.

measured as the ratio of long-term debt to total assets. The net *cash flow* from operating activities scaled by its total assets was also controlled for (Goranova, Dharwadkar, and Brandes, 2010). *State ownership* was measured as the percentage of shares owned by the state. Generous managerial compensation will cause incumbent managers to resist takeover (Cotter *et al.*, 1997). *TMT compensation* was measured by the logarithm of the sum of the reported annual monetary compensation of the top managers.⁵ The sum included their salaries, bonuses, and miscellaneous fringe benefits (Hambrick and Finkelstein, 1995).⁶ The models also included industry fixed effects⁷ to control for industry differences, and year fixed effects.

Statistical modeling

The dependent variable was the hazard rate of a firm experiencing a takeover (Allison, 1984). The number of listed companies at risk of a takeover each year was termed the risk set. Following Allison's (1984) recommendation, we conducted discrete-time event history analyses using logistic regression models with maximum likelihood methods.

RESULTS

Means, standard deviations, and correlations of the variables are presented in Table 1. The estimates from the discrete-time event-history analyses are shown in Table 2. Model 1 included the control and moderating variables. In Model 2, the coefficient of *equity share of the largest shareholder* was negative and significant, consistent with the prediction of the PP perspective. Hypothesis 1 predicts

that the negative effect of the largest shareholder equity on the takeover hazard will be mitigated for firms located in the regions with more institutional development. In Model 3, the coefficient of the interaction between *equity share of the largest shareholder* and *regional institutional development* is positive and significant (at $p < 0.05$ level), supporting Hypothesis 1. Hypothesis 2 predicts that the negative effect of the largest shareholder equity on the takeover hazard will be mitigated for firms with politically connected CEOs. In Model 4, the coefficient of the interaction between *equity share of the largest shareholder* and *CEO political connection* is positive and significant (at $p < 0.01$ level), supporting Hypothesis 2. Following Aiken and West (1991), these interactions with one standard deviation above and below the mean were plotted, based on the full model (Model 5). Figures 2 and 3 are consistent with our predictions, providing further support to Hypotheses 1 and 2.⁸

DISCUSSION

These results aim to offer theoretical and empirical insights into the nature of corporate takeovers in a transition economy. We have explicitly incorporated the Chinese context in the development of the theory and hypotheses, providing us an opportunity to test and extend the formal framework that we use: the PP perspective. In particular, we test directly the effect of PP conflicts in the context of corporate takeovers in China, where the level of institutional development varied substantially across regions. The variations of the institutional development across different (subnational) regions provide us an opportunity to test and confirm the applicability of the PP perspective in a transition economy, extending prior work focusing mainly on cross-country differences in institutional development. The results support the hypothesis that in the regions with higher levels of institutional

⁵ Tests with the compensation of only the top three managers gave consistent results.

⁶ Managerial equity ownership is another frequently used incentive-based mechanism (Beatty and Zajac, 1994; Djankov and Murrell, 2002). However, top managers of Chinese publicly listed firms owned very few shares or none at all (Qi *et al.*, 2000). Future study could use a different sample to test this mechanism.

⁷ Thirteen industries were identified by the CSRC: agriculture, forestry, livestock, farming and fisheries; mining; manufacturing; electric power, gas and water production and supply; construction; transport and storage; information technology; wholesale and retail trade; finance and insurance; real estate; social services; communications and cultural industries; and others.

⁸ As a supplementary analysis, to explore whether the results might differ depending on the nature of the largest shareholder, a split sample analysis was conducted segregating state-owned and non-state-owned target firms. The results showed that 1) the dominance of the largest owner had a stronger negative relationship with takeover risk for SOEs, and 2) privately owned firms were more likely to have interests that conflicted with the goals of the politically connected CEOs, weakening the resistance of the controlling shareholders. The results are available upon request of the authors.

Table 1. Descriptive statistics and correlation matrix

Variables	Mean	S. D.	1	2	3	4	5	6	7	8	9	10
1 Corporate takeover	0.02	0.15										
2 Firm age (log)	2.02	0.53	0.05									
3 Debt ratio	0.05	0.08	-0.03	0.05								
4 State ownership (%)	37.31	0.25	-0.05	-0.21	0.06							
5 Cash flow	0.05	0.08	-0.01	0.02	0.03	0.08						
6 Firm size	21.09	0.96	-0.10	0.09	0.28	0.17	0.17					
7 ROE (industry adjusted)	0.00	0.24	-0.05	-0.09	0.02	0.05	0.19	0.11				
8 TMT compensation	13.54	1.08	-0.07	0.18	0.04	-0.05	0.12	0.37	0.11			
9 Equity share of the largest shareholder (%)	43.54	0.17	-0.07	-0.42	0.01	0.53	0.11	0.18	0.09	-0.08		
10 Regional institutional development	6.60	2.03	0.00	0.30	-0.09	-0.14	0.07	0.21	0.02	0.35	-0.11	
11 CEO political connection	0.15	0.35	0.01	0.02	0.05	-0.01	0.04	0.07	0.03	0.07	-0.01	0.01

N=9,377. Correlations > |0.04| are significant at the $p < 0.01$ level (two-tailed).

Table 2. Factors related to the risk of corporate takeovers among Chinese listed companies

	Model 1	Model 2	Model 3	Model 4	Model 5
Constant	-4.408*** (0.318)	-4.504*** (0.322)	-4.499*** (0.322)	-4.532*** (0.322)	-4.527*** (0.323)
Firm age	0.381*** (0.102)	0.277** (0.107)	0.257* (0.108)	0.273** (0.107)	0.256* (0.108)
Debt ratio	-0.110 (0.088)	-0.112 (0.089)	-0.107 (0.089)	-0.117 (0.089)	-0.112 (0.089)
State ownership	-0.163* (0.079)	-0.016 (0.095)	-0.021 (0.094)	-0.010 (0.094)	-0.014 (0.094)
Cash flow	0.077 (0.071)	0.086 (0.072)	0.091 (0.072)	0.087 (0.072)	0.092 (0.072)
Firm size	-0.699*** (0.093)	-0.675*** (0.094)	-0.680*** (0.093)	-0.691*** (0.094)	-0.693*** (0.094)
ROE	-0.140** (0.050)	-0.132** (0.050)	-0.138** (0.050)	-0.132** (0.050)	-0.138** (0.050)
TMT compensation	-0.240*** (0.059)	-0.251*** (0.059)	-0.253*** (0.059)	-0.244*** (0.059)	-0.246*** (0.059)
Regional institutional development	0.095 (0.085)	0.117 (0.085)	0.195* (0.091)	0.116 (0.085)	0.189* (0.091)
CEO political connection	0.384* (0.197)	0.354 (0.198)	0.361 (0.197)	0.473* (0.200)	0.475* (0.200)
Equity share of the largest shareholder		-0.330*** (0.099)	-0.339*** (0.109)	-0.445*** (0.109)	-0.446***
Equity share of the largest shareholder * regional institutional development			0.208* (0.083)		0.194* (0.084)
Equity share of the largest shareholder * CEO political connection				0.496** (0.188)	0.466* (0.190)
Industry dummies	Included	Included	Included	Included	Included
Year dummies	Included	Included	Included	Included	Included
Likelihood-ratio chi-square	221.20***	232.72***	239.02***	239.55***	244.95***
Log-likelihood	-898.57	-892.81	-889.67	-889.40	-886.70

N=9,377.

* Significant at the $p < 0.05$.

** $p < 0.01$.

*** $p < 0.001$ level (two-tailed test). Standard errors are in parentheses.

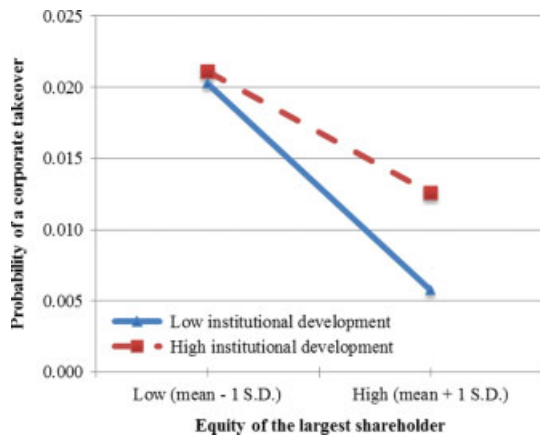


Figure 2. Interaction between equity of the largest shareholder and institutional development in predicting a corporate takeover

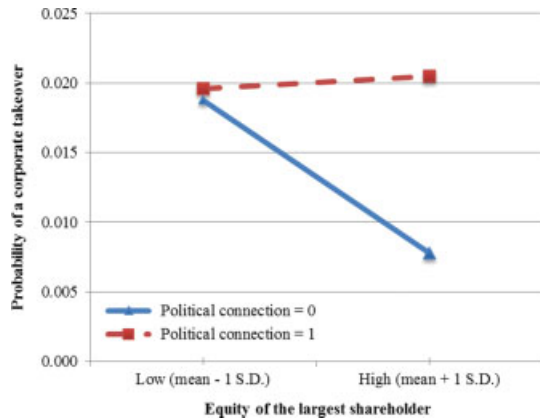


Figure 3. Interaction between equity of the largest shareholder and CEO political connection in predicting a corporate takeover

development, the potential for the expropriation of minority shareholders decreases. This mitigates the resistance of large owners toward potential takeovers.

Importantly, this study builds on the context of China’s political environment and extends the theoretical framework of PP conflicts by relaxing a critical assumption that top managers represent the interest of the controlling shareholders. By revealing the political context within which the top managers are embedded, and demonstrating the asymmetric relationship between controlling shareholders and top managers, we found that the resistance of controlling owners was mitigated for target firms with politically connected CEOs. The goals pursued by the politically oriented managers

are not necessarily the same as those of the controlling shareholders. These results highlight that the relationship between top managers and the controlling shareholders can be more complicated than assumed in the PP conflict framework.

Fundamentally, the study demonstrates that the distinctions between the controlling and minority shareholders lead to the differential PA relationships in different contexts. In developed economies where the rules and regulations for curbing the power of the controlling shareholders are well established, a PA relationship is typically reflected as the conflict between top managers and shareholders as a group (Jensen and Meckling, 1976). However, in transition economies where institutions are weak, the PP conflict between the controlling and minority shareholders can dominate, and the PA relationship is reflected as the conflict between top managers (who are more likely to be affiliated with the controlling shareholders) and minority shareholders. Thus, rather than a standardized universal theory, we found that the PP conflict framework is affected by specific contexts and is a more context-driven perspective. This is an example of the opportunities that may be offered by exploring a novel context, an approach deserving more attention in management research (Tsui, 2007).

The results have practical implications for the institutional transformation currently under way in China and other transition economies. As previous researchers noted, PP conflicts are more prevalent in transition economies (e.g., Young *et al.*, 2008), and exist not only in China’s economy but also in other transition economies such as Russia’s. Thus, our results could potentially be generalized to other transition economies. Future research should attempt to confirm these results in other transition economies. However, as was pointed out by Tsui, the specific context cannot be ignored during this theory generalization process (Tsui, 2007).

While this study focuses on PP conflicts and corporate takeovers, future research might fruitfully examine the dynamic relationships among PP conflicts, PA relationship, incentive-based and monitoring-based governance mechanisms and their impacts on other firm-level outcomes. For instance, the impact of governance mechanisms on the performance of transition economy firms would be a promising area for future research (Li and Zhang, 2007; Peng, 2004). Also, future research could examine how PP conflicts and other

governance mechanisms would affect firm-level strategic choices, such as the decision to invest in research and development. Our findings also suggest that a more efficient institutional system needs to be set up to limit the power of the controlling shareholders in transition economies. A good start might be to build up the legal system to effectively protect the interests of minority shareholders. Legal contracts that clearly lay out each party's rights and obligations in different sets of circumstances may substantially reduce the feasibility of expropriating minority shareholders.

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