



When heirs become major shareholders: Evidence on pyramiding financed by related-party sales

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ABSTRACT

This study investigates how related-party sales are used as a means to financially support the firms in which heirs become major shareholders and allow them to strengthen control over other firms in the group through pyramiding. From a universe of Korean chaebol firms during 2000–2011, we identify a subset of firms where heirs become major shareholders (treatment group) and compare them against their propensity-score-matched firms (control group) before and after the ownership change. A series of difference-in-differences tests with firm fixed effects reveal that treatment group firms experience greater related-party sales, benefit from them in terms of earnings, and gain importance in controlling other firms in the group. However, we do not find these results when non-heirs (e.g., controlling shareholders and other relatives) become major shareholders.

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1. Introduction

Family business owners who wish to see their business transferred to the next generation need to complete two tasks. One is to appoint their chosen heir to a top management position (hereafter “managerial succession”) and the other is to transfer equity stakes to the heir (hereafter “ownership succession”). This second task is not trivial. Assuming that the family firm repeatedly relies on external equity financing, the equity stakes the heir inherits may not be large enough to ensure control over the firm. The existence of estate tax may further aggravate the problem. It would be interesting to investigate how these challenges affect the behavior of family firms and what alternative mechanisms may be devised to preserve control within the family when ownership succession is prohibitively costly. The variations in such mechanisms across countries with different legal settings also deserve serious investigation.

The existing literature, however, is uneven. Research, to date, has mainly focused on the appointment of family members to top management positions and its impact on firm performance (Smith and Amoako-Adu, 1999; Pérez-González, 2006; Bennedsen et al., 2007; Bertrand et al., 2008; Cucculelli and Micucci, 2008; Mehrotra et al., 2013). Exceptions to this include Ellul et al. (2010) and Tsoutsoura (2015), who investigate how inheritance law or succession tax influences the investment decisions of family firms. Another exception is Villalonga and Amit (2009), who document the use of dual-class shares, trusts, foundations, and limited partnerships by US family firms. They suggest that founders may have introduced these mechanisms to perpetuate family control over subsequent generations.

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In this study, we investigate how related-party transactions are used as a means to financially support the firms in which heirs become major shareholders, and allow them to strengthen control over other firms in the group through pyramiding. In other words, we explore the possibility of another mechanism, besides dual-class shares, that may be employed by business groups to preserve family control when ownership succession is prohibitively costly. It is true that pyramiding is less efficient than dual class shares as a control-enhancement mechanism. According to Villalonga and Amit (2009), the wedge between control and cash flow rights in US family firms mainly comes from dual-class shares. They also show that indirect ownership through trusts, foundations, limited partnerships, and other corporations rarely creates a wedge. In certain jurisdictions, however, corporate pyramiding may be the only available alternative.

Consider a country where inheritance tax rates are high but dual-class shares are unavailable. In this setting, corporate pyramiding financed by intra-group, related-party transactions between member firms may serve as an alternative mechanism of preserving family control over subsequent generations. This involves setting up a small, privately held company with the heir as a major shareholder and instructing other firms in the group to purchase goods and services from that firm. Increased sales and earnings will enlarge the firm's asset size, eventually allowing it to acquire controlling equity stakes in other member firms. In the end, this pyramiding allows the heir to take control over the entire business group.

We test this possibility through a study of family-controlled business group firms in Korea, known as “chaebol” firms. We use Korean data for several reasons. First, Korea has a legal setting where ownership succession is costly (i.e., with inheritance and gift tax rates of 50%), dual-class shares are prohibited by law, and indirect ownership through trusts and foundations are heavily regulated, making corporate pyramiding the only remaining option. Second, family-controlled business groups dominate the Korean economy, and the two key elements of the control preservation mechanism that we examine in this study – pyramidal shareholdings and related-party transactions – are prevalent in Korea. Third, Korea is one of the few countries where data on inter-corporate shareholdings and inter-corporate related-party transactions are available, even for non-listed firms. Such information is indispensable for addressing our research question.

From a universe of Korean chaebol firms during 2000–2011, we identify a subset of firms in which heirs have become major shareholders (treatment group) and compare them against their propensity-score-matched firms (control group) before and after the ownership change. A series of difference-in-differences tests with firm fixed effects reveal several results consistent with our predictions.

This study makes a number of contributions to the literature. Most importantly, to the best of our knowledge, this is the first study to explore the possibility that corporate pyramiding financed by related-party sales is used as a means of preserving family control when ownership succession is costly. As mentioned, research on family succession has focused mainly on managerial succession rather than on ownership succession. Moreover, research on ownership succession has focused mainly on dual class shares as an alternative mechanism when ownership succession is costly. By focusing on corporate pyramiding, we hope to shed light on a different mechanism that has not received much attention.

Second, our study contributes to family firm performance studies, which have gained in popularity since Anderson and Reeb (2003).¹ We contribute to this area by highlighting the importance of related-party transactions in performance assessments, especially when family firms are a part of a business group. More remotely, our study is also related to studies on managerial ownership and firm performance (Morck et al., 1988). Again, in a business group setting, the relationship between ownership and performance cannot be assessed without considering related-party transactions.

Third, we enrich the literature on business group tunneling (Bae et al., 2002; Bertrand et al., 2002; Baek et al., 2006; Cheung et al., 2006; Black et al., 2015).² We report empirical evidence that related-party transactions could benefit firms in which heirs become major shareholders, presumably at the expense of minority shareholders in counterparty firms. Our evidence on tunneling, however, remains indirect, as in other tunneling studies.

2. Pyramiding backed by related-party sales

A business owner wishing to hand over controlling equity stakes to the next generation generally faces two challenges: the risk of dilution and the risk of taxation.

If a family firm repeatedly relies on external equity financing, the equity stake that later generations inherit may not be large enough to warrant control over the firm (Helwege et al., 2007). In certain jurisdictions, this challenge is overcome by the use of dual-class shares or voting agreements (Villalonga and Amit, 2009). Business owners holding shares with multiple voting rights or possessing contracts that revoke the voting rights of other shareholders may be free from the risk of dilution.

The risk of taxation is another major challenge. Although some jurisdictions have abolished inheritance tax, many others still impose it.³ In the US, the tax rate is as high as 35%. Moreover, even in jurisdictions that have abolished inheritance tax, capital gains tax may still apply upon succession. Similarly, while some jurisdictions have abolished the gift tax, several jurisdictions have retained it. In certain jurisdictions, this challenge of taxation is resolved with the use of trusts or private foundations that receive shares as donations (Thomsen, 1999; Villalonga and Amit, 2009). As charitable entities, they are exempt from taxation but are still governed by family members who serve as trustees or are on their board of directors.

¹ For studies on the relationship between family ownership and firm performance, see Maury (2006), Miller (2007), and Andres (2008).

² The literature also documents the bright side of intragroup transactions—helping to overcome market frictions; see Gopalan et al., 2007; Buchuk et al. (2014) and Gopalan et al. (2014).

³ Some jurisdictions use the term “estate tax” instead of “inheritance tax.”

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