A Debate on Corporate Governance of Family Firms and Business Groups*

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This article reviews corporate governance literature of family firms and business groups which is relevant to Korean conglomerates. We summarize major issues on corporate governance for Korean conglomerates and classify studies according to those issues: existence of controlling shareholder, deviation from the one share-one vote principle, family members' participation in management, succession of control to family members, and the relationship between financial and industrial capital within business groups. Existing literature shows that firms with controlling shareholders are common globally. While many factors related to corporate governance impact firm value, they create both positive and negative ramifications in a nuanced manner. Also, corporate governance endogenously emerges under different circumstances—law, degree of market development, or management-union relations across countries. Thus, there is no single standard corporate governance system that can apply to all family business groups in different countries. Proper frameworks for policy makers and managers will arise only in the particular contexts in which family business groups operate.

Keywords: Corporate Governance, Family Firm, Business Group, Controlling Shareholder, One Share-One Vote Principle, Succession of Control

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* This work was supported by the National Research Foundation of Korea Grant funded by the Korean Government [NRF-2010-332-6000110].
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I. INTRODUCTION

Family-owned business groups have been an important topic in business. For example, Korean chaebols (or family-owned conglomerates) have made a substantial impact on the domestic economy and have evolved into major global players. On the one hand, corporate governance literature has found that governance can influence firm value and social welfare significantly. However, much debate still remains in many areas of corporate governance. In particular, despite numerous studies about family firms and business groups, few discuss key issues and there has yet to be a consensus reached about the subject. In this paper, we investigate what the core issues and findings are in the existing literature about family firms and business groups, and suggest managerial and policy implications with particular reference to chaebols.

A bulk of existing literature has conducted theoretical and empirical studies about corporate governance of family firms and business groups. For the purposes of this paper, family firms are those in which the founder and his or her family hold shares or are the members of the management or board of directors of the company in a narrow sense. They can also refer to firms in which the founder and his or her family are the controlling shareholders. A business group refers to a type of firm in which several independent companies are connected through shares or family relations. Two pioneering studies related to this topic include La Porta, Lopez-de-Silanes, and Shleifer (1999) and Anderson and Reeb (2003).

La Porta et al. (1999) analyze corporate governance of large companies in 27 developed countries and offer several findings. First, many have controlling shareholders and are controlled by a family and the state. In the study, a controlling shareholder refers to one who holds more than 10% of voting rights. Second, many firms deviate from the classic one share-one vote principle through pyramid structures or participation in management. Third, the controlling family significantly affects the management of a firm. Findings suggest that controlling family participation in management occurred in 75% of family firms in countries with good shareholder protection, while this level was 64% in countries with poor shareholder protection. The extent of shareholder protection is a legal issue. Corporate law or commercial law, for example, specifies the one share-one vote rule, shareholder ratios for opening general meeting of shareholders, or the possibility of class action. A country offers good shareholder protection if it guarantees a one share-one vote, has lower shareholder ratios required to summon extraordinary general meetings, and enables class action. Cross-shareholding is rare, except in Sweden and Germany.

Anderson and Reeb (2003) analyze the performance of U.S. family firms among S&P 500 companies in 1992. For their study, family firms were defined as firms in which the founder and related family members own shares or are members of the board of directors. They found that one-third of S&P 500 companies are family firms. While the family owned just around 18% of shares on average, family control and influence were much more powerful than indicated by the shareholding level alone. For instance, their voting rights for boards of directors were 150% greater than their cash-flow right. In addition to these findings, the study found that family firms tended to perform better than non-family firms.

The aforementioned studies triggered many follow-up studies centering on the following issues: (1) whether and what types (family, financial institutions, etc.) of controlling shareholders exist in each country, (2) what factors determine the types of controlling shareholders, (3) whether and to which degree controlling shareholders participate in management, (4) what performance or what advantages and disadvantages the various ownership and control structures generate, (5) what is the international pattern and distribution of family firms, corporate structure, and performance, (6) how succession of control within family firms occurs, and (7) what are the major characteristics of family business groups.

This line of literature has significant implications to chaebols because most chaebols are family business groups as they show properties of both family firms and business groups. As such, the literature is very relevant to many important issues on the corporate governance of chaebols. Of course, there are corporate governance studies specific to Korean conglomerate issues such as Amsden (1989), Guilen (2000), Chang (2003), and Chang and Hong (2000, 2002), but we survey the previous literature more broadly to provide more implications.

First, there are debates about the patterns of controlling shareholders (ownership concentration) or control by the founder and family in chaebols. In general, dispersed ownership structures are considered more advanced. Family members may control companies only in developing countries. However, there is an argument that the firm should have a controlling shareholder. A controlling shareholder has positive influence on the market value of a firm since family members have larger incentives for monitoring management. See Shleifer and Vishny (1986), Admati, Pfeiderer, and Zechner (1994), Huddart (1993), Noe (1997), and Maug (1998). Also, there is no empirical evidence that family businesses are inefficient (Anderson and Reeb 2003; Villalonga and Amit 2006a, 2006b; Francisco Perez-Gonzalez 2006).

Second, managerial and regulatory issues include deviations from the one share-one vote principle, problems of the pyramid structure, mutual investment, and circular equity investment, among others. A controlling shareholder can exercise more control through a pyramid structure or circular equity investment than what shareholdership itself implies. Such problems can generate conflicts of interest between controlling and minority shareholders, often referred to as tunneling (Johnson, La Porta, Lopez-de-Silanes, and Shleifer 2000; Bae, Kang, and Kim 2002; Bertrand, Mehta, and Mullainathan 2002; Campbell and Keys 2003;