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Group control motive as a determinant of ownership structure in business conglomerates☆ Evidence from Korea's chaebols

Woochan Kim [a,*], Youngjae Lim [b], Taeyoon Sung [c,1]

[a] *KDI School of Public Policy and Management, Chongryangri-Dong, Dongdaemun-Ku, Seoul, Republic of Korea 130-868*

[b] *Korea Development Institute, Chongryangri-Dong, Dongdaemun-Ku, Seoul, Republic of Korea 130-012*

[c] *KAIST Graduate School of Management, Chongryangri-Dong, Dongdaemun-Ku, Seoul, Republic of Korea 130-722*

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Abstract

In this paper, we attempt to make two major contributions to the literature that studies the ownership structure of business conglomerates. First, we introduce the concept of *group control motive* and empirically show that this motive greatly shapes the controlling-minority ownership structure. Using a two stage least squares (2SLS) framework, we show that controlling families hold greater direct shareholdings in firms that have greater contribution to group control, and alternatively show that firms in which the controlling families hold greater direct shareholdings are made to have greater contribution to group

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* Corresponding author. Tel.: +82 2 3299 1030; fax: +82 2 968 5072.
E-mail addresses: wc_kim@kdischool.ac.kr (W. Kim), yjlim@kdi.re.kr (Y. Lim), econsung@kgsm.kaist.ac.kr (T. Sung).
[1] Tel.: +82 2 958 3535; fax: +82 2 958 3604.

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control. Second, we find that the level of disparity between voting and cash flow rights is significantly higher than the levels previously reported in the literature on Korean firms when we include non-public firms and adopt a control concept that is more flexible and closer to reality.

JEL classification: G32; G34
Keywords: Ownership structure; Business conglomerate; Chaebol; Group control motive

1. Introduction

Recent literature on corporate ownership gives increasing attention to firms in which a shareholder (or a family) exercises significant control while owns only a small fraction of cash flows. Typically, these firms are members of a large business conglomerate characterized either by dual class shares, pyramids, or cross-shareholdings. This ownership structure, termed as the controlling-minority structure by Bebchuk et al. (2000), is now recognized among scholars as a major form of corporate ownership in addition to the other two that previously received more attention: dispersed and concentrated ownership structures. Also, research shows that most of the firms in East Asia and in continental Europe fall into this category (Claessens et al., 2000; Faccio and Lang, 2002). More importantly, many recent works show that such separation between ownership and control – also known as disparity – has an important implication on firm performance (La Porta et al., 2002; Claessens et al., 2002; Mitton, 2002; Fan and Wong, 2002; Joh, 2003; Haw et al., 2004; Lins, 2003; Lemmon and Lins, 2003; Baek et al., 2004; Morck et al., 1988).

Surprisingly, however, despite the long list of papers that empirically study the impact of control-ownership disparity on firm performance (hereafter *disparity-to-performance studies*), not many papers attempt to study the determinants of disparity (hereafter *determinants-of-disparity studies*). What makes a controlling family hold company shares directly (e.g. increase cash flow rights) rather than holding them indirectly through member firms (e.g. increase disparity)? Why are some firms located on the top of the corporate pyramid structure and others at the bottom? If control-ownership disparity is important, we believe it is also important to study the determinants of such disparity and provide answers to such questions.

To our knowledge, there is only one study that empirically studies the determinants of disparity. Chang (2003) investigates how inside ownership and family portion of this inside ownership interact with firm performance using a two-stage least squares (2SLS) framework. Using a sample of group-affiliated public firms in Korea during 1986–96, he finds that controlling families tend to increase inside ownership in firms with higher profitability or firm value, but not vice versa. The causality running from profitability to inside ownership, however, is found to be weak. Also, the author did not find the impact of performance on the family portion of inside ownership.

In this paper, we build upon the work of Chang (2003) and attempt to make a number of important contributions to the literature. First, we study the controlling family's group control motive as an important determinant that shapes the controlling-minority ownership structure. *Group control motive* is the desire to structure intra-group ownership in a way that maximizes the controlling shareholder's control over the whole business conglomerate at a given level of direct share investment. More specifically, using a two-stage least squares (2SLS) framework, we show that controlling families hold greater direct shareholdings in firms that have greater