

# Related Party Transactions and Ownership Concentration: Theory and Evidence

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## Abstract

**We model the effect of ownership concentration and analyze its impact on related party transaction. As for the related party transaction conduct between Taiwan and China, we find that it is easy for minority shareholders of companies to suffer from ownership concentration of controlling shareholders. Cash flow rights held by the controlling shareholders of firms represent higher ownership concentration of their subsidiaries. We find that higher ownership concentration speeds up related party transaction.**

## 1. Introduction

Kim et al. (2005) examines whether the tunneling behavior exists in the internal capital market within a business group (chaebol) in Korea. The so-called tunneling behavior within a chaebol (Korean business groups) benefits the controlling shareholders by distorting the allocation of internal funds. They argue that the discrepancy in cash flow rights among firms that the controlling shareholders control creates the tunneling incentives in the internal capital market. However, the internal capital market serves as tunneling devices through which the controlling shareholders fulfill their private incentives at the expense of minority shareholders. Similar to the meaning of tunneling, we find another form of allocating internal fund that also benefits controlling shareholders. In this paper, we call it related party transaction.

We review literature related and summarize two definitions of related party transaction. First, related party transactions are generically defined as transactions between a company and related entities (e.g., subsidiaries, affiliates, principal owners, officers, and directors)<sup>1</sup>. Gordon et al. (2007) discuss the techniques of auditing related party transactions and find the definition of related parties varies across regulatory bodies. However, they state that related party transactions should be assessed in the context of the company's overall governance structure, particularly given the importance of managements' assertions about the existence and nature of these transactions. Second, Young (2005) defines related-party transactions, as transactions between a company and an insider, which have been the subject of heightened scrutiny from investors and the financial media since the collapse of Enron in late 2001.

To derive the relationship between related party transaction and concentrated ownership, we first model the effects of related party transaction with companies' corporate governance arrangements. Burkart et al. (1997) view dispersed ownership as a commitment device ensuring that shareholders will not exercise excessive control, which might hinder managerial activism. If the controlling rights of a company are under control by several controlling shareholders, then concentrated ownership may enable them to exercise excessive control. Young (2005) finds that the high level of related-party transactions creates a trend toward its relationship with concentrated ownership, especially when certain kinds of these transactions and relationships involving a company and entities in which directors or nominees have particular interests.

There are some papers focusing their discussion on the relationship between related party transactions and company performance (Igor et al., 2001; Grosfeld and Tressel, 2002; Ming and Wong, 2003; Young, 2005; Bennedson et al., 2007) However, we focusing on the key question: does ownership concentration result in related party transactions. We propose that ownership concentration of controlling shareholders speeds up related party transactions.

As principal owners play the role of controlling shareholders and have the potential to be particularly effective monitors, they may also have incentives that do not coincide with the interests of other investors in the

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<sup>1</sup> Related party transactions are defined as transactions between a company and its subsidiaries, affiliates, principal owners, officers or their families, directors or their families, or entities owned or controlled by its officers or their families (Statement of Financial Accounting Standards No. 57 [FAS No. 57], FASB 1982).

company (Gordon, 2007). This may create room for low protection of minority investors where expropriation of minority shareholders by the controlling shareholders is extensive. As this expropriation may take various forms, such as related-party transactions, use of transfer pricing, assets stripping and other forms of 'tunneling' of revenue and assets from firms (Morck et al., 1998; La Porta et al., 2000b; Igor et al., 2001), controlling shareholders may have strong incentives to divert resources in ways that make them better off at the expense of other shareholders (Wruck, 1989). To demonstrate this situation, we suppose that there may be a trade-off between incentives and rent-seeking effects associated with concentrated ownership by shareholding.

Based on our theoretical model, we further make three empirical hypotheses to test whether the controlling shareholders of the mother companies in Taiwan transfer resources to their subsidiaries in China. By doing so, the controlling shareholders can benefit their investment opportunities in China though this action expropriate the minority shareholders of the mother companies in Taiwan. It looks like another form of internal funds transfer inside companies. What we wonder is this kind of internal funds transfer is encouraged by ownership concentration. Since the controlling shareholder discretion and agency problems both contribute to ownership concentration, these agency problems may reinforce each other (Stulz, 2005).

In Taiwan, the authority regulates the total amount companies invest in China. From the synergy point, these rules of optimal financing behavior restrain the efficient use of capital across countries. However, due to the complexity and information asymmetries across countries, these rules seem to protect minority shareholders of the mother companies in Taiwan from being expropriated. Survey of Krishnamurti et al. (2005) indicates that almost 74% ownership of firms in Taiwan has a controlling shareholder, and the mean ownership by three largest shareholders is only about 18% indicating lower degree of ownership concentration as compared to other countries in Asia except Japan. In contrast with the lower ownership concentration, we find that controlling shareholders of business groups in Taiwan have higher ownership concentration in their subsidiaries in China. Focus on the relationship between mother companies in Taiwan and their subsidiaries in China, we find that capital transfers by related party transaction do exist to benefit the controlling shareholders in Taiwan although these firms belong to the same business groups and controlling shareholders. While controlling shareholders undertake this capital transfer across counties, it is easy to distort the allocation of internal funds in such a way.

Political change has brought about fresh impetus to improve corporate governance arrangements in Taiwan, but expropriation chances are not relatively higher in Taiwan (Krishnamurti et al., 2005). Data from Taiwan (TEJ) enables us to analyze the relationship between related party transaction and ownership concentration across countries. The separation of ownership and control in family-controlled firms and small firms in Taiwan become more prominent among Asian countries (Claessens et al., 2000; Krishnamurti et al., 2005). Besides, ownership concentration in our sample of China subsidiaries is strikingly high and primarily represents controlling shareholders of the same families in Taiwan. These families show that corporate holdings frequently take the form of complex webs of holdings and pyramids of inter-corporate holdings (Franks and Mayer, 2001).

The article is organized as follows: section 2.1 gives an overview of the mainstream controlling shareholders literature with a view to contextualize capital transfer and ownership structure. In Section 2.2, a static model built to analyze the relationship between controlling shareholders of mother companies and the managers in subsidiaries, and derives some hypotheses. Section 2.3 describes empirical models and data. Section 3 tests the hypotheses and shows these results of regressions. Section 4 concludes.

## 2. The Model

### 2.1. Previous research

The relation between ownership and related party transactions has gradually become an important debate in the empirical research. As observed by Johnson et al. (2000), looting of firms by controlling shareholders may be assets transferred, profits siphoned, and propping troubled firms by using loan guarantees. The definition of tunneling quoted by Baek et al. (2006) is the degree to which the controlling shareholders of the business group siphon resources out of firms to increase their wealth. In Taiwan, the authority regulates the amount companies put in to invest in China. However, another form of tunneling<sup>2</sup> we find in this article is legal capital transfer. We use the data of Taiwan Economic Journal (TEJ) Database to confirm that tunneling occurs in countries with effective law enforcement (Johnson et al., 2000).

A number of studies explicitly model the expropriation of minority shareholders by the controlling shareholders (Shleifer and Wolfenzon, 2002). Almeida and Wolfenzon (2006) thus analyzes the creation of business groups (a collection of multiple firms under the control of a single family) and finds that, in several countries, single individuals or families control a large number of firms; an organization typically referred to as a family business group. The controlling shareholders, who have a small fraction of total stake in Taiwan companies, always take control in discretion of allocating financial resources. They tend to expropriate minor

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<sup>2</sup> The term is defined as the expropriation of minority shareholders, such as the transfer of assets and profits out of firms for the benefit of those who control them by Johnson et al. (2000).

shareholders easily though the authority regulates this situation. As a result, families that already own successful firms might be the only ones with discretion of allocating financial resources to set up new firms in China (Almeida and Wolfenzon, 2006).

A number of studies do research the role controlling shareholders play. Controlling shareholders do have the authority to allocate new investment across two countries, and they are charging with identifying effective ways of transferring resources (Scharfstein et al., 2000). They will want to transfer, or tunnel, profits across firms (Bertrand et al., 2002); especially in all East Asian countries, control is enhanced through cross-holdings among firms (Claessens et al., 2000). Within the framework of our model, we prove that the controlling family in Taiwan may benefit from setting up new firms. Then we examine empirically how revenue differs between firms of the same group in these two places (Taiwan and China).

Demsetz and Lehn (1985) take the view that owners believe they can influence the success of their firms, and in many countries, the evidence suggests controlling shareholders use private funds to provide temporary support to a firm that is in trouble (Friedman et al., 2003). Leuz and Felix (2003) empirically indicate that politically well-connected firms received considerable support during the Asian financial crisis. However, this kind of support may be abused by controlling families to facilitate the extraction of private benefits of control, suggested as expropriation of minority shareholders in Taiwan.

## 2.2. Mathematical Model

Consider a business group that is composed of a mother company and a subsidiary. The subsidiary is a newly founded company and its revenue comes from its daily operation and the transaction between itself and the parent company. The company is only controlled and founded by its controlling shareholders alone. To express its revenue structure, we let

$$(1) \quad R = R_m + R_d,$$

where the subscript m means the mother company and d means the subsidiary.

When the subsidiary is set up successfully, the probability of its success is denoted by  $p$ . The entrepreneur of the subsidiary (one of controlling shareholders) can enhance its probability of success  $p=p_h$  by raising the fractional stake controlling shareholders keep, which costs minority shareholders  $G$ . But the entrepreneur may not successfully raise the stake which controlling shareholders keep and results in the failure of establishing a new subsidiary in China by probability  $p=p_l$ , where  $\Delta p \equiv p_h - p_l$ . We denote  $I$  as the investment put in the subsidiary by the mother company, and the contribution from the subsidiary to its mother company as

$$(2) \quad p_h R_d = I - G,$$

However, the subsidiary's value may be under-estimated by the board's misbehavior, which creates the cost of private benefits  $B$ . To evaluate the relationship between the subsidiary and its mother company, investors have their utility in the IPO as

$$(3) \quad \begin{cases} p_h R - I > 0 \\ p_l R - I - B < 0 \end{cases}$$

Meanwhile, to estimate the value added brought by the subsidiary, the controlling shareholders of the mother company evaluate the investment of the subsidiary as the following:

$$(4) \quad [p_l R_d - (I - G)] + [p_l R_m - (B + G)] \geq 0.$$

where the first bracket is the task of the entrepreneur of the subsidiary, and the second bracket is the controlling shareholders of the mother company prefer. This situation yields our first testable hypothesis as follows:

Hypothesis 1: The revenue transferred between the subsidiary and its parent companies does not contribute to the parent companies' revenue.

Assume that the controlling shareholders of the mother company want to speed up tunneling (extracting their private benefit). The incentive to siphon resources from the subsidiary to the mother company can be drawn by the following constraint:

$$(5) \quad p_h R_m \geq p_l R_m + B,$$

It shows that the controlling shareholders of the mother company want the newly founded company operate successfully at the beginning. The more success it is, the more they (the controlling shareholders of the mother company) can drain from the subsidiary. We can rewrite the equation as

$$(6) \quad R_m > \frac{B}{\Delta p},$$

No matter how successful the IPO of the subsidiary is, the controlling shareholders of the mother company would benefit from the revenue separated from the subsidiary. We can thus derive pledgeable income contributed by the subsidiary to the mother company as  $p_h \left( R_m - \frac{B}{\Delta p} \right)$ .

However, the controlling shareholders of the mother company also suffer the risk of enforcing corporate governance arrangements, which cause the possibility of being scrutinized together. To put up with the potential risk, the investment they make in the subsidiary must satisfy their individual rationality constraint as

$$(7) \quad p_h \left( R - \frac{B}{\Delta p} \right) \geq I - G,$$

which enables us to derive the cost  $G \geq p_h \frac{B}{\Delta p} - (p_h R - I)$  of the controlling shareholders of the mother company to enforce corporate governance arrangements in the newly founded company.

The controlling shareholders of the mother company can calculate the cost of enforcing corporate governance arrangements as

$$(8) \quad p_h \frac{B}{\Delta p} - (p_h R - I) = \bar{G},$$

On the other side, the newly founded company's manager (the entrepreneur) also wants to extract private benefits without operating the company continuously.

$$(9) \quad p_h \frac{B}{\Delta p} - (p_h R - I) > 0,$$

We can thus derive the cost of minority shareholders to buy the newly founded company's stock as

$$(10) \quad p_h R - I < p_h \frac{B}{\Delta p},$$

which enables us to make hypothesis 2 as the following:

Hypothesis 2: While the newly founded company's revenue is partly transferred to its parent companies, this does not reduce the subsidiary's value.

The minority shareholders of the mother company have kept the stock on their hands already. However, the newly founded subsidiary has been a burden for them because

$$(11) \quad [p_l R_d - (I - G)] + [p_l R_m - (B + G)] < 0,$$

Even though the tunneling done by the controlling shareholders of the mother company does undertake legally, the minority shareholders of the mother company still suffer the risk of losing their money. We can derive their utility as

$$(12) \quad U_d = \begin{cases} 0 & G < \bar{G} \\ p_h R_d - G & G \geq \bar{G} \end{cases}.$$

In Taiwan, the mother company can tunnel their resources through an offshore company to a newly founded company set up in China. This is harmful to the minority shareholders and investors of their mother company in Taiwan. This yields the final hypothesis 3 as the following:

Hypothesis 3: The mother company's capital transferred to subsidiaries in China will not have an impact on the mother company's revenue.

### 2.3. Empirical models and data

Tunneling implies that there is a positive relation between related party sales and capital transfer beyond them. This kind of capital transfer significantly has an impact on the revenue of mother companies in theory. In this paper, we employ the following econometric models to examine the presence of tunneling in the forms of related party sales, foreign investment, and investment opportunities sets in China.

$$(13) \quad \text{moincome} = \alpha_0 + \alpha_1 \text{mode} + \alpha_2 \text{demo} + \alpha_3 \text{trafund} + \alpha_4 \text{invest} + \alpha_5 \text{contri}$$

$$(14) \quad \text{deincome} = \alpha_0 + \alpha_1 \text{mode} + \alpha_2 \text{demo} + \alpha_3 \text{trafund} + \alpha_4 \text{invest} + \alpha_5 \text{contri}$$

Friedman et al. (2003) argue that higher ownership concentration is considered to represent stronger corporate governance while ownership concentration is the percentage of shares held by the largest shareholder. We retrieve data from Taiwan Economic Journal (TEJ) Database. Our sample contains 282 data of listed companies on the Taiwan Stock Exchange (TSE) from March 2004 to September 2006. The controlling shareholders of sample companies are characterized by setting up new companies in China and controlling business groups across Taiwan and China. Table 1 summarizes the definition of our variable by different forms of capital transferring.

**Table 1 Definitions of variables**

Hypothesis	Variable	Definition
H1	Demo	Revenue from subsidiaries to mother company
	Mode	Revenue from mother company to subsidiaries
H2	trafund	Amount of investment through an offshore company
H3	Invest	Amount of investment in subsidiaries in China
	Contri	Net income of mother company contributed by the subsidiaries in China
	moincome	Revenue of mother companies in Taiwan
	deincome	Revenue of subsidiaries in Taiwan
	moshare	Shares held by first ten shareholders in mother companies
	deshare	Shares held by the controlling shareholders in subsidiaries

We show that the sample of China subsidiaries is characterized higher ownership concentration as we summarize the descriptive statistics in Table 2. Pointed out by Krishnamurti et al. (2005), the lower degree of ownership concentration in Taiwan mother companies is 38.37 % in our sample.

As depicted in Table 2, we retrieve our data by the listed company's organizational structure as a business group, whose major related parties include only its subsidiaries in China. All transactions between the largest shareholders of the mother companies in Taiwan and its affiliates are classified as related party sales with the largest shareholder. Other important related parties are their subsidiary companies where the controlling shareholders of the listed companies in Taiwan own almost 82.66 % shares and thus can exert significant influence over them but do not consolidate them into their financial statements in Taiwan.

**Table 2 Descriptive Statistics**

Variable	Mean	STD	Min	Med	Max
Demo	415501.77	1868248.01	0	164	16595085
Mode	417273.63	2076257.98	-1529	0	16451351
trafund	452680.05	1130344.48	200	196080	14006880
Invest	381726.40	2052685.95	-1828507	21038	21101712
Contri	-2.46	114.89	-1625	4	193
moincome	4340900.69	11239688.00	9629	832527	88765462
deincome	1665247.91	3635159.03	0	206321	1695544
moshare	38.37	11.92	14	36	81
deshare	82.66	21.19	8	92	100

### 3. Empirical tests and results

From Table 3, our tests of hypotheses by simple regression analysis provide evidence for the possibility of positive correlation between the related party sales and the revenue of the mother company in Taiwan. Further, the related party transactions also have impact on the subsidiaries' revenue. There are many kinds of related party transactions. In this paper, we first focus on related party sales because they usually belong to the normal operations of the company and are easier to be detected. Other types of related party transactions such as investment through an offshore company are normally reported as non-operating items, which is hard to be detected.

**Table 3 Results of hypotheses by simple regression**

Test	Independent Variable	Dependent Variable	Coefficient	R <sup>2</sup>
H1	mode	moincome	1.4490***	0.0712
H2	demo	deincome	0.9815***	0.2529
H3	invest	moincome	4.3356***	0.6269

Asterisks denote significance levels: \* = 10%; \*\* = 5%; and \*\*\* = 1%

Based on the role of largest shareholder in mother companies, most of the related party sales provide evidence about a positive relation between the listed entity and its subsidiaries. We then directly test the capital transfer of related party sales by univariate analysis. As Table 4 shows, both revenues of mother companies and subsidiary are all affected by capital transfers beyond the related party sales. However, the force of sales from mother companies to their subsidiary is weaker than that from subsidiaries to their mother companies. Besides, the foreign investment by which the mother companies in Taiwan transfer their resource to subsidiaries in China significantly affect the revenue of mother companies in Taiwan. However, the contribution from the China subsidiaries to their mother companies in Taiwan is not significant.

**Table 4 Results of hypotheses by univariate analysis**

Dependent Variable	moincome	deincome	Dependent Variable	moincome
Intercept	3284444.89***	815105.565***	Intercept	2682476.21***
Demo	1.1052**	1.0303***	Invest	4.3396***
Mode	1.4912***	1.0328***	Contri	-770.8616
Adj- R <sup>2</sup>	9.82%	59.52%	Adj- R <sup>2</sup>	62.43%
Hypothesis	H1	H2	Hypothesis	H3

To analyze all hypotheses derived from our theoretical model, we recall our full model as the following.

$$(15) \quad moincome = \alpha_0 + \alpha_1 mode + \alpha_2 demo + \alpha_3 trafund + \alpha_4 invest + \alpha_5 contri$$

$$(16) \quad deincome = \alpha_0 + \alpha_1 mode + \alpha_2 demo + \alpha_3 trafund + \alpha_4 invest + \alpha_5 contri$$

From Table 5, it is clear to see the significant relationship between the revenue of mother company and any form of related party transaction except the income contributed by subsidiaries in China. Still, there exist relation between the revenue of subsidiary and any form of related party transaction. Since the foreign investment is not transferred from the subsidiary, no relation between them is reasonable in our tests. But we notice that the income provided by subsidiaries in China also does not contribute to its subsidiaries in Taiwan. Obviously, there is only single direction for the controlling shareholders of mother companies in Taiwan to allocate the resource. We argue that this situation only benefit the controlling shareholders in Taiwan, not inclusive the minority shareholders.

**Table 5 Original model**

Dependent Variable	moincome	deincome
Intercept	1105589.34**	745502.326***
Demo	1.2045***	1.0342***
Mode	1.7813***	1.0468***
trafund	0.6144**	0.0016
Invest	4.5127***	0.1637**
Contri	-1625.4188	614.8396
Adj- R <sup>2</sup>	78.18%	60.01%
Hypothesis	All	All

Hence, we revise our model and rerun the results of our hypotheses. From Table 6, we employ another econometric model to explain the relation between mother companies and their subsidiaries in both Taiwan and China. FIX model is as the following:

$$(17) \quad \text{moincome} = \alpha_0 + \alpha_1 \text{mode} + \alpha_2 \text{demo} + \alpha_3 \text{invest}$$

$$(18) \quad \text{deincome} = \alpha_0 + \alpha_1 \text{mode} + \alpha_2 \text{demo}$$

We simplify the capital transfer beyond related party sales and find that related party sales do contribute the revenue of mother companies in Taiwan. In other words, we find the revenue in Taiwan companies tend to be inflated by their controlling shareholders. Besides, the foreign investment through an offshore company also enhances the level of revenue in mother companies in Taiwan. On the other hand, the subsidiaries in Taiwan mainly depend on its sales with mother companies to operate normally. It is why we revise the econometric model of the revenue of subsidiaries in Taiwan.

**Table 6 Fix model**

Test	Dependent Variable	Independent Variable	Coefficient	R <sup>2</sup>
H1	moincome	mode	1.4490***	0.0712
H2	deincome	demo	0.9815***	0.2529
H3	moincome	invest	4.3356***	0.6269
FIX	moincome	mode	1.8896***	0.7821
		demo	1.2280***	
		invest	4.5246***	

Although capital transfer beyond related party transaction contributes to fasten the cooperation through inter-firms sales, it also inflates the revenue of business groups. Consider levels of related party transaction between zero to one. On one end, the synergy between companies makes the form of business group possible. On the other end of the spectrum, several controlling shareholders-controlled companies enhance frequency of related party transactions by having the lowest level of stake. It is worth noting that controlling shareholders-controlled companies, in comparison with other firms, have a higher level of related party transactions with their associates. The income contributed by subsidiaries in China is not significant in our paper, however. If we add up each type of transactions with all related parties, controlling shareholders-controlled companies dominate the two types of related party sales in both Taiwan and China.

#### 4. Conclusions

Companies may offer trade credits and other lending with related party purchases and sales to those parties. In this paper, we do not test net credits within group-controlled companies. While most of these transactions occur between the listed company and its major subsidiaries, only related party transactions with their mother companies show on the formal statement. Concentrating on capital transfer beyond the related party transactions with the business relationship across countries increases the power of our tests. No matter whom the entrepreneur is, listed companies may have similar abilities to conduct transactions with their associates.

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