Dead money: Law and the longevity of family firms

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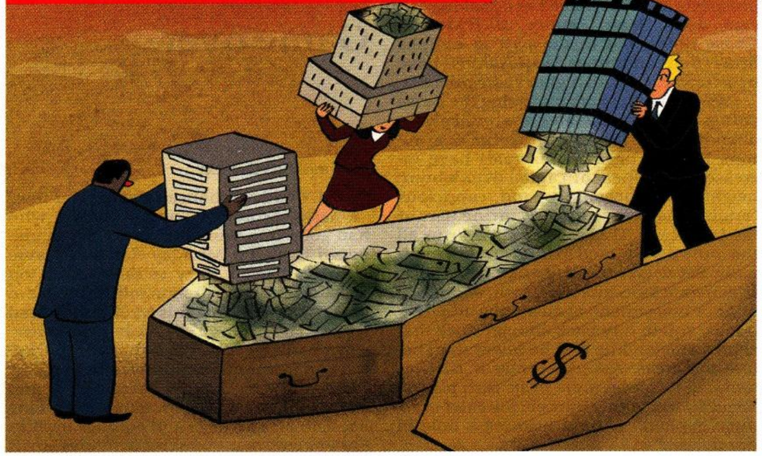

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Corporate savings

Dead money

WASHINGTON, DC

Cash has been piling up on companies' balance-sheets since before the crisis

MONETARY stimulus gets you only so far. In America, third-quarter profits and revenues for companies in the S&P 500 index appear to have fallen year on year for the first time since 2009, according to Thomson Reuters. Profits for roughly half the firms in the European Stoxx 600 have fallen short of expectations so far.

Companies in search of a culprit may want to glance in the mirror. Firms are trimming their budgets for everything from technology-consulting services to semiconductor equipment in the face of what Sir Martin Sorrell of WPP, a British advertising and marketing giant, calls four "grey swans" (unlike black swans, people know about grey ones). The four worries unnerving business are: the euro-zone crisis; upheaval in the Middle East; a possible recession in China; and America's economic health and "fiscal cliff"—the combination of tax increases and spending cuts scheduled to occur at the end of this year.

This is not a new problem. Investment has steadily risen since the recession ended, but not as vigorously as profits. In America, for example, nominal capital expenditure this year (on an annualised basis) has risen by 6% compared with 2007; internal cash flow is up by 32%. Companies have been net suppliers, instead of users, of funds to the rest of the economy since 2008. Firms in the S&P 500 held roughly $900 billion of cash at the end of June, according to Thomson Reuters, down a bit from a year earlier but still 40% up on 2008.

Business leaders and conservative critics cite that cash mountain as proof that meddlesome federal regulations and America's high corporate-tax rate is locking up cash and depressing investment. But that cannot explain why the same phenomenon prevails worldwide. Japanese companies' liquid assets have soared by around 75% since 2007, to $2.8 trillion, according to ISI Group, a broker. Cash stockpiles have continued to grow in Britain and Canada, too, to the immense frustration of policymakers there. "Dead money" is how Mark Carney, the Bank of Canada's governor, has described the nearly $300 billion in cash Canadian companies now hold, 25% more than in 2008. Mr Carney admonished them to "put money to work and if they can't think of what to do with it, they should give it back to their shareholders."

Hoard instinct
Corporate saving as % of total private saving

Source: Loukas Karabarbounis and Brent Neiman, University of Chicago Booth School of Business

No single factor seems to explain companies' high savings. The Bank of England notes that natural-resource companies account for a disproportionate share of the cash build-up. That may reflect the boom in commodities prices and the paucity of promising new sources of supply.

Low interest rates have reduced borrowing costs, adding roughly a percentage point to American profit margins, according to BCA Research. (Yet rock-bottom interest rates also make it less attractive to hold cash.) The financial crisis has made firms more skittish about relying on banks or securities markets for funds. Since questions were raised in 2008 about the ability of General Electric's finance arm to fund itself, the company has been stockpiling cash: $85 billion at the end of the third quarter, the most in the S&P 500.

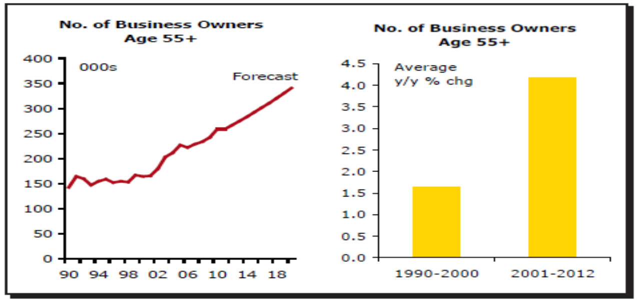
A rapid reversal is unlikely. That's because rising corporate saving has deeper roots than the crisis, the commodities boom or this interest-rate cycle. In a recent study Loukas Karabarbounis and Brent Neiman at the University of Chicago found that across 51 countries they examined between 1975 and 2007, companies' share of private saving rose in aggregate by 20 percentage points. In countries where corporate saving rose, labour's share of GDP in the corporate sector shrank, by five percentage points in aggregate.

Mr Karabarbounis and Mr Neiman link both rising corporate saving and labour's shrinking share of GDP to a fall in the relative price of investment goods that began in the early 1980s. That drop may be down to the plunging cost of computing, or to the ▸▸

CIBC World Markets Inc.

Chart 1

Business Owners Getting Older



Source: Statistics Canada, CIBC

What happens to capital accumulated by founders?

- Canadian succession crisis?
- 310,000 owners will exit in next 5 years

- "…Next 5 yrs CDN$1.9 trillion in business assets will change hands-the largest turnover of economic control on record"

- Old money in Boston: "In the next 50 years, approximately $1.25 trillion is expected to pass from one generation to the next in Greater Boston alone.."(The Boston Foundation, 2006)

How does founders capital become “dead money”?

- Successors less capable, more risk, loss averse, underperform founders (Miller et al, 2006)
- Successors less innovative, entrenchment (Morck et al, 2000)
- Capital progressively divided: loss of scale, inefficiency
- Capital transferred into the hands of individuals who consume it (spendthrift children) or *agents who have neither ability nor incentive to keep it in productive use*.

• Intergenerational wealth strategy: How can founders & society keep capital ‘alive’ in the hands of those with ability & incentive to keep it in productive use?

My storyboard…

Dynastic intent of founders of large fortunes

Realization depends partly upon

Institutional context
- Law
- Politics
- Tradition/Custom

Normative social order

As manifested in:

- Succession & FF Longevity
- Surrogacy: Role of fiduciaries, Trusts, MTAs, Family Offices

Contribution:

Comparative institutional analysis of succession & surrogacy

Law & FF Longevity

- Law & Finance literature (La Porta et al)
  - Life-cycle hypothesis, availability of external finance enables FFs to dilute…
- Contract law (Gilson, 2007)
  - Potentially infinite life hypothesis: weak commercial law ffs are long-lived repositories of reputation
- Inheritance law
  - Inherited wealth hyp: (Morck, Strangeland & Yeung, 2000) Billionaires who inherit characterized by low growth & entrenchment

Inheritance law is understudied & highly variable across jurisdictions

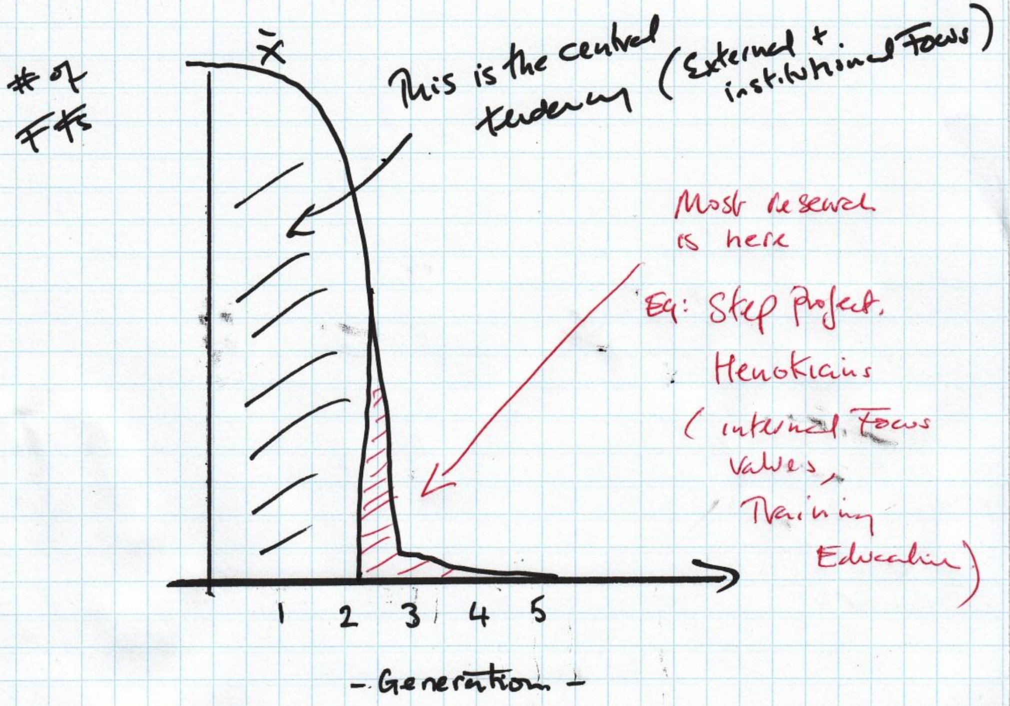
1. Testamentary freedom: the right to bequeath
2. Entailing: modern trusts are functional equivalent of *en tail* property rights
3. Intestacy law: reflects normative order
4. Death & taxes: estate & inheritance taxes

Table 1—Inheritance Law Permissiveness and Investor Protection Around the World

Country	2 children, no spouse (1)	3 children, no spouse (2)	1 child, with spouse (3)	2 children, with spouse (4)	3 children, with spouse (5)	Anti-director index (6)	Self-dealing index (7)	Median number of children of firm owners (8)
Panel A. Countries included in the estimation								
Argentina	0.667	0.556	0.667	0.556	0.5	2	0.34	—
Australia	1	1	1	1	1	4	0.76	—
Austria	0.75	0.667	0.833	0.667	0.611	2.5	0.21	2
Belgium	0.667	0.5	0.5	0.333	0.25	3	0.54	2
Brazil	0.75	0.667	0.75	0.667	0.625	5	0.27	—
Canada	1	1	1	1	1	4	0.64	—
Chile	0.75	0.667	0.75	0.625	0.6	4	0.63	—
Colombia	0.75	0.667	0.5	0.375	0.333	3	0.57	—
Denmark	0.75	0.667	0.833	0.667	0.611	4	0.46	2
Finland	0.75	0.667	1	0.75	0.667	3.5	0.46	—
France	0.66	0.5	1	0.66	0.5	3.5	0.38	2
Germany	0.75	0.667	0.75	0.667	0.625	3.5	0.28	2
Greece	0.75	0.667	0.875	0.688	0.625	2	0.22	2
Hong Kong	1	1	1	1	1	5	0.96	—
Iceland	0.667	0.556	0.778	0.556	0.481	4.5	0.24	—
India	1	1	1	1	1	5	0.58	—
Ireland	1	1	0.667	0.667	0.667	5	0.79	—
Israel	1	1	1	1	1	[illegible]	0.73	—
Italy	0.667	0.556	0.667	0.5	[illegible]	[illegible]	0.42	2
Japan	0.75	0.667	0.75	0.625	[illegible]	[illegible]	0.5	—
Mexico	1	1	1	1	1	[illegible]	0.17	—
Netherlands	0.75	0.667	0.75	0.667	[illegible]	[illegible]	0.20	2
New Zealand	1	1	1	1	1	[illegible]	0.95	—
Norway	0.667	0.556	0.75	0.417	0.305	3.5	0.42	—
Peru	0.667	0.556	0.667	0.556	0.5	3.5	0.45	—
Philippines	0.5	0.333	0.5	0.333	0.25	4	0.22	—
Portugal	0.667	0.556	0.667	0.542	0.472	2.5	0.44	—
South Africa	1	1	1	1	1	5	0.81	—
South Korea	0.75	0.667	0.7	0.643	0.611	4.5	0.47	—
Spain	0.833	0.778	0.667	0.5	0.444	5	0.37	2
Sweden	0.75	0.667	1	0.75	0.667	3.5	0.33	3
Switzerland	0.625	0.5	0.75	0.5	0.417	3	0.27	2
Taiwan	0.75	0.667	0.75	0.667	0.625	3	0.56	—
Thailand	1	1	1	1	1	4	0.81	—
UK	1	1	1	1	1	5	0.95	2
USA	1	1	1	1	1	3	0.65	2

Absolute Freedom

Mandatory inheritance



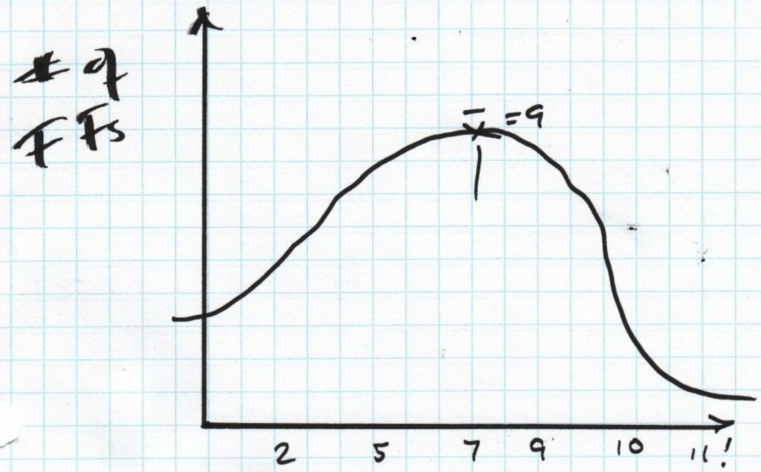
Left censoring in Succession Research

IBV-based view of FF longevity

- Much succession research has an internal focus: best governance, succession planning
- How do legal inheritance institutions moderate dynastic preference & succession outcomes?
- Comparative institutional analysis:
  - Persistence: FFs continue unchanged
  - Mortality (FF lose vigor, divide, fail)
  - Revitalization (FF divide & regenerate)
  - Transform (separation of ownership & control)


Ahr
Mosel-Saar-Ruwer
Rheingau
Franken
Rheinhessen
Nahe
Pfalz
Baden

– German Vinyards –



– Generation –

Most Vinyards Founded in 15/16th Century + still in same Family, some in 11th century!

Most Vinyards are Small $\bar{x}$ 7-5 Employees
21 Acres
100k litres production p.a.

Why so long lived as FFs?

An Institutional explanation of longevity?

- **Anerbenrecht-**
- Feudal right to inherit an undivided farm, made positive law in 19th century in many German States, intended to protect the “whole house.”
- Unsatisfactory explanation for family succession non-agricultural, industrial family firms

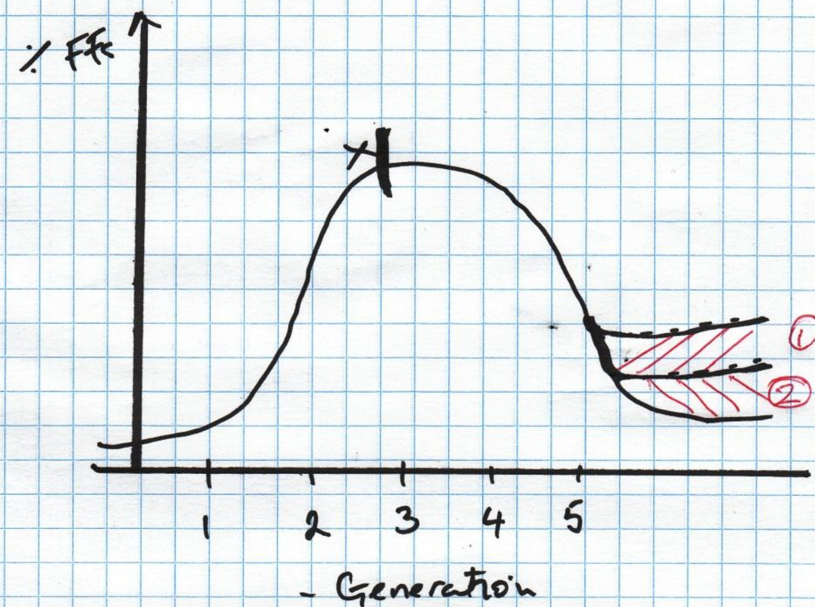
Asset divisibility and heritability

- Immovables/land/farms: heritable and divisible but division leads to unproductive diseconomies of scale
- Financial capital: heritable and divisible
- Intangible assets (e.g. reputation): at best partially heritable and indivisible

Germany’s long-lived Mittelstand

- Two Germanys: MS decentralized industrial order …not peripheral or dependent. It was a different viable, self reproducing system of industrial production within the German economy (Herrigel, 2000:114)
- MS a middle rank, a desirable social class, neither urban working poor nor wealthy landed estate owners living off rents. “Person of solid and legitimate wealth” (Berghoff, 2006: 264)
- 90% in business-to-business markets, 70% based in small towns and rural areas, largely self financing, deep embeddedness in local communities (Pichet & Lang, 2006)
- ‘Hidden champions” (Simon 1996, 2007)… pocket-size multinationals, with revenues of less than €800 million, focused on niche markets, unique organization cultures close relationships with suppliers and customers, 95% family films
- homage and duty to the family heritage …raison d'être is not maximizing short-term profits but securing the company's existence for the next generation (Berghof, 2006:273)

Persistent
Mittelstand



High levels of FF succession

in 20^{th} century (Berghoff)

#1 Post WW Male deficit = Spouse/Extended
Family succession

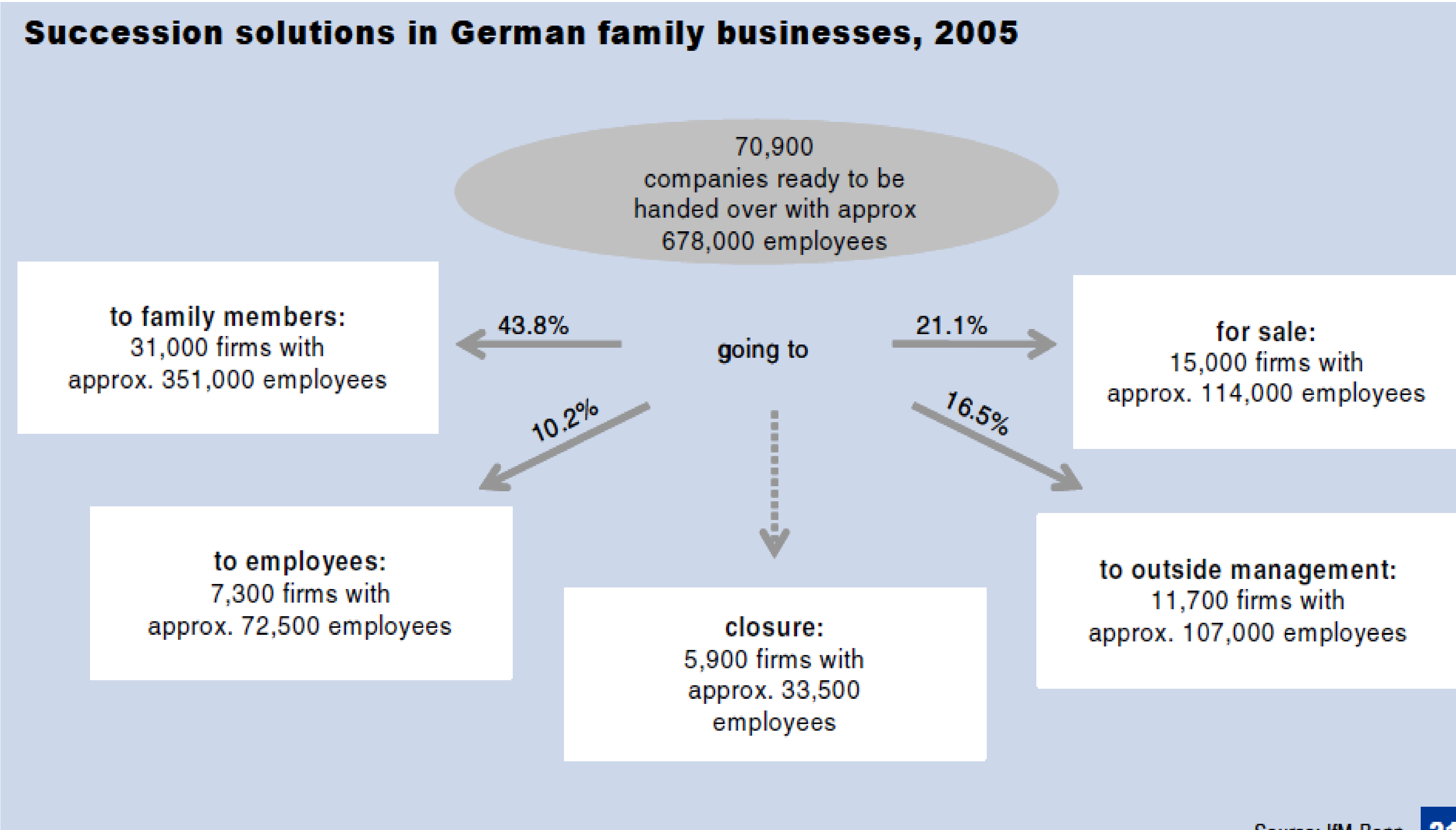
#2 Very low Birthrate = Sales ≠ FF
but...
Sales often to other, local Families!!

German inheritance law institutionalizes "sense of the family”

- Limited testamentary freedom: Germanic law automatically installed the surviving family members as heirs and did not know the individual disposition over property (Beckert, 50)…
- Late abolition of Entailing, Fideikommisse persists until (1946): The prevailing view, not merely an instrument to preserve aristocratic power but the idea of family continuity (Beckert, 147)
- Intestacy law: protects spouse & children, “reveals the profound importance of the family principle based on blood kinship” (Beckert, 90)
- Inheritance tax.. the reference point for the debates on inheritance taxes continues to be family wealth and the extent to which it contributes to providing for surviving family members…
- Evolution 2009 Mittlestand provisions
  - “inheritance tax single objective was to ensure company's long-term survival and maintain employment. Inheritance taxes can be partially or totally exempted depending on what commitments heirs make when they inherit. ..15% inheritance tax but heirs must agree to maintain the company's activities for five years without undertaking any major redundancy program”

Are Germany's Mittelstand an endangered species?
(Deutsche Bank Research 2007)

- "The succession gap Is a chimera"
- The future is bright for the mittelstand on a long-term timeline



Mid-sized companies (1): France

Why doesn't France have a Mittelstand?

PARIS

Envy of Germany's medium-sized family firms sparks a desire to emulate them

THE word *Mittelstand* has no exact equivalent in French but has a clear enough meaning: as the euro crisis eats away at the confidence and success of France's big national champions, emulating Germany's medium-sized, mostly family-owned businesses is seen as the way to boost French growth, jobs and exports. The *Mittelstand* has become an ambition. What is not clear is how far the French can achieve it.

This week they unveiled their big effort to do so. François Hollande's government announced a new bank, merging various bodies set up by the previous administration to steer finance (public and private) into middling firms. The new Banque Publique d'Investissement (BPI) looks very like Germany's venerable KFW (Kreditanstalt für Wiederaufbau), the reconstruction bank set up after 1945.

Characteristically, the French in their centralising way are latching on to the only bit of the German system that has anything to do with the federal government. The heart of the *Mittelstand* miracle lies not in Berlin but under the rolling fields of the German *Länder* (states).

By sticking to their knitting and improving efficiency, the French believe, German firms have prospered in specialised markets, earning good margins which finance more innovation and produce a virtuous circle. In contrast, despite their strength in consumer industries such as fashion, food and drink and in high-tech nuclear and aerospace, France's large companies have been left behind since 2000.

Strictly, a *Mittelstand* firm has fewer than 500 employees and turnover of less than €50m ($66m), though in practice the term also applies to larger firms. It took France until 2008 to come up with its own term for *Mittelstand:* ETI (*entreprises de taille intermédiaire*), which means in-between-sized firms: ie, bigger than small businesses but not giants. Most ETIs have between 250 and 5,000 employees and a turnover of up to €1.5 billion. According to a study by Ernst & Young, a business-services group, there are twice as many such creatures in Germany as in France.

But for Ludwig Erhard, the economics minister who crafted West Germany's post-war revival, the *Mittelstand* was never just about numbers. "It is more an expression of a state of mind and a specific attitude," he wrote in 1956.

Nicolas Sarkozy spent five years as president trying to imbue the French with a similar attitude. His idea was to create a state-backed fund, the Fonds Stratégique d'Investissement (strategic investment fund, or FSI), to support companies—large, medium and small. The fund is now being subsumed into the new BPI. So far it has invested over €7 billion, taking minority stakes alongside private investors in more than 1,800 businesses. Last week it published a study looking at why medium-sized firms in France lag those in Germany.

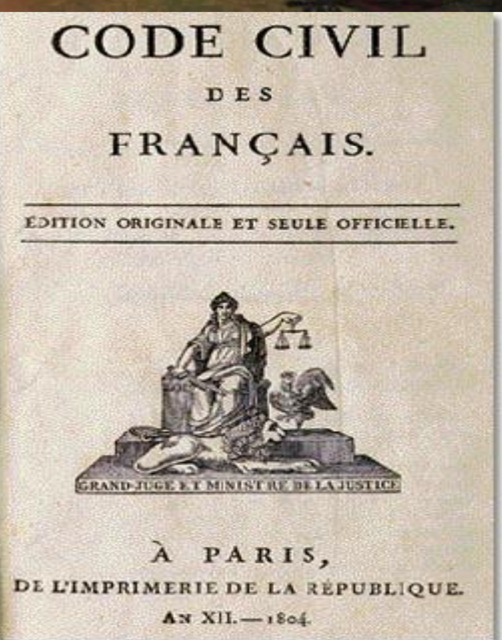
L'état le veut

History provides part of the answer. The term *Mittelstand* originally referred to artisans who flourished in the 19th century. But it was Germany's post-war economic settlement that consolidated the position of middling firms. In 1945 Germans started reconstruction with a distaste for big business, which was tarred by association with the Nazi regime. The division of the country further helped regional smaller firms. Siemens and Daimler, big firms ousted from Berlin, breathed life into Bavaria and Baden-Württemberg, hotbeds of the *Mittelstand.* In contrast, France went in the opposite direction. Private firms left basic industries and capital goods to Germany and competed with Italy in consumer goods, while the state built up national champions in then-emerging sectors such as nuclear power and aerospace.

This history helps explain the different roles of the state. Guy Maugis, chairman of the Franco-German chamber of commerce, points out that when France wants to do something to improve competitiveness it starts with top-down decisions in Paris; the new bank is a case in point. *Mittelstand* firms, by contrast, look to their regional governments and regional banks for support. Studies have identified attachment to the local area and close connections with these banks as factors in their long-term development.

But history and traditions of government are not everything. Jean-Daniel Weisz, one of the report's authors, compares the way German firms and their French counterparts operate. French middling companies, he says, have twice as many layers of management between the boss and the shop floor: usually 18, compared with a German maximum of nine. German firms also pay more attention to their supply chains, he argues, taking managers from their suppliers on trade trips to China, for example. This is something French firms rarely do. Germans firms tend to promote specialists, technicians who know the answers to precise technical questions, whereas French firms promote from an elite cadre of generalist engineers.

Some of these German management practices can doubtless be copied. Layers of management can be stripped out, different people promoted. But the weight of history and governing traditions cannot so easily be shifted. Consider France's efforts to help middle-sized firms adopt the German approach of relentless incremental innovation. Jean-Yves Gilet, the chief executive of FSI, is taking his fund out into the provinces and forming public-private partnerships to boost regional companies and help them become leaders in their sectors. But injecting money into little companies is no magic wand. *Mittelstand* firms themselves usually prefer steady growth from retained profits to borrowing. The French (like other would-be *Mittelstand*-mimickers) have a way to go. ■



CODE CIVIL

DES

FRANÇAIS.

ÉDITION ORIGINALE ET SEULE OFFICIELLE.

GRAND-JUGE ET MINISTRE DE LA JUSTICE

À PARIS,

DE L'IMPRIMERIE DE LA RÉPUBLIQUE.

AN XII. — 1804.

Revolution established new inheritance principles
Political goals to strengthen
the democratic foundations
of the Republic through
a balanced distribution of property

- *The quotité disponible*

- *Obligatory portion*

- *Réserve*

Code Civil institutionalized divided inheritance

- *But… Napoleon also reintroduced entails with the majorat* *in a letter to his elder brother Joseph (King of Naples and Sicily, King of Spain) Napoleon wrote*

"Introduce the Civil Code in Naples and at the end of a few years all the fortunes not attached to you will be destroyed and any that you wish to preserve will be consolidated. This is the great advantage of the Civil Code the consolidation of power. For by its means all wealth not in the form of gifts by trust disappears and no great families remain except those you transform into fiefs. That is why I recommend the Civil Code and why I established it".

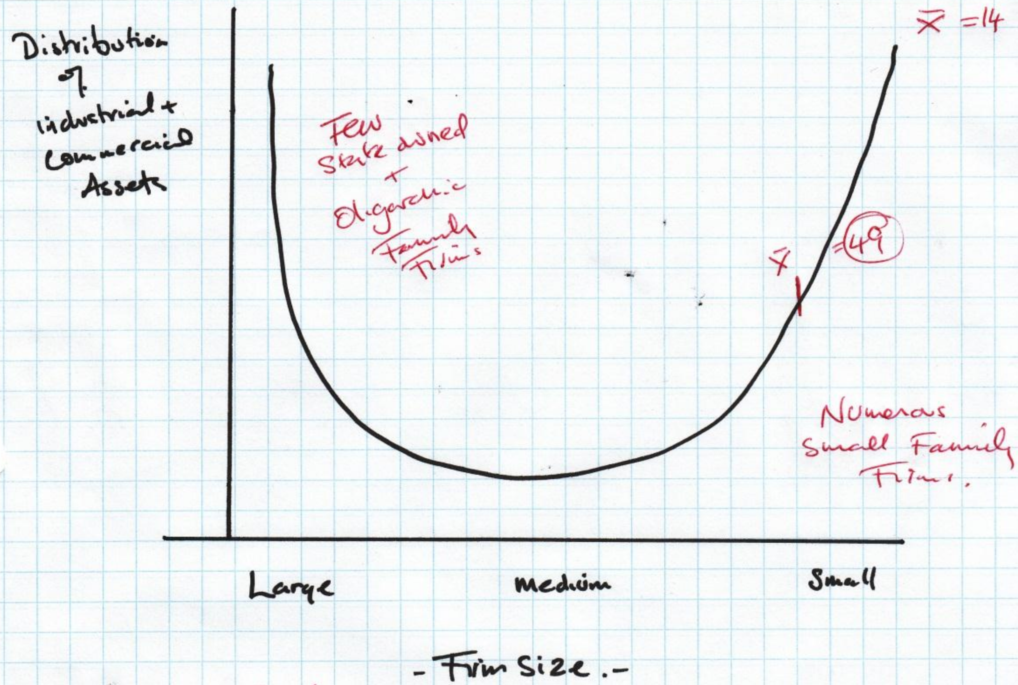
FFs and Politics

- “In countries with French Commercial code large firms are typically controlled by families or the state” La Porta (1999) Corp ownership around the world
- “Countries with French civil code, less external finance, slower firm growth Levine, 1999 . Legal environment, banks and long-run economic growth
- Politically connected firms are significantly more likely to be bailed out than similar non-connected firms (Faccio et al. 2006 JoF)
- Wealthy families and oligarchic family control of the large corporation is associated with... Red tape, price controls, limited shareholder rights family control in large firms... FFs preserve the status quo, increases corruption and entrench wealthy insiders (Fogel, JIBS, 2006)

But… French Inheritance law institutionalizes divided inheritance

- Very limited testamentary freedom: Egalitarian inheritance, “mandatory quotient” the law established in the first Civil Code "exist largely unchanged to this day" (Beckert, 82)
- Entailing: Continuing tension between freedom and equality, highly contested illegal political discourse.. Residual fear of oligarchic families controlling politics. Majorats finally abolished in 1904
- Intestacy law: Based on the principle of equal division and the mandatory portion that had to be bequeathed in accordance with the rules of egalitarian division
- Inheritance tax.. highly progressive… In the mid-1920s... Combined estate tax with high inheritance taxes could amount to a complete confiscation! 1921 law stipulated that inheritance taxes could not exceed 80% of the aggregate inheritance, gradually lowered over the 20th century but remain high!

France's missing middle



* Concentrated Family ownership in France's largest Firms (Franks et al)

* No New entrants to CAX-40 since Founded in 1987.
(Economist, 2012)

Hong Kong’s single generation FFs! 平等的繼承權

- Following succession Public listed FFS in Hong Kong and Singapore lose an average of 56% of their market value within five years… value not recovered in a subsequent time period (Fan, Jian, & Yeh, 2007).
- Organization's subdivide when they are large into more or less separate units each with its own products and markets… complex coordination needed to integrate products research, market research,… is outside the normal range of overseas Chinese business behavior (Redding, 1990: 216).
- Wong (1985) identifies four stages of the Chinese families firm: (Emergent centralized segmented, disintegrative)…
- Younger inheritors… press for the creation of new ventures in which they will be heads, the result is the emergence of distinct spheres of influence and the proliferation of departments, factory plants, and subsidiary companies within the family concern
- Subject to centrifugal forces that lead to their perennial fissioning (Tam, 1991)

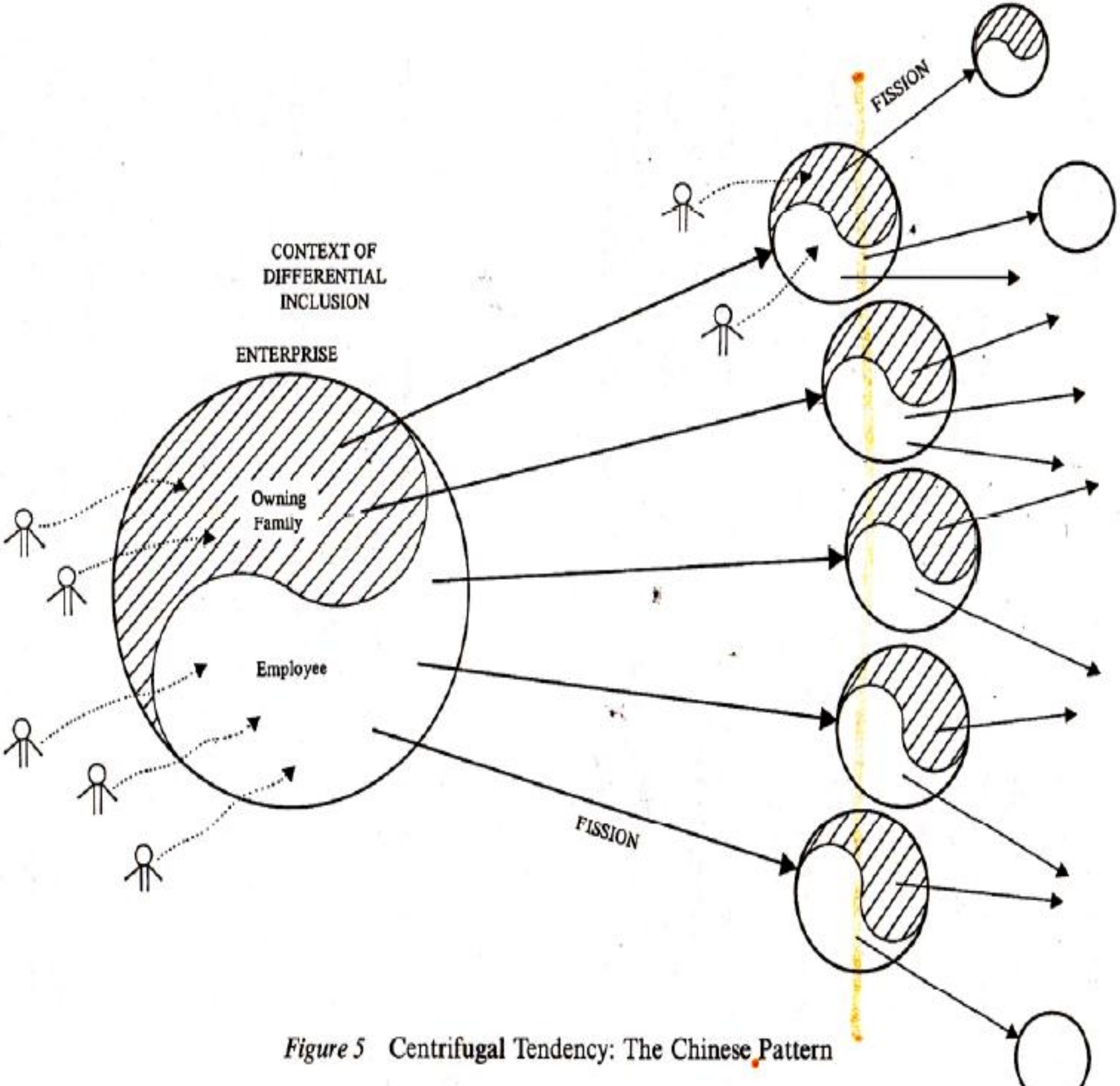
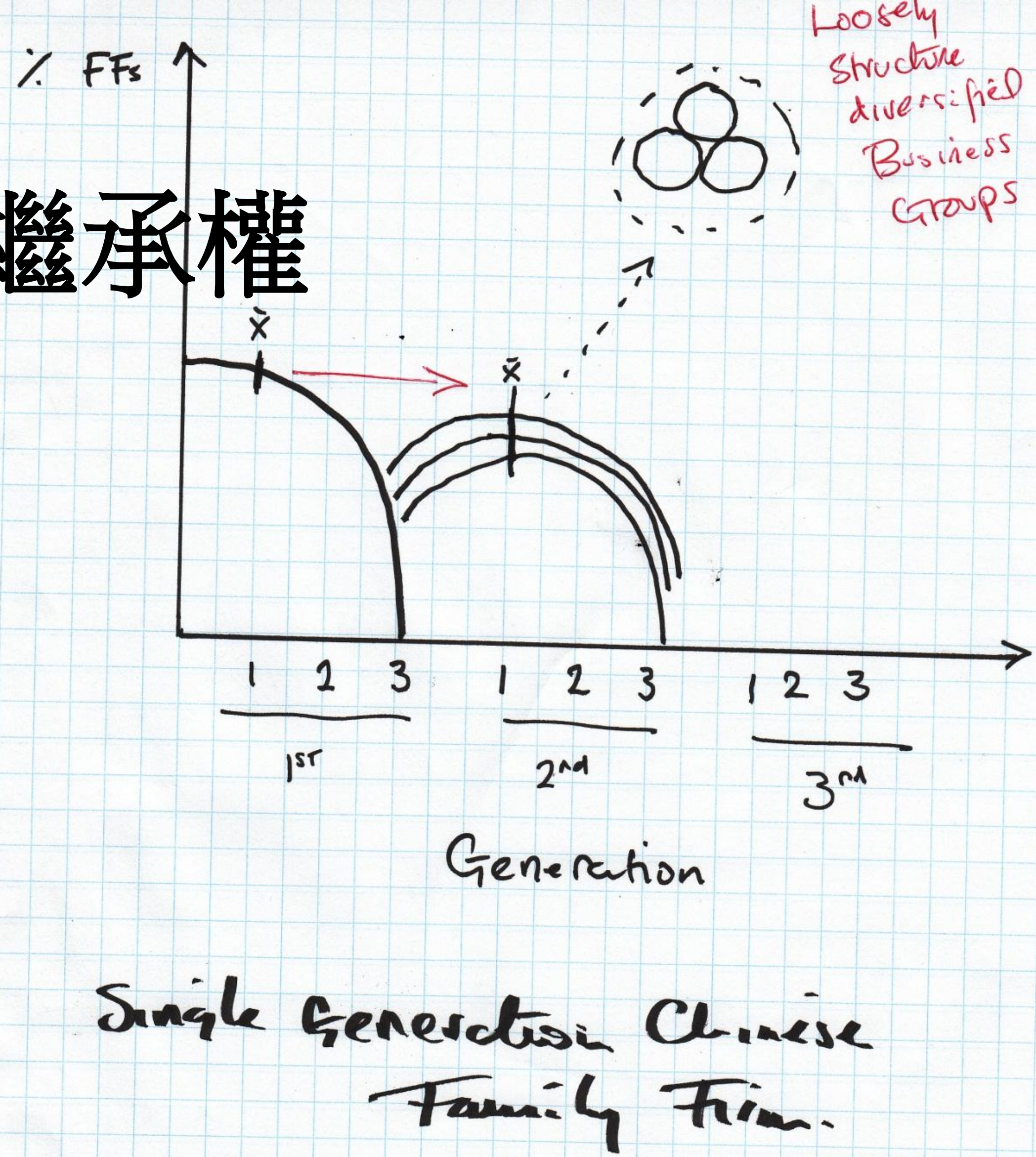


Figure 5 Centrifugal Tendency: The Chinese Pattern

平等的繼承權



% FFs
Loosely structure diversified Business Groups
x̄
x̄
1 2 3
1 2 3
1 2 3
1st
2nd
3rd
Generation
Single Generation Chinese Family Firm.

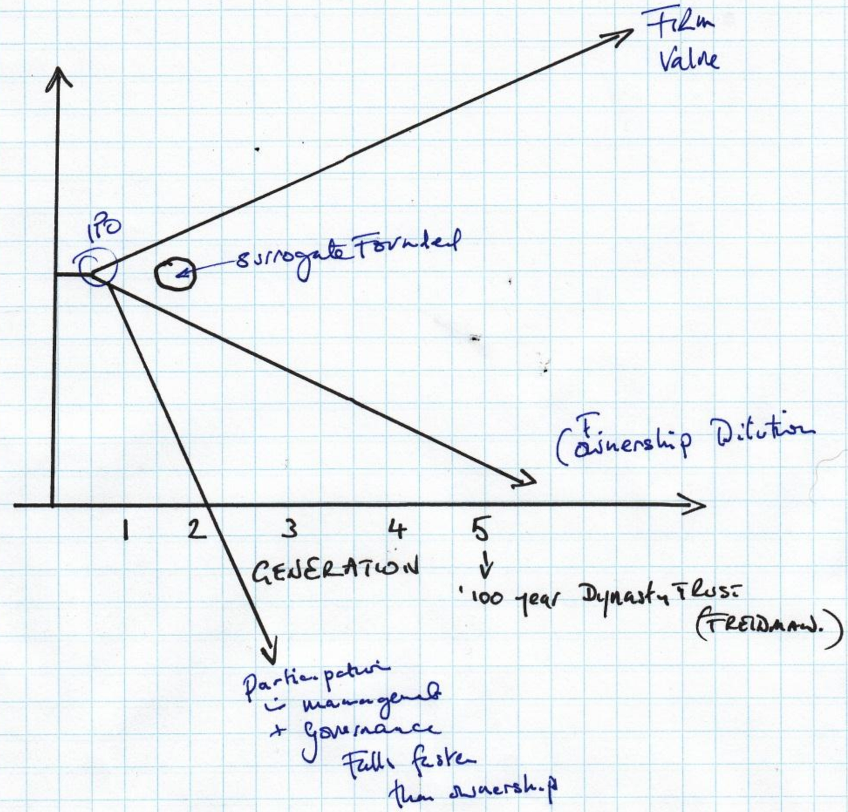
Hong Kong Inheritance law institutionalizes partible inheritance among sons

- English common law with continued applicability of Chinese customary law of partible inheritance
- Absolute testamentary freedom:
  - “forced heirship” relatively small value set aside for the surviving spouse
  - “In the absence of any specific contractual restraints or conditions of grant affecting a property, the owner of property in Hong Kong is free to dispose of it in whatever manner he sees fit, either during his lifetime or by will”
- Intestacy law: based on partible inheritance
- Entailing: Trusts in Hong Kong! Frequent estate litigation, if probate not granted then laws of intestacy apply!
- Estate & Inheritance Tax: None

Capital is divided but money doesn't die!

- Industrial power is released by atomistic firms … organized in constellations" (Tam, 1991: 71)
- "An abundance in the supply of well-equipped, well rounded entrepreneurial talent is evident in Hong Kong.. "There is a constant renewal of very conservative firms… system is continually given new leases of life because of fission and refusion… The creativity of divisiveness… in the Chinese case is a virtuous circle. It is virtuous because it constantly revitalizes the system as a whole and prevents ossification. (Tam, 1991: 174-175)
- Intensive emphasis on transmitting human & social capital (Zhang, 2010)

U.S.A. (+ other common law countries)



P-A problem Seperation of ownership and Control!

Surrogate P.A issues! Not well investigated!

USA inheritance law institutionalizes individual rights

- Unlimited testamentary freedom
- Abolished entailing 1776, common law allowed for the establishment of trusts…
- But trusts limit the rights of individual beneficiaries.. Solution is rule against perpetuities!
- Century long dynastic trust
- Death tax: 1935-1990 very progressive estate tax, abolished in 2000!

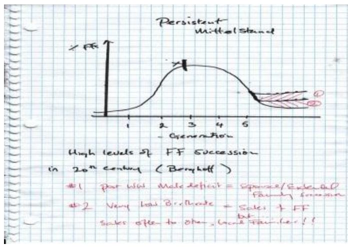
Law & family business in the US

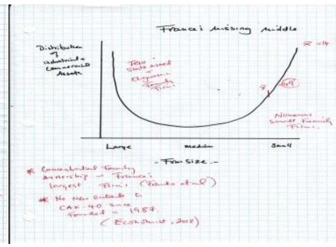
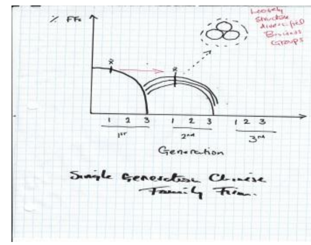
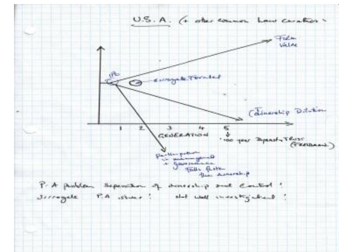
- Inheritance law establishes the principle of individual rights
- Strong laws protect minority investor rights & ensure liquid capital markets... And its founders to dilute.
- Permits double separation of ownership and control
- Law allows creation of a two types of surrogate
  - 1) highly specified estate plan, mechanically dictates the allocation of assets
  - 2) appointment of a trustee; with a fiduciary duty to beneficiary, fiduciary has right of title

Surrogates as fiduciaries

- "Once legally constituted the surrogate takes on a life of its own.. " (Marcus, 1992)
  - MTAs
  - Dynastic trust instrument
  - Family holding company
  - Family office
  - Private equity, Wealth Management Industry
- How do fiduciaries facilitate the productive transmission of family capital? Source of SEW
- Gatekeepers (Coffee, 2006) that exist in an unseen world
- Potential principal agent problem between the beneficiary and the fiduciary (Stinchcombe, 1986)..
- Obama administration is intent on uncovering

Summary: Comparative institutional analysis of FF longevity



Germany	France	Chinese family business	US
Persistent mittelstand	France missing middle	Single generation entrepreneurs	Transformation
Law preserves family property	Law fragments family property	Law enables rapid fragmentation	Law allows for the double separation of ownership and control
Small medium size firms become part of a local community	Medium-sized family firms fail to materialize	Small and medium-size firms spontaneously regenerate	Surrogates proliferate in different types of trust
Capital stays alive	Capital divided	Capital stays alive	Capital preservation over capital generation