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ORIGINAL ARTICLE

Expropriation mechanisms, corporate governance, and cross-border acquisitions by Indian firms

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Abstract
Research regards related party transactions (RPTs) and control-ownership divergence (wedge) as expropriation mechanisms manifesting severe agency conflict in emerging markets. Since corporate governance greatly influences firms' investments and strategic behavior, this study examines how different RPTs and the wedge affect cross-border acquisition (CBA) size and returns. In line with agency theory, opportunistic RPTs like loans/guarantees reduce CBA returns. However, operating RPTs are positively related to returns as the market seems to link these RPTs with benefits to firms. The CBA performance of wedge firms varies with RPT types. While loans/guarantees by wedge firms reduce returns due to combined tunneling incentives, operating RPTs impact returns positively, reflecting more economic benefits in wedge firms. The wedge or RPTs are also positively related to CBA size. But increased tunneling incentives restrain wedge firms that give loans/guarantees from large CBAs. Finally, family firms or large group affiliates that provide loans/guarantees or sustain the wedge reduce returns yet make larger CBAs. Overall, agency costs of expropriation mechanisms depend on RPT types and receive further impetus in family firms or group affiliates with extensive intra-group linkages.

Keywords Corporate governance · Related party transactions · Control-ownership divergence · Tunneling · Cross-border acquisitions · India

Introduction

Extant research links related party transactions (RPTs) with value misappropriation, as several scams, even in India, have stemmed from the abuse of RPTs. RPTs illustrate poor corporate governance in firms (Balsam et al. 2017; Gordon et al. 2004; Kohlbeck and Mayhew 2004; Utama and Utama 2014a,b). But not all RPTs are value-destroying (Kohlbeck and Mayhew 2010). The double-edged nature of RPTs has led to mixed evidence (Moscariello 2012) and policy dilemmas in past research. For example, loans/guarantees are a more detrimental RPT type than beneficial operating RPTs (Fooladi and Farhadi 2019), but rules apply equallyto both. Naturally, strict regulation on RPTs has invited criticisms for hurting legitimate businesses. Similar to the case of RPTs, Indian laws have also restricted dual-class stocks due to the link between the control-ownership divergence (wedge, hereafter) and investor expropriation (Claessens et al. 2002). Recent calls by entrepreneurs and industry bodies to dilute this law have subjected regulators to immense pressure. Just as helpful as it is to identify value-reducing RPTs for a better balance in law, policymaking should evaluate wedge firms' incentives to make RPTs. I examine agency conflict behind wedge and moral hazard in RPTs to study how these twin mechanisms interact to impact cross-border acquisition (CBA) size and returns.

Corporate governance impacts strategic choices like CBAs (Strange et al. 2009). These CBAs entail large undiversifiable risks and higher complexity than domestic M&As (Hitt et al. 2009) that a controlling owner may desist from due to risk aversion. Information asymmetry, long-term nature, complexity, and sizeable risks of CBAs can foster agency conflict in a controller's decision (Michael & Pearce 2004; Strange et al. 2009). I draw upon the thesis that governance deficit may drive overinvestment in bad acquisitions (e.g., large-sized or wealth-reducing CBAs) (Jensen 1986; Masulis et al. 2009). Past works have studied the value effects of M&As by firms with a wedge (Buysschaert et al. 2004; Holmen and Knopf 2004; Faccio and Stolin 2006) or

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