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How Reported Board Independence Overstates Actual Board Independence in Family Firms: A Methodological Concern

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How Reported Board Independence Overstates Actual Board Independence in Family Firms: A Methodological Concern

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ABSTRACT

Despite successive codes of best practice of France, Germany and the UK highlighting the importance of the independence of non-executive directors, the codes tend to ignore the links that directors of family firms might have with the controlling shareholders. This is of particular concern for firms with concentrated family control as the risk of minority shareholder expropriation is greater for such firms. This paper proposes a new measure of board independence for family firms. Using a sample of listed French, German and UK family firms with an incumbent family CEO due for re-appointment or replacement over 2001-2010, we show that our measure of board independence is significantly lower than reported board independence. In contrast to reported board independence, our measure is a good predictor of

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the type of new CEO succeeding the incumbent CEO. Our results suggest that conventionally defined, or reported, board independence is biased and fails to provide investors, including minority shareholders, with an accurate measure of board independence. This conclusion has important policy implications for regulators and best practice in corporate governance.

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1

Introduction

Boards of directors, and more specifically independent directors, are now widely regarded to be a key governance mechanism (Baum, 2017)[1]. However, it remains unclear, especially for companies with dominant shareholders, how to measure board independence. Indeed, conventional board independence, as reported in annual reports or defined in the literature, does not measure independence of directors from controlling shareholders. Importantly, the independence of these directors, who are stated on paper as independent, may be compromised by their links to the controlling family. Such links may potentially result in minority shareholder expropriation, whereby the controlling shareholder extracts private benefits of control[2] from the firm with the support of the so-called independent directors (Villalonga and Amit, 2006). In what follows, a family firm is defined as a firm whose largest shareholder

[1]See also Judge and Talaulicar (2017) for a comprehensive review on the boards' involvement (and their importance) in the strategic decision-making process.

[2]Extraction of private benefits of control at the expense of minority shareholders can be through e.g. special dividends, excessive compensation and tunnelling activities (Anderson and Reeb, 2004). The controlling family may also pursue non-economic objectives such as maintaining control over the company, firm survival, financial independence and/or family harmony, to the detriment of nonfamily stakeholders' interests (Jones *et al.*, 2008).

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is a family, owning at least 25% of the votes, and whose CEO is a family member.

Given the importance of board independence as a key corporate governance mechanism to mitigate minority shareholder expropriation (Anderson and Reeb, 2003b), it is crucial that directors reported as independent are truly independent. This issue has received limited attention in the codes of best practice and also the literature where the primary focus has been on the links that directors may have with the firm and/or its management. Affiliations with the controlling family are often ignored and the measures used for board independence are greatly influenced by methodological convenience. Therefore, we propose a measure adjusting board independence vis-à-vis the controlling family shareholders. We call this measure *de facto* or adjusted board independence.

We study board independence in French, German and UK listed family firms. We focus on these countries because of their distinct legal and corporate governance systems. While investor protection is strong under UK common law, it is much weaker under French and German civil law. Ownership and control are much more concentrated in France and Germany compared to the UK and the three countries also differ in terms of their board structures (see Ansari *et al.*, 2014 for more details).

Our contribution to the literature is both methodological and empirical. There is a lack of methodological consensus as to how board independence should be measured in family firms. This paper highlights the magnitude of this issue and proposes a measure that can be used by academics to ensure a more robust research design and improve the reliability of their results. Equally, practitioners can use our measure of *de facto* independence when assessing a family firm's governance quality. Our results suggest that indeed the *de facto* measure of board independence is significantly lower than reported board independence. Finally, and in contrast to reported board independence, our measure is a good predictor of the type of CEO successor in family firms.

The remainder of this paper is organised as follows. Section 2 reviews the literature on the influence of ownership and control of families in their firms, with particular focus on the CEO succession decision. We postulate that the choice of the CEO successor in family firms is

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determined by important corporate governance characteristics of these firms, the key determinant being correctly measured board independence. The discussion in this section is critical to support and develop our proposed measure of board independence in family controlled firms. Section 3 focuses on directors' independence. This section begins with a discussion of the recommendations regarding board independence in the codes of best practice of France, Germany and the UK. This is followed by a review of the literature and the motivation for adjusting directors' independence. Next, we present our methodology for the adjusted measure in Section 4, followed by a discussion of the observed differences between conventional and adjusted board independence in Section 5. Finally, Section 6 concludes.

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