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Commitment or entrenchment?: Controlling shareholders and board composition

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Abstract

This paper examines the determinants of board composition and firm valuation as a function of board composition in Taiwan – a country that features relatively weak protection for investors, firms with controlling shareholders, and pyramidal groups. The results suggest that there is poor governance when the board is dominated by members who are affiliated with the controlling family but good governance when the board is dominated by members who are not affiliated with the controlling family. In particular board affiliation is higher when negative entrenchment effects – measured by (1) divergence in control and cash flow rights, (2) family control, and (3) same CEO and Chairman – are strong and lower when positive incentive effects, measured by cash flow rights, are strong. Moreover, relative firm value is negatively related to board affiliation in family-controlled firms. Thus, the proportion of directors represented by a controlling family appears to be a reasonable proxy for the quality of corporate governance at the firm level when investor protection is relatively weak and it is difficult to determine the degree of separation between ownership and control.

JEL classification: G30; G32; L22
Keywords: Board composition; Ownership; Control; Corporate governance

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1. Introduction

Is corporate board structure indicative of corporate governance in firms with concentrated ownership? Does shareholder concentration allow controlling shareholders to select board members that are more likely to monitor or provide expertise? Or does shareholder concentration allow controlling shareholders to select board members that enable them to expropriate wealth from minority shareholders? Does the independence of the board appear to matter in firms with concentrated ownership? These are important questions that have not been fully addressed in the literature. Existing studies on corporate boards of directors are generally restricted to large US firms with disperse ownership, and they generally treat board composition as exogenous (see Hermalin and Weisbach, 2003, for a survey). It remains an open question whether results in existing studies can be generalized to firms with controlling shareholders.

Hermalin and Weisbach (1988) argue that understanding how directors are chosen is crucial to understanding the roles the board can play and how effectively it can play them. Existing studies suggest CEOs wield major influence in selecting new board members when ownership is disperse (Mace, 1971; Lorsch and MacIver, 1989; Shivdasani and Yermack, 1999).[1] Moreover, Shivdasani and Yermack find that when CEOs are involved in selecting directors, they choose directors who are less likely to monitor. However, several recent studies suggest that ownership tends to be more concentrated and agency problems tend to be more severe in countries with weaker investor protection (e.g., La Porta et al., 1999, 2000).

On the one hand, concentrated ownership arises when investor protection is weaker to help solve the managerial agency problem because controlling shareholders have the power and incentive to discipline management (e.g., Grossman and Hart, 1988). On the other hand, concentrated ownership creates the conditions for a new agency problem because the interests of controlling and minority shareholders are not perfectly aligned, especially when there is a divergence between control and ownership (e.g., Bebchuk et al., 2000; Claessens et al., 2002). In such instances, corporate boards could play an important role in limiting the power of controlling shareholders to expropriate the interests of minority shareholders by ratifying and monitoring important decisions (Fama and Jensen, 1983). However, board composition is likely to be influenced by controlling shareholders in such instances. Therefore, a firm's board structure could serve as an important indicator of whether the controlling shareholder is committed to good corporate governance or is entrenched.

This paper contributes to both the literature on corporate boards and the literature on ownership structure. As mentioned previously, existing studies on corporate boards generally focus on US firms with disperse ownership. On the other hand, cross-country studies on firms, which are predominantly characterized by concentrated ownership structures, have not yet examined the role of corporate boards. For example, Claessens et al. (2002) find that relative firm value increases with con-

[1] The average (median) CEO ownership in Shivdasani and Yermack (1999) is 2.7% (0.4%).