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Dominant shareholders, corporate boards, and corporate value: A cross-country analysis ☆

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Abstract

We investigate the relation between corporate value and the proportion of the board made up of independent directors in 799 firms with a dominant shareholder across 22 countries. We find a positive relation, especially in countries with weak legal protection for shareholders. The findings suggest that a dominant shareholder, were he so inclined, could offset, at least in part, the documented value discount associated with weak country-level shareholder protection by appointing an 'independent' board. The cost to the dominant shareholder of doing so is the loss in perquisites associated with being a dominant shareholder. Thus, not all dominant shareholders choose independent boards.

JEL Classification: G30; G34

Keywords: Board of directors; Dominant shareholders; Independent directors; Corporate governance

1. Introduction

This paper is an empirical investigation of the relation between corporate value and board composition in firms with a dominant shareholder. The question addressed is whether a 'strong' board can offset the market value discount in firms domiciled in countries with weak legal protection for shareholders. Such a discount has been documented by Claessens, Djankov, Fan, and Lang (CDFL, 2002), Durnev and Kim (DK, 2005), and La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 2002). This discount is often attributed to the ability of

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a dominant shareholder to divert corporate resources from other shareholders to himself for personal consumption, especially in countries with weak legal shareholder protection. In essence, the question that we address is whether a dominant shareholder could, were he so inclined, increase firm value by appointing a strong board with a mandate of assuring minority investors that he will refrain from diversion of the firm's resources and whether the effect of board composition on firm value, if there is any, is different between countries with weak and those with strong legal shareholder protection.

The studies most closely related to ours are DK (2005) and Klapper and Love (KL, 2004). These studies empirically investigate the relation between firm value and the 'quality' of a firm's corporate governance where the proxies for the quality of governance are two firm-specific indices: the Credit Lyonnais Securities Asia (CLSA) corporate governance scores and the Standard & Poor's (S&P) transparency rankings. As do the other studies cited above, these two report that proxies for Tobin's Q are lower in countries with weak legal shareholder protection. They further report, however, that the value discount is less in firms with higher corporate governance scores. We complement these studies by exploring what role, if any, the composition of the board of directors has in reducing the value discount in firms with a dominant shareholder across countries with strong and those with weak legal shareholder protection.

The premise underlying our analysis goes as follows. Dominant shareholders have an incentive and, in the absence of a countervailing force, the ability to divert corporate resources from other shareholders to themselves for personal consumption. Such diversion reduces the observed market value of the firm. In some instances, however, a dominant shareholder may be willing to reduce his diversion of corporate resources in exchange for an increase in firm value. The most likely instance in which this will occur is when the dominant shareholder wishes to sell equity either on personal account (for diversification or consumption purposes) or through the firm (to undertake positive net present value projects).

The problem for the dominant shareholder is convincing outside shareholders that he will refrain from diverting resources. We investigate whether he can do so by appointing a strong board charged with a mandate of curbing the dominant shareholder's diversion of corporate resources. This proposition raises at least three related questions.

First, can the appointment of a strong board be a deterrent to diversion given that the dominant shareholder can just as easily remove directors as appoint them? In such circumstances, appointment of a strong board would be unlikely to increase firm value. A counter argument is that, at the margin, if replacement of strong directors is costly to the dominant shareholder for any reason, appointment of a strong board could at least ameliorate the loss in value associated with a firm having a dominant shareholder.

That leads to the second question: What incentive does a director have to monitor a dominant shareholder who can replace him? The answer lies in the market for directors. Fama and Jensen (1983, p. 315) argue that "[e]ffective separation of top-level decision management and control means that outside directors have incentives to carry out their tasks and not collude with managers to expropriate residual claimants." The incentive arises because "there is substantial devaluation of human capital when internal control breaks down"(p. 315). Given that a market for outside directors occurs, the failure to monitor implies a loss in human capital for ineffective directors. This argument holds together only so long as a market for outside directors occurs.

The third question is: What power does an outside director have to control the dominant shareholder even if he chooses to be an effective monitor? Outside directors may derive their power legally, contractually, or implicitly. Regarding legal power, Djankov, La Porta, Lopez-de-Silanes, and Shleifer (DLLS, 2007) report that, in 20 of the 22 countries in our sample, boards can be held liable for approving unfair or prejudicial transactions between the dominant shareholder and the firm, but that might not be the primary source of their power. Instead, assuming that directors suffer losses in human capital when they fail to monitor, ex ante, directors will seek assurances, either contractually or implicitly, from the dominant shareholder that they have the freedom to monitor effectively.

Our foregoing discussion frames the issues that we address empirically. We conduct our analysis with data on boards of directors for 799 firms with dominant shareholders from 22 countries. We classify directors as affiliated with the dominant shareholder or independent. We use an expansive definition of "affiliated" such that affiliated directors encompass more than just the executives of the firm and our definition of an "independent" director is narrower than outside directors in which any nonexecutive is typically considered an outside director.