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Independent directors' board networks and controlling shareholders' tunneling behavior ☆

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ABSTRACT

As one of the channels by which board directors build important relationships, board networks can affect the governance role of independent directors. Defining director board networks as their connections based on direct ties they establish when serving on at least one common board, this paper explores the role of the network centrality of independent directors in restraining tunneling behavior by controlling shareholders in the Chinese capital market. Our empirical evidence shows that tunneling behavior by controlling shareholders is negatively related to the network centrality of independent directors and that this relationship is stronger when non-operating fund occupation is used as the measure of tunneling. The results of our study show that board networks can help independent directors to restrain tunneling behavior by large shareholders, which plays a positive role in corporate governance.

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1. Introduction

In the corporate governance field, relations among directors are one kind of social network that cannot be ignored (Conyon and Muldoon, 2006; Engelberg et al., 2012; Fracassi and Tate, 2012). The behavior of directors depends simply not only on their own contacts, but also on the influence of other people's contacts within social networks (Granovetter, 1985). Independent directors not only play a role in monitoring the company, but also play many other social roles, such as serving as company executives, industry association leaders, government officials, university professors and members of a variety of associations. Directors with many social roles naturally have a variety of social network connections, such as through their membership of professional associations, alumni networks and clubs, fellowships, in-law relationships and kinship networks. This paper focuses on one of the unique forms of social networks – interconnections forged among directors of listed companies by serving on at least one common board at the same time – to investigate the governance role of independent directors in China.[1]

Specifically, this paper examines the role of independent director board networks in mitigating agency problems between large shareholders and minority shareholders. That is, whether the network centrality of independent directors pushes them to deter tunneling by controlling shareholders. In comparison with the U.S. and a few countries with characteristics of dispersed ownership, most countries have more concentrated equity ownership (La Porta et al., 1999), and most firms are controlled by one or a few large shareholders. The existence of controlling shareholders gives prominence to agency problems with minority shareholders and tunneling[2] is the most direct form of evidence of controlling shareholders' agency problems that seriously damage the interests of minority shareholders.[3] The tunneling behavior of controlling shareholders in China's capital market hinders its healthy development (Chen and Wang, 2005; Jiang et al., 2010). A series of policies have been issued to restrain tunneling behavior by controlling shareholders. However, these policies have not achieved their goals in practice (see Section 3 for more details). Many tunneling events have occurred in China's capital market to date. Moreover, these events are becoming increasingly serious.[4]

This paper does not examine all types of network relations among directors and is limited to an investigation of the network centrality and governance role of independent directors. There are three reasons for this approach: first, the weak tie and structural hole theories hold that independent directors play the key role in board networks, whereas most inside directors are isolated and their network characteristics are not obvious. Second, most inside directors are also executives, which reduces their monitoring role (Fama and Jensen, 1983). This is especially in China, where the chairman of the board plays a role somewhat similar to that of the CEO in the U.S. (Firth et al., 2007; Ye et al., 2011). Third, due to the mandatory policies on independent directors implemented in China's capital market from 2003 to date, many prior studies find that the average proportion of independent directors is one third, just meeting the CSRC requirement, and that they have no obvious governance role in China. Hence, given this institutional background, this paper only investigates independent director networks and their economic consequences.

Among the various mechanisms designed to prevent controlling shareholders from tunneling in China, governance by independent directors has been one of the key measures since it was introduced for A-shares in

[1] For example, I1, I2 and I3 are three independent directors. I1 and I2 do not serve on the same board, so there is no direct connection between them; however, when I1 and I3 both serve on the board of Company B, and I2 and I3 both serve on the board of Company C, then I1 and I2 are indirectly connected by I3.

[2] The word "tunneling" was proposed by Johnson et al. (2000) to describe the behavior of company controllers transferring the company's assets and profits to further their own interests.

[3] Under certain circumstances, controlling shareholders prop up listed companies. For example, Jian and Wong (2010) find that controlling shareholders prop up listed companies through abnormal related party transactions to reach refinancing standards or avoid delisting. However, they also point out that such propping behavior is accompanied by controlling shareholders transferring listed company funds in the next period.

[4] Based on CSRC data on penalties imposed on controlling shareholders for using listed company funds from 2007 to the end of 2010, we find that such penalties were imposed in relation to 30 listed companies (involving 80 year-observations). During this period, the number of penalty observations for the use of company funds by large shareholders was still 38 in years after 2007, accounting for 23% of all such observations between 2000 and 2010.