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Board structure, controlling ownership, and business groups: Evidence from India☆

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ABSTRACT

We examine the impact of controlling founder ownership (CS) and business groups (BGs) on firm board structure for Indian firms, where most of the firms are inter-connected. We argue that due to inadequate legal protection, CS and BGs should influence the board structure of Indian firms. Our empirical evidence finds a U-shaped relationship between board independence and CS. We show that firms affiliated with business groups have lower board independence compared to standalone firms. We also find that investors value CG reforms related to board independence.

1. Introduction

The role of firm boards as an important internal control mechanism is well established in the finance literature. Consequently, in a diffused ownership context, such as the USA and the UK, determinants of board structure have received extensive attention both in the policy discussion on corporate governance as well as in academia (Raheja, 2005; Harris and Raviv, 2008; Adams and Ferreira, 2007; Lehn et al., 2009; Boone et al., 2007; Coles et al., 2008; Guest, 2008) We examine determinants of board structure for an emerging nation, India, where concentrated founder ownership (henceforth, controlling ownership) and the prominent role of business groups are two of the most distinct characteristics of firms (Claessens et al.,

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2000). We therefore consider that these characteristics may raise vital questions related to the role of the board in ensuring adherence to corporate governance mechanisms,[1] because these characteristics are norms rather than exceptions for emerging markets.

We develop two arguments pertaining to controlling ownership. The first argument is related to the alignment effects. Concentrated ownership gives incentives and capacity to a controlling owner to discipline managers, and thus, it mitigates *the principal-agent conflicts* (Davis et al., 1997; Anderson and Reeb, 2003). Therefore, these firms should have a smaller board but strong governance. More explicitly, it should have higher board independence to send a signal to the market that the interests of small shareholders are properly safeguarded (Peasnell et al., 2003). The second argument is associated with the entrenchment effects of controlling owners, originated by a separation of ownership and control. The problem of separation of ownership and control is further exacerbated for Indian firms, where controlling owners control firms more than their equity ownership through cross-holding ownerships (Claessens et al., 2002). In this case, we hypothesize that controlling owners, for expropriation, have incentives to appoint a board of directors that is predetermined to support owners' decisions instead of monitoring them. Thus, controlling owners can recruit a higher proportion of their representatives in firm boards leading to weak corporate governance (less board independence). Overall, an understanding of how board structure is determined in the presence of controlling owners is an important question that needs to be answered. The Indian institutional framework represents an ideal setting to examine this question because it features relatively weak investor protection along with a high controlling ownership concentration—characteristics common to many countries (Claessens et al., 2000).

Furthermore, most Indian firms are owned by business groups. Therefore, even though they are legally independent, they are actually inter-connected through formal or informal means (Khanna and Palepu, 2000). In many cases, controlling owners control firms through complicated pyramidal and cross-holding ownerships. These ownership structures allow controlling owners to own low-equity ownership while retaining tight control of the firm, creating a separation of control and ownership (Burkart et al., 2003). Furthermore, most of these firms are owned by family members, and they play a central role in decision making and are associated with a vibrant internal transfer of resources from one firm to another for private benefits (Friedman et al., 2003; Cheung et al., 2006; Gopalan et al., 2007; Khanna and Yafeh, 2007; Bae et al., 2008). Consequently, minority shareholders suffer because there is a deficiency of transparency shown by managers in handling their concerns (Khanna and Yafeh, 2007). One would thus expect that the role of firm boards is of vital importance in such environments. Nevertheless, to the best of our knowledge, there is no study that explains the impact of business groups on board structure. Hence, an empirical study specific to Indian business groups in terms of its effects on board structure may enhance our understanding of the determinants of board structure.

Using large sample of Indian firms over 2002 to 2012, we find that controlling ownership is positively related to board size. However, this relationship turns negative when the ownership of controlling owners crosses a minimal level of ownership, consistent with the idea that larger boards are considered less effective (Yermack, 1996). We further find a significant nonlinear relationship between board independence and controlling ownership. This curve is initially downward and then moves upward once ownership exceeds a certain threshold. This is consistent with the view associated with the separation of ownership and control. Therefore, ownership beyond a certain threshold increases the incentive for controlling owners to align interests with smaller shareholders, resulting in higher board independence to convey a signal to the market about the commitment of controlling owners.

We next show that business group-affiliated firms have fewer board members and even less board independence compared to standalone firms because the separation of ownership and control is more problematic in these firms due to cross holdings. We also show that while taking a decision with respect to the constitution of their boards, the costs and benefits of a board's monitoring on the firm performance are given due consideration. Our evidence supports that when the external monitoring mechanism is efficient, the internal monitoring mechanism takes a backseat (Dow and Gorton, 1997; Giroud and Mueller, 2011; Ferreira et al., 2011). For instance, firms with high stock price informativeness and high product market competition have

[1] Bhattacharyya (2014) argues that in Indian firms, the controlling shareholder, who enjoys significant power, manages the firm through its nominee managers, and the board has less power in the appointment of CEO, directors and senior management. Therefore, the general perception of independent director fails in India because controlling shareholders appoint directors, including independent directors.