Journal of Corporate Finance xxx (2013) xxx–xxx

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

The determinants of the CEO successor choice in family firms

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ARTICLE INFO

Article history:
Received 16 September 2013
Received in revised form 25 November 2013
Accepted 9 December 2013
Available online xxxx

JEL classification:
G32
G34

Keywords:
Family firms
CEO succession
Corporate governance
Corporate control and ownership

ABSTRACT

This paper studies the factors that influence the CEO succession decision in family firms whose incumbent CEO is a member of the controlling family. The sample includes all such firms from France, Germany and the UK. We propose a new measure of directors' independence, which adjusts for various links with the controlling family. While we find that conventionally defined directors' independence has no impact on the CEO succession decision, our corrected measure reduces the likelihood of the successor being another family member. There is also evidence that firms from France that are cross-listed in the UK or USA are less likely to appoint another family CEO.
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1. Introduction

Bertrand and Schoar (2006) argue that family founders have a long-term view of their firm and have a strong interest in its continuity and survival. In support of this argument, there are many examples of successful and well-known family firms that have stood the test of time and have survived for generations. Such firms include Ford Motor Company, BMW, l'Oréal and Siemens. Conversely, myopia and short-termism are traits frequently associated with widely held firms (see e.g. Franks and Mayer, 1997).

However, family firms face a major challenge when it is time to 'pass on the baton' as the retiring family CEOs often appoint their offspring as successors (Plath, 2008). More specifically, Bertrand and Schoar (2006) argue that the firm's family founders may be subject to 'dynastic thinking', resulting in the top management jobs being filled with their relatives rather than more talented nonfamily managers (Barnett, 1960). Although family members are often not the best candidates for the job, as they may lack proper education and professionalism, they typically have an unfair advantage over outsiders in getting the top jobs in the firm (Schulze et al., 2001). Nonfamily, i.e. minority shareholders' preference for better qualified, nonfamily CEOs may thus clash with the family's desire to extract private benefits of control from their firm.

The literature refers to this conflict of interests as minority shareholder expropriation (see e.g., Maher and Andersson, 2000; La Porta et al., 1997; Denis and McConnell, 2003; Goergen and Renneboog, 2008). This paper attempts to identify the factors that determine the choice of CEO successor in family firms, thereby also identifying the conditions under which the large shareholder's interests may override the interests of the minority shareholders. More specifically, this paper studies this choice in listed family firms in France, Germany and the UK.

Why study these three countries? First, France, Germany and the UK are representatives of the three main legal families (La Porta et al., 1997, 1998), i.e. French civil law, German civil law and common law, respectively. While investor protection is

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http://dx.doi.org/10.1016/j.jcorpfin.2013.12.006

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strong under common law, the law of the UK, it is much weaker under French and German civil law. Second, all three countries have distinct corporate governance systems. In France and Germany, corporate control is highly concentrated whereas in the UK it is dispersed. There is also often a wedge between the control and ownership held by the large shareholder in France and Germany whereas this is not the case in the UK. Further, there are also major differences between France and Germany. In particular, France's corporate governance system has traditionally been characterized by the existence of a 'noyau dur', a system of cross-shareholdings between large quoted companies, some of which are former state-owned banks and insurance companies, that was set up to reduce the influence of foreign ownership on French business (see e.g. Bloch and Kemp, 2001). As a result, and contrary to common wisdom, France is the only country in Europe with substantial equity ownership by banks (15.5% on average of the equity). While Germany is often considered to be a bank-based corporate governance system, ownership by banks is much lower and their influence is typically derived from proxy voting, i.e. from voting the shares of their depositors, in otherwise widely held companies. The three countries also differ in terms of their corporate boards. While the UK has a single-tier board where the executives, including the CEO, and the non-executives sit, Germany has a two-tier board with a supervisory board (*Aufsichtsrat*) where the non-executives and employee representatives sit and a management board (*Vorstand*) where the executives sit. While France gives its firms the choice between a single-tier board and a two-tier board, most firms have opted for the former (Goergen et al., 2006). Hence, we also analyze whether the three countries show differences in the impact of the hypothesized determinants on the CEO successor choice. Our empirical analysis suggests that there are cross-country differences.

This paper makes three major contributions to the literature. First, existing studies on CEO successions tend to focus on widely held firms, which by definition do not have large shareholders, or unlisted family businesses, which typically have no minority shareholders. In contrast, this paper focuses on listed family firms that have both large and small shareholders and may therefore be subject to minority shareholder expropriation, which may manifest itself via the choice of CEO successor. Second and as stated above, this paper studies three very different corporate governance systems. Hence, it provides insights into the determinants of CEO succession decisions across substantially different institutional settings. Third, this paper makes a colossal effort to assess whether so called independent directors are *de facto* independent of the family shareholder. Our results suggest that it is important to measure board independence properly as our measure of board independence reduces the likelihood of a family member succeeding the CEO whereas conventionally defined board independence has no such effect.

The remainder of this paper is structured as follows. Section 2 reviews the literature and formulates the hypotheses. Section 3 explains the sample selection process, the variables and the methodology. The empirical analysis is presented in Section 4 while Section 5 focuses on robustness checks. This is followed by conclusions and policy implications.

2. The determinants of the CEO successor choice

Despite the prevalence of family firms in most countries, research has as yet not extensively investigated the impact of family control and ownership on corporate decision making. On the one hand, some theoretical models predict that strong control, including family control, is likely to mitigate the principal-agent problem, thereby creating shareholder value (see e.g. Admati et al., 1994; Kahn and Winton, 1998). There is empirical evidence on the USA and Germany that family control and ownership generates shareholder value. Anderson and Reeb (2003) report that US family firms in the S&P 500 outperform nonfamily firms. Similarly, Andres (2008) finds that German family firms have superior performance. Conversely, Faccio et al. (2001) find that family firms in East Asia expropriate their minority shareholders via dividends that are too low. On the other hand, Burkart et al.'s (1997) model predicts that, while large shareholder monitoring may be beneficial, the large shareholder may interfere too much with the way the firm is managed, thereby severely reducing executive discretion and destroying firm value. Further, the large shareholder may extract private benefits of control rather than maximize shareholder value.

More generally, the view that strong family ties may impede shareholder value and economic development is not new. Already Weber (1904) argued that strong predictable family values may constrain the development of economic activities, which require more individualistic forms of entrepreneurship and the absence of nepotism. Similarly, Fukuyama (1995) argues that countries whose businesses are dominated by strong family or blood ties, i.e. 'familism', may suffer from reduced economic growth as such ties put limits on the size of firms and the industrial sectors firms operate in.

We posit that there are five determinants of the choice of the CEO successor: family power, family generation, directors' independence, shareholder protection, and past firm performance. These five determinants are discussed in detail below.

2.1. Family power

There are two broad theses on family control: 'competitive advantage' or 'security benefits of control' and 'private benefits of control' (Grossman and Hart, 1980; Villalonga and Amit, 2010). The main difference between the two is the group of shareholders for whom firm value is assumed to be maximized. According to the competitive advantage thesis, value is maximized for all shareholders (Bertrand and Schoar, 2006; Villalonga and Amit, 2010). Grossman and Hart (1980) call this type of value creation via the monitoring the large shareholder performs the security benefits of control. According to the private benefits of control thesis, value is maximized only for the family, who expropriates the nonfamily shareholders (Burkart et al., 2003; Villalonga and Amit, 2010). While the family may create security benefits of control, the private benefits of control it extracts from the firm exceed the latter.

The question arises as to when this is the case. This is likely to be the case when there is a deviation between cash-flow rights and control rights. It is not uncommon for families from all over the world to use mechanisms such as dual-class shares, voting pacts and pyramidal ownership, to enhance their control rights relative to their cash-flow rights (Claessens et al., 2000; Faccio and

Please cite this article as: Ansari, I.F., et al., The determinants of the CEO successor choice in family firms, J. Corp. Finance (2013), http://dx.doi.org/10.1016/j.jcorpfin.2013.12.006

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