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How reported board independence overstates actual board independence in family firms: A methodological concern

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Abstract

Despite successive codes of best practice of France, Germany and the UK highlighting the importance of the independence of non-executive directors, the codes tend to ignore the links that directors of family firms might have with the controlling shareholders. This is of particular concern for firms with concentrated family control as the risk of minority shareholder expropriation is greater for such firms. This paper proposes a new measure of board independence for family firms. Using a sample of listed French, German and UK family firms with an incumbent family CEO due for re-appointment or replacement over 2001-2010, we show that our measure of board independence is significantly lower than reported board independence. In contrast to reported board independence, our measure is a good predictor of the type of new CEO succeeding the incumbent CEO. Our results suggest that conventionally defined, or reported, board independence is biased and fails to provide investors, including minority shareholders, with an accurate measure of board independence. This conclusion has important policy implications for regulators and best practice in corporate governance.

Keywords

Family firms, corporate governance, corporate control, board independence

1. Introduction

Boards of directors, and more specifically independent directors, are now widely regarded to be a key governance mechanism (Baum 2017)¹. However, it remains unclear, especially for companies with dominant shareholders, how to measure board independence. Indeed, conventional board independence, as reported in annual reports or defined in the literature, does not measure independence of directors from controlling shareholders. Importantly, the independence of these directors, who are stated on paper as independent, may be compromised by their links to the controlling family. Such links may potentially result in minority shareholder expropriation, whereby the controlling shareholder extracts private benefits of control² from the firm with the support of the so-called independent directors (Villalonga and Amit 2006). In what follows, family firm is defined as a firm whose largest shareholder is a family, owning at least 25% of the votes, and whose CEO is a family member.

Given the importance of board independence as a key corporate governance mechanism to mitigate minority shareholder expropriation (Anderson and Reeb 2003b), it is crucial that directors reported as independent are truly independent. This issue has received limited attention in the codes of best practice and also the literature where the primary focus has been on the links that directors may have with the firm and/or its management. Affiliations with the controlling family are often ignored and the measures used for board independence are greatly influenced by methodological convenience. Therefore, we propose a measure adjusting board independence vis-à-vis the controlling family shareholders. We call this measure *de facto* or adjusted board independence.

We study board independence in French, German and UK listed family firms. We focus on these countries because of their distinct legal and corporate governance systems. While investor protection is strong under UK common law, it is much weaker under French and German civil law. Ownership and control are much more concentrated in

¹ See also Judge and Talaulicar (2017) for a comprehensive review on the boards' involvement (and their importance) in the strategic decision-making process.

² Extraction of private benefits of control at the expense of minority shareholders can be through e.g. special dividends, excessive compensation and tunnelling activities (Anderson and Reeb 2004). The controlling family may also pursue non-economic objectives such as maintaining control over the company, firm survival, financial independence and/or family harmony, to the detriment of nonfamily stakeholders' interests (Jones *et al.* 2008).

France and Germany compared to the UK and the three countries also differ in terms of their board structures (see Ansari *et al.* 2014 for more details).

Our contribution to the literature is both methodological and empirical. There is a lack of methodological consensus as to how board independence should be measured in family firms. This paper highlights the magnitude of this issue and proposes a measure that can be used by academics to ensure a more robust research design and improve the reliability of their results. Equally, practitioners can use our measure of *de facto* independence when assessing a family firm's governance quality. Our results suggest that indeed the *de facto* measure of board independence is significantly lower than reported board independence. Finally, and in contrast to reported board independence, our measure is a good predictor of the type of CEO successor in family firms.

The remainder of this paper is organised as follows. Section 2 reviews the literature on the influence of ownership and control of families in their firms, with particular focus on the CEO succession decision. We postulate that the choice of the CEO successor in family firms is determined by important corporate governance characteristics of these firms, the key determinant being correctly measured board independence. The discussion in this section is critical to support and develop our proposed measure of board independence in family controlled firms. Section 3 focuses on directors' independence. This section begins with a discussion of the recommendations regarding board independence in the codes of best practice of France, Germany and the UK. This is followed by a review of the literature and the motivation for adjusting directors' independence. Next, we present our methodology for the adjusted measure in Section 4, followed by a discussion of the observed differences between conventional and adjusted board independence in Section 5. Finally, Section 6 concludes.

2. Family ownership and control

“Families are willing to invest in the long-term and undertake sustainable strategies, because they think in generations and not in short-run profits.” (Dr. Ulrich Wacker, CEO of Wacker Construction Equipment AG).

“The only reason I was on the payroll is because I was the son of the boss.”
(John H. Tyson, CEO of Tyson Foods, Inc).

The views on the advantages and disadvantages of family ownership and control of firms, as reflected above, are the subject of an ongoing debate (Bertrand *et al.* 2008; Bennedsen *et al.* 2010). Especially when a family promotes one of its members to replace the incumbent family CEO, the debated question is whether the family successor is truly appropriate for the position or simply a reflection of favouritism due to family ties (Pérez-González 2006). The two theses underlying this debate are the security benefits of control and the private benefits of control. These are based on the group of shareholders for whom value of their investment is assumed to be maximised. According to the security benefits of control thesis, value is maximised for both family and nonfamily shareholders. On the contrary, the private benefits of control thesis advocates that value is maximised only for the family shareholders. That is, whether the controlling family provides a competitive advantage to all shareholders and to the family members or extracts private benefits of control at the expense of other shareholders depends on the legal environment it operates in (La Porta *et al.* 1998; 1999). The remainder of this section discusses the two theses on security and private benefits of control. We provide theoretical grounding and conduct a literature review of theoretical and empirical work on CEO successions in family firms in order to construct the argument that correctly measured directors' independence is the key determinant of CEO successor choice in such firms.

2.1 Theories on family ownership and control

Despite the recent advances of research on family firms there is, as yet, no unified theory for ownership and control in such firms. Established theories of the firm such as

the agency theory³ (Jensen and Meckling 1976) and the resource based view⁴ (Barney 1991) have been applied to family firms while considering the distinctiveness of family control (e.g. Burkart *et al.* 2003). These theories underlie the emerging theses on family control used as a basis for this paper, which fall into two classes of benefits of control: ‘security benefits of control’ and ‘private benefits of control’ (Grossman and Hart 1980; Villalonga and Amit 2010). As mentioned in Section 2, the main difference between the two theses is the group of shareholders for whom firm value is assumed to be maximised. Grossman and Hart (1980) consider the value creation via the monitoring that large shareholders perform, which benefits all of the shareholders, and forming the security benefits of control. In contrast, according to the private benefits of control thesis, value is maximised only for the family, expropriating the nonfamily shareholders (Burkart *et al.* 2003; Villalonga and Amit 2010). Although the family shareholders are in a position to create security benefits of control as well as private benefits of control, nonfamily shareholders would be worse off if the family sought to only maximise value for itself rather than for all shareholders.

Security benefits of control

Security refers to the share of the company, hence, security benefits are the cash flow benefits to the controlling shareholder which are not private, reflected through the market value of the firms’ shares. Such benefits are more exclusive to the controlling shareholder(s) when the firm deviates from the one-share one-vote security structure. Such a deviation is often observed in family firms in Europe but is not exclusive to them. The resource based view (Barney 1991) guides the theoretical development of the security benefits of control created by family shareholders in their firms. Two sets of theoretical arguments can be distinguished under the security benefits of control category. These are control potential, referring to wealth gain achievable through more

³ According to the agency theory (Jensen and Meckling 1976), the primary agency conflict in corporations (i.e. the principal-agent conflict) occurs between dispersed shareholders (the principals) and professional managers (the agents) who are delegated to run the day-to-day activities of the firm on behalf of the shareholders (Berle and Means 1932). The lack of monitoring of the managers by the shareholders and the non-alignment of the interests of the managers with those of the shareholders results in a conflict of interests between the two.

⁴ The resource based view supports the idea that the resources a firm possesses are the primary determinants of its performance, as they contribute to a sustainable competitive advantage for the firm. Resources include all assets, capabilities, organisational processes, firm attributes, information, and knowledge (among others) controlled by the firm that enable it to conceive and implement strategies that improve its efficiency and effectiveness (Barney 1991).

effective monitoring of managerial performance (Demsetz and Lehn 1985; Habbershon and Williams 1999), and long-term profit maximisation, whereby the controlling family wishes to benefit future family generations (Villalonga and Amit 2009).

When management is in the hands of nonfamily managers, control potential refers to the wealth gain achievable through family shareholders conducting effective monitoring of managerial performance (Demsetz and Lehn 1985). It is assumed, as with the classic agency theory, that there is a conflict of interests between family owners and nonfamily managers (Berle and Means 1932; Jensen and Meckling 1976). According to Demsetz and Lehn (1985), families have a substantial proportion of personal wealth invested and, considering no additional layers of agency exist between nonfamily managers and family shareholders, the latter have strong incentives to monitor these managers. Moreover, the authors argue that operating in less regulated industries where the protection of minority investors is low and managers are able to extract personal benefits, family shareholders are likely to intensify monitoring. In these cases the family is assumed to create security benefits of control for all shareholders.

Further to this, there is a systematic relationship between the family and business which is a potential resource that family firms can use strategically to improve performance (Barney 1991). Habbershon and Williams (1999) build on this prediction and suggest that ‘familiness’ consists of idiosyncratic internal resources created by family involvement.⁵ Familiness can be distinctive, providing valuable, unique, hard-to-imitate resources which serve as the competitive advantage of family firms (Habbershon and Williams 1999; Durand and Vargas 2003; Sirmon and Hitt 2003). In the same vein, collectivistic behaviour can motivate family members to consider family firm objectives that are greater than their individual objectives (Miller *et al.* 2008).

Similar to the argument of Bertrand and Schoar (2006) that family founders tend to have a long-term view of their firm and have a strong interest in its continuity, Villalonga and Amit (2009) argue that founding families see themselves as stewards of the family business for future generations, prompting a longer profit horizon compared to

⁵ Habbershon and Williams (1999) argue that the idiosyncratic internal resources are a unique combination or a bundle of resources relating to beliefs, practices, philosophies and the like specific to a family and their firm.

nonfamily investors. As a result, greater control by family shareholders promotes long-term profit maximisation strategies that are beneficial for all shareholders. This view is also supported by James (1999) who postulates that families have longer investment horizons, leading to greater investment efficiency. Although this perspective is often considered to be a competitive advantage for family firms, it has also been criticised. This is because the long-term view of family founders may be confounded with the family's 'dynastic thinking', whereby the family prefers to retain control for as long as possible and fill top management jobs with relatives rather than more talented managers (Barnett 1960).

Private benefits of control

The term 'private benefits of control' was proposed by Grossman and Hart (1980) to refer to benefits that can be appropriated by controlling managers or shareholders at the expense of minority shareholders. Dyck and Zingales (2004: 541) define private benefits of control as "*some value, whatever the source, [that] is not shared among all the shareholders in proportion of the shares owned, but [...] enjoyed exclusively by the party in control*". If the controlling family extracts private benefits of control in excess of the security benefits that it creates, then the minority shareholders are worse off. The private benefits of control category can be classified (related) to two theoretical arguments, namely minority shareholder expropriation (La Porta *et al.* 1999; Burkart *et al.* 2003), and the use of control enhancing mechanisms (e.g. Wolfenzon 1999). These arguments are discussed below.

Private benefits of control are likely to exceed security benefits if there is a separation of control and ownership (Becht and Mayer 2001). It is common for controlling families or shareholders to use mechanisms such as dual-class shares,⁶ voting pacts⁷ and

⁶ Dual-class shares consist of two different types of share classes whose voting rights are not necessarily equally distributed. This means that a firm may issue a fraction of shares which have all the voting rights and assign these to the controlling shareholders, while the remaining shares could be non-voting shares and sold to outside investors (Bebchuk *et al.* 2000).

⁷ Voting pacts, or voting agreements, refer to pacts among shareholders that result in, for example, the founder, or founding family, holding voting power over a larger number of shares than they actually own (Villalonga and Amit 2009). Whilst such pacts between multiple large shareholders may serve as a commitment device and create security benefits of control, Zwiebel (1995) argues that it is more likely that the members of such coalitions extract benefits of control from smaller shareholders, which reduce firm value.

pyramidal ownership⁸ to enhance their control rights relative to their cash-flow rights (La Porta *et al.* 1999; Claessens *et al.* 2000; Faccio and Lang 2002; Villalonga and Amit 2009). The use of such mechanisms has been argued to reduce firm value and performance and it is considered a way for the controlling family to extract private benefits of control (La Porta *et al.* 1999; Claessens *et al.* 2000; Villalonga and Amit 2006). The use of such mechanisms also discourages investments by institutional investors⁹ (Li *et al.* 2008). More generally, Bebchuk *et al.* (2000) predict that, holding the controlling stake constant, the magnitude of the conflicts of interests between the large and small shareholders rises non-linearly (at a sharply increasing rate) with a decrease in the fraction of cash-flow claims held by the large shareholder.

Further, Wolfenzon (1999) estimates the costs and benefits of pyramidal and a horizontal ownership structures that a large shareholder (an individual or a family) may use to control a number of different firms. He proposes a model for analysing the choice between the two structures. This choice is the result of a payoff maximising decision by the large shareholder who already controls an established firm, A, and wants to set up a new firm, B, either in a pyramidal structure (as a subsidiary of firm A), or in a horizontal structure (as an independent concern). In the pyramidal structure the large shareholder shares the verifiable value (i.e. revenues minus the cost of set up) of the new firm with the other shareholders of firm A, whilst in the horizontal structure he captures this value entirely. According to Wolfenzon, even if the new firm is profitable, the extraction of private benefits might reduce revenue so as to make the verifiable value negative. In such cases, the large shareholder opts for the pyramidal structure in order to allocate part of this value to the minority shareholders of the parent firm (firm

⁸ Bebchuk *et al.* (2000: 298) explains that “*in a pyramid of two companies, a controlling minority shareholder holds a controlling stake in a holding company that, in turn, holds a controlling stake in an operating company. In a three tier pyramid, the primary holding company controls a second-tier holding company that in turn controls the operating company*”. A controlling minority shareholder in this definition refers to the controlling shareholder; the term ‘minority’ is used to emphasize that such shareholders exercise strong control over the firm while retaining only a small fraction of the cash-flow rights.

⁹ In economies with strong investor protection, privately held intermediate entities in pyramids may serve as investment vehicles for institutional investors such as pension funds (Villalonga and Amit 2009). This is because such investors may play a monitoring role with respect to the founding family and are vigilant enough, unlike the public shareholders of listed intermediate entities, to prevent the extraction of private benefits.

A). The model predicts that pyramidal structures will be more common in countries with poor investor protection.¹⁰

The use of control enhancing mechanisms, especially when investor protection is poor and when these mechanisms are employed to gain excess control over and above the equity stakes, leads to the expropriation of minority shareholders. According to Shleifer and Vishny (1997), relinquishing control is a greater cost to bear for the controlling shareholders compared to the cost of their lack of diversification. With regards to the pyramid structure, Jensen and Meckling (1976) argue that the tendency of controlling shareholders to pursue their private benefits increases if such shareholders own less equity. For family firms, Burkart *et al.* (2003) put forward the possibility of outside investor expropriation that comes with control in their model of CEO successions (discussed in detail in Section 2.3). The authors state that, even if the founder considers a nonfamily manager to be of superior ability to the family heir, the founder's choice of the successor is primarily driven by the maximisation of private benefits of control, which may not necessarily benefit nonfamily shareholders.

In summary, theory suggests that controlling families either create an advantage for all shareholders, or just for the family members whereby nonfamily shareholders are worse off. Families may reduce agency costs by monitoring nonfamily managers (Fama and Jensen 1983) with the added benefit of personal satisfaction stemming from the long-term success of their firm (Villalonga and Amit 2009). When controlling families derive private benefits of control at the expense of other shareholders, they misuse their status to expropriate the minority shareholders (Shleifer and Vishny 1997; Claessens *et al.* 2000; Li *et al.* 2008; Gompers *et al.* 2010).

2.2 Empirical studies on family ownership and control

Most of the empirical studies have compared the performance of family and widely-held firms to examine the effectiveness of family control (Morck *et al.* 2005; Franks *et al.* 2010; Pindado *et al.* 2014). These studies suggest that the relationship between family control and performance depends on how family firms are controlled and the level of

¹⁰ In line with the model of Wolfenzon (1999), Riyanto and Toolsema (2008) propose a model of tunnelling and propping to justify the pyramidal ownership structure.

investor protection in the country where the firms are incorporated. If the family's percentages of equity ownership and voting control are the same (following the one-share one-vote principle) and control-enhancing mechanisms are not in place, evidence suggests that family firms outperform widely-held firms (Anderson and Reeb 2003b; Barontini and Caprio 2006). This effect is more apparent in countries with better minority shareholder protection (Anderson and Reeb 2003b, 2003a; Bennedsen *et al.* 2010). However, where families control firms via control mechanisms and investor protection is poor, performance is shown to be worse than for widely-held firms (Morck *et al.* 2000; Claessens *et al.* 2002). In this section, we first review studies that find evidence in support of the security benefits of family control, followed by those that focus on private benefits of control extracted by the family.

Anderson and Reeb (2003b) compare the value (measured by Tobin's Q) of family and nonfamily firms. They examine large public firms (Standard and Poor's 500 firms) from 1992 to 1999, and find that families are an important class of shareholders, with firms controlled by family shareholders outperforming nonfamily firms. Nevertheless, firms with founder-CEOs have a higher ROA whereas firms with descendant-CEOs show no such effect. Although Anderson and Reeb's findings support the existence of security benefits of family control, it should be noted that their results are specific to their sample, which is drawn from a highly regulated and transparent market with strong investor protection.

The positive effect of family ownership and control on performance is also found by Maury (2006), studying firms from 13 Western European countries¹¹; Andres (2008), studying listed German firms, and Isakov and Weisskopf (2014), who investigate listed Swiss firms. All of these investigations find that family firms perform better than nonfamily firms¹². The potential benefits of family firms are explained by the family shareholders' long-term view, concerns for survival of the firm and also the family's reputation (Anderson *et al.* 2003; Ali *et al.* 2007; Villalonga and Amit 2009; Chen *et al.*

¹¹ These include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the UK.

¹² However, Maury (2006) points out that, while active family control (i.e. family involvement in management) increases profitability compared to nonfamily firms even when different judicial settings are considered within Western Europe, such increased profitability does not translate into higher valuations when shareholder protection is low.

2010). There is also evidence of higher dividend payments and lower investment-cash flow sensitivities for family firms (Andres 2011; Pindado *et al.* 2012). The latter implies that family firms make more efficient investment decisions and have fewer agency conflicts. Hence, the advantages of family firms in aligning the interests of the managers with those of the shareholders, as well as aligning the interests of different types of shareholders, appear to outweigh the possible disadvantages in terms of access to external capital.

In a similar vein, Khanna and Palepu (2000) compare the performance of 655 member, or affiliated, firms of Indian business groups¹³ with that of 654 unaffiliated firms listed on the Bombay stock exchange for the year 1993. They find that both return on assets (ROA) and Tobin's Q¹⁴ for group affiliates are better than for their unaffiliated peers, especially when business groups span over many distinct industries. Their findings suggest that family controlled firms (i.e. business groups) perform better. However, the authors make a point of explaining that such evidence may be limited to economies with poorly functioning markets and institutions. Specifically, in economies where information asymmetry is severe, and institutional devices signalling trustworthiness are ineffective, external financing is expensive and limited. Hence, a business group may enhance monitoring and overcome liquidity constraints by letting group affiliates pool resources. The group's controlling shareholder (or family) may allocate capital more efficiently than the weak capital market.

Pindado *et al.* (2014), using a sample of family controlled firms from nine Western European countries¹⁵ for the period 1999 to 2006, examine how the value premium (or value discount) attributable to family control depends on country-level investor protection. They find a nonlinear relationship, i.e. an inverted U-shape, between family

¹³ A business group is defined as a set of firms which, although legally independent, are bound together by a constellation of formal and informal ties, with the individual firms in this group accustomed to taking co-ordinated actions (Khanna and Palepu 2000; Khanna and Rivkin 2001). Firms in Indian groups have ties via common ownership of a significant block of shares in group firms, often by a family.

¹⁴ Tobin's Q is defined as follows: (market value of equity + book value of preferred stock + book value of debt)/(book value of assets), where the market value of equity is calculated using the closing stock prices on the last trading day of the year. Other studies in this literature review using Tobin's Q employ similar definitions; hence, we do not report the definition for each of those studies.

¹⁵ These include Finland, France, Germany, Greece, Netherlands, Spain, Sweden, Switzerland, and the UK.

control and firm value¹⁶. This relation turns from positive to negative when families own approximately 50% of the voting rights. More importantly, the authors find that the shape of this relationship depends on the level of investor protection, and is only observed for countries with stronger investor protection¹⁷, which suggests that expropriation of minority shareholders only takes place when families accumulate enough power. Family influence on firm value is positive in countries with weak investor protection regardless of the level of control. The authors find that, overall, family firms outperform nonfamily firms. Therefore, family control is beneficial to minority shareholders in countries with a moderate to high level of investor protection, such as Western Europe, but only if family control does not exceed 50%.

However, studies that highlight the potential costs associated with family control question the positive effects of such control. As discussed in the review of the theoretical literature, family control may be harmful to minority shareholders, and to firm performance, when the interests of the controlling family are not closely aligned with those of the other shareholders. Claessens *et al.* (2002) conduct a study disentangling the incentive and entrenchment effects of large shareholdings using data for 1996 for 1,301 publicly listed firms across eight East Asian economies¹⁸. They find that there is a negative correlation between the difference in voting rights and cash flow rights for the largest shareholder on the one side and firm value on the other side. This correlation is observed primarily for family shareholders, to a lesser extent for the state, and not at all for widely-held corporations. Their findings provide evidence that controlling shareholders with voting rights in excess of their cash flow rights expropriate minority shareholders in East Asian firms. An earlier study by these authors (Claessens *et al.* 2000) report similar results using a sample of 2,890 firms for 1996 across nine East Asian countries but also accounting for cross-holding and pyramid

¹⁶ Firm value in this study is measured in four ways: (i) the ratio of the market value of equity and the replacement value of total assets (i.e. the sum of the replacement value of tangible fixed assets, and the difference between the book value of total assets and the book value of tangible fixed assets); (ii) the industry-adjusted value of the first measure (using the most precise SIC level for which there is a minimum of 5 firms); (iii) Tobin's Q; and (iv) the industry-adjusted Tobin's Q (Pindado *et al.* 2014, refer to Appendix A in the paper for details).

¹⁷ Strong investor protection is a dummy variable that equals one for countries with an anti-director rights index (Spamann 2010) above the sample median, and zero otherwise. Similarly, countries with weak investor protection are those countries with an anti-director index below the sample median.

¹⁸ These include Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.

structures. Similarly, using data on 613 Canadian firms from 1998 to 2005, King and Santor (2008) find that family ownership reduces firm value when the level of family control exceeds its share of the firm's cash flow rights. Taking into account the level of investor protection (indicated by the judicial system efficiency), Lepore *et al.* (2017) analyse a sample of 565 listed companies in Germany, France, Italy and Spain in 2013 to study the relationships between judicial efficiency, ownership structure and firm performance. They find that companies experience a performance decline if ownership concentration levels are high. Judicial efficiency (the moderator variable) is also negatively related to firm value, suggesting that the more days it takes for a judicial system to resolve a proceeding, the lower firm performance is.

In summary, the review of the literature on family control and firm value suggests both positive and negative effects of family control. Controlling families have a long-term view of their firms and reduce the agency conflicts by effective monitoring. However, they also enjoy exclusive rights as the controlling shareholders of their firms, sometimes at the expense of other shareholders. Evidence shows that if the control from being the major shareholder is practiced excessively through the use of control enhancing mechanisms, then minority shareholders may be worse off. Therefore, it is important to analyse the conditions under which the interests of the controlling family may override those of the minority shareholders and identify mechanisms that can mitigate the potential expropriation of minority shareholders. To this end, we use one of the most important corporate decisions, the choice of the CEO successor, to carry out our analysis.

2.3 Succession in family firms

CEO succession is an important event in the life of any firm, but the choice of the successor in family firms seems to have greater symbolic importance, especially when management is being handed down from the founder (Finkelstein and Hambrick 1996; Burkart *et al.* 2003; Zhang and Rajagopalan 2004). As asserted by Dalton and Kesner (1985), the CEO is the person who is ultimately responsible and accountable for action on, and reaction to, the strategy, design, environment, and performance of the firm. Given the importance of the CEO succession decision, it is not surprising that not only the firm's primary shareholders, but also external parties, view this decision as a signal

about the firm's future, as the successes and failures of individual CEOs translate into successes and failures for the firm (Beatty and Zajac 1987). It is no secret that family firms often struggle with governance and leadership transitions. For example, Fiat, the Italian auto group run by heirs of Gianni Agnelli, went through five family CEOs and three chairmen in only two years before bringing in an outsider to lead the company. The Doosan Group, a South Korean conglomerate, was in mayhem when the clan that runs the group replaced one brother with another as the CEO. The review of the literature on family ownership and control highlights the importance of studying individual corporate decisions in family firms.

For example, the choice of successor to the incumbent family CEO may be a manifestation of conflicts of interests between family and nonfamily shareholders. Thus, the CEO succession decision presents an ideal setting to analyse the conditions under which the interests of the controlling family may override those of the minority shareholders. For this reason, we review the theories on CEO successions in family firms (i.e. successor choice and determinants of this choice) and their impact on performance. The review of theories enables us to explore whether having truly independent directors on the board, i.e. directors independent of the firm and the controlling family, influences the choice of CEO successor.

2.3.1 Theories on management succession in family firms

Theory predicts that the CEO successor choice between a family and a nonfamily candidate is a function of several different variables, or determinants. These are as follows: the level of family control, investor protection, the attachment of the founder to his/her firm, the quality of the successor, board independence, and past performance.

Burkart *et al.* (2003) theorise that family control and the level of investor protection determine the choice of CEO successor. Accordingly, they postulate that the founder chooses one of the following three options. First, in regimes with the strongest legal protection of minority shareholders, the optimal choice for the founder is to appoint a professional manager rather than a less qualified heir and sell off shares in the market (unless the private benefits of control are huge). This, the authors claim, gives rise to the Anglo-Saxon model of governance (with dispersed ownership), in which law is the

primary constraint on managerial discretion and the conflict of interests is between the manager and the shareholders. Second, in the case of intermediate levels of minority shareholder protection, the founder may still appoint a nonfamily executive, but the law is not stringent enough to curb the manager's discretion. Hence, the founders, or their family members, stay on to monitor the manager in their function as large shareholders. This situation gives rise to the dual problems of a conflict of interests between the manager and controlling shareholders, and between the latter two on the one side and the minority shareholders on the other side. Third, when the protection of minority shareholders is at its weakest, agency problems become too severe to allow for the separation of ownership and management. The founder considers it necessary that management stays within the family, in which case he/she may choose to continue to manage the firm. Alternatively, a suitable family heir may be appointed. The objective function, nevertheless, from these options is to maximize the founder's welfare, which is the sum of the value of his/her retained stake in the firm, the revenues from selling part of that stake to investors, and the private benefits of control (should the family maintain control). In summary, the authors assume a nonfamily manager to be preferable to a family successor and their model predicts that greater family control, especially when investor protection is moderate to low, increases the likelihood of a family successor.

Giménez and Novo (2010) present a model of family firm succession where the founder, who also manages the firm, considers the possibility of appointing a nonfamily or a family successor. Unlike Burkart *et al.*, their model of succession does not involve the incumbent founder-manager selling off all or part of his stake. However, it is similar in that the succession decision is based on the founder's welfare maximisation. These authors define the founder's welfare as the sum of the revenues generated, depending on the identity of the successor, and the private benefits of control exclusive to the founder (which they refer to as 'amenity potential'). A nonfamily CEO is appointed if he/she is able to generate revenues in excess of the sum of the costs of hiring the CEO and the private benefits exclusive to the founder. In order to appoint a family heir, it is assumed that the founder would have to train the heir. So, if both the family and nonfamily candidates are equal in terms of their characteristics, the founder chooses a nonfamily successor only if training the heir requires a notably big effort. This suggests that indeed

founders retain a higher proportion of private benefits if management remains within the family. In conclusion, the authors present an important extension to their model, which predicts that, if the firm has been performing well, the founder always prefers a family heir.

Gomez-Mejia *et al.* (2007) argue that the sense of dynasty has important implications for the decision-making process in family firms. This is based on their socio-emotional wealth thesis of family firms that captures the ‘affective endowment’ of family owners. This includes, among others, the family’s desire to exercise authority, appoint family members to important posts, and continue the family dynasty. Emotional attachment to the firm is much stronger for the founder (and his generation) than his descendants. Meaning that founders view the firm as a long-term family investment to be bequeathed to the descendants and prefer the latter’s participation in the management than appointing nonfamily candidates (Berrone *et al.* 2010). Overall, the socio-emotional wealth thesis implies that emotions permeate family firms to such an extent that the family is sometimes willing to make decisions that are not driven by economic logic (Baron 2008). Whilst Gomez-Mejia *et al.* (2007) associate the family’s sense of dynasty with a competitive advantage for family firms, Caselli and Gennaioli (2013) postulate that it has on average a detrimental effect on firm performance, reducing the firm’s total factor productivity (TFP)¹⁹.

The controlling shareholders’ propensity to expropriate minority shareholders may be also be mitigated by the appointment of independent directors (Chou *et al.* 2016). Board independence is considered the key driver of CEO turnover when performance is poor (Dimopoulos and Wagner 2016). This argument primarily follows Hermalin and Weisbach (1998), who propose a theoretical framework in which the board acts in the interests of shareholders and monitors the CEO. Declines in firm performance lead the board to update its information about the quality of the CEO and, in turn, increase the probability that the board appoints a better quality new CEO. According to their

¹⁹ Caselli and Gennaioli (2013) formulate a growth model where poor enforcement of financial contracts leads to untalented heirs owning and also managing the family firm. The authors argue that poorly working financial markets cause this productive inefficiency by: (i) stifling the working of the market for corporate control, and (ii) impeding capital mobility across firms. Hence, Caselli and Gennaioli predict that, in the presence of poor financial infrastructure, dynastic management can be minimised by the reallocation of top management jobs to nonfamily managers (in the market for control), and by promoting credit markets to lend capital to capable family business owners.

framework, the independence of the board intensifies the threat of removal of an underperforming CEO. However, the focus of this model is on the CEO's bargaining power vis-à-vis the board of directors in firms with dispersed ownership.

Research also identifies board composition as an important corporate governance mechanism that serves to offset the extraction of private benefits by the controlling family through the CEO successor choice. DeMott (2008) argues that independent directors are crucial actors at the highest level of firm governance as they have sufficient detachment to resolve difficult questions that implicate family ties in the decision of the CEO successor. In her theoretical paper on the influence of directors independent of both the management and the controlling family, DeMott emphasises the monitoring role of these directors. She argues that vigilance practiced by the independent directors can help safeguard the firm's assets from legally problematic extractions by the controlling family. Moreover, such directors have been argued to reduce information asymmetries and set limits to the family decision-makers' discretion (Bammens *et al.* 2011). Hence, DeMott supports the view that keeping management within the family is likely to be valued only by the family shareholders, but not by the nonfamily investors. When it comes to within-family CEO succession, in the absence of effective service by truly independent directors, the board will focus too much on whether the designated family successor will be "good enough" as the firm's CEO. This is not the same as whether the designated successor represents the "best" available choice. Hence, the implications for the controlling family of appointing a nonfamily CEO to replace the incumbent family CEO can be best handled by an independent board – that is, a board with directors independent of not only the firm but also the controlling family. Overall, DeMott's arguments suggest that a more independent board is more likely to prefer a nonfamily candidate over a family member to replace the incumbent family CEO.

Three views on management succession suggest past performance as a determinant of the successor type (Cannella and Lubatkin 1993). These are the rational adaptive view, the inertial view (scapegoating), and the contingency view²⁰. First, according to the

²⁰ These management theories primarily consider insider vs. outsider CEOs. Although family successors may be considered outsiders, not having worked in their family's firm before, family successors are part of a network created by blood ties, marriage, and interactions since childhood. Family relationships also

rational adaptive view, firms adapt in response to corporate environmental challenges with executive selection decisions representing an important adaptation mechanism (Pfeffer and Salancik 1978; Friedman and Singh 1989). One challenge from the corporate environment is poor performance. Thus, when performance is poor, outside managers are perceived to be better capable of changing the objectives and strategy of the firm than the insiders. Second, the inertial view postulates that the management selection process is not adaptive because of the large number of persons and vested interests involved, and the tendency of firms to resist change (Child 1972; Hannan and Freeman 1984). Thus, even when faced with poor performance, firms are more likely to maintain their out-dated strategies and resist outside appointments. Lastly, the contingency view suggests that several socio-political factors, such as the power of the incumbent CEO²¹, moderate the relationship between performance and the choice of an outside manager (Goodstein and Boeker 1991). An extension of this view is that past performance is a strong predictor of the probability of appointing outside successors, provided the incumbent CEO is dismissed, there is no heir, and the incumbent CEO is not also the chairman (Cannella and Lubatkin 1993).

To summarise, theory, though limited, suggests several determinants of the choice of the CEO successor between a family and a nonfamily candidate. These are the level of family control, investor protection, the attachment of the founder to his/her firm, the quality of the successor, board independence, and past performance. Although the theories on family control advance different conditions under which the family may choose an heir or a nonfamily CEO, they all conclude that there is a greater likelihood that management is passed on to another family member because of the associated private benefits of control. Of the suggested determinants, board independence appears

have an influence on inter-firm relationships, such as strategic alliances and resource acquisition, as family members tend to generate the firm's initial network structure and have external networks joined through family executives (Anderson, Jack, and Dodd 2005). In this regard, using these management theories, we consider family successors similar to the insiders and, nonfamily successors similar to the outsiders. It is important to note that, whilst we draw on literature on insider-outsider CEOs here and in the ensuing empirical sections, it is not intended to suggest that the insider-outsider distinction is the same as the family-nonfamily distinction, because this is not the case. The use of these references is due to a lack of availability of literature concerning family firms and these are used with caution not to make any direct comparisons.

²¹ Examples of other socio-political factors are: director expectations and attributions, and availability of alternative candidates for the CEO position (Fredrickson *et al.* 1988).

to be the key factor reducing the private benefits of control by decreasing the likelihood of a family successor.

2.3.2 CEO successor choice and its impact on performance: empirical evidence

In this section we review the empirical evidence on CEO successions in family firms (i.e. the successor choice and the determinants of this choice), and the impact of succession announcements (i.e. the market reaction) on performance.

Smith and Amoako (1999) analyse the factors that influence the successor choice, and the immediate and long-term impact on financial performance of these successions, using a sample of 124 Canadian family firms²² listed on the Toronto stock exchange during 1962 and 1996. They find that family successors are more likely to be appointed in firms with greater family power, where family power is defined as the majority of the management positions being held by the controlling family and the absence of nonfamily blockholders. There is some evidence that poor firm performance leads to the appointment of a nonfamily CEO rather than a family member, supporting the rational adaptive view. In terms of performance post-succession, the authors find that the appointment of a family member replacing the incumbent family CEO hurts operating performance. Specifically, the operating return on assets (OROA) of firms appointing nonfamily CEOs is significantly below the industry median over the four years before succession, but improves over the four years after succession. However, firms appointing a family successor experience the opposite effect on OROA²³. The immediate stock market reaction is negative and significant around the announcement of a family successor ($CAR[-1;1]=-3.20\%$), compared to insignificant CARs when a nonfamily successor is announced. The negative CARs are explained by the young age of the family successor which signals his/her inexperience compared to a nonfamily candidate.

²² A family firm includes those where the departing CEO is a family member, i.e. a founder or a descendent (Smith and Amoako-Adu 1999).

²³ Using three-year averages of OROA and return on sales (ROS), Cucculelli and Micucci (2008) reach similar conclusions for 229 Italian family firms.

Pérez-González (2006) examines a sample of 335 CEO successions in US family firms²⁴ in 1994²⁵. He finds that firm performance suffers if the successor is related to the incumbent family CEO. In particular, the OROA for the firms choosing a family member as successor to the CEO falls by 20% within the two years of the appointment, whilst for firms appointing nonfamily CEOs there is no change. This decline in performance is largely explained by the poor academic record of the family successor. Academic record is measured by the type of undergraduate institution attended by the successor where attending a selective college²⁶ provides a valuable signal of ability (Spence 1974). Accordingly, firms appointing family successors who did not attend a selective college (45% of all family successors) experience a 25% lower OROA and market-to-book ratio within the 3 years of the succession compared to firms appointing nonfamily CEOs. There is no significant difference if firms appoint family successors who attended selective colleges. Consistent with the view emphasising poorer managerial quality of family successors discussed in Section 2.3.1, the findings related to academic record suggest that the efficiency losses are linked to the managerial abilities (or lack thereof) of the family heir. Pérez-González's (2006) event study on the succession choice between a family and a nonfamily successor (for the [0; 2] event window) suggests that there is no market reaction if a family member succeeds the incumbent family CEO whereas external nonfamily CEO appointments are met with positive CARs of 4.8%.

Bennedsen *et al.* (2007) compare family and nonfamily successions in family firms from Denmark during 1994 and 2002, using the gender of the departing CEO's firstborn child as an instrumental variable to overcome selection bias and endogeneity. They find a substantial decline in the OROA around family successor appointments (using both the one- and three-year averages before and after the year of the announcement). Family successors are not associated with lower rates of bankruptcy as one would expect if the lower OROA were the result of a conservative management style. In fact, the authors

²⁴ A family firm is defined as a firm where the retiring CEO is related to the founder (Pérez-González 2006).

²⁵ Although the study is conducted on data from 1994, the requirement was that the sample firms should have been active since at least 1970.

²⁶ Pérez-González uses the Baron's Profiles of American Colleges (1980) to identify 'selective' colleges. A selective college is an undergraduate institution classified as "very competitive or better" in Barron's (1980) profiles. In 1980, a total of 189 colleges that primarily considered applicants who ranked in the top 50% of their graduating high school class were classified as "very competitive or better".

find the opposite as relatively less profitable firms managed by family successors are more likely to file for bankruptcy than firms managed by nonfamily members. This, together with theory, suggests that firms appointing a family successor underperform compared to firms appointing a nonfamily CEO, and the consequences of allocating assets to less talented family heirs can potentially extend beyond family firms, hurting aggregate total factor productivity and economic growth (Burkart *et al.* 2003; Caselli and Gennaioli 2013).

This underperformance is also evidenced for firms managed by family heirs, i.e. subsequent generations (Morck *et al.* 1988; McConaughy and Phillips 1999; Morck *et al.* 2000; Villalonga and Amit 2006). From an investigation into a sample of Canadian firms managed by heirs of the founder, Morck *et al.* (2000) find that such firms underperform compared to similar US firms with dispersed ownership. The other three studies also confirm the underperformance of descendants as compared to the founder. Bloom and Van Reenen (2010) survey managerial practices in the USA, the UK, France, and Germany. They find substantial cross-country differences in the quality of management, but about half of these differences disappear when they control for the intensity of product market competition and the greater incidence of family firms managed by the descendants of the founder. That is, descendants in general are less efficient than the founders (and poorly manage their firms).

Not all of the evidence suggests strong support for the argument that family firms appointing nonfamily CEOs perform better than firms appointing a descendant of the founder as CEO. Sraer and Thesmar (2007) document the performance and behaviour of family firms listed on the French stock exchange between 1994 and 2000. About one-third of the firms are widely-held, one-third are founder controlled, and the remaining one-third are descendant controlled. The authors find that descendants do not generally inherit the management of the best firms and descendants whose firms de-list do not systematically underperform. This evidence suggests potential endogeneity issues, but overall the authors conclude that both founder and descendant controlled firms perform (measured by ROA, ROE, and market-to-book value) better than nonfamily firms. Although they find evidence that nonfamily CEOs bring financial expertise to the firm and are keener to avoid capital wastage, the descendants are seen to have the managerial

horizon necessary to commit to a protective employment policy and are rewarded by greater labour productivity. Ehrhardt *et al.* (2006) analyse the evolution of ownership, control, and performance in 62 German founding family owned firms from 1903 to 2003. Using a matching sample of 62 nonfamily firms in 2003, they find that family firms outperform nonfamily firms in terms of OROA, but not stock performance (using buy-and-hold abnormal returns (BHARs)). The performance of family firms in this sample seems to decrease through the generations, possibly due to the fact that families give up ownership slowly.

The study by Hillier and McColgan (2009) presents evidence on CEO succession and firm performance for the third country we examine in this thesis, the UK. The authors use a sample of 683 firms (164 family and 519 nonfamily firms) listed on the London Stock Exchange (LSE) to analyse succession decisions, and the subsequent firm performance, over the period 1992 to 1998. They find that the departure of a family CEO, especially the founder, improves operating performance over the three years post-succession (irrespective of performance over the three years pre-succession). They find significant and positive mean CARs (3.42% for the [-3; 3] event window) when the family CEO departs. When a nonfamily CEO departs, the CARs are insignificant. A comparison of founder and descendant CEO departures for the family firms in the sample shows that the market reacts more positively to the departure of the founder²⁷. Overall, shareholders appear to benefit if the family CEO departs his/her firm and is replaced by a nonfamily CEO. In terms of governance characteristics, although the authors measure the independence of directors from the CEO, their results do not offer clear insights into the impact of independent directors on CEO turnover and succession decisions. Their findings, however, are consistent with other literature on family firms and corporate governance which generally finds a negative relationship between managerial power and board independence (Young 2000; Anderson and Reeb 2003a).

While theory predicts the influence of independent directors on the choice of the CEO successor, the related empirical literature for family firms is limited. With the exception of the study conducted by Hillier and McColgan (2009) discussed above, other studies

²⁷ The finding related to the market reaction applies to both the short-term announcement CARs and the three-year post-announcement BHARs.

that broach the subject of how director or board independence influences CEO successor choice are on widely-held firms and mostly in the USA (Dalton and Kesner 1985; Park and Rozeff 1994; Borokhovich *et al.* 1996; Parrino 1997; Huson *et al.* 2004; Borokhovich *et al.* 2006; Ferris *et al.* 2015; Dimopoulos and Wagner 2016). Four of these show support for the hypothesis that outsider dominated boards are more likely to choose a CEO from outside the firm (Park and Rozeff 1994; Borokhovich *et al.* 1996; Parrino 1997; and Ferris *et al.* 2015). Huson *et al.* (2004) find that, after CEO turnover, firms with more outsiders on the board experience more significant improvement in accounting performance.

Dalton and Kesner (1985) use a sample of firms listed on the New York Stock Exchange (NYSE) to investigate the effects of board composition on executive succession. They find no evidence of a significant relationship between outside director representation on the board and the inclination of the board to appoint an outsider as CEO. However, the definition used in this paper for independent, or outside, directors treats relatives of executives, directors doing business with the firm (e.g. suppliers, bankers), and previous employees of the firm as outside directors. This definition of an outside director could go some way to explaining the results.

In contrast, Park and Rozeff (1994) find a positive relationship between the percentage of outside directors and the likelihood of an outside CEO appointment. Their study consists of firms listed on the NYSE that appointed a new CEO during the period of 1979 and 1986. Directors who do not hold any management positions in the firm are classified as outside (and independent) directors. They find that when outsiders occupy a minimum of 80% of the board seats, the appointment of an outside CEO is more likely²⁸. However, when outsiders occupy less than 80% of the board seats no likelihood of an outside CEO being appointed is shown.

Borokhovich *et al.* (1996) examine a sample of 969 CEO changes between 1970 and 1988 in 588 NYSE listed firms. They use the 'director incentives' hypothesis to explore CEO replacement decisions and state that, if director incentives affect the likelihood

²⁸ This is based on an estimated logit model with piecewise variables for the fraction of outside directors on the board.

that a poor CEO is replaced, these incentives are also likely to affect the choice of the new CEO. The authors argue that, since the appointment of a strong CEO enhances the reputations of the outside directors, these directors tend to select the best candidate for the position regardless of whether they are an insider or an outsider. They find a positive relationship between the percentage of outside directors on the board and outside CEO appointments. However, this relationship is only significant if at least two-thirds of the board seats are occupied by outsiders. In a later study, Borokhovich *et al.* (2006) examine board quality and executive replacements around the deaths of CEOs. Although they find that boards with greater independence are more likely to appoint an outsider, this finding is more economically and statistically significant when there is no apparent heir, or related successor, and firm performance is poor. Similarly, Weisbach (1988) finds that the stock market reaction to the succession announcement also depends on the independence of the board of directors, and that this relationship is strengthened when pre-succession performance has been poor.

Using a very comprehensive dataset of all CEO successions in S&P 500 firms over the 1951-2010 period, Ferris *et al.* (2015) examine how the choice between an internal or external CEO successor influences strategically critical decisions. One aspect they explore is the influence of the independent directors on the choice of the CEO successor. They find that a board with more independent directors tends to push the appointment decision towards an external candidate. The study, however, suffers from a clear limitation as the details of the exact definition of independence are not disclosed.

More recently, Dimopoulos and Wagner (2016) investigate 812 CEO changes in listed UK and German firms over the period 1995-2005. They study whether better governance improves the credibility and effectiveness²⁹ of CEO turnover. For the UK firms, independent directors are defined based on the UK Combined Code on Corporate Governance whereas for the German firms, all members of the supervisory board are considered independent. They find that, while independent directors perform an important monitoring role of the incumbent CEO and oversee the selection of the new

²⁹ That is, to prevent performance declines, the threat of replacing the CEO needs to be *credible*: the likelihood that a CEO is replaced must increase as performance worsens. And, for CEO turnover to be *effective*: CEO replacement decisions need to yield performance improvements under the management of the new CEO.

CEO, they *neither* are more likely to fire the CEO after bad performance, *nor* are they associated with the appointment of new CEOs that bring about larger improvements in performance³⁰. That is, independent directors (or greater board independence) appear to be irrelevant for the successful turnaround that firms experience both in Germany and in the UK³¹.

In summary, the majority of empirical research reviewed here provides support for the private benefits of control thesis and finds that firms appointing nonfamily CEOs perform better on average. However, these findings can be explained by the young age and/or inexperience of family successors; their lack of qualifications compared to nonfamily CEOs and poor past performance of the firm. Evidence on the influence of board independence on the successor choice and the subsequent performance is mixed. There is evidence to suggest that the independent directors have a positive impact on CEO turnover (Weisbach 1988; Borokhovich *et al.* 1996), and reduce the incidence of fraud and opportunistic timing of stock option grants (Beasley 1996; Dechow *et al.* 1996; Beasley *et al.* 2000; Bebchuk *et al.* 2010). Nevertheless, the question as to whether the independent directors affect the CEO selection decision remains open to debate. The same applies to cross-country differences in terms of investor protection. Interestingly, whilst studies based on North American and UK firms find evidence on the under-performance of family successors, those based on French and German family firms find that family successors perform better.

Our review of both the theoretical and empirical literature on board independence suggests an important caveat in that there is no consistency in the way board independence is defined. The commonly used definition is that directors not employed by the firm, i.e. outside directors, are independent. We argue that this definition, especially for firms with controlling shareholders, requires more attention. That is, outside directors in family firms may include non-executive members of the same family, or others that have links to the controlling family, links which none of the

³⁰ Performance in this study is measured by the return on assets (ROA), the industry-adjusted return on assets (IAROA), the control-group adjusted return on assets (CGAROA), and abnormal stock returns (AR).

³¹ The authors find similar results for other board characteristics, such as board size, the percentage of bankers on the board, the percentage of family blockholders on the board, and CEO and chairman separation.

studies discussed so far has considered. Hence, in this study we raise the important methodological issue of correctly measuring board independence in family firms, provide the rationale behind the use of this measure and present empirical evidence on its improvement over other definitions of nominal independence used in the literature.

3. Directors' independence

3.1 Independence as defined by legislation and codes of best practice

Despite the differences in corporate governance and board practices in France, Germany and the UK, the codes of best practice in all three countries advocate the independence of non-executive directors. Nevertheless, it is interesting to note that none of these codes explicitly considers the links between a director and the family shareholder, other than those stemming from the director being a representative of a significant shareholder or being a family member of another director on the same board. This may pose a problem, particularly in France and Germany, where the concentration of control is high (La Porta *et al.* 1999) as the definition of independence may not necessarily mean independence from the controlling shareholder (Gutiérrez and Sáez 2013).³² In this section, therefore, we argue that, if actual board independence from controlling shareholders is measured using the recommendations in the codes of best practice, the definition of independence requires adjustment to include links between directors and controlling families.

The duties of non-executive directors as per the respective commercial law, such as the exercise of care and diligence, are comparable across the three countries (Fauver and Fuerst 2006; Bermig and Frick 2010). Among these duties, there is the duty to exercise independent judgement and to represent the interests of all shareholders (France and the UK), and to pursue the best interests of the company³³ (Germany). As highlighted in Section 1, the ability to exercise independent judgement when considering the interests of all shareholders may be a concern if the directors are linked to one particular shareholder. This concern is much more pronounced if the interests of the family

³² Gutiérrez and Sáez (2013) argue that European jurisdictions have failed to make the distinction between the role of independent directors in firms with controlling shareholders and firms with dispersed ownership structure. They point out that, in both the codes of best practices and in other regulations, such as listing requirements, independent directors are seen as protecting shareholders against managerial abuses, but not against abuses by other (controlling) shareholders.

³³ The company means all the stakeholders.

diverge from those of the nonfamily shareholders. Next, we discuss how board independence is defined in the codes of best practice in each of the three countries.

In the UK, board independence was first introduced as a recommendation of good corporate governance by the Cadbury Report (1992). The report was based on the assumption of a positive relationship between board independence and the quality of financial reporting and corporate governance. Prior to this report, boards of UK firms were largely populated by executive directors, with few non-executives. Following the sudden financial collapses of Colorol Group, Polly Peck, BCCI and Maxwell,³⁴ the focus on the independence of non-executive directors increased (Wearing 2005). The Higgs Report (2003) introduced a revised and more stringent definition of independence which was incorporated in subsequent UK codes of best practice. According to this definition, “*A non-executive director is considered independent when the board determines that the director is independent in character and judgement, and there are no relationships or circumstances which should affect, or appear to affect, the director’s judgement*” (Higgs 2003: 37). The Combined Code (2003)³⁵ elaborates on the relationships and circumstances that are perceived to compromise the independence of the director. These circumstances include the following.

The director

- has been an employee of the firm within the last five years;
- has (or has had within the last three years) a material business relationship with the firm;
- sits on other boards with any of the directors of the firm in question;
- represents a significant shareholder;
- has been a board member for more than nine years;
- has family ties with other directors; and/or
- he/she receives additional remuneration from the firm.

³⁴ All of these scandals involved foul play by powerful CEOs in firms with weak boards. For instance, the discovery of Robert Maxwell's appropriation of £440m from his companies' pension funds led to the Maxwell Group filing for bankruptcy in 1992.

³⁵ We use the 2003 Code as our basis because our sample period is from 2001 to 2010. However, we have checked the provisions (and revisions) to the code up to the most recent version (April 2016) and we have not identified any changes in terms of the directors' independence criteria that may affect our argument.

Clearly not all possible links to the family shareholder are covered by this list, casting doubt on the actual independence of directors satisfying these criteria. For example, a director with no former employment with the firm within the last five years is considered independent. However, the same director could have been an employee prior to the five-year period, transferred to a subsidiary of the firm and then been promoted to the board of the firm which first employed her. The particular director may have been placed in the firm and its subsidiary by the family shareholder for her/his expertise and loyalty to the family. In such cases, although the director complies with the recommended definition of independence in the code of best practice, he/she nevertheless has a strong affiliation to the controlling family³⁶.

Similar to the UK, board independence was also introduced by the very first corporate governance code in France, the Viénot Report (1995). The later Bouton Report (2002) is credited for having introduced a more stringent definition of independence. A report published by the working group of MEDEF³⁷ and chaired by Daniel Bouton claims that the definition of independence in the French code of corporate governance is far more demanding than those in the codes of best practice of the USA (Principles of Corporate Governance 2002) and the UK (Code of Good Practice 2001). This report also claims that an independent director is to be understood not only as a ‘non-executive director’, i.e., a person not performing management duties in the firm or its group, but also as a person lacking vested interests (such as those typically associated with a significant shareholder or employee). The definition of independence in the Bouton Report (2002) reads as follows: “*A director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgment*” (Provision 8.1: 9). In addition to this definition, the following criteria are perceived to mean that the director is dependent.

The director

- is or has been an employee or director of the firm, its parent or a consolidated subsidiary within the last five years;

³⁶ See for e.g. Coles *et al.* (2013) on co-opted boards.

³⁷ Stands for ‘Mouvement des Entreprises de France’ (i.e. the ‘Movement of French Businesses’).

- is a corporate officer of another firm in which the concerned firm holds, either directly or indirectly, a directorship;
- has a material business relationship with the firm or its group (i.e. the director is a customer, supplier, or a banker);
- has family ties with other directors;
- has been an auditor of the firm in the previous five years; or
- has been a board member for more than twelve years.

The first criterion may be more stringent compared to the corresponding one in the UK code of best practice, in terms of considering employment not only with the parent, but also its subsidiaries. The remaining criteria are comparable to the ones in the UK code. Also, similar to the UK code, there is no emphasis on links to the controlling family shareholder. In a country where concentrated corporate control is the norm rather than the exception³⁸, it is surprising that the current definition does not account for potential ties to the controlling family. For example, the criterion which states that a director has to be a board member for more than twelve years to be considered dependent is not only longer than the nine years stipulated in the UK code, but is unrealistic considering the high incidence of cross-directorships and the preponderance of director networks in France (Yeo *et al.* 2003)³⁹. Overall, even after taking into account developments up to 2016, the definition of independence in the French corporate governance code (2003-2016) is more detailed, but not necessarily more stringent than that in the UK code (i.e. the Combined Code 2003, 2005, 2006, 2008, and 2009, and the Corporate Governance Code 2010, 2012, 2014, and 2016).

In contrast to the UK and also France,⁴⁰ Germany has a two-tier board, with a separate management board and supervisory board. No single person is allowed to be a member of *both* boards. Hence, the two-tier board system separates management from

³⁸ “French family ownership and control is highest in Europe, with the top five families controlling as much as 22 per cent of stock market capitalisation, and the top 10 families 29 per cent. This compares with just 4.1 per cent and 5.8 per cent respectively in the UK. Altogether the top 15 families control more than one-third (35 per cent) of French stock market capitalisation” (Maclean, Harvey, and Press 2006: 182–83).

³⁹ Yeo *et al.* (2003) find that it is not uncommon for CEOs of French firms to sit on each other’s boards as outside (independent) directors. The authors stress that when firms exchange their CEOs, these CEOs as outside directors are not truly independent and name such outsiders on the board as ‘grey directors’ (p.88).

⁴⁰ Strictly speaking, French companies have a choice between a single-tier board and a two-tier board. However, virtually all firms have adopted the former.

supervision. Generally, it has been considered to provide a greater level of independence of non-executive directors than the single-tier board. A significant milestone in the acknowledgement of director independence on the supervisory board was the 2005 amendment of the German Corporate Governance Code (GCGC), which recommends that the supervisory board should include an adequate number of independent members (Section 5.4.2 of GCGC as of 2 June 2005)⁴¹. Independent supervisory board members are expected to monitor the business decisions taken by the management board without being subject to conflicts of interests and consistent with the interests of all shareholders. Nevertheless, the emphasis in the German code is still on the expertise of the supervisory board directors rather than on their independence (Hopt 2016).

Section 5.4.2 of the GCGC (2005: 10) states the following: “*A supervisory board member is independent if he/she has no business or personal relations with the company or its management board which cause a conflict of interests*”. This suggests that representatives of banks, suppliers or customers cannot be considered to be independent; however, representatives of the controlling shareholder, or family, are not covered by this definition. The assumption behind the recommendation in the German code is that all shareholders share similar interests and that the interests of the controlling shareholder are no different from those of the minority shareholders. The possibility that shareholder interests may diverge has been ignored. Other than being a formal representative of the controlling shareholder, a director may have other ties to the latter. Disregarding such ties is of concern as many German supervisory boards of family firms are not only populated with members of the controlling family, but also with other, nonfamily directors with close ties to the family shareholders (Klein 2000). Although law forbids any one person to sit on both boards in Germany, suggesting some stringency of the German code, the definition of independence quoted above still fails to account for ties to the controlling family. In addition, it is frequently the case for German family firms that some family members sit on the supervisory board while others sit on the management board.

⁴¹ Following recommendation 2005/162/EC of the European Commission on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (as of 15 February 2005); available at: <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF> (last accessed on 5 February 2014).

To summarise, the definitions of independence in the codes of best practice of France, Germany and the UK do not account for the potential ties that directors may have with controlling family shareholders. Hence, we conclude that these definitions require adjustments to arrive at a true measure of actual independence. In the next section (Section 3.2), the definitions from the existing literature and problems arising from links between directors and controlling shareholders or families, are reviewed. This provides further support to our conclusion that the various ties to the controlling family need to be considered when defining and measuring director independence. Section 4 then discusses our adjusted measure of *de facto*, or actual, independence.

3.2 The need to adjust existing definitions of directors' independence

In this section we argue that it is not board independence per se, but links that the director may have with the controlling shareholder that matter to minority shareholders in family firms. To be free of such links is what some directors refer to as '*independence of mind*' as opposed to independence requirements defined by regulators (Leblanc 2016). One may ask why these links are of such importance. There are two main reasons for this. First, directors with strong business, family, or social ties to the controlling family may attempt to avoid conflict with the dominant shareholder in order to maintain their social capital with the latter. Second, the family may take advantage of its power and position in the firm to gather support for its own interests from directors with whom it has ties (e.g. the two parties may collude to approve self-dealing transactions (Gutiérrez and Sáez 2013)⁴².

For instance, so-called independent directors may include those that Maclean *et al.* (2006) call '*trusted lieutenants*' and are appointed by the family through special rights and on whom the family can rely. Such directors feel indebted to the family (Ponomareva and Ahlberg 2016). One such potential example cited by Maclean *et al.* (2006) is Sir Lindsay Owen-Jones, former CEO of L'Oréal (appointed as the chairman and CEO of the board), and a close friend of the Bettencourt family (the controlling

⁴² Similarly, directors with close connections to the controlling family may be placed on the board resulting in such directors simply approving what family members have already decided (Cuadrado-Ballesteros *et al.* 2015).

shareholder of L'Oréal)⁴³. Nevertheless, nominally independent directors demonstrating links to the controlling families may not necessarily be directly appointed by the family. They may sit on boards of other firms controlled by the same family. For example, Michel Bouissou is an independent director according to the annual reports of Boiron SA, a French firm majority owned by the family with the same name. In addition to his directorship at Boiron for over 15 years now (starting in May 2002), Mr. Bouissou is also a director of Sodeva (a holding company majority owned by the Boiron family). With reference to German family firms, Klein (2000: 169) speaks of supervisory boards with so-called independent directors as “*follower-boards*” (a board whose members do not question the proposals or decisions of the controlling shareholder(s), but just follow their wishes).

As argued by Attig and Morck (2006), allegations of wrongdoing at Hollinger Inc., a Canadian media company that went bankrupt in 2007, arose despite the presence of established individuals as independent directors, including former Secretary of State Henry Kissinger, former Assistant Defence Secretary Richard Perle, and former Illinois Governor James Thompson. The founder of the Hollinger Group, Lord Conrad Black (and his family) was so dominant that these so-called independent directors were allegedly comrades of Lord Black. The authors argue that “where one man dominates every aspect of financing and business, it seems unlikely that independent directors would voice even the limited dissent that might arise in a freestanding widely held firm” (Attig and Morck 2006: 3).

To limit the family's control over the firm's resources and to protect the interests of nonfamily shareholders, scholars emphasise the need for supervision by independent boards with the formal authority to challenge the decisions of the controlling family (Anderson and Reeb 2004; Chen and Hsu 2009; Setia-Atmaja *et al.* 2009). However again, the definitions of independence typically focus on associations between directors and the firm and/or its senior management, rather than on links with a particular shareholder. In this regard, directors could be reported as being independent yet be dependent on the controlling shareholder. As highlighted in the introduction, such dependence is likely to increase the risk of minority shareholder expropriation whereby

⁴³ Maclean *et al.* (2006) present this example as an excerpt from an interview with Jean-Claude Le Grand, Director of Corporate Recruitment at L'Oreal, Paris, as of 10 March 2003.

the controlling shareholder may extract private benefits of control with the support of the so-called independent directors (see e.g. Villalonga and Amit 2006). Considering the importance of board independence in preventing the expropriation of minority shareholders by the controlling family, it is crucial that directors reported as independent do not have any links to the controlling family. In the remainder of this section we strengthen our argument by referring to the existing literature.

Agency theory and the resource dependence view are the commonly suggested theoretical approaches advocating board independence (Johnson *et al.* 1996; Daily *et al.* 1999). Whilst agency theory refers mostly to the monitoring role of the independent directors, the resource dependence view refers to the additional resources, connections, reputations and professional expertise that such directors bring to the firm (Daily *et al.* 1999). Based on these two theories, board independence has been operationalised in several ways in the literature. These operationalisations broadly follow one of the following two approaches: the outside directors approach and the non-affiliated directors approach (Dalton *et al.* 1998). Neither of these approaches, however, considers links between the director and the controlling family in the context of family firms. The lack of measuring actual independence of directors from the controlling shareholders, the various methods of measuring board independence in the literature, and the failure to adjust for endogeneity may explain the absence of consistent results regarding the relationship between board independence and firm performance (see e.g. Hermalin and Weisbach 1998).

The most common approach to measuring director independence is to check whether the director is an outsider or a non-executive director (Daily *et al.* 1999), i.e. a director not currently employed by the firm is considered independent. Nevertheless, there are no fewer than nine ways whereby outside directors have been defined in the literature⁴⁴ (Daily *et al.* 1999). In the context of concentrated control, Attig and Morck (2006) extend the definition of an outside director to directors having no executive position in the firm and any firm above it in the control chain (of a pyramidal group), no family ties with the ultimate controlling shareholder, and no large equity block in the firm.

⁴⁴ Refer to Daily *et al.* (1999: 88) for a detailed review of the different operationalisations of board composition and the proportion of outside directors.

The other commonly used approach is non-affiliated, or grey, directors. According to this approach, outside directors who have special relationships with the firm are considered to be grey directors and, as such, not independent (Byrd and Hickman 1992; Daily *et al.* 1999). Daily and Dalton (1994) present a detailed classification for affiliated directors as used in the USA. This is based on SEC regulation 14A, Item 6(b), whereby directors (or nominees) with the following relationships with the firm are not independent: (1) employment by the corporation or an affiliate within the last five years, (2) any family relationship by blood or marriage closer than second cousin, (3) affiliation in the last two years with a concern that has had a customer, supplier, banker, or creditor relationship with the firm, (4) affiliation with an investment banker who has performed services for the firm within two years or will do so within one year, (5) holding control of corporate stock, with control based on the extent of shareholdings, and (6) association with a law firm employed by the firm. According to this classification, directors with close personal or professional ties with the firm are not considered independent⁴⁵. The grey directors classification is revisited in a recent study by Houston *et al.* (2016) who argue that the measure of board independence should incorporate both the varying roles played by the firm's grey directors and the firm's decision on whether to classify former executives as independent or grey – suggesting that some firms may choose to identify their affiliated directors as 'independent'. In the context of listed family firms, Hillier and McColgan (2009) use a similar classification of grey directors (i.e. those with existing or potential business relationships with the firm) and independent directors (i.e. those who do not have any business relationships with the firm). The latter study does not suggest any impact of board independence on CEO turnover. Despite the non-affiliated director approach being more detailed than the outside director approach, it still does not take into account possible ties to the controlling shareholder other than via employment within the last five years or a relationship by blood or marriage.

Another dimension to the independent director debate is that of social ties. Hwang and Kim (2009) evaluate the degree of director independence in the Fortune 100 firms from

⁴⁵ Some other studies that follow the non-affiliated director approach include Schmidt (1977), Baysinger and Butler (1985), Cochran *et al.* (1985), MacAvoy and Millstein (1999), Anderson and Reeb (2003b), Yermack (2004), and Houston *et al.* (2016).

1996 to 2005 using the following two criteria: the conventional criterion whether a director has financial or family ties to the CEO, and a second criterion encompassing social ties, including mutual alma mater, military service, regional origin, academic discipline and industry. They report that 87% of boards in the US are conventionally independent whereas only 62% are conventionally and socially independent. They conclude that network connections between a firm's CEO and its directors jeopardise corporate governance. Professional and social networks could be used to appoint trusted friends to the board, which could erode the independence of these directors.

Professional and social director networks are particularly beneficial in terms of information collection enabling firms to develop effective corporate strategies, on the one hand, but on the other hand directors that are well connected may exert strong influence (e.g. higher compensation) that may come at the detriment of shareholders (Renneboog and Zhao 2011; 2014). In family firms, however, the informational advantage of director networks may be used to benefit all shareholders of the firm or only the controlling family. Moreover, directors appointed through social networks, who also have a high network reputation, are likely to stay with the firm for a long time (Ballinger *et al.* 2016). This is because they are at the risk of underperforming when they leave their beneficial network position that helps them to get work done in the current organisation. While social ties are an important consideration in measuring true independence, these encompass only one dimension of possible links between a director and the controlling family⁴⁶.

According to the model proposed by Hermalin and Weisbach (1998), affiliation is not what matters for independence, but the relative time of appointment, i.e., whether the director was appointed before or after the current CEO took office⁴⁷. The authors

⁴⁶ It is also important to bear in mind that, whilst we acknowledge that social ties is an important dimension in measuring true independence, in practice, it is extremely difficult to identify such lack of independence in appointments and to gather data on social ties for directors in family firms, especially in countries with concentrated control. As Lorsch (2017) suggests, the way to better understand the complex social systems of boards of directors and their networks is to use first-hand experience with boards rather than secondary data.

⁴⁷ One operationalization of this model can be found in Bøhren and Strøm (2010), a study that relates the value of the firm (Tobin's Q) to the use of employee directors, board independence, directors with multiple seats, and to gender diversity in listed Norwegian firms. The authors measure board independence as the difference between the average tenure of the board's non-CEO directors and the tenure of the current CEO. The greater this difference, the more independent is the board.

postulate that previous studies may have failed to find a significant relationship between board independence and performance because they may not actually be measuring independence. We argue that this approach may not work for family firms for the following reason. For family firms, there is a high likelihood that the incumbent CEO is the founder. If the CEO is the founder, then all the directors will have been appointed to the board *after* the incumbent CEO took office. Even if the incumbent is a descendant of the founder any director would still be appointed while either the founder or one of his/her descendants was CEO.

Crespí-Cladera and Pascual-Fuster (2014) analyse the characteristics and performance consequences of listed Spanish firms that declare directors as independent even though these directors do not match the recommended definition of independence in the Spanish code of corporate governance (2006). The recommended definition, comprising eight criteria⁴⁸, is referred to as '*strict independence*'. The authors find that, although only 14.2% of the directors are strictly independent, the sample firms classify 32.5% of the directors as independent. Still, Puchniak and Lan (2017) find that, for Singaporean firms, independent directors complying with the definition of independence (in the Singapore Code of Corporate Governance, 2012) are more prevalent in family firms. The authors explain that this is because such directors are normally recruited on account of friendship between the independent directors and the family shareholders. Hence, these directors serve as 'family friends' while complying with the Code, thereby signalling "good" corporate governance to the market whilst allowing the family to remain dominant (Puchniak and Lan 2017).

Overall, the above review of the literature suggests that actual independence of directors is not being measured even though the definitions stipulated in codes of best practice are adhered to. This is because links to the controlling shareholders are ignored. Too much emphasis has been placed on the 'number' rather than the actual 'independence' of independent directors. On the boards of family firms, the latter is more important than

⁴⁸ These criteria include the following: (1) proposed for appointment or renewal by the nomination committee, (2) tenure as independent director for up to twelve years, (3) not having a significant business relationship with the company, (4) not holding a directorship, to be a manager or an employee of a significant shareholder or a shareholder with board representation, (5) not having other relevant relationships with significant shareholders or a shareholder with board representation, (6) not being a director or executive in subsidiaries, (7) not having a company as board director, and (8) not being an executive director of the firm in the previous year.

the former for the mitigation of conflicts of interests between the family and minority shareholders. This leads to the conclusion that the findings of existing studies need to be interpreted with caution, especially studies investigating family controlled firms. In the next section, we propose a measure of board independence that accounts for links to the controlling family.

4. Methodology and Sample

4.1 Measuring directors' independence in family firms

In this section, we present our measure of board independence which adjusts for links directors have with the controlling family shareholder. We begin with an assessment of outside or non-executive directors, which most of the existing literature regards as independent⁴⁹ (Lending and Vähämaa 2017). In Section 3.1 we discussed the definitions of independence and the criteria required for directors to be considered independent by the codes of best practice in France, Germany, and the UK. We found that none of these accounted for links to the controlling family. Here we start with the criteria for independence outlined in Section 3.1 and make adjustments and add new criteria to include links with the controlling family. In doing so, we develop a measure that is comparable across the three countries and only relies on information made public by the firms in their annual reports, director profiles, and IPO prospectuses⁵⁰. For Germany, we exclude employee representatives as *de facto* these represent the interests of the employees and not those of the shareholders. We propose the following six criteria that violate *de facto* independence of directors and would classify them as dependent:

- (1) the director is related by blood or marriage to the controlling family;
- (2) the director has tenure of at least nine years with the firm;
- (3) the director was appointed to the board by the controlling family⁵¹;
- (4) the director is an employee or a director of another firm controlled by the same family;
- (5) the director sits on other boards together with the family directors; or

⁴⁹ This is especially the case for studies that use board data from existing databases, e.g. BoardEx.

⁵⁰ Information on each director is hand collected from the annual reports, directors' profiles on the corporate websites, and/or IPO prospectuses. Many of the annual reports were not detailed enough to gather information on all the criteria and in many cases were only available in French or in German.

⁵¹ Personal lawyers, accountants or similar advisory personnel of the family only (and not their firm), who has become a friend of the controlling family over time would not be picked up by this criterion unless disclosed as such in the annual report.

(6) the director is a former employee of the firm.

Table 1 summarises these criteria (column 1), the related recommendations in the codes of best practice in France (column 2), Germany (column 3) and the UK (column 4), and the rationale behind each criterion (column 5) which is discussed in detail in the following sections. As stated in Section 2.1, board independence was only broadly defined prior to 2002 in France and the UK as the explicit criteria for independence were only introduced in 2002 in France, and in 2003 in the UK. There are still no explicit criteria in the German code for board independence, except for the one related to former employment (i.e. our sixth criterion) which appeared in the 2005 amendment of the Cromme Code.

INSERT TABLE 1 ABOUT HERE

(1) The director is related by blood or marriage to the controlling family

This is the most obvious link to the family, although some family directors may still be reported as independent as not all family members are involved in the day-to-day running of the business or have been former employees of the firm. Therefore, despite their family relationship, such directors may still fulfil the criteria for conventional independence and are accordingly reported as such. For example, Klein (2000) shows evidence of such directors on German supervisory boards, and Barontini and Caprio (2006) present the same findings for Continental European firms. There has also been a tradition in German firms whereby family CEOs and/or family executive directors become the non-executive chair when retiring (Andres *et al.* 2014). For such cases, members of the controlling family, which are reported as independent, are only nominally independent (Daily and Dalton 1997).

(2) The director has tenure of at least nine years with the firm

In their study on the relationship between family firms, length of tenure of the directors, and firm value using a sample of 1,585 industrial firms from the S&P 1500 index, 684 of which are classified as family firms, Li *et al.* (2013) find that directors reported as independent with tenure of twelve years or more are friends of the controlling family. The authors find that these directors do not increase firm value – measured by Tobin's

Q and CAR (to the announcement of mergers and acquisitions by the firm) – and serve on the board as friendly advisors to the family. Evidence of friendships developing between directors with long tenures and the management is also found in a study of widely-held firms listed on the 1994 Forbes List (Vafeas 2003). The French code of best practice recommends that a non-executive director with tenure in excess of twelve years should no longer be considered independent. In the UK the maximum recommended length of tenure is nine years, whereas the German code does not state a maximum period. Here we use the shortest maximum length of tenure of nine years found in the codes of best practice of the three countries to distinguish between independence and dependence⁵².

(3) The director was appointed to the board by the controlling family

This is a new criterion which we propose to include to account for directors who are appointed (through special voting rights) directly by the controlling family. These special voting rights mean that family representation on the board in the form of family members, friends or trusted colleagues may be formally assured (DeMott 2009)⁵³. The family shareholders are likely to appoint directors that are unlikely to oppose the family (Chen and Jaggi 2000; Yeh and Woidtke 2005; Cuadrado-Ballesteros *et al.* 2015). The same argument demonstrating director dependence also applies to the next criterion discussed below.

(4) The director is an employee or a director of another firm controlled by the same family

This fourth criterion, also a new one, limits actual independence to those directors who are not employees or directors of another firm controlled by the same family. It is not unusual for families owning (and controlling) more than one firm to nominate nonfamily directors that the family can rely on across the boards of all their firms (Maclean *et al.* 2006; Cannella *et al.* 2015). This practice is similar to the ‘*familiarity*

⁵² A related issue is how long an independent director can remain independent. It is difficult for independent directors to be socially independent throughout their tenure as they inevitably socialise with other members of the board. Over time, this may drive them to align themselves more with the insiders’ interests than with the outsiders’ interests (Gutiérrez and Sáez 2013). We acknowledge the difficulty in measuring social independence, and hence, use the most stringent recommended maximum tenure of nine years, as recommended in the UK code of corporate governance.

⁵³ Special voting rights in annual reports and/or IPO prospectuses of the firms are stated as voting rights exclusive to the controlling family to appoint one or more directors to the board.

effect' explained by Bouwman (2011) in his study on overlapping boards of directors in widely-held US firms. This familiarity effect relates to directors being appointed because they work at other firms with similar governance practices⁵⁴, implying that there is a greater likelihood that the views of such a director is aligned with those of the CEO or controlling shareholder.

(5) *The director sits on other boards together with the family directors (joint board membership)*

This criterion relates to interlocking directorships, i.e. two firms sharing one or more directors (Lester and Cannella 2006). This is also a new criterion, which we refer to as joint board membership. The code of best practice of the UK states that a director, who sits on other boards with the same directors, is not independent. The comparable criterion for France states that, if a corporate officer (i.e., an executive who is not a board member) is a non-executive director on the board of another firm and the latter firm has directors which sit on the board of the former, the two directors should not be considered independent. Nevertheless, in France it is common practice that retired CEOs sit on each other's boards as non-executive directors (Maclean *et al.* 2006). This practice suggests that a non-executive director and a family member may serve on more than one board together, which, by our definition, would demonstrate dependence. Because of this mutual dependency between family directors and the so-called independent directors, the latter are unlikely to criticise the actions of the family. For this reason, we suggest that joint board membership is accounted for in the existing recommendations on board independence.

(6) *The director is a former employee of the firm (or its subsidiary)*

This final criterion is to prevent classifying former employees of the firm as independent. The codes of best practice of both France and the UK state that directors who were employees of the firm in the last five years are not independent. In Germany,

⁵⁴ Bouwman (2011) uses a set of eight criteria to measure governance practices. They are: (1) board size, measured as the number of directors; (2) the percentage of outside directors; (3) the number of board meetings; (4) director base pay; (5) CEO total pay; (6) the percentage of directors who are active CEOs; (7) the percentage of directors over the age of 70; and (8) CEO duality, i.e., situations in which the CEO is also the chairman of the board.

there is no particular reference to former employees but there is a recommendation that the directors of the supervisory board should not have been members of the management board within the last two years⁵⁵. The appointment of such directors is also limited to a maximum of two. However, family firms (having family shareholders with at least 25% votes) are exempted from this rule (Andres *et al.* 2014). This means that in family firms, especially those in which the founding family still controls the majority of the votes, former executives could be appointed to the firm as non-executive directors any time after the recommended time (immediately in Germany; five years in France and the UK) and classified as independent. We argue that, although these directors satisfy the criteria for independence on paper, they are likely still linked to the controlling family through relationships formed during previous employment. Because of these relationships between the controlling family and former employees we consider all former employees (and executive board directors), regardless of the time away from the firm, not to be independent.

4.2 Sample selection

In order to test our adjusted measure of board independence we use a unique hand-collected dataset of CEO successions in listed family firms from France, Germany and the UK over 2001-2010. We believe that using an important firm decision, such as the CEO succession, will help differentiate between the effects of conventional board independence and our adjusted board independence on this decision. We define a family firm as a firm in which the founder, or their family, owns at least 25% of the votes⁵⁶, and the CEO is a member of this family (see e.g. Hillier and McColgan 2009 and Bennedsen *et al.* 2010). In addition to this, at least one of the following three criteria has to be met: (i) the CEO is explicitly described in the annual report or media as the founder or a descendant of the founder; (ii) the CEO shares the same name with the firm; and/or (iii) the CEO shares his/her surname with at least one other member of the firm's board of directors.

⁵⁵ German company law states that a person who has been a member of an executive or management board within the past two years cannot become a member of the same firm's supervisory board.

⁵⁶ In this paper, we focus on ultimate ownership of votes and stakes that are held indirectly are also taken into account. Votes are measured by the voting rights of the shares held by the controlling family in the case of a single class of shares. In case of dual-class shares (voting and non-voting), the family's total voting rights attached to both classes types are considered.

The final sample comprises a total of 283 succession announcements in 231 firms across the three countries. This was achieved as follows. Data collection started with the full population of listed firms in the three countries equalling 1,780 French firms, 1,307 German firms, and 2,437 UK firms. Next, financial firms were excluded and the remaining firms checked against the voting threshold of 25%. In cases of pyramidal ownership, the ultimate owner was identified to calculate the total votes held by them. This resulted in the identification of 227 French, 151 German, and 110 UK family firms. Firms where the controlling family did not remain the largest shareholder for at least half of the period of study (and those firms whose IPO was after 2007) were excluded. This reduced the country samples to 187, 120, and 88 family firms in France, Germany, and the UK, respectively. Additional criteria were that the incumbent CEO is a family member and that there had to be at least one change in the CEO or a re-appointment⁵⁷ of the incumbent CEO during the 2001-2010 period. Applying these two criteria considerably reduced the sample resulting in 115 French, 78 German, and 38 UK firms. The final sample includes 283 events (i.e. CEO successions as well as re-appointments) in 231 firms, of which 137 events took place in French firms, 94 in German firms and the remaining 52 events in UK firms. As well as looking at each country individually, we also differentiate between the successions based on the type of CEO successor. We classify the succession type as family-to-family if a family successor is appointed, and as family-to-nonfamily if a nonfamily successor is appointed.

Another interesting aspect that we put forth is the inclusion of re-appointments of the incumbent family CEO which most existing literature excludes (or ignores), except for Smith and Amoako-Adu (1999). The latter study, however, includes only four such cases. The theories of succession discussed earlier in Section 2.3 (Burkart *et al.* 2003; Giménez and Novo 2010) assume that the incumbent family CEO faces three options: retaining his/her position; appointing a family member as successor; or selecting a nonfamily successor. This implies that a powerful controlling family wanting to retain their control can either push for the re-appointment of the incumbent CEO (in cases

⁵⁷ A re-appointment is defined as the appointment of the incumbent family CEO to office for a further period of time. The extended or renewed length of term of the CEO may be one of the following: (1) specifically fixed by the firm (as stated in the IPO prospectus or annual report), or (2) based on the country specific governance regulation on maximum CEO term, which is six years in the case of France, five years for Germany, and three years for the UK.

where there is (as yet) no suitable successor within the family) – despite possible opposition from the minority shareholders – or it can appoint another family member as CEO. Considering that the risk of minority expropriation by the controlling family is one with greater implications and the crux of our proposed methodological proposition to adjust board independence, we consider re-appointments as part of our succession sample. The fact that there are only 28 re-appointments in the UK out of a total of 52 succession events (54%) compared to 140 re-appointments in France and Germany out of a total of 231 succession events (61%) gives some credence to our argument as minority shareholder protection is greater in the UK⁵⁸.

4.3 Variables definitions

The variables used to run our tests of differences are those related to board independence and family control, defined below. Following these, we also present a set of firm and CEO characteristics variables in order to provide a more detailed background of the firms used in this study.

Board independence

Board independence is measured using the following two different measures: reported board independence and adjusted (or *de facto*) board independence. Reported board independence is the percentage of non-executive directors on the board as reported by the firm and adjusted board independence is the percentage of directors independent of the controlling family. The percentages are calculated by dividing the number of independent directors (for each measure) by the total board size⁵⁹. We also calculate the difference in board independence which is the difference between the previous two measures. Independence of directors from the controlling family is determined using the six criteria proposed in Section 4.1.

Family control

Family control is measured as the votes held by the family shareholders plus any additional voting control resulting from pyramidal ownership (measured by the weakest link in the chain of control) expressed as a percentage of total votes outstanding. This paper follows

⁵⁸ Appendix A.2 explains the legal and institutional framework across the three countries pertaining to the re-appointments that are considered part of our successions sample in this paper.

⁵⁹ Employee representatives are excluded from the German supervisory boards and the sum of the management and supervisory boards is considered the total board size.

the methodology used in the existing literature to identify the votes controlled by the family shareholders. The controlling shareholder's cash-flow rights and control rights may differ not only because of dual class shares, but also because of indirect ownership through one or more intermediate firms that the shareholder also controls. This is termed as a control chain (La Porta *et al.* 1999; Villalonga and Amit 2009). In such cases, the cash-flow rights are the product of the ownership stakes along the control chain and the voting rights are measured as the 'weakest link' or the lower percentage in the control chain. Villalonga and Amit (2009) provide the example of a sample firm B controlled by a family through the family's ownership stake in an intermediate firm A. Firm A has one class of shares, but firm B has two classes with different voting rights. The family owns 80% of all shares and votes in firm A. Firm A owns 40% of all shares outstanding and has 60% of the votes in firm B. The family's cash-flow rights in total are then the product of its ownership in firm A (80%) and firm A's ownership in firm B (40%), i.e. 32%. The family's total control rights are measured by the 'weakest link' in the control chain (i.e. the least of the two voting stakes 80% and 60%), which is 60%.

Firm characteristics

In line with existing literature, we use a set of industry and firm characteristics for a better understanding of the firms used in this paper. These include assets growth, industry-adjusted market-to-book value (both proxies for future growth), long-term debt to equity, dividend payout, interest coverage (lower levels suggesting lower free cash-flow, thereby reducing the extraction of private benefits of control), market value and total assets (both indicators of firm size which may impact the successor choice), and the Herfindahl index (a proxy for the competitiveness of the firm's industry) (Anderson and Reeb 2003; Jensen 1986; Smith and Amoako-Adu 1999; Chen *et al.* 2013). These variables are defined as follows, all of which are measured in the fiscal year prior to the year of the succession announcement.

- *Assets growth* is calculated as the percentage change in total assets from two years before the year of the succession announcement to one year before the year of the succession announcement.

- *Industry-adjusted market-to-book value* is defined as the ratio of the market value of the voting and non-voting shares to their book value minus the equivalent ratio for the same industry and country⁶⁰.
- *Long-term debt to equity* is defined as the long-term debt measured as a percentage of the book values of the voting and non-voting shares.
- *Interest coverage* (which determines the firm's ability to generate enough earnings to pay interest on its outstanding debt) is a dummy variable that is equal to one if the interest coverage ratio calculated as earnings before interest and tax divided by interest expense is greater than two, and zero otherwise⁶¹.
- *Dividend payout* is measured as the weighted dividend per share as a percentage of earnings per share, both measured in the year before the succession⁶².
- *Firm size* is measured by the logarithm of total assets.
- *Herfindahl index* is the sum of the market shares in terms of sales (EU-KLEMS 2012), i.e. a measure of the size of the firm in relation to the industry. The index is measured in the year before the succession announcement year, except for the years after 2006, where the index is based on the 2006 value. Indeed, the index is not available for the years following 2006. Nevertheless, there is very little variation in the Herfindahl index across time, which suggests that the lack of data after 2006 is not a major issue.

CEO characteristics

Existing literature has used several CEO characteristics such as age, gender, tenure, family relationship to the founder, level of education, work experience both with the firm under study and in other executive roles. However, due to the scope of this study and the difficulty in hand-collecting data on CEOs of family firms, we only present the information related to tenure and age (Smith and Amoako-Adu 1999; Chen *et al.* 2013). Moreover, due to the lack

⁶⁰ The industry classification is based on the Fama and French 10 industries classification, which can be found at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_10_ind_port.html (accessed 5 December 2010).

⁶¹ Interest coverage of less than two is typically considered to be a sign that the firm faces severe financial needs and/or financial constraints (e.g. Goergen and Renneboog 2001).

⁶² Weighted dividend per share is calculated as $[\text{DPS (for voting shares)} * \text{MV (for voting shares)} + \text{DPS (for non-voting shares)} * \text{MV (for non-voting shares)}] / [\text{MV (for voting shares)} + \text{MV (for non-voting shares)}]$, where DPS is the dividend per share and MV is the market value (data sourced from Datastream).

of variability and data availability, characteristics of gender and education have been excluded from the paper⁶³. Tenure and age are defined as follows.

- *Tenure of the incumbent CEO* is defined as the number of years he/she has served as the CEO in the firm. If the incumbent CEO is the founder, then the age of the firm is considered to be their tenure at the announcement of the succession.
- *Tenure of the successor* is defined as the number of years he/she has been a director in the firm (wherever applicable). An analysis of the successor tenure is carried out to identify whether the successors, particularly those that are not family members, are indeed outsiders⁶⁴. In cases of family member successors we are unable to accurately determine tenure⁶⁵.
- *Age* represents the age of the incumbent CEO and the successor at the time of the succession announcement.

The definitions and sources of all the variables used in this paper are presented in the Appendix A.1 in Table 7.

5. Results

5.1 Descriptive statistics of the sample firms

Table 2 presents the distribution of our sample of 283 succession announcements across time in Panel A and across countries in Panel B. Of this total, 212 are family-to-family successions (including 168 re-appointments of the incumbent family CEO), and 71 are family-to-nonfamily successions (i.e. a nonfamily CEO successor replaces the incumbent family CEO). Panel A shows that the lowest number of successions are observed in 2001, and the highest in 2006. This trend is mainly driven by the limited data availability before 2002⁶⁶. It is also interesting to note that greater percentages of

⁶³ Data were collected relating to CEO gender and education. Out of the 283 successions, only four involved a female CEO. The data relating to education (university degree) proved to be difficult to obtain, being available for only 70 successions out of the 283. Hence, both variables have been excluded.

⁶⁴ The criteria used to identify outsiders are similar to those applied to identify the directors that are independent of the controlling family.

⁶⁵ Given that many family members start working with their family's firm very early on they are often promoted to director at a young age. Whilst some continue to serve as directors, others leave the firm to pursue higher education or work experience with a different firm. Such detailed information is not available making it difficult to determine the years the successor has served as a director prior to their succession to CEO in these cases.

⁶⁶ There is limited data availability in Thomson One Banker prior 2002. Where possible, we supplemented the data using various sources of information (see Section 4.2.1). The loss of observations is driven by France and Germany as the corporate governance codes of these two countries are more recent than those of the UK. The level of detail disclosed in annual reports, in terms of ownership and control data, improved significantly after 2001.

family-to-nonfamily successions took place in the most recent years 2009-2010 as compared to family-to-family successions. This could be due to greater emphasis being placed on the importance of having a professional outsider CEO to run family firms (Lin and Hu 2007). The 283 succession announcements in the sample have taken place in 231 firms. Of these firms, 82% (190 firms) had at least one succession announcement during the period of study. Nevertheless, one firm has had five succession announcements; another, four; six firms had three, and 33 have had two announcements during the period of study (results not presented)⁶⁷.

Panel B of Table 2 shows that 48.4% of the succession announcements relate to French firms; 33.2% to German firms, and 18.4% to UK firms. Not surprisingly, the succession announcements in all three countries are predominantly family-to-family rather than family-to-nonfamily, suggesting a clear preference of a family CEO in such firms. Though one would expect this dominance to be less pronounced in the case of the UK (which has relatively less listed family firms than the other two countries), it is interesting to note that there are small differences between the three countries with France having more than 80% as family-to-family successions, whereas both Germany and the UK have fewer such successions at 68%.

INSERT TABLE 2 ABOUT HERE

5.2 Comparison of the two succession groups (firm and CEO characteristics)

Table 3 provides descriptive statistics for our sample firms and incumbent CEO characteristics in Panel A, and a comparison of these characteristics between family-to-family and family-to-nonfamily successions in Panel B. The average market capitalisation of the firms is approximately €284 million, suggesting that the sample firms are relatively large. However, on comparing to the average market capitalisation of €1.42 billion for all the firms listed on the three stock exchanges, the firms in our sample are quite small. The high standard deviation of market capitalisation in our sample of firms, with a maximum of €5.3 billion and a minimum of €0.96 million, shows a good representation of different firm sizes across the sample. The average

⁶⁷ These additional successions in a single firm are at least three years apart. However, there are six cases where the successions are only two years apart, and one case where the succession is only one year apart.

assets growth is 9.43% (median of 5.02%). Long-term debt to equity is low with an average of 26.21%. The average Herfindahl index is also low at 0.13, suggesting that the average firm operates in a highly competitive industry. The variability associated with this average value is again high with a maximum value of 0.78, which suggests a near monopoly. The average tenure with the firm for the incumbent CEO is about 20 years (median of exactly 19 years), with an average incumbent CEO age of 57 years (median of 58 years). The maximum values observed for the tenure (53 years) and age (80 years) of incumbent CEOs is not unusual for family firms with their founders still actively managing (and controlling) their firms. The age of the successor is about 50 years. The CEO characteristics, especially the age of both incumbent and successor, are similar to those observed for Canadian family firms (Smith and Amoako-Adu 1999).

Panel B highlights significant differences between the two succession groups using a *t*-test for differences in means, and a *z*-test (Mann-Whitney U) for differences in medians. Firms in the family-to-family group have a significantly (at the 5% level) lower average market value, i.e. €201 million, compared to €534 million. However, this is not the case for the median (€47 million, compared to €69 million). The family-to-family successions also show much lower total assets for both the mean (€261 million, compared to €886 million) and median (€69 million, compared to €106 million), significant at the 1% and 10% levels, respectively. In terms of CEO successor age, the nonfamily successors appear to be significantly (at the 10% level) younger than the family successors. However, this is believed to be due to the considerable number of re-appointments included in this study (i.e., a greater number of ‘older’ family incumbent CEOs being re-appointed). To investigate this further, the comparison was repeated with re-appointments excluded. This still revealed a significant difference (at the 1% level) in successor age between the two groups. However, this was in the opposite direction with the family successors being younger⁶⁸.

INSERT TABLE 3 ABOUT HERE

⁶⁸ Assuming that one generation spans approximately 30 years, this finding suggests that many of the firms in our sample are relatively young. While the average firm age was found to be 45 years, there are at least 26 firms that are older than 100 years, the oldest one Toye and Co. being 324 years (at the time of the succession announcement).

5.3 Adjusted board independence

In this section, we discuss our results obtained from adjusting the reported board independence via the six criteria described in Section 4.1.

Table 4 presents the number of directors reported as independent in France (413), Germany (356, excluding employee representatives), and the UK (136), giving us a total sample of 905 non-executive directors. First, directors satisfying the first criterion of a family tie to the controlling family are deducted from the total number of non-executives. France has the highest number of non-executive family directors at 132 (or 32.0%), with Germany and the UK demonstrating fewer cases of relationships through blood or marriage at 29 and 6 (or 8.1% and 4.4%), respectively. Second, the remaining five criteria were checked in conjunction with each other and the director removed from the list if at least one of them were met: 134 non-executives in France, 126 in Germany, and 40 in the UK met at least one of the criteria (2) to (6). The percentages of directors satisfying these five criteria are similar across the three countries with 34.4% in France, 35.4% in Germany, and 29.4% in the UK. The large and consistent difference between the reported and adjusted board independence further strengthens our argument that board independence should be considered vis-à-vis the controlling family.

Our new measurement of adjusted board independence shows that only 147 non-executive directors are independent from the controlling family in France, 201 in Germany, and 90 in the UK. When compared to the numbers of non-executive directors reported as independent in each country, we find a relatively low percentage of non-executive directors meeting all of the six more stringent criteria. The UK comes out best with 66.2% of those investigated still being classified as independent. Germany is next with 56.5%, and France comes in last with only 35.6% of those reported as independent demonstrating *de facto* independence.

INSERT TABLE 4 ABOUT HERE

As reported in Table 4 and discussed in the preceding paragraph we observe the greatest difference between the number of directors reported as independent and those demonstrating *de facto* independence for France. This suggests that French firms have

the highest systematic bias in terms of classifying their non-executives as independent, primarily due to the many family members serving as non-executives in French firms. Overall, we find that the percentages of directors that are classified as independent, but are not *de facto*, correlate with the levels of family control (and/or power) across the three countries. Using the voting rights of the controlling family as a measure of control⁶⁹ we find that in France, which has the highest levels of family control, 64% of the non-executives are classified as independent whilst by our criteria of adjusted board independence they are not. The equivalent percentages in Germany and the UK (which has the lowest levels of family control) are 44% and 34%, respectively.

5.4 Difference between conventional and adjusted board independence

Table 5 presents the descriptive statistics and the differences between reported board independence and adjusted board independence (based on our six criteria). The table reports the descriptive statistics aggregated across the three countries as well as for each individual country. The descriptive statistics for the sub-samples of succession type (family-to-family vs. family-to-nonfamily) are presented in Table 6. In order to explain independence in relation to the level of family control we also include in Table 5 the percentage of family control calculated for each country.

Panel A in Table 5 reports the descriptive statistics for family control, reported and adjusted board independence for the full sample of 283 successions. In Panel B, we report the mean and median values across the three countries for family control, reported and adjusted board independence, and the difference between the latter two measures. Panel C presents the results from the tests on the differences in means (t-tests) and medians (z-tests) between France and Germany, Germany and the UK, and the UK and France.

INSERT TABLE 5 ABOUT HERE

⁶⁹ Family control is measured as the votes held by the family shareholders plus any additional voting control resulting from pyramidal ownership expressed as a percentage of total votes outstanding. We follow the methodology used in the existing literature to identify the votes controlled by the family shareholders (La Porta *et al.* 1999; Villalonga and Amit 2009). Refer to Ansari *et al.* (2014) for a more detailed explanation.

Panel A shows that the average family control in the sample is 60.71%. Considering that our definition uses a minimum of 25% voting control to be classified as a family firm, the firms in our sample generally show considerably greater levels of control. The average reported board independence of 54.84% (median 57.14%) is more than double that for our measure of adjusted board independence at 23.71% (median 25.00%)⁷⁰. In Panel B of Table 5, we find that France has the highest level of family control, at 65.28%, followed by Germany at 57.14%, and the UK at 48.46%. All three countries show significantly higher average percentages of reported board independence compared to adjusted board independence and all the differences are significant at the 1% level. France has the greatest difference at 18.33%, followed by Germany at 14.10% and lastly the UK at 7.02%. A similar pattern is obtained for the median values (i.e. France 9.32%, Germany 7.65%, and the UK 5.81%). These results again strengthen our argument for the need to make adjustments for links to the controlling family as the majority of directors reported as independent, especially in France, are not *de facto* independent. We observe a negative correlation between the level of family control and adjusted board independence⁷¹. In addition to the high levels of family control, firms in France also show high levels of cross-directorships (i.e., interlockings) and widespread director networks when compared to Germany and the UK (Maclean *et al.* 2006). These links are overlooked when measuring board independence in the conventional way. Thus, France starts with having the largest proportion of non-executives reported as independent, and ends up with the lowest proportion of non-executives that are truly independent according to our adjusted board independence measure. Finally, Panel C of Table 5 suggests that, while France and Germany have significantly higher reported board independence when compared to the UK and the difference is significant at the 1% level, after adjusting this measure for *de facto* independence there is no longer a significant difference between Germany and the UK. This leads us to the conclusion that Germany is more similar to the UK than France, when it comes to adjusted board independence in family firms.

⁷⁰ The minimum percentage for both reported and adjusted board independence is zero. Reported board independence of zero percent is observed for only one succession in a French firm, whose board is comprised of four executive directors only (i.e., no non-executive directors), three of which are family members.

⁷¹ The correlation coefficient is not statistically significant, but this does not invalidate our inference.

Next we split the sample into two groups dependent on the type of CEO successor (family or nonfamily) to investigate differences between the two succession types in terms of board independence. Table 6 presents the reported and adjusted board independence for family-to-family successions (Panel A) and family-to-nonfamily successions (Panel B) for France, Germany and the UK. The tests on the differences in means (t-tests) and medians (z-tests) of the reported and adjusted board independence between the two succession types in each country are also provided (Panel C).

INSERT TABLE 6 ABOUT HERE

We find that reported board independence for family-to-family successions is higher compared to family-to-nonfamily successions for France (57.31% versus 44.40%) and the difference is significant at the 1% level (reported in Panel C). For Germany and the UK we find the opposite. Family-to-nonfamily successions in Germany and the UK show greater reported board independence (61.66% and 46.87%, respectively) than family-to-family successions (56.78% and 44.60%, respectively). Nevertheless, the differences between the two groups are small and only significant at the 5% level for Germany (as shown in Panel C). More importantly, we find that the family-to-family successions have lower mean adjusted board independence in all three countries (13.53% in France, 27.79% in Germany, and 23.75% in the UK) compared to the family-to-nonfamily successions (30.12%, 38.41%, and 40.04%, respectively) and all the differences are significant at the 5% level or better. Finally, the difference in board independence is positive and significant (at the 5% level or better) for both France and the UK (as shown in Panel C). For the German firms, the difference is still positive, although it is insignificant. While French firms have a greater level of family control than UK firms (see Table 5), both countries have a greater percentage of non-executive directors reported as independent but *de facto* having ties to the controlling family in the category of successions resulting in a family member (re)appointment compared to successions resulting in a nonfamily CEO appointment. The latter is more evident from the difference in board independence for family-to-nonfamily successions for France and the UK as compared to Germany (Panel B compared to Panel A). One explanation for the above result is the emphasis on independence in the respective countries' codes of corporate governance. As mentioned in Section 3.1, whilst the French and UK codes

have a clear set of criteria defining director independence, this does not apply to the German code. Whilst independence of the directors on the supervisory board came to the forefront in the Recommendation of 2005 in Germany (see Section 3.1), supervision and control by persons who have lengthy experience and are experts in the field is regarded more important (Hopt 2016). Therefore, although there is a significant difference between reported and adjusted board independence for Germany, the difference does not seem to be affected by the likelihood of the type of CEO successor appointed (see Ansari *et al.* 2014 for more details). Table 6, hence, suggests that, in terms of the difference in board independence between family-to-family and family-to-nonfamily successions, France and the UK are similar and show a significant and positive difference.

In sum, the definitions of director independence in the codes of best practice of France, Germany and the UK ignore links that the non-executive directors may have with the controlling family. We have proposed six criteria to adjust for these links and we have found that reported board independence as stated in the annual reports is vastly overstated. Furthermore, our measure of adjusted board independence is negatively correlated with the level of family control. While France has the highest level of family control out of the three countries, we find that it also has the lowest adjusted board independence. Finally, once board independence has been adjusted we no longer find that Germany is different from the UK.

6. Conclusion

The codes of best practice of France, Germany and the UK recommend the independence of non-executive directors. The literature has various operationalisations of board independence, whereby independent directors are primarily outsiders, i.e. not affiliated with the firm. Nevertheless, the codes of best practice, as well as the existing literature, have focused on the links that directors may have with the firm and/or its management, with little attention given to potential ties to the controlling family shareholders. This is of particular concern for firms with concentrated control. Directors reported as independent, despite having ties to the controlling family, are likely to look

after the interests of the latter, potentially resulting in the minority shareholders being misled about the independence of such directors.

We find that there are significant differences between the reported board independence and our adjusted measure of *de facto* board independence. In support of the above argument, adjusting board independence is found to be of great importance because it has an influence on the choice of the CEO successor, whilst reported board independence does not have any such influence (see Ansari *et al.* 2014 for more details). Not only is our measure an improvement on the conventional definitions, but it is also an improvement in terms of cross-country comparability. Overall, there is a negative correlation between the level of family control and our measure of adjusted board independence, which highlights the magnitude of this methodological issue and its implications for future empirical research on family firms.

This leads us to conclude that conventionally defined, or reported, board independence is indeed biased and fails to provide minority shareholders with an accurate measure of board independence and strength. This result has important policy implications for regulators and best practice in corporate governance.

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Table 1: Criteria for board independence in family firms: Recommendations in the codes of best practice and our proposed criteria

This table explains the six criteria used to measure board independence in family firms. Column 1 lists the six criteria. The next three columns describe the related recommendations in the codes of best practices for France, Germany and the UK, respectively. The criteria retained for our measure of board independence are discussed in the last column. As stated section 2.1, board independence was broadly defined prior to 2002 in France and the UK. The explicit criteria violating independence were only introduced in 2002 in France, and in 2003 in the UK. There are still no explicit criteria in the German code that suggest the violation of board independence except the one related to former employment (i.e. our sixth criterion) which appeared only in the 2005 amendment of the Cromme Code. ⁺ According to a 2009 law, a person having been a member of a listed firm's management board within the past two years cannot become a supervisory board member. This waiting period can be waived by shareholders holding at least 25% of the votes.

	<u>France</u>	<u>Germany</u>	<u>UK</u>	Our retained criteria for each director
	Based on Corporate Governance Code of Listed Corporations, 2002, 2003, 2004, 2008, 2010, 2011, 2013, 2016	Based on German Corporate Governance Code, 2002, 2003, 2005, 2007, 2008, 2009, 2010, 2012, 2013, 2014, 2015	Based on Combined Code 2003, 2005, 2006, 2008, 2009; Corporate Governance Code 2010, 2012, 2014, 2016	
1. Not related to the controlling family	No family ties with other directors.	–	No family ties with other directors.	Not related to the controlling family through blood ties or marriage.
2. Limited board tenure	Less than 12 years.	–	Less than 9 years.	Board tenure of less than 9 years.
3. Not appointed by the controlling family	–	–	–	Not appointed via special voting rights by the controlling family.
4. Not an employee/director at other related firms	–	–	–	Not an employee or director of another firm fully/partly owned by the controlling family.
5. No joint board membership with family members in other firms	–	–	–	Does not sit on other boards with any family member (during the same period).
6. No former employment with the firm	Not an employee or director of the firm, its parent or a consolidated subsidiary during the last 5 years.	Not an executive of the firm during the last two years. ⁺	Not employed by the firm during the last 5 years.	Has <i>never</i> been an employee (incl. an executive) of the firm.

Table 2: Distribution of the sample of successions by year and country

This table reports distribution of the sampled 283 successions (137 French; 94 German, and 52 UK) in 231 firms by year (Panel A), and by country (Panel B). Both panels report the number of family-to-family and family-to-nonfamily successions (N) and the percentage of contribution to the total of each succession type (%).

<i>Panel A: Annual distribution of successions</i>						
Year	Family-to-family		Family-to-nonfamily		Total	
	N	%	N	%	N	%
2001	3	1.4	5	7.0	8	2.8
2002	17	8.0	10	14.1	27	9.6
2003	18	8.5	3	4.3	21	7.4
2004	19	9.0	4	5.6	23	8.1
2005	33	15.6	5	7.0	38	13.4
2006	31	14.6	9	12.7	40	14.1
2007	21	9.9	9	12.7	30	10.6
2008	33	15.6	5	7.0	38	13.5
2009	21	9.9	13	18.3	34	12.0
2010	16	7.5	8	11.3	24	8.5
Total	212	100	71	100	283	100

<i>Panel B: Country distribution of successions</i>						
Country	Family-to-family		Family-to-nonfamily		Total	
	N	%	N	%	N	%
France	113	53.3	24	33.8	137	48.4
Germany	64	30.2	30	42.3	94	33.2
UK	35	16.5	17	23.9	52	18.4
Total	212	100	71	100	283	100

Table 3: Firm and CEO characteristics summary statistics for the 231 sample firms; and comparison of the characteristics of the family-to-family and family-to-nonfamily successions

This table provides summary statistics for the 231 firms included in the sample using the first succession only. Descriptive statistics on firm and CEO characteristics are presented in Panel A, and the mean and median comparisons for the 212 family-to-family and 71 family-to-nonfamily successions for France, Germany and the UK are reported in Panel B. Differences in means are assessed using a *t*-test whereas differences in medians are tested using a *z*-test (Mann-Whitney U). § indicates that the variable is a dummy variable and the difference in this case is tested using a binomial test. ***, **, * denotes significance at the 1%, 5%, and 10% level, respectively (two-tailed test). Due to missing values the actual number of observations for some variables is smaller than 231 (for the total sample). All variables except the CEO characteristics are measured in the year before the succession announcement year. The successor tenure is only available for nonfamily CEOs and is, therefore, omitted from this table. All the variables are defined as in Table 7 in Appendix A.1.

	Mean	Median	SD	P25	P75	Min	Max
<i>Panel A: Summary statistics</i>							
Market value, million €	283.63	41.86	769.64	12.63	152.98	0.96	5,300
Total assets, million €	424.47	69.53	1,866	22.00	238.91	2.16	26,000
Assets growth, %	9.43	5.02	35.50	-4.97	14.91	-69.65	225.07
Industry-adjusted M/B	0.42	-0.22	0.98	-1.00	-0.28	-8.58	31.01
Long-term debt to equity, %	26.21	13.04	77.23	0.55	43.40	-701.24	434.14
Interest coverage [§]	0.70	1.00	0.46	0.00	1.00	0.00	1.00
Dividend payout, %	25.16	19.38	25.99	0.00	43.86	0.00	97.09
Herfindahl index	0.13	0.10	0.14	0.04	0.13	0.01	0.78
Incumbent CEO characteristics							
Tenure	20.02	19.00	10.29	13.00	25.00	2.00	53.00
Age	56.79	58.00	10.03	49.00	64.00	34.00	80.00
Successor CEO characteristics							
Age	50.56	50.50	9.46	44.00	58.00	29.00	79.00
<i>Panel B: Comparison of the characteristics between succession types</i>							
	Mean			Median			
	Family -to- family	Family -to- nonfamily	Diffe- rences (t-test)	Family -to- family	Family -to- nonfamily	Diffe- rences (t-test)	
Market value, million €	200.71	534.16	-3.32**	46.89	68.69	-1.19	
Total assets, million €	261.16	885.61	-2.68***	69.36	105.52	-1.67*	
Assets growth, %	9.96	4.25	0.26	4.87	4.64	1.17	
Industry-adjusted M/B	0.45	0.19	0.56	-0.22	-0.44	0.92	
Long-term debt to equity, %	26.33	25.47	0.09	13.93	9.75	0.36	
Interest coverage [§]	0.71	0.67	0.61				
Dividend payout, %	25.74	26.23	-0.13	21.95	21.16	0.14	
Herfindahl index	0.13	0.15	-1.26	0.10	0.10	-0.70	
Incumbent CEO characteristics							
Tenure	19.78	20.62	-0.51	19.00	19.50	-0.35	
Age	55.55	57.87	-1.56	56.00	59.50	-1.45	
Successor CEO characteristics							
Age	51.68	49.14	-1.77*	52.00	48.00	-1.46	

Table 4: Adjusting reported directors' independence

This table presents the process of adjusting reported directors' independence starting with the total number of non-executive directors (455 in France, 404 in Germany and 136 in the UK). These directors are then checked against our proposed six criteria that violate actual independence of directors. In the first step, the criterion of family relation is checked, as this information is available for all directors. In the next step, we check if any one of the criteria (2) to (6) is met that would suggest violation of independence. The first column under each country presents the number of non-executive directors whereas the second column presents the percentage of non-executive directors. The sample used in this table is based on a total of 905 non-executive directors at the time of 283 succession announcements.

Adjusting directors' independence	France		Germany		UK		Total	
	N	%	N	%	N	%	N	%
Total non-executive directors	413	100.0	356	100.0	136	100.0	905	100.0
less directors satisfying criterion 1 (family member)	132	32.0	29	8.1	6	4.4	167	18.5
less directors satisfying at least one criterion from 2 to 6	134	34.4	126	35.4	40	29.4	300	33.1
Total non-executive directors independent of controlling family	147	35.6	201	56.5	90	66.2	438	48.4

Table 5: Summary statistics and differences in family control and board independence between the countries

This table presents the summary statistics for family control (i.e. percentage of total votes held by the family) and board independence measures for the full sample of 283 succession events in Panel A. Panel B presents the mean and median values for family control, reported board independence, adjusted board independence and the different between the latter two for France, Germany and the UK. Panel C presents the mean and median differences (i.e. the respective t- and z-values) in family control, reported board independence and adjusted board independence between the three countries. Differences in means are assessed using a t-test whereas differences in medians are assessed using a z-test (Mann-Whitney U). ***, **, * denotes significance at the 1%, 5% and 10% level, respectively (two-tailed test).

	Mean	Median	SD	Min	P25	P75	Max
<i>Panel A: Family control & Board independence – full sample descriptives</i>							
Family control, %	60.71	61.01	15.86	25.12	50.50	70.87	99.36
Reported board independence, %	54.84	57.14	16.04	0.00	45.45	66.67	85.71
Adjusted board independence, %	23.71	25.00	19.93	0.00	0.00	38.46	77.78
	France		Germany		UK		
	Mean	Median	Mean	Median	Mean	Median	
<i>Panel B: Family control & Board independence across countries</i>							
Family control, %	65.28	66.73	57.14	56.28	48.46	49.34	
Reported board independence, %	55.19	57.14	58.27	60.00	45.34	44.44	
Adjusted board independence, %	16.46	10.00	31.37	28.57	29.07	30.95	
Difference in board independence	18.33***	9.32***	14.10***	7.65***	7.02***	5.81***	
	France vs Germany		Germany vs UK		UK vs France		
<i>Panel C: T-values/z-values related to the mean/median difference tests between the respective countries</i>							
Family control	4.00***	3.84***	3.34***	3.15***	-7.23***	-6.42***	
Reported board independence	-1.50	-1.10	5.53***	4.86***	-3.59***	-3.68***	
Adjusted board independence	-5.59***	-5.40***	0.73	-0.47	4.04***	4.08***	

Table 6: Differences in board independence between family-to-family and family-to-nonfamily successions for each country

This table compares the mean and median board independence between firms undergoing a family-to-family succession and those undergoing a family-to-nonfamily succession, for each country. There are 113, 64 and 35 family-to-family successions in France, Germany, and the UK, respectively. There are 24, 30, and 17 family-to-nonfamily successions in France, Germany, and the UK, respectively. Panel A reports board independence for firms appointing a family successor whereas Panel B reports board independence for firms appointing an outsider. Panel C reports the mean and median differences between the two groups of successions. Differences in means are assessed using a t-test whereas differences in medians are assessed using a z-test (Mann-Whitney U). ***, **, * denotes significance at the 1%, 5%, and 10% level, respectively (two-tailed test).

	France		Germany		UK	
	Mean	Median	Mean	Median	Mean	Median
<i>Panel A: Family-to-family successions</i>						
Reported board independence, %	57.31	60.00	56.78	59.17	44.60	40.00
Adjusted board independence, %	13.53	0.00	27.79	27.27	23.75	25.00
Difference in board independence	42.55	40.00	27.01	22.22	20.86	20.00
<i>Panel B: Family-to-nonfamily successions</i>						
Reported board independence, %	44.40	48.33	61.66	61.25	46.87	50.00
Adjusted board independence, %	30.12	37.50	38.41	40.00	40.04	40.00
Difference in board independence	16.72	11.12	23.17	18.18	6.82	0.00
<i>Panel C: T-values/z-values related to the mean/median difference tests between the two groups of successions</i>						
Reported board independence	3.08***	2.96***	-2.14**	-1.72*	-0.49	-0.73
Adjusted board independence	-3.26***	-3.36***	-2.51**	-2.77***	-3.45***	-2.90***
Difference in board independence	5.82***	4.75***	0.97	1.20	3.58***	2.19**

APPENDIX A.1

Table 7: Definitions of variables

This table presents definitions of the variables used in the tables in this paper. Year *t* refers to the year of the succession announcement.

Variable	Definition	Source
Family control	Votes held by the family shareholders plus any additional votes resulting from pyramidal ownership (measured by the weakest link in the chain of control) expressed as a percentage of votes outstanding in year <i>t</i> -1, i.e. the year before the year of the succession announcement.	Osiris, Thomson One Banker, Hoppenstedt Aktienführer Guides, Annual reports and own calculations
Family ownership	The number of shares of all classes held by the family as a percentage of total shares outstanding in year <i>t</i> -1. The numerator includes all shares held by family representatives (e.g. co-trustees, and family designated directors).	Osiris; Thomson One Banker, Hoppenstedt Aktienführer Guides and Annual reports
Founder	Refers to the person that founded and/or established the firm.	Annual Reports
Board size	Total number of directors on the board(s) of the firm in year <i>t</i> -1. The number includes all executive and non-executive directors for single-tier boards and all the member of both the management and supervisory boards for two-tier boards. Employee representatives of German firms are excluded.	Annual reports and own calculation
Reported board independence	The percentage of total non-executive directors on the board.	Annual reports, Firm Prospectus, Thomson One Banker and own calculations
Adjusted board independence	A director is classified as being independent vis-à-vis the controlling family if he/ she does not meet any of the following six criteria: (1) the director is related by blood or marriage to the controlling family; (2) the director has a tenure of at least nine years with the firm; (3) the director is an employee or a director of another firm controlled by the same family; (4) the director was appointed to the board by the controlling family; (5) the director sits on other boards together with the family directors; and (6) the director is a former employee of the firm (and/or a subsidiary). Adjusted board independence is thus, the percentage of total <i>de facto</i> independent directors on the board.	Annual reports, Firm Prospectus, Thomson One Banker and own calculations
Difference in board independence	The difference between reported and adjusted board independence.	Own calculations
Assets growth	The percentage change in total assets from year <i>t</i> -2 to year <i>t</i> -1.	Datastream and own calculation
Industry-adjusted M/B	Market value of voting and non-voting shares divided by the book value of these shares adjusted by respective industry market-to-book value by country in the year <i>t</i> -1.	Datastream and own calculation
Long-term debt to equity	Long-term debt measured as a percentage of voting and non-voting shares in year <i>t</i> -1.	Datastream and own calculation

Variable	Definition	Source
Interest coverage	This is a dummy variable that is equal to one if interest coverage, calculated as earnings before interest and tax divided by interest expense, is greater than two in year t-1, and zero otherwise.	Datastream and own calculation
Dividend payout	Weighted dividend per share as a percentage of earnings per share, both measured in year t-1. Weighted dividend per share is calculated as [DPS (on voting shares) * MV (for voting shares) + DPS (on non-voting shares) * MV (for non-voting shares)] / [MV (for voting shares) + MV (for non-voting shares)], where DPS is dividend per share and MV stands for market value.	Datastream and own calculation
Herfindahl index	It is measured as $H = \sum Si^2 / N$, where S_i is the market share of firm i in industry sales (turnover) and N is the number of firms in the industry. H ranges from $1/N$ to one. A low index value indicates a competitive industry with no dominant players. The closer this is to one, the more concentrated the industry. H is measured in year t-1, except for successions in years 2007 to 2010 as the index is only available until the year 2006.	EU-KLEMS
Tenure	The number of years the individual has been a CEO in year t.	Annual reports, Thomson One Banker and own calculation
Incumbent CEO age	The age of the incumbent CEO in years, measured in year t.	Annual reports, Thomson One Banker
Successor age	The age of the CEO successor in years, measured in year t.	Annual reports, Thomson One Banker
Lnsizes	The natural logarithm of total assets, measured in year t-1.	Datastream
Total assets	Total assets of the firm in year t-1.	Datastream
Market capitalization	Year-end market price multiplied by the number of total shares outstanding in year t-1.	Datastream and own calculations
France	Country dummy that is equal to one if the succession takes place in a French firm (i.e. the home/base country for this firm is France), and zero otherwise.	Own calculations
Germany	Country dummy that is equal to one if the succession takes place in a German firm (i.e. the home/base country for this firm is Germany), and zero otherwise.	Own calculations
UK	Country dummy that is equal to one if the succession takes place in a UK firm (i.e. the home/base country for this firm is the UK), and zero otherwise.	Own calculations

APPENDIX A.2

Re-appointments: Legal and institutional framework for France, Germany and the UK

This section presents the legal and institutional framework pertaining to re-appointments or re-elections in France, Germany and the UK. The purpose of this section is to highlight the way re-appointments were selected to be part of our sample and that these re-appointments are as close as possible to genuine successions involving a change from the incumbent to a new CEO.

In France, directors are generally appointed for six years and/or their term of office shall be determined in the memorandum and articles of association (not exceeding six years). As per the French Commercial Code (Code de commerce), the directors shall be eligible for re-election unless otherwise specified in the memorandum and articles of association (Article L225-18). Exceptions to the appointment and re-election are permitted only when they are made in accordance with the conditions specified in Article L225-24 of the code.

Based on the above articles, we only consider those re-appointments (or re-elections) of the incumbent CEO which fulfil the legal conditions and have been approved through the formal procedure of appointment of a director, i.e. subject to majority vote at an annual general meeting (AGM). In France, we note that some of the re-appointments are after a period of two years. These re-appointments of the incumbent family CEO were the outcome of a majority vote at the AGM unlike the mandatory six-year renewal of term. An example of one such firm in our sample is Unibel SA. It is likely that incumbent family directors go through this process within the firms controlled by their families as a re-assurance to all shareholders of a fair election process.

In Germany, members of the management board (including the CEO) are generally appointed for five years. They can be removed by the supervisory board, but only for a 'good reason' (AktG section 84(3) ein wichtiger Grund). This includes a vote of no confidence by the shareholders. Re-appointment is permissible but requires a proposal from the Supervisory board (AktG section 84(1)) and a process of (re) electing the director

similar to their first appointment to the board. Such a process is not necessary if the re-appointment is before the end of the five-year period.

Based on the above articles from the German Companies Act, we only consider those re-appointments that have gone through the regular appointment process through the supervisory board, i.e. we consider those re-appointments that are genuine re-elections (Wiederwahl) rather than rubber-stamping extensions (Verlängerung) as indicated in the respective annual reports of the firms.

In the UK, all directors (executive and non-executive) are to be subject to re-appointment by the shareholders every three years and in some cases every year depending on the company articles (Companies Act 2006). In some firms, the AGM gives the shareholders the opportunity to vote on the re-appointment of directors. In some others, re-appointment is a renewal of the director's term simply approved by the board based on his/her appraisal. The shareholders may not be privy to the detail of the board's appraisal of individual directors but the Code does require the chairman to confirm to them that, following an appraisal, the performance of the director up for re-election 'continues to be effective and to demonstrate commitment to the role'. In fact, the board is required to tell shareholders why it believes an individual director should be re-elected, particularly in the case of the CEO (see the UK Corporate Governance Code 2010-2012).

Hence, similar to France and Germany, for the UK, we only consider those re-appointments as genuine successions which go through the formal voting process at an AGM and are explicitly stated as such in the respective annual report.

In addition to considering those re-appointments that are voted for at an AGM, for all three countries, we also take into account publication of the related re-appointment in a reliable news source as well as the AGM agenda presented in the annual report of the firms. The stringency observed in considering only re-appointments that genuinely represent succession events is reflected in our results. We find that although the maximum office term for directors in the UK is half that for French directors, there are a greater number of re-appointments that we classify as succession events in France as compared to the UK.