

MINORITY DIRECTORS: A REVIEW OF DETERMINANTS AND CONSEQUENCES AND SUGGESTIONS FOR FUTURE RESEARCH

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Abstract

How to cite this paper: Fera, P., Salzillo, G., & Cantone, C. (2022). Minority directors: A review of determinants and consequences and suggestions for future research. *Corporate Board: Role, Duties and Composition*, 18(3), 8–14.
<https://doi.org/10.22495/cbv18i3art1>

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ISSN Online: 2312-2722

ISSN Print: 1810-8601

Received: 14.11.2022

Accepted: 23.12.2022

JEL Classification: M48, M19, M00, G3

DOI: 10.22495/cbv18i3art1

In contexts characterised by high ownership concentration, an important corporate governance issue is represented by the so-called “principal-principal conflict”. Indeed, the separation between control rights and cash flow rights, the widespread use of control-enhancing mechanisms, and the concentration of voting rights can generate significant costs related to the potential appropriation of private benefits of control. In such contexts, independent directors as an internal mechanism for good corporate governance practices may lack the mandate, the incentives, and the ability to be an effective monitoring mechanism. For these reasons, academics have recently started focusing on minority directors (i.e., directors directly appointed by minority shareholders) as a mechanism to promote greater directors’ accountability and ease tensions between corporate controllers and outside investors. Relying on the preliminary evidence of this research strand, the aim of this paper is to propose a systematization of determinants and consequences related to the appointment of minority directors. As for the determinants, previous literature turns out that the appointment of minority directors mainly depends on internal corporate governance and ownership structure characteristics. As for the consequences, previous studies highlight an overall positive impact of minority directors on corporate governance practices, financial performance, corporate transparency, and financial reporting quality. Therefore, this paper is of interest to academics, as well as practitioners and regulators, as it provides an academic framework related to the appointment of minority directors on which insights for future developments depend.

Keywords: Minority Directors, Minority Shareholders, Corporate Governance, Independent Directors, Agency Theory

Authors’ individual contributions: Conceptualization — P.F.; Data Curation — G.S. and C.C.; Writing — Original Draft — G.S. and C.C.; Writing — Review & Editing — P.F.; Supervision — P.F.

Declaration of conflicting interests: The Authors declare that there is no conflict of interest.

1. INTRODUCTION

In contexts characterized by high ownership concentration, one of the main corporate governance issues is represented by the so-called principal-

principal conflict (also known as “agency problem II”) (Dharwadkar, George, & Brandes, 2000; Bebchuk, Kraakman, & Triantis, 2000; Villalonga & Amit, 2006; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008; Renders & Gaeremynck, 2012). The separation between control

rights and cash flow rights characterizing closely-held corporations can in fact generate significant agency problems and costs related to the potential appropriation of private benefits of control by majority shareholders at the expense of minority shareholders (Shleifer & Vishny, 1997; Faccio & Lang, 2002; Federowicz & Aguilera, 2003; Gospel & Pendleton, 2005; Thomsen, Pedersen, & Kvist, 2006; Sancetta, Cucari, & Esposito De Falco, 2018). Indeed, without sufficient legal deterrents, majority shareholders have strong incentives and the ability to “tunnel” resources out of the firms they control (in the form of asset tunneling, cash flow tunneling as well as corporate perks) and to transfer corporate wealth to firms in which they have a majority ownership position (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000).

Board independence has often been depicted as an effective mechanism to mitigate agency costs and — especially in the presence of a dominant shareholder — to reduce the threat of resource diversion and transfer of value from minority shareholders. Indeed, due to reputational concerns and legal responsibilities, independent directors have strong incentives to monitor the controlling shareholder’s actions, making it more difficult and costly for the block-holder to extract private benefits, with a positive impact on corporate value (Dahya, Dimitrov, & McConnell, 2008). However, empirical evidence also shows that in a high-ownership concentrated context the appointment of a high proportion of independent directors in the board might not be an effective mechanism to mitigate the agency costs and the effects of board independence might not be significant (Erickson, Park, Reising, & Shin, 2005; Cho & Kim, 2007). In closely-held firms, the dominant shareholder might select outside directors less likely to control managers from self-satisfying behaviours or might exercise its influence to turn non-executive members of the board into affiliated or “grey” directors (Yeh & Woidtke, 2005; Cho & Kim, 2007). Directors appointed by controlling shareholders might be even threatened with dismissal for opposing the interests of those shareholders (Dahya, Dimitrov, & McConnell, 2009). In other terms, the strong influence of the controlling shareholder mitigates the role of independent directors in monitoring opportunistic behaviours (Pizzo, 2013). Specifically, Gutiérrez and Sáez (2013) argue that independents lack the mandate, the incentives, and the ability to be an efficient monitoring device for companies with concentrated ownership structures.

The abandonment of the single-winner model — according to which the shareholder who holds most of the voting rights has the power to elect the entire board — in favour of a new multiple-winner election system (also known as “slate-vote-system”) — in which the appointment of the members of the board is also the expression of the will of the minorities — may therefore represent an effective mechanism to alleviate the principal-principal conflict. The appointment of “minority directors” might, in fact, prevent the corporate controller from adopting opportunistic behaviours and protect minority shareholders from the discretionary activity of the blockholder. Allowing minority shareholders to pick at least one director might represent an important mechanism to alleviate the principal-principal conflict and positively affect firm value by

reducing agency costs. Indeed, minority directors not performing executive functions (independent-outside minority directors) might play an important role in monitoring self-dealing transactions and reducing the risk of value diversions to the detriment of minority shareholders (Pacces, 2018).

In this framework, it is worth emphasising the difference between minority and independent directors. In particular, this concerns the specific requirements of independent directors. The latter are defined as such when: 1) they have no economic relations on or direct/indirect influence with the company and its subsidiaries; 2) they do not have close family ties with the company’s shareholders, and 3) they have not been significant representatives of the company or its subsidiaries in the last three years prior to their appointment and have not received significant additional remuneration. As far as minority directors are concerned, it is formally enough that they are appointed from one of the lists presented by minority shareholders. Therefore, although in practice minority directors also tend to be substantially independent, formally they are not required to follow independence requirements (Cappellieri, Moscariello, & Pizzo, 2019; Fera, Moscariello, Pizzo, & Ricciardi, 2022).

For these reasons, academics have recently started focusing on minority directors (i.e., directors directly appointed by minority shareholders) as a mechanism to promote greater directors’ accountability and ease tensions between corporate controllers and outside investors. Relying on the preliminary evidence of this research strand, the aim of this paper is to propose a systematization of determinants and consequences related to the appointment of minority directors.

In this regard, the Italian equity market is the most analysed context since it represents an ideal setting to deepen the role of independent minority directors as a mechanism to alleviate the principal-principal conflict. Indeed, the Italian context is characterized by a high ownership concentration and, since June 2007, the possibility of appointing a minority director to alleviate the principal-principal conflict, prevent the corporate controller from behaving opportunistically, and protect minority shareholders from the discretionary activity of the block holder, led Italy to develop of specific regulations concerning the presence of minority directors on the boards of listed companies (Melis, 2006; Eckbo, Paone, & Urheim, 2011; Organisation for Economic Co-operation and Development [OECD], 2012). The introduction of a slate-vote system in the Italian setting is likely to foster the block holder’s accountability and to increase the minority shareholders’ voting power (Enriques & Volpin, 2007; Melis, Carta, & Gaia, 2012; D’Onza, Greco, & Ferramosca, 2014) and, although it is not compulsory for minority shareholders to present a slate of candidates, the Italian regulation has been mentioned as a possible leading example concerning the adoption of corporate governance instruments able to stimulate shareholders’ activism (Zingales, 2008; Ventoruzzo, 2010; Esposito De Falco, 2017).

Based on the main literature related to the Italian institutional context along with other studies analysing different markets, results show that, as for the determinants, the previous literature

has not yet gone very far and it turns out that the appointment of minority directors mainly depends on internal corporate governance and ownership structure characteristics. Moreover, as for the consequences, previous studies highlight an overall positive impact of minority directors on corporate governance practices, financial performance, corporate transparency, and financial reporting quality.

The remainder of the paper is organized as follows. The Section 2 presents the institutional characteristics of minority directors in a context, such as Italy, that formally recognizes their role. Section 3 and Section 4 summarize the findings of the previous literature that deepens, respectively, the determinants and consequences related to the appointment of minority directors. Section 5 concludes.

2. THE ITALIAN INSTITUTIONAL SETTING AND THE REGULATORY FRAMEWORK

Italy is a typical European civil law country with a highly concentrated ownership capital market. The ownership structure of the Italian listed companies is in fact characterized, on average, by the presence of a dominant shareholder able to monitor and influence the companies' senior managers (Melis, 2000; Volpin, 2002; Barucci & Falin, 2005). In such a scenario, the ownership concentration — together with investor-unfriendly corporate governance systems, ineffective enforcement systems, and the widespread use of control-enhancing mechanisms (such as pyramids, shareholders' agreements, and/or dual-class actions) — encourage the corporate block-holder to extract private benefits to the detriment of minority shareholders. For these reasons, the Italian market has been historically depicted as a setting with weak managers, strong blockholder, and unprotected minority shareholders (Melis, 2000).

However, in the last fifteen years, the Italian institutional setting has been involved in important legal reforms aiming at strengthening shareholder protection and at increasing the accountability of block-holders (Enriques, 2009; Belcredi & Enriques, 2014). In this context, the slate-voting is a peculiar feature of the current Italian corporate governance regulation that gives minority shareholders the right to appoint at least one member of the board of directors (De Poli & De Gioia Carabellese, 2017; Bianchi, Enriques, & Milic, 2018).

In Italy, in fact, a proportional list voting system is applied, whereby minority shareholders are given the opportunity to submit a list of candidates. This system entails that only the presentation of the list makes the election of a minority director mandatory, with the aim to improve the governance structure of state-owned companies boosting their appeal to private investors.

Slate voting was first introduced in Italy by Legislative Decree No. 332/94, converted by Law No. 474/94 which regulated the privatisation of state-owned enterprises. For the Italian privatized listed companies, this norm required directors to be appointed on the basis of shareholders' proposal of alternative slates of candidates and that at least

one-fifth of the members of the board had to be elected from a slate presented by one or more minority shareholders. With the Legislative Decree No. 58/1998, the same procedure of voting became mandatory also for the election of statutory auditors of all listed companies of the Italian Stock Exchange, and in 2005 (Law No. 262/2005) the Italian law encouraged all listed companies to adopt the slate-voting system for the election of statutory directors in order to prevent possible abuses by the blockholder to the detriment of minority shareholders. Finally, since June 2007, the slate-vote system has been implemented for all listed companies, giving minority shareholders the right to appoint at least one member of the board of directors.

For this reason, the number and percentage of minority directors on the board of directors are closely related to the number of minority lists submitted and the votes gathered by each list, according to the proportional representation method. Clearly, in the absence of a list of candidates presented by minority shareholders, minority directors will not be part of the board of directors.

This new board election system, boosting the minority shareholders' voting power, is likely to foster the block holder's accountability (Enriques & Volpin, 2007; Melis et al., 2012; D'Onza et al., 2014) allowing minority shareholders to have self-protection against possible abuse (Bianchi, Ciavarella, Novembre, & Signoretti, 2011; Belcredi, Bozzi, & Di Noia, 2013).

For these reasons, Italy has been the most analysed context on this topic so far, since it is particularly suitable for investigating corporate elections and testing the effectiveness of rules favoring minority shareholders' activism to overcome the "rational apathy" phenomenon and improve investor self-protection.

3. DETERMINANTS OF MINORITY SHAREHOLDERS' REPRESENTATIVENESS IN THE BOARD OF DIRECTORS

As shown in Cappellieri et al. (2019), the number of Italian companies with at least one minority director sitting on the board — although slightly increasing over time — does not exceed 50%, whereas the percentage of minority directors is about 7%. Specifically, the mean percentage of independent directors within the board has increased over the reference period (2012–2016) with the percentage of majority independent directors ranging between the 36% and the 40%, while independent directors elected by the non-controlling shareholders — although increasing over time — do not exceed the 7.5%. Moreover, Cappellieri et al. (2019) also highlight that the number of firms with at least one minority director has been increasing over the reference period (+10%), as well as the trend relative to the number of minority directors that has steadily increased from 73 to 94. However, when these numbers are adjusted for the board size of firms with at least one minority director within the board, it can be noted that the percentage of minority directors has instead decreased over the reference period.

Table 1. Board independence and minority directors

<i>Independents descriptive statistics</i>	2012	2013	2014	2015	2016
% of independent in the BoD	41.77%	42.73%	44.88%	45.51%	46.63%
% of majority independent	36.19%	36.35%	38.61%	38.74%	39.34%
% of minority independent	5.58%	6.39%	6.28%	6.77%	7.29%

Table 2. Minority directors' trend

<i>Minorities descriptive statistics</i>	2012	2013	2014	2015	2016
Firms with minority directors	42	49	52	52	54
% of firms within the sample	36.52%	42.61%	45.22%	45.22%	46.96%
No. of minority directors	73	80	84	90	94
% of minority directors in BoD	20.86%	19.74%	18.41%	18.75%	19.11%

Cappellieri et al. (2019) have therefore analysed the determinants of minority directors' election through a binary logistic regression panel model. Findings from their model suggest that the probability of minority directors' appointment within the board is negatively influenced by the CEO duality and by the percentage of independent directors elected from the majority shareholders' slate. At the same time, the probability to find at least one minority director is positively influenced by both the firm size and the presence of institutional investors. Overall, these results — highlighting a strong relationship between firm size and the appointment of at least one minority director — suggest that minority shareholders' representativeness is still confined to the largest companies while confirming the activism of institutional investors and their role in improving corporate governance transparency. On the other hand, the negative influence exercised by both CEO duality and the percentage of independent directors elected from the majority shareholders document that minority shareholders' activism is more pronounced when board independence (relative to the board size) is not sufficiently guaranteed by the corporate controller, and — surprisingly — that it is weaker when, *ceteris paribus*, the monitoring role of the board is threatened by CEO duality.

4. CONSEQUENCES OF MINORITY SHAREHOLDERS' REPRESENTATIVENESS IN THE BOARD OF DIRECTORS

Allowing minority shareholders to have representatives on the board can represent an important mechanism to promote directors' greater accountability and ease tensions between corporate controllers and outside investors (Enriques, 2009; Belcredi & Enriques, 2014). In this regard, several studies assert the positive impact exercised by minority directors on both corporate governance and financial performance.

Bianchi et al. (2011) find a positive relationship between the level of compliance with the Corporate Governance Code for Italian listed companies and the number of minority directors. Similarly, Fera (2020) and Fera and Vinciguerra (2022) highlight that the presence of minority directors enhances the level of compliance with the regulation on related party transactions. These results confirm Paces (2018) describing minority directors (non-controlling shareholder-dependent directors — NCS-directors) as a new fundamental player in the boardroom able to carry out a procedural screening of related party transactions (RPTs) and, so doing, to reduce the agency problems and costs

related to the potential appropriation of private benefits of control by majority shareholders. Directors appointed by minority shareholders also play an essential role in defining monetary incentives, which encourage executives to work for the best interest of shareholders and to mitigate agency costs. Indeed, Zhou, Fan, An, and Zhong (2017) find that the board representation of non-controlling shareholders has a positive impact on executive pay-for-performance sensitivity. In parallel, empirical results suggest that minority shareholders' representation seems to have a positive influence on stock option plans (SOPs) (Melis et al., 2012). Boards with a higher proportion of minority directors are in fact more likely to design SOPs explainable by optimal contracting theory (rather than rent-extraction reasons). Still, concerning the fairness of the remuneration policies, Belcredi et al. (2013) find that minority directors sitting on the board and/or on the remuneration committee increase the likelihood of shareholders' dissent on executives' remuneration policies. Indeed, minority directors act as a conduit of information to the market, promoting better disclosure and thereby facilitating further engagement by active shareholders. Moreover, Marchetti, Siciliano, and Ventoruzzo (2017) document that minority-appointed directors are more likely to dissent than directors (even if formally independent) appointed with a majority of the votes and that market prices react slightly negatively when a director votes against the majority, especially when they are minority-appointed ones. The authors conclude that these findings suggest a certain degree of "trust" by the market in minority-appointed directors.

Focusing on financial performance, a positive relationship is also observable between firms' value and minority directors. Minority directors seem to play a fundamental role in reducing agency costs associated with the risk of self-dealing transactions by the corporate controller and, in turn, in increasing firm value. Lefort and Urzua (2008), analysing a context characterized by high ownership concentration, find that where the percentage of outside directors is higher (elected with minority shareholders' votes), company value and performance are greater. More recently, Moscariello, Pizzo, Govorun, and Kostyuk (2018), by examining a sample of non-financial Italian firms from 2007 to 2012, find supporting evidence about a positive relationship between the proportion of minority directors and the firm value. Barry, Lepetit, Strobel, and Tran (2018) also find a positive relationship between board structures that include directors related to minority shareholders and the market

valuation of banks with concentrated ownership. In addition, relying on the previous literature highlighting the beneficial effect of minority directors on corporate transparency and assuming an inverse relationship between earnings management (as proxied by the magnitude of abnormal accruals) and the financial reporting quality, Fera et al. (2022) conclude that minority directors can be effective in constraining earnings management activities and enhancing the quality of financial reporting. Moreover, Fera, Moscariello, Pizzo, and Ricciardi (2021), focusing on the institutional investors' representativeness on the board of directors, investigate whether directors appointed by institutional shareholders are more effective in constraining earnings management activities in the case of companies with a concentrated ownership structure, compared with the mere presence of institutional shareholders. Specifically, they find that institutional investors, regardless of their characteristics (i.e., strategic or no strategic), are more effective in constraining earnings management activities and in enhancing the quality of financial reporting when they can count on an agent on the board of directors.

Finally, according to Marchetti et al. (2017), minority directors significantly influence corporate transparency. In fact, minority directors appear to have a positive impact on both the amount and quality of firm disclosure.

5. CONCLUSION

A concentrated ownership structure can generate significant agency conflicts related to the potential appropriation of private benefits of control by majority shareholders at the expense of minority shareholders (principal-principal conflict).

Board independence may only partially mitigate this conflict due to the influence that the dominant shareholder is likely to exercise over the majority-appointed directors. More generally, Gutiérrez and Sáez (2013) discuss three main problems that weaken the independents' monitoring role for companies with concentrated ownership structures. First, the existing definitions of independence (having no familiar or corporate ties with the insiders, managers, or block-holders) do not capture all the potential influences that may affect a director's behaviour. Second, the selection and nomination system should guarantee that the appointed independent directors are effectively independent of the controller and that they are accountable to outside shareholders. However, majority shareholders have the power to select and appoint both executive and independent directors. Third, it is important to find the main incentives that should motivate independent directors to discharge their functions

effectively. The authors conclude that the current focus of the regulators and codes of best practice on empowering independents is ineffective and that companies operating in institutional settings characterized by high ownership concentration would be better off choosing their board members freely or by introducing the so-called "minority directors" (Gutiérrez & Sáez, 2013, p. 63).

The slate-voting system might, therefore, represent an important mechanism to alleviate the principal-principal conflict as minority directors (special interest directors) might, in fact, prevent the corporate controller from adopting opportunistic behaviours and protect minority shareholders from the discretionary activity of the blockholder. Allowing minority shareholders to have representatives on the board can represent an important mechanism to promote directors' greater accountability and ease tensions between corporate controllers and outside investors (Enriques, 2009; Belcredi & Enriques, 2014). In this regard, several studies assert the positive impact exercised by minority directors on both corporate governance and financial performance.

Notwithstanding the documented positive effects on firm corporate governance and performance, the previous literature has not yet gone very far in analysing the determinants related to the appointment of minority directors and it turns out that their appointment mainly depends on internal corporate governance and ownership structure characteristics.

Overall, this paper provides an overview of the existing literature on the subject of minority directors and aims to offer a number of insights for future studies. Since minority directors have been found to act as "new independents" in a context characterized by high ownership concentration, it may be interesting to test their influence on many other aspects for which independent directors seem to lose their monitoring role. Other issues that deserve further investigation concern the intrinsic characteristics of minority directors (e.g., diversity, expertise, etc.) as well as their impact on non-financial performance and other sustainability matters related to business organizations. Moreover, the research strand that investigates the determinants related to the appointment of minority directors needs more effort. Furthermore, considering that the slate voting system has been institutionally implemented only in Italy, future research may examine the role played by minority directors in settings that adopt different board election systems. Lastly, since the previous literature mainly confirms that minority directors represent a fundamental corporate governance mechanism, it may be interesting to extend the knowledge on this figure through qualitative studies too, to deepen other possible peculiar aspects.

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