Expropriation via Non-Executive Director and Outside Consultant in Family-Owned Companies

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Abstract

This article develops a conceptual framework for remuneration committees related to expropriation in family firms involving a non-executive director and outside consultant. The committee manipulates power and control for reward with higher remuneration for themselves with less justification linked to performance criteria. This study highlight issues of ensuring independence, securing positions within firms and maintaining contract leads to the remuneration committee's expropriation. Of particular interest is the committee's composition, consisting of a non-executive director but still influenced by the executive family during the remuneration process. Not surprisingly, although their task is to check and balance along with their consultancy, they actually support proposals to please family members. Minority shareholders put the burden on family members' shoulders for higher remuneration, but poor performance cannot be proven because the proposal reflects a collective decision.

Keywords: remuneration committee, non-executive director, outside consultant, expropriation

1. Introduction

A firm's governance system consists of multiple components, such as board structure, remuneration structure, auditors, the corporate charter, debt contracts, and government regulation. These components need to be integrated and matched with firm strategies towards enhancing performance. For example, under the component board structure context, board composition, board size and meetings are required to review and establish effectiveness during implementation. Similar to the remuneration structure involved with a remuneration committee (Salim & Wan-Hussin, 2009), the level of remuneration (Abdul Wahab & Abdul Rahman, 2009) and structure of the remuneration (Mehran, 1995) need to be looked as a whole package, not as individual components. Such a holistic approach can positively improve governance practice. It is important to ask the following questions: What is the best size for a board of directors? How much should the board of directors be paid to mitigate agency problems and enhance performance? What is the best criterion to be used to reward great remuneration? These types of questions are central to improving governance standards and increasing firm performance.

Remuneration issues have been studied by many researchers; studies have been conducted on remuneration and performance (Croci, Gonenc, Ozkan, & Italy, 2010; Murphy, 1999), determination of remuneration (Abdul Wahab & Abdul Rahman, 2009; Gomez-Mejia, Larraza-Kintana, & Makri, 2003) and remuneration committees (Conyon, 1997; Salim & Wan-Hussin, 2009). For example, past empirical data indicates that CEO remuneration is negatively related to stock prices (Croci et al., 2010). Research and development and business risks are taken into account to reward great remuneration due to their impacts on firm financial performance (Gomez-Mejia et al., 2003). Furthermore, whether the firm is family or non-family (Murphy 1999; Croci et al. 2010) significantly impacts director remuneration. The responsibility for providing better remuneration falls in the hand of the remuneration committee, making it necessary to clarify the best factors linked to the best packages (Conyon, 1997).

Pay for performance is a difference practice in the family firm and non-family firm due to the ownership aspect. The family firm is not separated between power and control with management like the non-family firm. Empirical evidence in non-family firms indicates that CEO salaries increase firm performance and correlate with the firm size. Shaw and Zhang (2010) find that CEO cash remuneration is more sensitive to better performance than poor performance. An executive is appointed by the CEO and may be dismissed from the position if they do not perform satisfactorily. But in family firms, Craighead et al.(2004) indicate that the CEO in a widely-held firm received lower total remuneration than CEOs in closely-held firm. Family firms pay their CEOs more than non-family firms (Finkelstein & Hambrick, 1989). Due to this discrepancy, CEOs in family groups have ability to manipulate the power and control from monitors by minority shareholder and provide an opportunity for their own pay. Past studies show that expropriation occurs when an owner-manager effectively sets the level of their own remuneration (Cheung, Stouraitis, & Wong, 2005).

The uniqueness of family ownership occurs when key positions are held by family members, including board of director, CEO, Chairman, majority shareholder and remuneration committee. They are thus able to influence the relationship of pay to performance. Chrisman et al. (2007) notes that family executives receive remuneration which positively impacts performance. It is important for the family group because they have the intention of handing over the business to the next generation (Miler & Breton-Miler 2006). To keep performance increasing over time, the committee is responsible to design effective remuneration links to motivate executives. It is the responsibility of committee members to provide effective incentives links to performance criteria, which attracts executives to serve according to the firm's desire (Bebchuk & Fried, 2003). Gomez-Mejia and Barkema (1998, p.137) explain further:

> "the task of such board committee is to develop proposals, which approved by the full board, on the level and mix of CEO compensation. The members of remuneration members are supposed to be outside directors – individuals who are not executives of the firm on whose boards they sit".

On the other hand, the family executives who receive high remuneration actually are not linked with either achievement or firm performance so much as family background. Family ownership has a negative relationship with remuneration and performance (Barak et al. 2008). Furthermore, they are appointed even if they are not capable (Faccio, Lang, & Young, 2001), and they have potential to decrease performance. Basu et al. (2007) studied Japanese firms and found that higher ownership positively impacted higher remuneration to executive. Thus, the family executive who participates actively in the remuneration process makes the presence of a non-executive director less meaningful monitoring against Cadbury and MCCG suggestion. Furthermore, non-executive directors have less intention to cause conflict in the family group by contradicting their decisions because they want to keep their positions within the firm. The executive family thus takes into account by expropriation via remuneration from other shareholders. In fact, minority shareholders argue less so long as their representative, the non- executive director, is satisfied with the package.

Consultants face challenges in implementing their tasks and responsibilities because they are involved with collecting information related to the peer group of the same size and industry. However, the consultant using this information is not as common as supporting the packages to please family members and keep the contract. Indeed, the consultants are less independent because they were appointed by family members in addition to being proxies to the remuneration committee hiding their expropriation.

2. Discussion

2.1 Remuneration Committee

Incentives may motivate the majority shareholders by linking their talents to performance and attracting investment from others shareholder. Additionally, agency theory suggests that by providing incentives, it is possible to align similar interests between principal and agent (Jensen & Meckling, 1976) and between principal and principal (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008).

Many researchers focus on the relationship between remuneration and performance (Barontini, Bozzi, Sant'Anna, & della Libertà, 2010; Croci et al., 2010; Murphy, 1999). The results from the studies were mixed for various reasons. For example, Shaw and Zhang (2010) found that the remuneration increases firm performance than poor performance. Chrisman et al., (2007) explain that family executives tend to enhance performance after accepting remuneration as a contract.

This positive relationship may be due to the majority shareholder's satisfaction with the incentives, which match their abilities, such as knowledge and skills links to performance (Croci et al., 2010). In addition, the majority shareholder obtains two benefits if they accept remuneration linked to better performance; first, they receive a better remuneration, either a large salary or bonuses or both. Second, by shareholding in the firm, they receive better dividends via better performance. However, another perspective holds that the uniqueness of family ownership causes minority shareholders to suffer when their investments are purposefully manipulated to increase majority shareholder personal wealth.

Family ties cause higher remuneration among family members. Therefore, to keep higher remuneration, the family members are required to optimize power and control by influencing board, committee members and consultants with decisions that have a one-sided benefit. As a result, firms face difficulty in generating more profits when lowering other shareholders wealth. Barak et al. (2008) indicate that in family firms, CEO remuneration is negatively associated with performance. Abdullah (2006) notes that director remuneration was not associated with performance. Thus, family ties become a factor of remuneration determination; along with Cadbury's (1992) suggestion, this explains that remuneration should be linked to personal and firm performance.

Several questions naturally arise: Who is responsible for designing the packages and benefits for family executives? Furthermore, does expropriation begin at the remuneration committee level? Does active executive family strongly influence decision-making in the committee? Is there less effective monitoring by non-executive directors in committees and less useful consultancy from outside consultants? These kinds of questions are very important and should be taken into account for further discussion.

The remuneration committee is a sub-committee established for designing effective incentives for executives linked to performance, and the committee members consist of a non-executive director and an executive director. In addition, Greenbury (1995, p. 14) explains the code of best practice A1:

> "Board of directors set up remuneration committees of non-executive directors to determine on their behalf and on behalf of shareholder within agreed terms of reference, the company`s policy on executive remuneration and specific remuneration packages for each of executive directors including pension rights and any compensation payments".

In family firms, committees face challenges to implementing their tasks and functions at the design level because of involvement with top management, which significantly impacts firm performance. Furthermore, Cadbury (1992) recommends that the performance criteria become the main factor to determine the level of remuneration along with adherence to the policies and procedure (Salim & Wan-Hussin, 2009). In fact, one part of the committee tasks is to evaluate performance of executives and makes recommendations for bonus remuneration. As Spira and Bender (2004, p. 494) explain:

> ...remuneration committee members have to deal with schemes that are becoming more and more intricate, and to understand the layers of regulation that have been introduced in recent years.

On other hand, the family firm intends to provide positions for family members rather than hiring more qualified manager (Moores & Craig, 2008) even if they are not talented to run a business (Faccio et al., 2001).

Thus, a family firm can use remuneration to benefit themselves. This relationship is not illegal because the firm belongs to them and has a right to award higher remuneration even though they are unqualified so long as it is not proven risky to the firm. Chourou (2010) notes that owner managers use their power to derive financial benefits only when they do not bear the full cost of their actions. Therefore, Cadbury (1992) and MCCG (2000) recommend that the composition of the board of directors should be wholly or mainly be dominated by the non-executive director to perform a checks and balance in addition to enhancing performance. This notion applies to the remuneration committee, too. To ensure that packages are transparent, outside consultants are required to review non-executive directors' advice. As a result, the proposal is linked to the performance after consulting in order to ensure it is more comprehensive and competent with the peer groups in similar industries.

Moreover, the remuneration process is dominated by family members, which causes inconvenience for non-executive directors and consultants to address the proposal fairly for all shareholders. Although the executive family is less present in committees, it still can influence decisions regarding key positions. Furthermore, the next step becomes more difficult because family members exist on the board of directors and as shareholders.

Therefore, to challenge the committee's decision-making is actually waste of time and creates more problem. Diagram 2 below indicates remuneration process.

Diagram 1: Remuneration Process

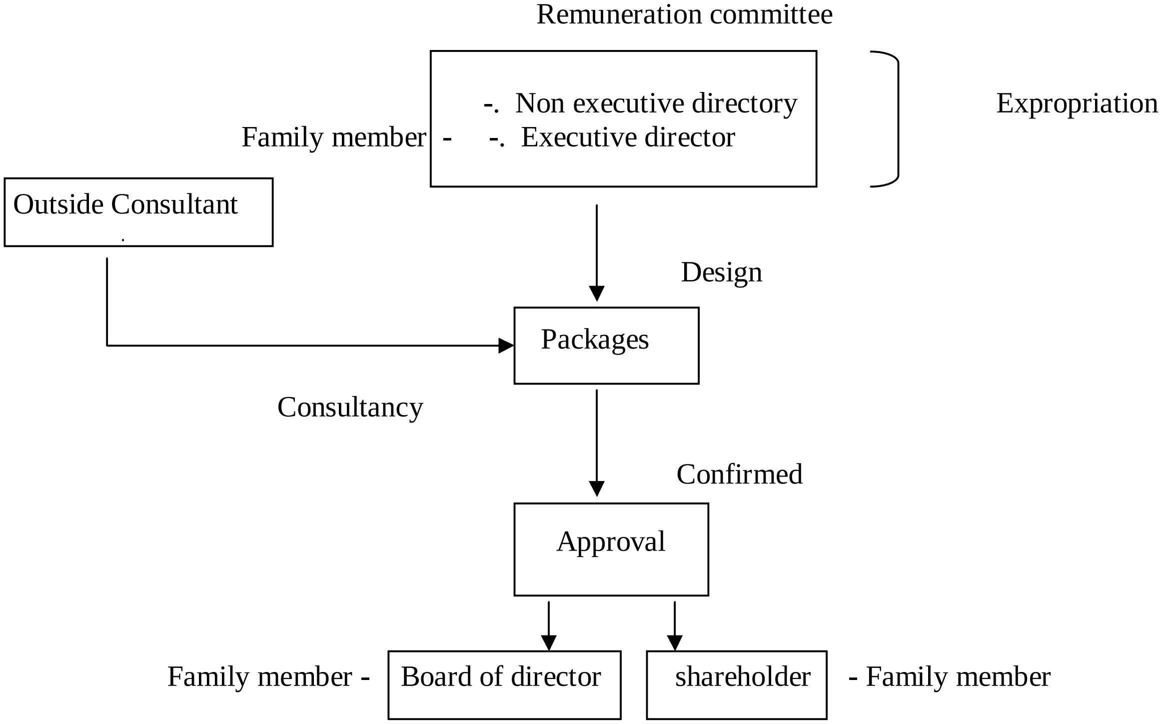
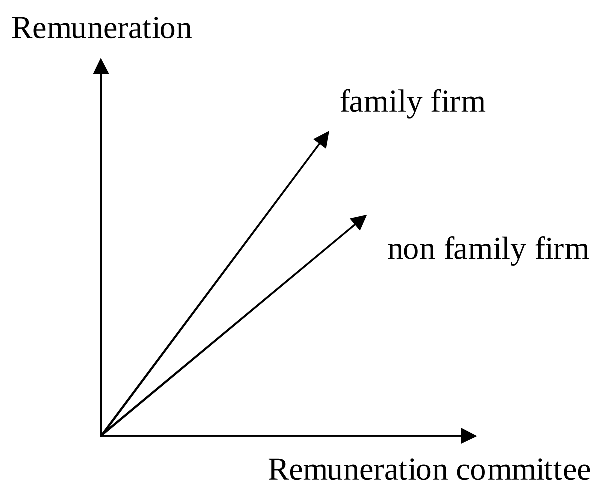


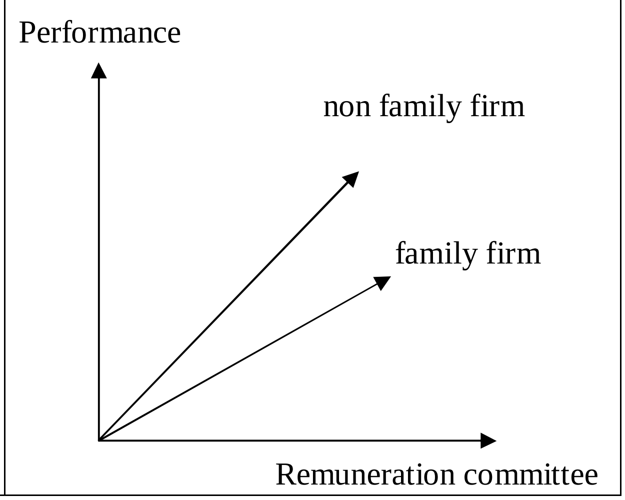
Diagram 1 indicates that the remuneration process can be dominated by family members via the remuneration committee, board of directors and shareholders. Committees responsible to design the best level of remuneration must link to majority shareholder motivation and performance. To make it work effectively, performance criteria needs to be a benchmark with committee members' focus rather than personal matters. Therefore, an outside consultant needs to review the proposal to support the non-executive director's advice and monitor to ensure that it is effective for impacting better performance.

From another perspective, the family members look at the remuneration process as the best place to expropriate via remuneration because they have the key position. Therefore, it is possible that the presence of family members may contradict the efforts of the non-executive and consultant purposefully to increase private benefit and expenses for minority shareholders. Furthermore, graph 2 below shows the different effects of remuneration in family firms and non-family firms.

Graph 1: Remuneration committee and remuneration in family firm and non-family firm



Graph 2: Remuneration committee and performance in family firm and non-family firm



In a family firm, the presence of the remuneration committee is positively associated with remuneration as shown in graph 1. First, family executives are actively present in the committee, strongly influencing the decision-making. Second, non-executive directors are less independent and want to hold onto their position. On the other hand, committee members in non-family firms do not have any relationship with each other and are able to design great incentives linked to better performance. Graph 2, following from graph 1, indicates that committee members tend to decrease performance in family firm because usually they agree with family members' suggestions even when it significantly impacts performance. The situation is different in non-family firms with no blood relationship in management. It provides an opportunity for committees to design great packages without pressure. They also are able to utilize their knowledge and skills to enhance performance as shown in graph 2.

2.2 Non-Executive Director

Majority shareholders in family firm have the ability to link their talent to private benefits. Indeed, a gap exists between minority shareholders. This situation leads to advantages for majority shareholders by providing great remuneration either less effectively monitored by minority shareholders or without connection to policies and procedures. Thus, agency theory suggests that non-executive directors may be required to monitor and control executive action (Jensen & Meckling 1976) and links to firm performance.

Research highlights the benefit of a non-executive director (Brickley, Lease, & Smith Jr, 1988; Fama & Jensen, 1983; Weisbach, 1988). The presence of a non-executive director is important as a check and balance, enhancing board effectiveness (Fama & Jensen, 1983). Non-executive directors have many advantages. They are decision experts (Fama and Jensen 1983); they are independent and not intimidated by CEOs (Weisbach, 1988), and they are able to reduce managerial consumption of perquisites (Brickley et al., 1988). In fact, non-executives can bring the executive director's concentration to profit maximization. Filatotchev et al. (2005) notes that board independence from a founding family positively impacts firm performance. Family firms are interested in mixed composition boards of director because the board is more independent when its composition is dominated by a non-executive director. Abdullah's (2001) study in Malaysia shows a similar result with boards largely dominated by non-executive directors. The question arises, how could the remuneration committee exploit the non-executive director through their advantages to hide from expropriation via remuneration?

Greenbury (1995) explains: the non-executive director does not have a personal financial interest other than as a shareholder in the committee decision. They should have better knowledge of the company and find it easier to make recommendations to the remuneration committee. Greenbury suggests that, although executive director is not a member of the remuneration committee, he/she should normally be invited to attend meetings to discuss performance with others members and make proposals as necessary. In practice, family ownerships are less interested in following Greenbury's suggestion because the firms belongs to them and a certain position is already portioned for family members. Furthermore, the in Malaysian context, MCCG (2000) suggests that the best principle is that executive directors should play no part in decisions regarding their own remuneration. Similarly with non-executive directors' remuneration, the individuals concerned should abstain from discussion of their own remuneration. Although the committees are wholly non-executive the director who responsible to design whole packages still needs the executive director's opinion before moving forward to the approval stages. This position puts the non-executive director in a dilemma whether to voice on behalf of minority shareholders or follow the rhythm of the executive director to benefit his/her career position.

Brick et al, (2010) explain that non-family executives have a difficult job in family firms because they are appointed by family members and easy to replace. Their performance basically is evaluated by a CEO, chairman or senior executives who are members of the business-owing family. This scenario puts non-family executives into a difficult situation in running a business due to less independence and limited space for making effective decisions. Basically, non-family executives and family executives have similar responsibilities, such as running a business daily; however, they have less power and control and cannot maximize themselves due to the key position held by family members. In the non-executive director context, the situation is serious because they are not responsible for running a business daily. They only provide advice and monitor an executive, which contributes to less power, control and independence to influence the committee's decision-making. As a result, they cannot go against the committee's decision; otherwise, they need to support the remuneration even it is not linked with performance.

Non-executive director cannot be effective monitors due to lack of business knowledge and lack of independence (Demb & Neubauer, 1992). This situation possibly provides an opportunity for the executive family to go against the firm's policies and procedures related to pay for performance. Less effectiveness by the non-executive director in monitoring shows that the composition of the board of directors does not influence performance (Klein, Shapiro, & Young, 2005).

The members should understand the company well, including operation and management purposes, to determine the packages. However, failure to obtain strong information or knowledge about firms causes a difficulty in curbing top management from expropriation. Accordingly, Patton and Baker show that the non-executive director does not possess strong business skills. Though they are dominated by either the board or committee, it does not make sense because one cannot curb private matters by majority shareholder. This provides an opportunity to increase pay for performance by manipulating the business information. For example, one might expanding a firm through a joint venture and note the resulting complexity of new executive tasks necessitates a pay increase. Actually, the joint venture with the parent company and the cooperation between companies already existed for a long time and contributed to less complexity. Furthermore, some of the decisions could be made through informal discussions at family gatherings and then forwarded on to the board meeting for formality only. The non-executive director is required to justify supporting remuneration even though it is not linked with performance. As a result, an agency problem arises and affects firm performance.

The discussion above stated that one of the advantages of a non-executive director is their independence; they are not intimidated by CEOs (Weisbach, 1988). However, another perspective argues that non-executive directors lack real independence (Demb & Neubauer, 1992). From the perspective of a family firm, this fact may benefit a family group in many ways. First, the non-executive director is appointed and feels reluctant to go against any decision when related to the family members. Second, they like to show their appreciation due to being a part of the board of directors. Third, they are interested in keeping their position in the firm and are less likely to argue any decision made by family members. Finally, their voices are not strong enough either to make amendments or to influence decision-making at design and approval stages, which are dominated by the family group.

As long as the committee is satisfied with the packages, the board and shareholders do not face a problem accepting the proposal. Supported by Bebchuk and Fried (2005) shareholders have incentives to support proposals that will advance their wealth interests. The proposal is designed by committee as a collective decision, and they cannot be blamed when the proposal is negatively related with pay for performance. As a result, the family members hide behind the non-executive director's tasks and functions, which prevent them from the guilt of expropriation.

2.3 Outside Consultant

Corporate performance positively is linked with better investment and an indicator of payout dividends. In fact, the better investment allows the firm to make strategies for expanding business and creating opportunities for increased firm profit. Wiwwattanakantang (2001) explains that the controlling shareholder may pay out the company's cash flow to themselves by paying excessive salaries and dividends. Meanwhile, the majority shareholders intend to abandon firm policy and procedure to pay their bonus, salaries or dividend more than their peer group. As a result, minority shareholders may feel that their interests are not being protected; they may lose confidence in the firm, sell stock and refuse to invest (Young et al. 2008). Therefore, collaboration between the committee and consultant is important for checks and balances with performance criteria and industry practices

Minority shareholders intending to invest suppose that if a family group is effective utilizing investment portfolio, it will bring more wealth via better dividends. Maury's (2006) study in Western European firms indicates that family control can increase performance. In fact, the outside consultant is responsible to review and link the proposal with majority shareholder abilities, such as expertise and knowledge. Implicit in this notion is the ability to motivate majority shareholders to work harder with higher commitment. As a result, the firm increases profit because the committee is not influenced by the consultant's work.

Outside consultants are hired due to their skills and expertise in obtaining relevant information to make it more attractive and able to increase shareholder wealth. It is possible that this information may provide consultants to cover each aspect, matching their skills and from other industries and optimal remuneration.

Bizjak et al. (2008) notes that consultants and remuneration committees usually use information on pay practices to compare with peer companies with similar size and industry. Furthermore, the consultant has the ability to attract investments from minority shareholders because they do not have any interest in the firm, which contribute to effective consultancy. In fact, consultants need to maintain their reputations in order to attract others to use their services. In addition, they cannot simply give consultancy without a strong justification; some members of the board of directors have many directorships and may provide a strong recommendation for their consultancy to other companies.

Another perspective refuses the role played by consultant because the committee makes use of them to increase pay for performance by hiding behind the consultant's role as the check and balance. The consultant performs less if the remuneration is proposed to decrease salary, fees, bonus or stock options, but performs creatively if remuneration increases. Core et al. (1999) explains that consultants tend to manipulate the remuneration packages. For example, when firm performance is better, the consultant strongly advises the committee to reward the remuneration based on firm performance data (Bebchuk & Fried, 2003). The results highlight that a large amount of salary, fees, bonuses and stock options directly go into the majority shareholder wealth. On the other hand, when firms do poorly, the consultants focus less on performance data and more on peer group pay to argue that CEO compensation should be higher to reflect prevailing industry levels. As a result, the minority shareholder wealth decreases and fewer dividends receive payouts.

The remuneration packages basically do not project the real picture of the relationship between pay for performance and are less effective in mitigating agency problem after consultancy. Accordingly, consultants' suggestions to committees may be nothing else but one-sided benefits, such as increasing the remuneration to please the board of directors (Crystal, 1991). Core et al. (1999) add that the board usually relies on the remuneration consultant hired by the CEO, which leads to the remuneration contract not being optimized for the firm but for the CEO. This contract might affect others' contracts as in parent companies under family firm control, such as subsidiaries or joint venture companies. Since the family group is satisfied with the consultant's role, they do not have any problem being appointed to parent companies or recommended to other companies.

Although the composition of executive director among family members is less in committees, comprehensive decision-making is still under their influence. Finkelstein and Hambrick (1989) note that family firms pay their CEOs more than non-family firms. The preceding outline highlighted that the non-executive director is less effective at monitoring due to independence but has strong consultancy to support proposals. Therefore, any advice or consultancy against the committees' desire leads to potential conflict. Even if the consultancy is not accepted, the committee is aware the presence of the consultant curbs remuneration from private benefit. This situation puts the consultant's contract in a dangerous zone, and it may not be extended. Based on diagram 1 above, the remuneration process is run by family members who hold key positions from the design level until approval. This situation provides the consultant with little choice; he/she follows the decision with less argument. In fact, power and control are relevant to make sure the consultant agrees with the packages even if they harm minority shareholders. In addition, the consultant has limited knowledge towards firm operation and management, and as a result, are unable to argue.

Less independence and the uniqueness of the family firm provide opportunity for the remuneration committee to manipulate the tasks and responsibilities of the consultant for expropriation via remuneration. Committees hide behind their expropriation activities through consultancy based on two aspects: first, financial reports, and second, comparisons with peer groups in similar industries and size. Therefore, the negative relationship between pay for performance actually is influenced by the committee, but minority shareholders cannot point this out because the proposal is a collective decision including consultancy. Consultants utilize all information purposefully to support the proposal with better justifications and to indicate to minority shareholders that the remuneration packages are a collective decision, not individual influence. This justification basically is less focused on performance criteria than keeping the proposal beneficial for the family group, resulting in a significant impact to the performance, as shown in graph 6. The consultancies try not to make changes even though the pay for performance causes a negatively relationship. Furthermore, the incentive is not consistent with the agency theory prediction to enhance performance and mitigate agency problem (Jensen & Meckling, 1976). Consultants usually obtain information purposefully to back up proposals with better justification while enhancing performance. However, these tasks are exploited by the committee, which supports proposals with potential to increase their wealth.

This result could lower firm performance and lead to fewer payout dividends. This becomes expenses for minority shareholders. Although the family member is less in committee composition than non-executive director, he/she still can influence decision-making through the uniqueness of the firm, which enables them to convince the consultancy to agree with the proposal even if the firm's performance decreases.

3. Conclusion

Consistent with the agency theory prediction, incentives are able to increase performance and mitigate agency problems. However, in family firms, the agency problem occurs between majority shareholders and minority shareholders, known as principal - principal (Young et al. 2008). However, fewer studies focus on the role played by the remuneration committee in designing effective remuneration (Anderson & Bijzak 2003), which consists of a non-executive director and executive director. The remuneration committee significantly influences top-level pay because the family member participates actively. Furthermore, the non-executive director mainly advises and monitors the remuneration process towards advantaging the committee by exploiting their tasks via increasing remuneration without justification. The non-executive director is less independent and prefers to maintain security in the position within the firm and contributes to expropriation by the committee.

Outside consultants are hired purposefully to review proposals to be transparent and motivate the majority shareholders to enhance performance. At the same time, they do not want to have any conflicts with family members because they want to keep their contract secure. This scenario contributes to independence during consultancy with one-sided benefits and less difficulty to increase remuneration by committee supported with better justification. Minority shareholders cannot blame individuals if the relationship between pay for performance is negative because the proposal is a collective decision. In this manner, committee expropriation via remuneration is exploited by consultant tasks and function.

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