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## ROLES OF INTERLOCKING DIRECTORATES IN AN EMERGING COUNTRY: CONTROL AND COORDINATION IN FAMILY BUSINESS GROUPS

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### Abstract

Maman (1999) proposed that, in countries in which business groups are dominant forms for organizing economic activities, the interlocking directorate is a managerial tool that can be prioritized to control and coordinate activities of their affiliated firms within the same groups and align their business objectives. This organizational connection appears to be an intentional strategy on the part of the groups' headquarters. In order to study the interlocking ties in Turkish family business groups (FBG), this study focused on interlocking directorates among listed firms in Turkey. The findings of preliminary study reveal that almost all of the interlocking ties were within the business groups (BG) in our sample. This is the result of assignment of family-affiliated and/or professional inside directors to the various boards of companies in the BG. We also found that compare to vertical ties; business groups are using more horizontal interlocking connections to bond their affiliated companies together.

**Keywords:** Interlocking Directorates, Business Groups, Turkish Family Business Groups, Emerging Markets

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### 1. Introduction

Board of directors' main responsibilities are hiring and managing of top executives careers, setting compensation, reviewing, approving and evaluating firm strategy, co-opting with external actors to reduce environmental uncertainty and overseeing and monitoring firm business activities (Finkelstein *et al.* 2009). Those crucial roles of board of directors position them equally on to center of corporate governance studies in the last two decades. Academic interest on board is focused mainly on understanding of their structure and composition. One of the important issues concerning board compositions and characteristics is the interlocking directorate. A direct interlocking directorate appears "when one person affiliated with one organization sits on the board of directors of another organization" (Mizruchi, 1996, p.271). However, an indirect interlocking directorate occurs "when two firms share same directors sitting on the board of a third independent firm" (Barringer and Harrison, 2000, p. 283). Interlocking directorates have been excessively studies in the related literature. Results of these study show that the direct or indirect interlocks help companies to diffuse and transfer their business practices, creates upper-class cohesion, acts as a mechanism for inter-firm collusion and cooperation, provides personal career advancement possibilities for directors, reduces dependence, controls and/or monitors others, presents a source of legitimacy and diminishes the probability of opportunistic behavior (Haunschild and Beckman, 1998; Mizruchi, 1996).

Considerable empirical work on this form of interorganizational connection has been conducted in developed countries context (Gulati and Westphal, 1999; Haunschild and Beckman, 1998; Forbes and Milliken, 1999). However, we know that organization of economic activities in emerging economies is influenced by different dynamics compare to developed countries and the concept of Business Groups (BG) has emerged as one of the suitable organizational form for governing large businesses in most of the emerging economies. Business groups usually unit together independent individual firms which are tied together by multiple links such as cross-ownership, close market related transactions and social networks such as family, kinship, or personal friendship ties, through which they could cooperate to realize shared strategic goals (Khanna and Rivkin, 2006; Granovetter, 1994). Although there are variations within and across countries in terms of ownership, authority structure, diversification level and size; an emerging market business group differs from a loose network of firms, which are connected to each other only by financial dependencies (such as conglomerates in the USA) due to well-established social arrangement among affiliated companies (Silva *et al.* 2006). The central research question that motivates this study is essentially to understand how an interlocking directorate could be used as a coordination and monitoring mechanism at business group level. We feel that Turkey is an interesting and valuable venue for considering board of directors, family ties and interlocking directorates. In this respect, this paper will explore the characteristics of board interlocks among listed firms in Turkey.

## **2. Business groups and Interlocking Directorates as Mechanisms of Control and Coordination: Literature Review**

### **2.1. Business Groups**

Granovetter (2005, p.429) describes a business group as “a collection of legally separate firms bound together in some formal and/or informal ways”. Business groups are dominant organizational forms in many emerging and developed economies. Common characteristics of business group in developing country context as stated by Leff (1978 in Khanna and Rivkin, 2006) are a joint management of several diversified companies operating in several industries (conglomeration), active role in financial sector and family ownership. Organizational and financial connections among group firms could motivate and facilitate the execution of mutually beneficial exchanges, diminish transaction costs by enabling flow of information between affiliates or by supporting firms’ interests and create social relationships which might fortify collaboration between firms (Khanna and Rivkin, 2006). Several researchers found that in developing economies, a firm’s affiliation to a BG might contribute positively to its financial performance (Claessens *et al.* 2000; Khanna and Palepu, 1999). Alternatively, business groups might also affect negatively organizational outcomes if they exploit their power to expropriate minority shareholders at the expense of overall performance (Silva *et al.* 2006).

However, all business groups have to deal with one similar and major issue: how headquarter of the group can coordinate and monitor the activities and performance of its affiliated companies? Effective management of organizational and financial connections between group-affiliated firms is beneficial and primordial for the parent company. This task becomes a more challenging one since each legally independent affiliated firm has a separate governance structure and team and a board of directors. However, it is group headquarters’ responsibilities to supervise activities and performance of their affiliated firms, to elaborate corporate and business strategies for the entire group and to allocate budgets and resources within the BG. In other words, business groups have to face with constant tension between the desire for autonomy of individual affiliated companies and the group headquarters’ requirement to regulate and monitor the actions of its affiliated companies (Maman, 1999).

### **2.2. Interlocking Directorates**

As Khanna and Yafeh (2007) pointed us the role of business group in emerging market as a mechanism to deal with information asymmetry, with imperfect markets in terms of product,

capital and labor and finally with institutional voids, coordination of the business activities across affiliated firms of the business groups is not only crucial for performance and continuity of the groups but also for the survival of those economies. Current literature on inter-firm coordination has focused on the core owner elite, equity interlocks and ownership pyramids as the instruments through which vertical linkages can be created between headquarters and affiliates and control can be exercised within the groups (Khanna and Thomas, 2009; Yiu *et al.* 2007). For example, in the case of cross-shareholding, members of a group hold each other's stock and this mechanism prompts mutual relationships and interdependence among member firms (Ortu *et al.* 1989). The existent research also reveals that firms in groups could often be bonded to each other in various manners such as by family ties and director interlocks. Although those are less formal ways of creating joint control mechanism, it is observed that they are common practices widely accepted by emerging market companies (Anderson and Reeb, 2003, Mizruchi, 1996, Granovetter, 1994). Granovetter (1994, pp.462-464) accentuated similarly the prominence of kinship relations, common ethnicity and religion and interlocks as mechanism to build confidence and then collaboration among the managers and firms involved. Anderson and Reeb (2003) proposed distinct managerial practices for business groups, such as counting on family members as managers or interlocking directors in order to create social ties and better coordination. They correspondently found (2003) that the active involvement of the family to governance activities contribute positively to monitoring performance. Furthermore they revealed a correlation between the existences of equity interlocks, shared individual owners and director interlocks and synchronicity of increased returns (Khanna and Thomas, 2009). This is consistent with the idea that markets view such ties as a control mechanism that contribute group headquarter monitoring effectiveness thus react positively.

A direct interlocking directorate can be define as a situation "when a director affiliated with one organization sits on the board of directors of another organization" (Mizruchi, 1996, p.271) and an indirect interlocking directorate occurs "when two firms have directors who sits on the board of a third firm" (Barringer and Harrison, 2000, p.283). However, intra-group direct interlock could be further classified as vertical and horizontal interlocks. Vertical interlocks are inter-organizational connections between the board of directors of the core-holding firm (group's headquarter) and its affiliated companies, whereas horizontal interlocks are the intra-group relations of directors among sister companies (Maman, 1999). Interlocking directorates have received a lot of academic attention. Empirical works on director interlocks and on their effects on diffusion of organizational structures (i.e. Palmer, Jennings and Zhou, 1993), strategies and behaviors (i.e. Haunschild, 1993; Chen *et al.* 2009) and performance (Ong *et al.* 2003) have generally been conducted in the developing countries, where the unit of analysis is individual and autonomous firms. The existent research advances that there are several reasons for the formation of interlocks. Firstly, according to the resource dependence model, companies are dependent on their external environment to procure necessary resources for their survival. In order to manage effectively this dependence in uncertain environments, interlocking directorates could be utilized as a mechanism for collaboration and cooptation (e.g. Schoorman *et al.* 1981; Haunschild and Beckman, 1998; Gulati and Wetsphal, 1999). Interlocking directorates could also help companies to diminish heir transaction costs by improving trust between members, facilitating information transfer and create joint problem-solving arrangements. Secondly, interlocks could also contribute personal development of the managers. Multiple assignments create extremely valuable openings for directors to access various and diverse information and networks, to learn from experiences of the others and to develop cognitive competencies. Sitting on the board of different firms, furthermore, exposes directors to different leadership styles, management knowhow and innovations (Ruigrok *et al.* 2006). Thirdly, interlocks with big and reputable firms could provide legitimacy, which is a prerequisite for securing the support of some financial institutions and reputable investors (Mizruchi, 1996). Finally, interlocking directorates could provide directors with financial incentives, prestige and professional contact opportunities, which may be crucial for their future career and their social cohesion with the upper class (Mizruchi, 1996).

### 2.3. Interlocking Directorates in Business Groups

Business groups' director interlocks are different from interlocks, which are formed across individual, autonomous and horizontally positioned firms. While there is broad accumulation of study on interlocking directorates, only a limited number of researches have focused on intra-group interlocking (Rommens *et al.* 2007; De, 2003; Lincoln *et al.* 1992; Keister, 1998; Maman, 1999; Collin, 1998; Gerlach, 1992).

Interlocking directorates facilitates the monitoring responsibilities of headquarters by pooling information from their affiliated companies and their managers. Interlocks also provide individual group companies a significant opportunity to access to divers network of information. Information sharing about technological advances, marketing opportunities and innovation strategies, which will enhance strategic decision-making performance of directors, is facilitated by interlock (Keister, 1998; Collin, 1998). Interlocks also reduce transaction costs, enable management of resource flows across group companies and serve as a mechanism for social cohesion (Keister, 1998). Vertical interlocks between group members and the headquarter company are mechanisms for monitoring group affiliated firms, whereas horizontal interlocks aim to coordinate activities and common interest of sister firms which are legally independent but interdependent to each other in terms of resources allocations and business opportunities. Interlocks are especially useful in large and diversified business groups, which often experience greater control and coordination issues (Collin, 1998; Maman, 1999; Orru *et al.* 1989; Rommens *et al.* 2007.)

Business groups in Turkey are very similar to conglomerates, in which a holding company hold in part or whole ownership of its affiliated companies, which operate in different industries. As a result, business groups in Turkey are usually highly diversified into unrelated product markets (Colpan, 2010). In these groups a core owner, generally a family, controls holding company. Another important characteristic of the holding company is that they are similar to a corporate headquarter and are controlling each individual group affiliated firms by investing in others. These individual affiliates act like subsidiaries, but actually they are legally independent, affiliated firms. Whether a core company dominates or controls a majority of the share in a specific affiliated firm is largely dependent on the contributions of this affiliated company to holding firm mission. In summary, business groups are significant actors in many markets around the world as well as Turkey. Maman (1999) suggested that most of the business groups follow a diversification strategy, which might create great deal of control and coordination issues for the holding company. He proposed that interlocking ties, both form of vertical and horizontal ones are most probable within business groups.

**Proposition 1:** Director interlocks are more likely to occur within business groups in Turkey.

**Proposition 2:** Business groups are likely to use both vertical and horizontal directorate interlockings in Turkey.

Several researchers suggest that family business groups (FBG), often called as "holdings", are dominant organizational structure preferred by Turkish businessman and entrepreneurs in Turkey as they are in other emergent countries (Onis, 1995; Bugra, 1994; Yildirim-Oktem and Usdiken, 2010; Goksen and Usdiken, 2001). In FBG, the desire to maintain control leads an founding/owner family to become actively involved in governing and managing their business. They control the business group through a holding company which function both as the control device and as a headquarter for the entire group. Equity holdings such as pyramidal shareholding structures and interlocking directorates are generally used to gain effective control over a large number of companies within the groups (Colpan, 2010). However, organizational characteristics, contextual conditions and institutional factors may force an founder/owner family to share the governance and management of its affiliated firms with those from outside of the family, such as firms' executives and outside managers. It was found that, in vertically oriented business groups in South Korea and Japan, a holding company focus on

strategic planning, the owner family of the group takes all strategic decisions and family control is executed by placing family members on various boards of directors (Orru *et al.* 1989). In this respect, we propose that:

**Proposition 3:** In family business groups, vertical interlocking directorates are more likely to occur with owner family members than other executives.

### 3. Methodology

#### 3.1. Sample, Data Collection and Variables

We test the above hypothesis in Turkey with a sample 331 listed firms on the Istanbul Stock Exchange (ISE) in 2008. We collected information about board of directors and ownership characteristics of the firm from KAP (Public Disclosure Platform of Turkey) electronic database and from individual companies financial reports. We first identified all corporations, which are interlocked with each other in the sample<sup>1</sup>. We then calculated the interlocking ties within the business groups and family business groups. To test our first proposition, we measure the proportion of internal ties out of all of the group's interlocking ties with other firms in the sample. We finally differentiated between various types of internal interlocking. Vertical internal interlocking are ties between headquarter of the group and its affiliated companies. When a director sit on the board of both the holding company and its affiliated company, we can say there is a vertical internal interlock within the business group. Horizontal internal interlocking, in contrast, is the relationship between same group affiliated firms. When a director has seats on the board of different affiliate companies of the same group we can say that he or she ties these companies together.

We classified member of board of directors into three categories:

1. Members of the founding/owner family or relatives as family member
2. Executives of the firm or group (inside directors)
3. Representative of other organizations (outside directors) (Finkelstein *et al.* 2009).

We identified the business groups by the 'holding' company that constitutes headquarter of the group. We used Colpan (2010) list of the 50 largest firms in Turkey to double check the ownership statue of a firm. The distinction between family and non- family business group is made based on the criteria of share holding and family member's active involvement in the management. If the family members hold the majority share of the business group and if the family members are the member of the board of directors of the holding company, we classified this group as a family business group (FBG).

### 4. Results

The results of the interlocks of 331 listed companies are presented in Table 1. We found that, out of a total of 2036 members of boards of directors, 269 thereof are interlocked to each other. In other words, there are interlocking ties between 184 companies. Approximately 70% of these companies are parent or affiliated companies of 31 different business groups (22 thereof are family-owned and managed) and 75% of the interlocks are realized within the same business group's affiliated firms. It is also worth noting that the majority of business group-affiliated firms are family-owned enterprises (118 out of 128) and 82% of director interlocks are within the family-owned and managed groups.

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<sup>1</sup> In turkey, there is no legal restriction regarding the number of interlocks.

**Table 1. Directors' interlocks in Turkish listed companies**

	<b>2008</b>
Number of directors in total	2,036
Number of multiple directors	269
Business Groups	202
Family Business Groups	166
Ratio of multiple directors	0.14
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Number of directors' interlocks	
2	199 (74%)
3	30 (11.2%)
4	25 (9.3%)
5	11 (4.1%)
More than 5	4 (1.4%)

Yurtoglu (2000) in his study on companies quoted to ISE indicates that: "holding companies are the largest owners with ownership stakes in 143 companies and with an average stake of 36%" (Yurtoglu, 2000). Moreover, Yurtoglu's paper revealed that family members mostly own listed companies in Turkey. Families control 198 of the 257 companies, with an average 53.8% holding of the equity capital in 2000. Goksen and Usdiken (2001) reported that there were out of 22 business groups 18 thereof were family-controlled. Demirag and Serter (2003, p.48) also named Turkey as an "insider system" country. They concluded that "Turkish-listed companies have a highly concentrated and centralized ownership structure and families, directly or indirectly, own more than 70% of all traded companies and retain the majority of control". Thus, we can say that, as proposed in proposition 1, the majority of the observed interlocks are intragroup in nature. There are 269 interlocks within business group companies compare to 67 interlocks between stand-alone firms. When we analyzed board interlocks between non-business group affiliated companies in detail, we also realized that such interlocks are also tied between companies, who also has equity holdings or family ties. However, we expected that being a member of a independent firm's board outside the business group and being exposed to the experience of other firms would provide valuable information to the directors (Haunschild and Beckman, 1998) and companies would also prefer non-control-oriented i.e. information-targeted interlocks.

When we have a closer look at the characteristics of interlocking directorates in our sample, Tables 2, 3 and 4 show different types of internal interlocking relationship in listed companies. We observe more horizontal internal interlock ties in our sample than vertical. We found that 66% of the total interlocks in all listed companies, 56% of the interlocks in business groups and 55% of the interlocks in family business groups are horizontal in nature. We also found that, in family business groups, 13% of directors connect more than two affiliated companies to the holding parent firm. However, we feel that we should interpret these observations with caution. The holding headquarters of all business groups presented in our sample were not quoted to ISE. It is therefore possible to observe the vertical interlock ties of 12 business groups out of 31. Thus, some vertical interlocks are unfortunately missing from our observations. Therefore, we cannot say that majority of the interlocks in family business groups serve as a mechanism of coordination and a flow of information. When we examine the characteristics of affiliated companies who share the same directors, we found that 42.7% thereof are operating in the same sector of activities. Thus, we can conclude that these directors not only coordinate the activities of sister companies, but also serve as a mechanism for sharing industry-specific knowledge and experiences.

**Table 2. Patterns of interlocking directorates in listed companies**

	Family Member		Inside Directors		Outside Directors		Others		Total	
		(%)		(%)		(%)		(%)		(%)
Vertical Interlocks	10	27.8	26	72.2	0	0	0	0	36	13.0
Horizontal Interlocks	57	32.0	112	62.9	2	1.1	7	3.9	178	66.0
Both <sup>2</sup>	14	56.0	11	44.0	0	0	0	0	25	9.0
Other <sup>3</sup>	6	20	5	16.7	19	63.3	0	0	30	11.0
<b>Total</b>	<b>87</b>	<b>32.3</b>	<b>154</b>	<b>57.2</b>	<b>21</b>	<b>7.8</b>	<b>7</b>	<b>2.6</b>	<b>269</b>	<b>99</b>

Note: Pearson chi-square: 154,792 df: 9 sig. (two-sided): .00

**Table 3. Patterns of interlocking directorates in listed business groups**

	Family Member		Inside Directors		Outside Directors		TOTAL	
		(%)		(%)		(%)		(%)
Vertical interlocking	10	29.4	24	70.6	0	0	34	17.0
Horizontal Interlocking	33	29.2	78	69.0	2	1.8	113	56.0
Both	13	54.2	11	45.8	0	0	24	12.0
Other	6	19.4	6	19.4	19	61.3	31	15.0
<b>Total</b>	<b>62</b>	<b>30.7</b>	<b>119</b>	<b>58.9</b>	<b>21</b>	<b>10.4</b>	<b>202</b>	<b>100</b>

Note: Pearson chi-square: 108,743 df: 6 sig. (two-sided): .000

<sup>2</sup> Both vertical and horizontal interlocks

<sup>3</sup> Nonintragroup interlocks such as links between a group affiliated company and a standal one company.

**Table 4. Patterns of interlocking directorates in listed family business groups**

	Family Member		Inside Directors		Outside Directors		TOTAL	
		(%)		(%)		(%)		(%)
Vertical interlocking	8	34.8	15	65.2	0	0	23	14.0
Horizontal Interlocking	33	35.9	57	62.0	2	22,0	92	55.0
Both	13	61.9	8	38.1	0	0	21	13.0
Other	6	20.0	5	16.7	19	63.3	30	18.0
<b>Total</b>	<b>60</b>	<b>36.1</b>	<b>85</b>	<b>51.2</b>	<b>21</b>	<b>12.7</b>	<b>166</b>	<b>100</b>

**Note:** Pearson chi-square: 91,150 df: 6 sig. (two-sided): .000

Jensen and Meckling's (1976) model confirmed that managerial opportunism (i.e. agency costs) in family businesses is low so internal governance mechanisms such as a board might not be indispensable. However, a more recent perspective (Chrisman *et al.*, 2004; Schulze *et al.*, 2002) suggests that altruistic family behavior might correspondingly be harmful for a company. They suggest that boards serve more than a governance mechanism and family firms' owners can utilize directors to assist family executives and to control family agency costs (Hillman and Dalziel, 2003; Johnson *et al.*, 1996). Therefore, we expect that family members organize interlocks not only for entrenchment and preservation purposes, but also to get advice from others who have specific experience (Lester and Cannella, 2006). Therefore, in line with our proposition, we would like to determine the family ties in boards of directors. However, as observed from Tables 4 and 5 and contrary to our expectations, we found that inside executives, in other words professional managers of the group companies not family members, fulfill 51% of the interlocks within family business groups and they are horizontal in nature. We can say that family controlling family business groups recognize the value of professionalizing governance and that there are also some institutional pressures that oblige them to do so. Generally, there are operational ties among the firms and group-affiliated companies share their executives with holding and affiliated sister companies. Contrary to our expectations, we also found that a very limited number of directors (only 12,7 %) link business group companies to other non-related companies. When we analyze these "outside directors", we found that, in most cases, they are ex-salaried executives of the group or ex-bureaucrats. However, in a study conducted by Kula (2005) about 356 Turkish companies, the proportion of outside executives on the boards is 11%.

## 5. Conclusions and Discussion

Maman (1999) proposed that, in countries in which business groups are a dominant form to organize economic activities, the interlocking directorate is a managerial tool that can be prioritize to monitor and coordinate activities of companies within the groups and align their business objectives. This organizational relationship seems to be an intentional strategy on the part of the groups in order that they can succeed control and coordination. The findings of this exploratory study revealed that almost all of the interlock relationships were within the BG in our sample. This is due to family-affiliated and professional inside directors assigned simultaneously to several boards of the firms within the same group. We also found that there are more horizontal than vertical internal interlocking ties between the companies. In other words, holding companies share executives between their affiliated companies to improve coordination among

sister companies and to benefit from the professional experiences of their managers in different business areas. When we take a closer look at the social ties between the boards of directors, we observe family interlocks between companies affiliated with the same group. This is not a very surprising result when we take into consideration the fact that majority of BG in Turkey are owned and controlled by families. However, inside directors in FBG represent 51% of the interlocks. We can say that there is a greater representation of professional executives in the boards of family businesses. Understandably, as the size of the business group gets larger, family members have to delegate operational execution of their individual affiliated companies to their executives (Colpan, 2010).

However, these results should be interpreted cautiously given the limitations inherent in this study. Limitation in terms of generalizability of the findings should be noted. The researchers used a limited sample size (ISE 331) and the interlocks between these companies. In order to have a more comprehensive opinion on the current issue, we feel that future studies should enlarge the sample size. Preliminary results show that there is a substantial association between social ties and business groups' corporate governance structures. However, more sophisticated research should be undertaken in order to comprehend the role of family ties, firm' characteristics (firm size, sector of activity, age, and diversification) and the effect of interlocks on the organizational outcomes.

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