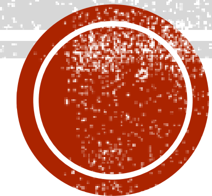
FIN536 CORPORATE GOVERNANCE



Lecture 8 The Board of Directors (2)

Prof. Daniel Sungyeon Kim

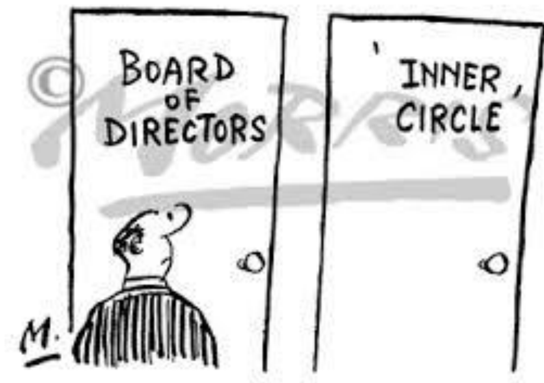
TODAY'S AGENDA

- A Theory of Friendly Board
- Board of Directors: Structure and Consequences
- Are All Inside Directors the Same?

1. A THEORY OF FRIENDLY BOARDS

- "*A Theory of Friendly Boards*" by Adams and Ferreira, 2007, Journal of Finance

- Consequence of the board's dual role as advisor and monitor of manager



1. A THEORY OF FRIENDLY BOARDS

- CEO dislikes monitoring by the board
  - He values (private benefits) control

- CEO likes advising by the board
  - Advice increases firm value without interfering with his choice
  - The expertise of the board is complementary to that of the CEO

- CEO faces a trade-off in disclosing information to the board
  - If he reveals his information, he receives better advice
  - However, informed board will monitor him more intensively

1. A THEORY OF FRIENDLY BOARDS

- Model Setup: Timing
  - Period 0
    - Shareholders set up the firm
    - Elect a board with certain degree of independence
    - Assume that insiders' career concerns inside the firm are sufficiently important (high cost of monitoring)
  - Period 1
    - The CEO gathers information and communicates with the board
    - The CEO and the board face a non-routine project choice decision
    - With certain probability, only the CEO acquires this information

1. A THEORY OF FRIENDLY BOARDS

- Model Setup: Timing
  - Period 2
    - Board gathers information and monitor the CEO
    - After the CEO's report, the board invest time to gather own private signal about the project
    - The board chooses its monitoring intensity.
  - Period 3
    - Control is allocated and the project is chosen
    - If monitoring is successful then the board has effective control over the project decision.
    - If monitoring is unsuccessful, the board will give the CEO its advice.

1. A THEORY OF FRIENDLY BOARDS

- More independent boards will choose to monitor more intensively
  - Board independence reduces the marginal cost of monitoring.
- Both monitoring and advising by the board are more effective when the board is better informed
- In both roles, the board depends crucially on the CEO for firm-specific information.
- To encourage the CEO to share information, shareholders may optimally elect a less independent or friendlier board that does not monitor the CEO too intensively

1. A THEORY OF FRIENDLY BOARDS

- U-shaped relation between board monitoring and private benefits

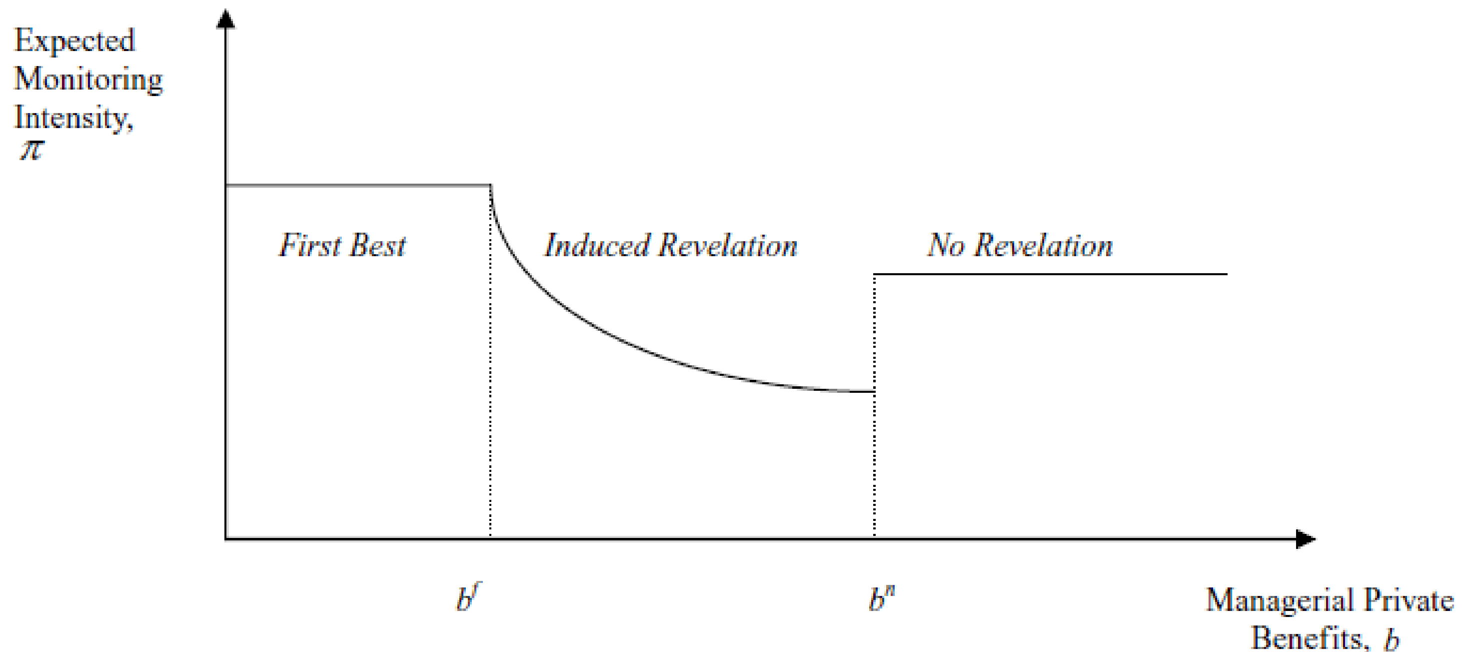


Figure 2. Expected Monitoring Intensity of the Board and Managerial Private Benefits.

1. A THEORY OF FRIENDLY BOARDS

- U-shaped relation between board monitoring and private benefits
  - With low private benefit of control (below b^f), CEO always shares information
  - As private benefit b increases, CEO is less likely to reveal the information
  - With high private benefit (above b^n), CEO does not share information
  - If CEO's information advantage is high, the threshold b^n increases.

1. A THEORY OF FRIENDLY BOARDS

- U-shaped relation between optimal board independence and managerial private benefits

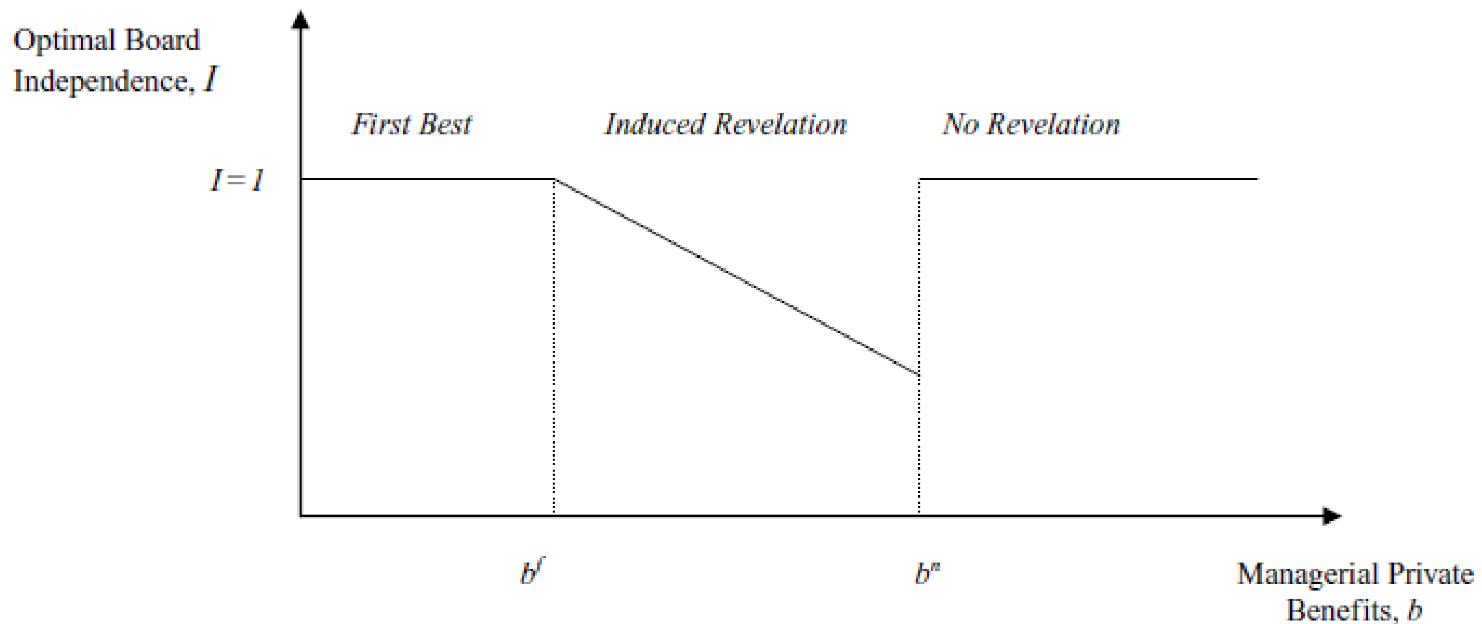


Figure 3. Optimal Board Independence and Managerial Private Benefits. The figure

1. A THEORY OF FRIENDLY BOARDS

- U-shaped relation between optimal board independence and managerial private benefits
  - With low private benefit of control (below b^f), board is fully independent
  - As private benefit b increases, the friendly board works better
  - With high private benefit (above b^n), the board is fully independent again.
  - If CEO's information advantage is high, friendly boards are optimal for a larger set of firms.

1. A THEORY OF FRIENDLY BOARDS

- Separating the Roles of Monitor and Advisor
  - Sole board vs. Dual/Two-tier board
  - Management board and Supervisory board
  - CEO does not face a trade-off in providing information
  - Cross-country variation in board structure

Board Structure Type	Country
Sole board system	Australia, Brazil, Canada, Egypt, India, Italy, Japan, Malaysia, Norway, Philippines, Singapore, South Africa, South Korea, Sweden, Thailand, Turkey, U.S., Ukraine, United Kingdom, Zimbabwe
Dual board system	Austria, Belgium, China, Croatia, Czech Republic, Denmark, Estonia, Georgia, Germany, Holland, Indonesia, Latvia, Mauritius, Poland, Spain, Taiwan
Mixed board structures	Bulgaria, Finland, France, Switzerland

1. A THEORY OF FRIENDLY BOARDS

- Separating the Roles of Monitor and Advisor
  - Carrasco (2005) argues that a two tier system results in more monitoring but less efficient information flow due to the potential lack of communication and higher cost of running a dual board
    - Neither board fully internalizes the effects of their choices on their peers' payoff.
    - Open discussions between the boards are the key

2. BOARD STRUCTURE AND CONSEQUENCES

- Boards are often described in terms of their salient structural features: size, independence, committees, diversity, etc.
- Do these attributes have an impact on the board's ability to monitor and advise the corporation?
- Do companies with certain structural features perform better/ worse than those who lack them?
- A determination of how to structure the board should be based on rigorous statistical evidence.
- At the same time, it should allow for situational differences across companies.

2.1. CHAIRMAN OF THE BOARD

- The chairman is the liaison between the board and management, and between the board and shareholders.
- The chairman presides over the board, schedules meetings, sets the agenda, and distributes materials in advance.
- The chairman leads the discussion of important items, including strategy, risk, performance, compensation, succession, and mergers.
- The chairman shapes the timing and manner in which items are discussed and therefore is critical to the governance system.

2.1. CHAIRMAN OF THE BOARD

- Should the chairman be independent?
  - Pros
    - Clear separation from management.
    - Clear authority to speak on behalf of the board.
    - Eliminates conflicts.
    - CEO has more time to run the company.

2.1. CHAIRMAN OF THE BOARD

- Should the chairman be independent?
  - Cons
    - Artificial separation if dual Chairman/CEO is effective.
    - Difficult to recruit new CEO that expects to hold both jobs.
    - Complicates decision making.

2.1. CHAIRMAN OF THE BOARD

- Should the chairman be independent?
  - No research evidence that an independent chairman improves or destroys shareholder value.
  - Decision to separate should be based on situation.
  - Boyd (1995); Brickley, Coles and Jarrell (1997)

2.2. LEAD INDEPENDENT DIRECTOR

- The lead independent director presides over executive sessions of the board.
- The lead director may play a prominent role in evaluating corporate performance, succession planning, director recruitment, and board evaluation.
- The lead director serves as a single point of contact between nonexecutive directors and management, institutional investors, and the media.

2.2. LEAD INDEPENDENT DIRECTOR

- Does the lead independent director add value?
  - Counterbalances a strong Chairman-CEO.
  - Provides leadership during a crisis.
  - Brings clarity of communication.
  - Responsibilities of the role vary widely.
  - May be a superficial designation.

2.2. LEAD INDEPENDENT DIRECTOR

- Does the lead independent director add value?
  - Modest evidence that lead directors improve corporate outcomes.
  - The effectiveness of the lead director will depend on the definition of the role and the authority granted.
    - Larcker, Richardson, and Tuna (2007)

2.3. INDEPENDENT DIRECTORS

- Independent directors are those who "have no material relationship" with the company (as defined by the NYSE).

- A director is not independent if director or family member has, in the last three years:
  - Served as an executive of the listed firm.
  - Earned compensation > $120,000 from the firm.
  - Served as an internal or external auditor of firm.
  - Served as executive at another firm where CEO of listed firm was on compensation committee.
  - Served as executive of another firm whose business with the listed firm is $1 million or 2% of revenue.

2.3. INDEPENDENT DIRECTORS

- Independent judgment is critical to the advisory and monitoring functions of the board.
  - Pros
    - Offer objective evaluation of company and management.
    - Allow for arms-length negotiation of compensation.
    - Make decisions solely in the best interest of the company.

2.3. INDEPENDENT DIRECTORS

- Independent judgment is critical to the advisory and monitoring functions of the board.
  - Cons
    - Directors who meet NYSE standards may not be independent.
    - Social ties may compromise judgment.
    - Only effective if they are qualified and engaged.

2.3. INDEPENDENT DIRECTORS

- Outside directors improve some governance outcomes, such as M&A premiums.
- Their effectiveness depends on their cost of acquiring information about the firm.
- True independence of judgment may differ from regulatory independence
- Cotter, Shivdasani, and Zenner (1997); Duchin, Matsusaka, and Ozbas (2010); Hwang and Kim (2009)

2.4. INDEPENDENT COMMITTEES

- Committees of the board deliberate topic-specific issues that are critical to the oversight of the company.
- Directors are selected to committees based on their qualifications and domain expertise (generally).
- The audit, compensation, and nominating/governance committees are required to be independent (Sarbanes Oxley).
- Specialized committees (strategy, finance, technology, and environmental, etc.) have no independence requirements and may include executive officers.

2.4. INDEPENDENT COMMITTEES

- Are committees more effective when they are independent (either majority or 100%)?
  - Pros
    - Objective advice and oversight.
    - Less susceptible to being co-opted by management.
  - Cons
    - Decision making may suffer.
    - Independent directors have a "knowledge gap."
    - Management brings important firm-specific knowledge.

2.4. INDEPENDENT COMMITTEES

- Some evidence that independent audit committees improve earnings quality. 100% independence is no better than majority independence.
- Specialized committees benefit from insider knowledge.
- The independence of a committee should depend on its function.
- Klein (2002); Kliein (1998)

2.5. Busy Boards

- "Busy" director: director holds multiple board seats (generally 3 or more).
  - "Busy" board: a majority of directors are busy.

- Total unique directors 29,089
  - Directors with:
  - 1 board seats 24,144
  - 2 board seats 3,583
  - 3 board seats 1,020
  - 4 board seats 254
  - 5 or more 88
  - Source: Corporate Board Member and Pricewaterhouse Coopers (2009)

2.5. BUSY BOARDS

- Are busy directors better or worse corporate monitors?
  - Pros
    - Bring important experiences from other directorships.
    - Broad social and professional networks.
    - May have high integrity (reason they are in demand).
  - Cons
    - May be too busy to properly monitor.
    - May be less available at critical moments.

2.5. BUSY BOARDS

- Are busy directors better or worse corporate monitors?
  - Companies with busy boards tend to have worse long-term
  - performance and worse oversight.
  - Busy boards are less likely to fire an underperforming CEO.
  - Busy boards award higher compensation.
  - Fich and Shivdasani (2006); Core, Holthausen, and Larcker (1999)

2.6. INTERLOCKED BOARDS

- Interlocked boards: the CEO of Firm A sits on the board of Firm B, while the CEO of Firm B sits on the board of Firm A.
  - Pros
    - Creates a network between companies.
    - Facilitates the flow of information and best practices.
  - Cons
    - Creates a dynamic of reciprocity.
    - Can compromise objectivity and weaken oversight.

2.6. INTERLOCKED BOARDS

- Network connections generally improve corporate performance.
- Effects are most pronounced among companies that are newly formed, have high growth potential, or in need of a turnaround.
- At the same time, interlocking leads to decreased monitoring (less to terminate underperforming CEO; award higher compensation).
- Companies must balance trade-off.
- Larcker, So, and Wang (2010); Hallock (1997); Nguyen-Dang (2009)

2.7. BOARD SIZE

- Board size tends to be correlated with company revenue.
  - Small companies (<$10 million): 7 directors, on average.
  - Large companies (>$10 billion): 12 directors, on average.
  - Pros
    - Large boards have more resources.
    - Allow for greater specialization.
  - Cons
    - Greater cost (compensation, scheduling conflicts, etc.).
    - Slow decision making.

2.7. BOARD SIZE

- Board size tends to be correlated with company revenue.
  - Larger boards tend to provide worse oversight (when company size is held constant).
  - Large "complex" firms (those with multiple business segments) benefit from larger board size while large "simple" firms do not.
  - Yermack (1996); Coles, Daniel, and Naveen (2008)

2.7. DIVERSE BOARDS

- Do diverse boards provide better advice and oversight?
  - Pros
    - Broader array of knowledge, experience, and perspective.
    - Lessens "groupthink" (premature consensus).
    - Encourages healthy debate.
  - Cons
    - Diverse groups exhibit lower teamwork.
    - May lead to "tokenism."

2.7. DIVERSE BOARDS

- Evidence on the relation between diversity and corporate performance is largely inconclusive.
- Modest evidence that female representation improves governance quality.
- Diversity for the sake of meeting arbitrary quotas is clearly detrimental (the cost of inexperience outweighs the potential benefits).
- Mentoring and development improves director qualification.
- Wang and Clift (2009); Hussein, Kassim and Bill M. Kiwia. 2009; Adams and Ferreira (2008); Ahern and Dittmar (2010)

3. ARE ALL INSIDE DIRECTORS THE SAME?

- "*Are All Inside Directors the Same?*" by Masulis and Mobbs, 2011, Journal of Finance
- Non-CEO inside directors
  - Inside operating officers listed as firm employees, and not CEO or Chairman of the board
  - Are they all homogeneous?

3. Are All Inside Directors the Same?

- Hypotheses
  - *Enhanced incentive 1*: Labor market for outside directors creates new incentives for offices to be more concerned with firm performance
    - The greater visibility to other firms facilitates a broader assessment of inside directors
  - *Enhanced incentive 2*: With greater career independence from their CEO, insider directors less susceptible to CEO influence
  - *Signaling quality*: Individuals obtain outside directorships when the external labor market for directors recognizes their skills (Fama and Jensen 1983)
    - Rational CEOs recognize these skilled and reputable operating officers, which increases CEO performance incentives

3. ARE ALL INSIDE DIRECTORS THE SAME?

- Results
  - 50% of sample has one or more inside directors and 10% of these officer-directors hold outside directorships.
  - They lead to stronger board monitoring, reduced CEO entrenchment and lower manager-shareholder agency cost.
  - A CID is associated with 8.8% greater market-to-book ratio relative to firms with non-CIDs.

3. ARE ALL INSIDE DIRECTORS THE SAME?

- Results: Market reaction
  - When inside directors acquire their first independent outside directorship, a significant positive market reaction to this news.
  - Appointments to a second independent directorship produce a smaller effect
  - Appointments to a third and greater elicit a negative market reaction, consistent with a "*Busy director*" effect

3. ARE ALL INSIDE DIRECTORS THE SAME?

- Results: CID and Firm decision making
  - Firms with CIDs make:
    - More profitable acquisitions
    - Better manage cash holdings
    - Less apt to restate earnings due to over-reporting