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# BOARD OF DIRECTORS

## STRUCTURE AND CONSEQUENCES



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## BOARD STRUCTURE

- Boards are often described in terms of their salient structural features: size, independence, committees, 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.

# BOARD STRUCTURE

## THE BOARD OF DIRECTORS OF THE AVERAGE LARGE U.S. CORPORATION

BOARD ATTRIBUTE	U.S. AVERAGE
NUMBER OF DIRECTORS	11
NUMBER OF MEETINGS PER YEAR	8
INDEPENDENT DIRECTORS	85%
INDEPENDENT CHAIRMAN	34%
DUAL CHAIR/CEO	47%
LEAD DIRECTOR	75%
AVERAGE AGE	63

Spencer Stuart (2019)

BOARD ATTRIBUTE	U.S. AVERAGE
NEW DIRECTORS FIRST-TIME DIRECTORS	27%
CEO SERVES ON >1 OUTSIDE BOARD	41%
CEO IS ONLY INSIDE DIRECTOR	62%
MANDATORY RETIREMENT	71%
MANDATORY RETIREMENT AGE	72
FEMALE DIRECTORS	26%
AT LEAST ONE FEMALE DIRECTOR	100%



# CHAIRMAN OF THE BOARD

- Should the chairman be independent?
  - (+) Clear separation from management.
  - (+) Clear authority to speak on behalf of the board.
  - (+) Eliminates conflicts.
  - (+) CEO has more time to run the company.
  - (-) Artificial separation if dual Chairman/CEO is effective.
  - (-) Difficult to recruit new CEO that expects to hold both jobs.
  - (-) Complicates decision making.

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No research evidence that an independent chairman improves shareholder value or governance quality. Forced separation decreases value.

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Krause, Semadeni, and Cannella (2013); Dey, Engel, and Liu (2011)



## 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.



# 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.

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- Shareholders react positively to adoption of lead independent director.
  - Their effectiveness will depend on their role and the authority granted.
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Lamoureaux, Litov, and Mauler (2019)



# 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 the director or a 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.



# INDEPENDENT DIRECTORS

- Independent judgment is critical to the advisory and monitoring functions of the board.
    - (+) Offer objective evaluation of company and management.
    - (+) Allow for arms-length negotiation of compensation.
    - (+) Make decisions solely in the best interest of the company.
    - (-) Directors who meet NYSE standards may not be independent.
    - (-) Social ties may compromise judgment.
    - (-) Only effective if they are qualified and engaged.
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- **Outside directors improve some governance outcomes, such as M&A premiums.**
  - **Little evidence they improve long-term performance.**
  - **Social relationships to the CEO tend to weaken “independence”.**

Cotter, Shivdasani, and Zenner (1997); Duchin, Matsusaka, and Ozbas (2010); Hwang and Kim (2009); Coles, Daniel, and Naveen (2014)





## 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.



# INDEPENDENT COMMITTEES

- Are committees more effective when they are independent?

(+) Objective advice and oversight.

(+) Less susceptible to being co-opted by management.

(-) Decision making may suffer.

(-) Independent directors have a “knowledge gap.”

(-) Management brings important firm-specific knowledge.

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- Some evidence that independent committees improve audit, compensation, and monitoring functions.
  - Specialized committees benefit from **insider** knowledge (not independence).
  - Whether a committee is independent should depend on its function.
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Klein (2002); Wang, Xie, and Zhu (2015); Guo and Masulis (2015); Klein (1998)

# BUSY BOARDS

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

NUMBER OF DIRECTORSHIPS	DIRECTORS	%
1 BOARD SEAT	27,296	80.1%
2 BOARD SEATS	4,742	13.9%
3 BOARD SEATS	1,484	4.4%
4 BOARD SEATS	420	1.2%
5 BOARD SEATS	97	0.3%
6 OR MORE	31	0.1%
TOTAL UNIQUE DIRECTORS	34,069	100.0%

} Potentially busy directors

Equilar data, fiscal years ending 2017



# BUSY BOARDS

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

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- 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.
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Fich and Shivdasani (2006); Core, Holthausen, and Larcker (1999)



# 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.
    - (+) Creates a network between companies.
    - (+) Facilitates the flow of information and best practices.
    - (-) Creates a dynamic of reciprocity.
    - (-) Can compromise objectivity and weaken oversight.
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- Shareholders react positively to connected directors in complex companies.
  - Both positive and negative practices spread through network connections.
  - Network connections generally lead to improved operating performance.
  - Interlocking can also lead to decreased monitoring.
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Cai, Nguyen, and Walkling (2017); Larcker, So, and Wang (2010); Hallock (1997); Nguyen (2012)



## 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
- (+) Large boards have more resources.
- (+) Allow for greater specialization.
- (-) Greater cost (e.g., compensation, scheduling conflicts, etc.).
- (-) Slow decision making.

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- 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.

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Yermack (1996); Coles, Daniel, and Naveen (2008)



# DIVERSE BOARDS

- Do diverse boards provide better advice and oversight?
  - (+) Broader array of knowledge, experience, and perspective.
  - (+) Lessens “groupthink” (premature consensus).
  - (+) Encourages healthy debate.
  - (+) Important social value, consistent with equality.
  
- (-) Diverse groups exhibit lower teamwork, higher turnover and dissatisfaction.

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- Evidence on the impact of diversity is highly mixed.
  - No consistent relation with performance or governance quality.
  - Diversity for the sake of meeting quotas is detrimental (the cost of inexperience outweighs the potential benefits).
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Williams and O’Reilly (1998); Rhode and Packel (2014); Ahern and Dittmar (2012).



## SUMMARY OF EVIDENCE

Most structural attributes are not correlated (positively or negatively) with performance.

Rather than adopt “best practices,” companies do best when they tailor their board structure and composition to meet their specific needs.

STRUCTURAL ATTRIBUTE	FINDINGS FROM RESEARCH
Independent Chairman	No evidence
Lead Independent Director	Modest evidence
# of Outside/Independent Directors	Mixed evidence
Independence of Committees	Positive on monitoring; negative on advising
Busy Boards	Negative impact
Interlocked Boards	Positive on performance; negative on monitoring
Board Size	Negative impact (unless company is "complex")
Diversity	Mixed evidence





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