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2. Qualifying Agency Theory's Discrete Interactions

Assumption: A Reassessment of Calls for Independent Boards of Directors⁴

It is almost an understatement to conclude that the literature on boards and corporate governance has abundantly addressed the boards' ability to control top managers and to protect the interests of shareholders. To illustrate the issue at hand, in their review of 127 empirical papers in prestigious academic journals, Gabriellsson and Huse (2004) find that 54 per cent apply agency-theoretical arguments addressing these topics. Also in business practice, the focus has been on the conflict of interests between managers and shareholders (Ghoshal, 2005). In line with agency theory, not very surprisingly, calls for independent boards abound. The business world includes many examples of boards that have been called upon to appoint unaffiliated members, from various functional backgrounds, having different personalities, and without shared interests with (the management of) the firm. This chapter focuses on relationship 3 in Figure 1.1, the one between executive and non-executive directors.

The underlying assumption in agency theory is that close ties between non-executives and managers impair the possibility of the board to ask critical questions or make tough decisions (e.g., Baysinger and Butler, 1985). In line with these calls, one would have expected that independent boards contribute unambiguously to corporate performance and value creation, either by means of the improved efficiency of corporate decision-making, or at least in terms of the investor appreciation of the value of the firm in the equity market. However, meta analyses do not find a significant association between corporate performance and a variety of indicators of board independence, such as CEO non-duality and outsider dominated boards (Dalton, Daily, Ellstrand and Johnson, 1998; Dalton, Daily, Johnson and Ellstrand, 1999). So far, conclusive evidence that independence contributes to the performance of the board or the firm does not exist (Hermalin and Weisbach, 2003).

One possible explanation for this ambiguity may be that agency theory only addresses a particular part of the behavior of the board. Indeed, it is considered appropriate to understand the virtues of the monitoring tasks of the board, but boards do generally fulfill other tasks as well (Zahra and Pearce, 1989). To analyze these resource, service and strategy

⁴ This chapter draws heavily on a manuscript with the same title, co-authored with Gijsbert Willenborg, Hans van Ees, and Morten Huse. The paper has been presented at the Academy of Management Annual Meeting (Philadelphia, 2007), and the European Academy of Management Meeting (Paris, 2007). It appeared in the EURAM corporate governance track best paper proceedings in 2007.

tasks, alternative theoretical perspectives such as stewardship theory (Davis, Schoorman and Donaldson, 1997) and resource dependence theory (Pfeffer and Salancik, 1978) are perhaps better equipped. Recently, efforts have also been made to embrace these other board tasks, for example through the lens of resource dependence theory (Hillman and Dalziel, 2003). In addition, it has been observed that it may be difficult for a director to separate monitoring from resource-provision activities. Therefore, we concur with Roberts, McNulty and Stiles (2005) that a more comprehensive picture of board behavior is needed.

The purpose of this chapter is, however, not merely to point at the complex and multiple tasks of the board of directors, but to question the suitability of agency theory as the appropriate framework to understand the monitoring tasks as such. Our argument criticizes the fundamental assumption in agency theory of the arms' length bargain as the most appropriate description of the interaction between board and management. Here, every single board decision is conceptualized as a discrete event. This ideal-typical representation of decision-making in the boardroom does not accurately reflect actual board behavior. By contrast, board members, executives and non-executives alike, are more likely to engage in a social contract (Huse, 1993). Both actors value the cooperation as such, engage in trusting behavior, and put effort into the preservation of the boardroom relationship and agreement on shared values, norms and working procedures. Following agency theory, such a similarity in values and norms could only harm board monitoring. Contrary to what agency theory predicts, we hypothesize and observe that proximity and trust-building do not only positively affect the advisory tasks, but also the monitoring tasks of the board. We thus build on Westphal's (1999) finding that the collaborative board model fosters board service tasks performance, yet we also apply this model to the monitoring activities. The bottom line of our argument is that a cooperative work attitude stimulates mutual information exchange and commitment to all board tasks. Consequently, the board's commitment to the monitoring activities is increased as well, which will have a positive impact on the monitoring task performance as such.

The core of this argument rests upon a distinction between two alternative types of trust (Gillespie, 2003): reliance and disclosure trust. These two trust types permit us to disentangle two consequences of trust. Reliance trust, on the one hand, entails the situations where a board trusts management to do what is good for the company. With reliance trust present, the perceived need to monitor is lower and boards are likely to be less involved. It is this type of trust that is referred to when agency theorists mention the downside of dependence. Disclosure trust, on the other hand, involves directors in decision-making because this type of trust concerns the willingness to share sensitive information or knowledge, and the willingness to lose face in discussions. A key advantage of using this trust construct is its measurement of trusting behavior, instead of trustworthiness. We

formulate hypotheses on both trust types, and how these are related to board task performance. This focus on behaviors instead of intentions to trust matches our aim to focus on what boards actually do, which is in line with a behavioral perspective on corporate governance.

In brief, this chapter offers two contributions to the literature on boards and corporate governance. First, we illustrate that interdependence and proximity between directors and managers may contribute to effective board behavior, in particular board monitoring, building upon the theory of contractual relations (Macaulay, 1963; MacNeil, 1980). Specifically, we show that proximity breeds trust, and that a trusting board engages more in both monitoring and advising. Second, we incorporate a multidimensional conceptualization of trust in the literature on boards and corporate governance. These concepts allow for both productive (i.e. disclosure) and unproductive (i.e. reliance trust) trusting behaviors caused by proximity.

In the next section, we develop our hypotheses. We first discuss the agency view on distance, and present a qualification. Subsequently, we build our hypotheses concerning trust and board task performance. Section 2.2 presents the data and methodology. The results of our estimations are contained in Section 2.3. We test our hypotheses on a unique dataset comprising 378 Norwegian companies. The results of simultaneous equation modeling efforts provide support for the core of our argument. A final section concludes and discusses the most important findings of this chapter.

2.1 Theory development

In the literature on corporate governance, board output is described in terms of two generic sets of tasks: the monitoring or control tasks and the resource, service and strategy tasks (Zahra and Pearce, 1989). The monitoring tasks of the board rest in agency theory, reflecting internal control mechanisms that safeguard the interests of shareholders. Board decision-making relates to corporate decision-making *ex post*, with a clear separation of management and board duties. From an agency theory perspective, the arms' length relationship between board and management creates independence, which facilitates corrective action and effective control by the board. However, proximity and close involvement create information advantages that can also improve board control (Adams and Ferreira, 2007). This is what may be called the independence paradox (Boot and Macey, 1999; Hooghiemstra and Van Manen, 2004). The effective balance between proximity and objectivity will have to be continuously redefined in the context of the working relationships between the management and the board or between board executives and non-executives.

The service and strategy tasks of the board concern the board's provision of essential resources in strategic decision-making, such as offering advice, legitimacy and counsel as well as links to other organizations (Tricker, 1994). The effectiveness of the board's strategy and service tasks will be enhanced if board members are more closely involved in the strategy formation process (McNulty and Pettigrew, 1999). Directors may establish strategic links to the external environment and secure critical resources, including prestige and legitimacy. Following upon this distinction between two sets of board tasks, we discern two generic types of board activities: monitoring and advising activities.

2.1.1 Agency theory

Principal-agent theory developed in the 1970s as a response to the key governance problems inherent to the public corporation. These problems originate from three sources, at least: first and foremost, the separation of ownership and control; second, the perspective that self-serving managers maximize private benefits without considering other interests; and third, the incentive of minority shareholders to free-ride on the monitoring activities of other shareholders (Jensen and Meckling, 1976). Consequently, the public corporation is not able to survive without knowledgeable managers and dispersed ownership, whereas these managers will not necessarily act in the interest of the firm, and the minority shareholders will not find it in their best interest to closely monitor the activities of their top managers. To cut through this dilemma, several internal governance mechanisms have been developed. Management compensation structures are designed to align the interests of the managers and shareholders *ex ante*, and shareholders are better off delegating their monitoring efforts to an independent board of directors that ratifies management decisions and monitors implementation *ex post* (Fama and Jensen, 1983).

The principal-agent perspective on the distribution of tasks at the strategic apex of the corporation naturally leads to a dominant monitoring task for directors in the interest of the principals – i.e., the shareholders. As a first line of criticism, it can be observed that this exclusive focus on the board's monitoring tasks is at odds with both corporate law and corporate practice. Blair and Stout (1999) analyze US corporate law and argue that although it may be most efficient to have directors elected by shareholders, their fundamental responsibility is with the corporation itself. Hence, the principal-agent representation of the corporation is at odds with the legal description of the corporation as an independent entity. Similarly, the shareholders cannot be formally taken as principals. On the contrary, the board of directors itself is better conceived of as representing the top of the corporate hierarchy, and the board's fundamental role is to mediate between all corporate stakeholders in situations

where stakeholder interests do not necessarily coincide (Kostant, 1999). This is also in line with corporate practice, as Lorsch and MacIver (1989) find that directors who feel that shareholders' concerns are their first and foremost responsibility are a true minority. A broader view of director responsibilities is likely to lead to inclusion of strategic tasks as well. Therefore, a study of what boards actually do, and how independence affects these tasks, calls for a broader conceptualization of board tasks.

A second line of criticism addresses two fundamental assumptions of the principal-agent model. Firstly, interactions between board members and management are essentially seen as discrete events in agency theory. Consequently, decision-making in discrete settings is most efficient in case all actors act as if they meet for the first time. In particular, the disutility of monitoring perceived by board members should be minimal and in no way be affected by the interests of the managers. Hence, independent boards are required to optimize the quality of board decision-making.

Obviously, this decision-making structure is only implicit and the emphasis of the principal-agent perspective is not on the process of decision-making itself, but on the (efficiency of the) decision of the board as such. Nevertheless, in case the interaction in the boardroom is conceived of as part of a long-standing relationship, the costs of organizing decision-making are lower if bargaining is based on informal trust instead of formal contracting (Griesinger, 1990; Huse, 1993). The costs of contracting, as opposed to the costs of trusting, have been wrongly ignored in theorizing efforts on the benefits of independence.

Secondly, human nature in agency theory is at odds with real-world observations. Human beings are assumed to be fully rational, capable and self-interested agents. Although corporate governance scandals have shown that self-interest exists, as a description of human behavior the definition misses its empirical counterpart (Etzioni, 1988; Griesinger, 1990). In his critique on why people strive for non-material goals, Etzioni (1988: 90) writes: "people often make non- or sub-rational choices, first because they build on their normative-affective foundations, and only secondly because they have weak and limited intellectual capabilities." Consequently, the assumption that all deviations from goals are due to misappropriation requires qualification (Hendry, 2005). This also implies that boards can be called upon to provide their expert advice to management.

Our starting point is that the assumption of the arms' length bargain underlying the classical principal-agent model, as the fundamental conceptualization of the board-management exchange relationship, does not capture the social dynamics inside the boardroom. In addition, dispersed corporate ownership cannot be regarded as a sufficient condition for the conclusion that the interactions between the board and managers are best conceived of as discrete events between anonymous actors. At best, the emphasis on board independence as a precondition of optimal control can be regarded as only one element of a

more comprehensive picture of social interaction. Indeed, “the challenge for directors is to build and maintain trust in their relationships with executives, but also to maintain some distance so that effective monitoring can be achieved” (Daily, Dalton and Cannella, 2003: 376). Therefore, following Forbes and Milliken (1999), we consider boards as special working groups, of executives and non-executives, characterized by a cognitive output, complex decision-making, and restrictive communication and operating procedures. The individual expertise and knowledge as well as the relational capital of board members serve as inputs for the decisions of the board.

2.1.2 Relaxing the discrete interactions assumption

Our main qualification of agency theory lies in abandoning its assumption of discrete interactions. The typical principal-agent model depicts the contract and related exchanges between the shareholders, or the board, and the manager as concluded in a relational vacuum. The contextual absence of relationships in the principal-agent model arises because the foundation for the theory lies in the exchange problem between managers and a large number of anonymous shareholders. The fact that a board consists only of a small number of individuals to represent the anonymous mass of shareholders is assumed not to affect the nature of the exchange. In such a discrete and impersonalized context, MacNeil (1980) argues that the interaction between the two parties is built on norms primarily related to implementation of planning and effectuation of consent – i.e., contract-related activities concentrate on the effectuation and enforcement of what was formally agreed upon. Hence, the emphasis in principal-agent theory on monitoring and discretion is perfectly consistent with MacNeil’s contract-based representation of discrete transactions.

However, interactions in the boardroom do not take place in a relational vacuum between anonymous individuals. Therefore, the exchanges between the non-executives and executives are better captured by what MacNeil depicts as relational exchange. In such a context, the relational contract between board and management will be built on relational norms, such as role integrity, preservation of the relation and harmonization of relational conflict (MacNeil, 1980). Consequently, when analyzing the activities of the board, including the monitoring tasks, the assumption of discrete interaction is flawed and the context of the boardroom is better captured by taking a relational lens. Thus, directors’ personalities and relationships as well as company characteristics shape the decision-making inside the boardroom (Forbes and Milliken, 1999). These board processes, or board working style, determine board task performance (Zona and Zattoni, 2007). The decisions of the board (i.e., board output) are part of the strategic decision-making of the company, which – ultimately –

affects corporate performance. The two sets of board tasks among which we distinguished before – monitoring and advising – call for a board that is both dependent upon and interdependent with management, because of the independence paradox (Boot and Macey, 1999; Hooghiemstra and Van Manen, 2004). Non-executive directors need information from management to perform their monitoring tasks. So, management partly controls the flow of information upon which the board decides the compensation of the CEO, but also the desirability of extending the CEO's contract. The realization that the decision of management to share information with the board can result in both positive and negative performance feedback (Adams and Ferreira, 2007), creates a necessary interdependence among the two parties. Effective boards are, therefore, able and willing to combine the knowledge and expertise of executives with the wider and more general knowledge and experience of non-executive directors.

In this chapter, we will denote this shared understanding of relational norms between the CEO and the board and, in particular, the board's chairperson proximity, as opposed to distance, is critical. (Huse, 1993; MacNeil, 1980). These concepts reflect perceptions of proximity rather than observable distance measures, which have commonly been used in the literature that seeks to establish a relationship between independence and performance. The above gives

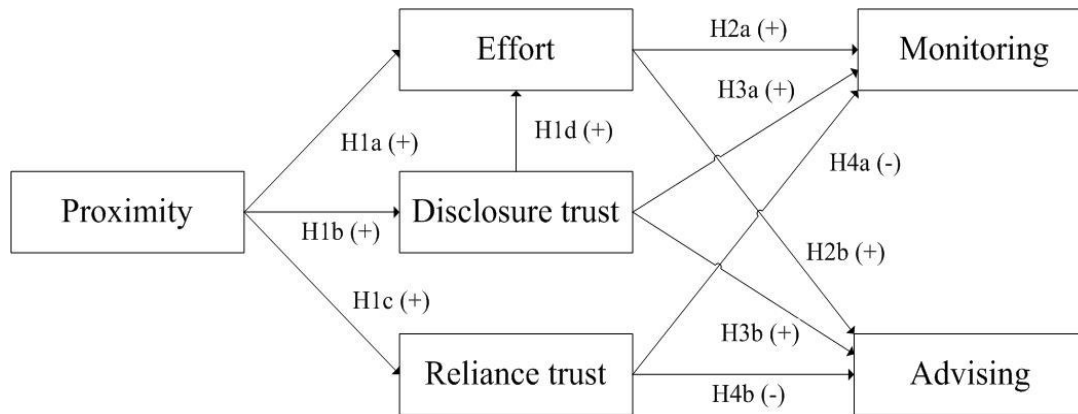
Hypothesis 2.1a: Proximity between the CEO and the board chairperson is positively related to board effort

The full conceptual model is depicted in Figure 2.1.

In our hypotheses, the relationship between the CEO and the board chairperson is emphasized, yet agency theory assumes that all interactions of directors and executives, regardless of their position, are discrete in nature. As a focus on the interactions of all board members would call upon the literature of intra-board and intra-management working relationships, substantial additional theorizing would be necessary. Moreover, this theorizing would not contribute substantially to the central argument, namely that social contract norms rather than discrete interactions govern the relationship between board members and executives. As, finally, the literature on intra-board relations, notwithstanding the intra-management process literature, is fairly underdeveloped (Hambrick, Von Werder and Zajac, 2008), we argue that a focus on a dyadic relationship keeps the arguments as simple as possible. The CEO – board chairperson nexus is the straightforward dyad to consider, as the CEO is generally the most powerful individual inside the firm (Finkelstein, 1992). Other executives are likely to feel subordinate obedience towards the CEO. In Norway, the country in which the empirical testing of this chapter takes place, the board chairperson is granted significant authority as “[m]atters to be considered by the board are prepared by the chief executive in collaboration with the [board] chairman, who chairs the meetings of the board. In

practice, the chairman carries a particular responsibility for ensuring that the work of the board is well organized and that it functions effectively” (Norwegian Corporate Governance Board, 2007: 35). Thus, the relationship between the CEO and the board chairperson is allegedly the key relationship to consider.

FIGURE 2.1
Theoretical Model



2.1.3 Effects of long-standing relations on trust and board performance

Due to incomplete information and complex decision-making, board-management relations are characterized by uncertainty and risk. Adopting Das and Teng’s (2001) analysis of risk in strategic alliances to the decision-making context of boards, we argue that the relationship between the CEO and the board chairperson is characterized by performance risk and relational risk. Performance risk represents the variation in business outcomes, whereas relational risk refers to the probability that the cooperation is not satisfactory. The complexity of the task environment as well as information asymmetries are among the causes of both risk types. Since there is a difference between actual risk and the perception of risk (Das and Teng, 2001), and since people’s risk-taking behavior depends on their perception of the riskiness of the various options (Mayer, Davis and Schoorman, 1995), mechanisms that mitigate the perception of risks induce risk-taking behavior.

Trust mitigates perceptions of risk (Das and Teng, 2001; Mayer et al., 1995; Van Ees, Van der Laan and Postma, 2008b). In a cross-disciplinary review of trust, Rousseau, Sitkin, Burt and Camerer (1998: 395) offer the following definition: “Trust is a psychological state comprising the intention to accept vulnerability based upon positive expectations of the

intentions or behavior of another.” In a state of interdependence characterized by risk, a trusting relationship involves the expectation that the trustee will not select uncooperative options. This ruling out of uncooperative behavior increases the perceived likelihood of cooperative behavior, and thereby the trustor is more likely to engage in cooperative, risk-seeking behavior herself.

Despite the convergence on the definition of trust, various measurement scales have been used throughout the literature. As Gillespie (2003: 5) notes, “the large majority of empirical studies examining interpersonal trust in organizations measure perceptions of trustworthiness as a proxy for trust.” Trustworthiness, however, has been shown to be a distinct concept, being an imperfect measure of the intention to accept vulnerability. Based on the work of Mayer et al. (1995) and Zand (1972), Gillespie developed and validated the so-called Behavioral Trust Inventory (BTI), which aims to measure behavioral intentions (see also Dietz and Den Hartog, 2006; Lewicki, Tomlinson and Gillespie, 2006). This conceptualization of trust is more in line with our aim, to proxy for actual board behavior, than scales of trustworthiness.

The BTI distinguishes between reliance and disclosure trust. The former refers to “relying on another’s skills, knowledge, judgments or actions, including delegating and giving autonomy,” whereas disclosure trust relates to “sharing work-related or personal information of a sensitive nature” (Gillespie, 2003: 10). Implicitly, when agency theorists mention trust, they refer to reliance trust: a trusting board relies on management to do a good job, therefore underperforming its monitoring tasks. We distinguish among both types of trust and thus allow for cooperative behavior as a result of trust alongside this negative effect. In the context of our study, distinctive concepts for trust types that make board members active (disclosure trust) and passive (reliance trust) parallel the distinction between dependent and independent boards, as independent boards are assumed – in agency theory – to deliver more value. This reinforces our choice for the behavioral trust inventory.

In Figure 2.1, we postulate two hypotheses on the antecedents of trust and three on the consequences. Various studies into the antecedents of trust have been conducted, leading to a plethora of possible causes. Butler (1991) derives ten factors from 84 interviews, ranging from discreteness and openness to receptivity and availability. Other researchers use three factors that supposedly lead to a willingness to be vulnerable: ability, benevolence, and integrity (Davis, Schoorman, Mayer and Tan, 2000; Mayer et al., 1995). Other causes have been identified as well (e.g., Gulati, 1995; Jones and George, 1998; Whitener, Bordt, Korsgaard and Werner, 1998). Several scholars have pointed out that proximity, particularly shared norms and values, is likely to be the most important driver of trust (Gillespie and Mann, 2004; Jones and George, 1998; Lewicki, McAllister and Bies, 1998). A norm is an expectation that another individual will act in a certain way. Acting in line with the value of

relationship preservation implies that trusting behavior is expected, for distrust will lead to a disruption of the relationship. Consequently, shared social norms may foster the development of trust (Casadesus-Masanell, 2004). Thus, we suggest

Hypothesis 2.1b: Proximity between the CEO and the board chairperson is positively related to disclosure trust

Hypothesis 2.1c: Proximity between the CEO and the board chairperson is positively related to reliance trust

We finalize our conceptual model by defining consequences of trust (see Figure 2.1). Disclosure trust is activating: board members are willing to share their private information with the CEO. Directors who exhibit disclosure trust, accept the risk that private information will become public and may affect their reputation. This risk is likely to make the director more involved in monitoring activities. Also, they are likely to seek application of knowledge in corporate strategy (Forbes and Milliken, 1999). The above suggests that proximity not only directly affects effort (Hypothesis 1a), but also generates a willingness to be active. This provides

Hypothesis 1d: Disclosure trust is positively related to board effort

Further, in line with previous research (Olson, Parayitam and Bao, 2007; Van Ees, Van der Laan and Postma, 2008a), we hypothesize that disclosure trust, by activating non-executives, relates positively to both types of task performance. For monitoring tasks, the willingness to disclose alleviates the problem of information asymmetry. Moreover, for advising tasks, knowledge of outside directors is applied, which increases the quality of decision-making. So, we have

Hypothesis 2.3a: Disclosure trust is positively related to monitoring task performance

Hypothesis 2.3b: Disclosure trust is positively related to advice task performance

Due to the interdependence relationship mentioned above, board members also need to build upon the quality and expertise of management. Reliance trust is the board members' subjective expectation that management is able and competent, and will strive for good company performance. This reduces the perceived need to be actively engaged with the behavior of management. The CEO may thus feel less scrutinized, and is more likely to behave opportunistically. Also, the reliance on the knowledge of executives reduces the application of the more general knowledge of non-executives to corporate strategy and may negatively affect the quality of decision-making. Therefore, we suggest

Hypothesis 2.4a: Reliance trust is negatively related to monitoring task performance

Hypothesis 2.4b: Reliance trust is negatively related to advice task performance

For the sake of completeness, and in line with Forbes and Milliken (1999), Van Ees, Van der Laan and Postma (2008a), and Zona and Zattoni (2007), we include the following hypotheses, which are also intuitively appealing.

Hypothesis 2.2a: Board effort is positively related to monitoring task performance

Hypothesis 2.2b: Board effort is positively related to advice task performance

In brief, we thus argue that perceived proximity between the CEO and the chairperson's norms and values affects effort, both directly and indirectly. If actors are more similar on these aspects, they will find it easier to cooperate. Simultaneously, they will develop trust, which contributes further to the effort that is put into their relationship. Trust comes in two forms. Traditionally, directors have been assumed to become passive when trusting managers. The concept of reliance trust captures this downside of trusting relationships. Simultaneously, however, trust creates an environment in which directors are willing to share their information and engage in discussions. This positive effect of trust is captured in the concept of disclosure trust. Thus, when relaxing the assumption of discrete interactions inside the boardroom, a relational model (Figure 2.1) can be developed which relates proximity – as opposed to distance or independence – to monitoring (and advice) task performance, through activating trusting behavior.

2.2 Data and method

2.2.1 Data

To test the proposed model in Figure 2.1, a database of Norwegian companies in 2003 was used (Haalien and Huse, 2005). The Norwegian context is studied, first, because corporate governance codes did not have a profound impact here at the time of study, contrary to many other countries (Aguilera and Cuervo-Cazurra, 2004). Such codes may distort economic efficiency, as suggested by Hermalin and Weisbach (2006). Particularly, we are concerned that the emphasis of codes on monitoring activities may bias the hypothesized relationship between board effort and board task performance, because directors – facing time constraints – cannot optimally allocate their effort to the various tasks if regulations primarily require them to fulfill their monitoring duties. Thus, a country in which codification has not developed too extensively is to be preferred in a study of board relations. Second, the Norwegian corporate governance system is rather prosocial compared to, for example, the United States (Lubatkin, Lane, Collin and Very, 2005). This may impair the findings' external validity, but it also positively affects response rates, an issue which traditionally complicates the application of a survey methodology to the study of boards (Pettigrew, 1992).

The database comprises 488 CEO-respondents, who filled out the ‘innovation survey’⁵ of the Norwegian School of Management BI (Haalien and Huse, 2005: 15-17). Questionnaires were sent out to 762 large companies and a sample of 968 SMEs. The response rate for the large companies was higher (33 per cent) than the response rate for SMEs (25 per cent), partly because boards were sometimes non-existent in SMEs. Two reminders were sent out, the second of which was accompanied by a small questionnaire asking for the reason of non-response. 75 CEOs replied to this smaller survey, indicating predominantly that time constraints and a lack of incentives to fill out the 200-item questionnaire caused their non-response. Noting that similar studies have achieved much lower response rates, we further conclude that the reasons for non-response appear to be unrelated to the topic of the survey. After deletion of cases with missing observations, 378 respondents remained for testing the proposed model, an effective sample size well above the recommended size for structural equation modeling, generally considered to be about 200 (Boomsma, 1983; Hair, Black, Babin, Anderson and Tatham, 2006: 741).

The data represent a variety of individuals and organizations from various corporate environments. Firm size, measured by both operating income and equity, has a mean of NOK 1 billion (operating income) and NOK 111 million (equity), and the standard deviation of both measures is substantial (NOK100 is roughly equal to USD15). The organizations represent a variety of industries as well: finance and real estate make up 14 per cent of the data, service firms 28 per cent, industrial and production companies 32 per cent, and other industries 26 per cent. The richness of the data extends to other variables as well, notably firm age and the number of employees. In a general study of board behavior, such contextual diversity enhances the external validity of the findings. Based on the above, we conclude that our data is representative for Norwegian medium and large-sized corporations.

Board size varies from 1-3 members (23 per cent), to 4-6 (52 per cent), and 7-12 (25 per cent). Norwegian boards are therefore smaller, compared to their American counterparts. This may partly be due to a size effect: even the largest Norwegian company is relatively small from a US perspective. Almost all CEOs are male (97 per cent), relatively young (mean age 49) and hold roughly one quarter of company stock (including stockholdings by family members and other top managers and their families). More than half of the board chairpersons do not have shareholdings in the company (mean board chairperson shareholdings is 17 per cent of company stock).

⁵ The questionnaire is available at www.bi.no/boards (last accessed: June 2008).

2.2.2 Analysis and Variables

The latent nature of the constructs and complex relationships in our study call for structural equation modeling (SEM) to be applied. Structural equation modeling takes measurement error into account when estimating relationships among latent variables, instead of fixing the parameters as usually happens when exploratory factor analysis and regression analysis are combined. Furthermore, the model is able to include multiple endogenous variables (Hulland, 1999). In fact, the standard OLS-model is nested within the structural equation model, when only one endogenous variable is assigned and the measurement model parameters are set to a predefined value. The use of moderation variables in SEM is somewhat more complicated, yet in a first estimation of our argument we deem it unnecessary to take contextual variation into account.

The data were analyzed using SPSS and LISREL 8.54 (Du Toit, Du Toit, Jöreskog and Sörbom, 1999; Jöreskog and Sörbom, 1999). The measurement and structural models were tested using the two-step estimation procedure advocated by Anderson and Gerbing (1988; see also Hair et al., 2006: 848). The advantage of this approach is that interpretational confounding will not occur. That is, the interpretation of relationships is separated from the establishment of a sound measurement theory (Anderson and Gerbing, 1988: 418). The covariance matrix was used as input matrix and maximum likelihood estimates were obtained.

The latent variables in our study are linear combinations of Likert-scaled items in the survey. *Proximity* measures the agreement on the goals and the work processes between the CEO and the board chairperson. Items were taken from a validated scale of Huse (1993: 238). *Disclosure trust* and *reliance trust* were taken from the Behavioral Trust Inventory (Gillespie, 2003). However, as the original BTI scale was intended to measure trust in employee-supervisor working relationships, the questions of the BTI were adopted to the board-management context. In this respect, the board is taken as the supervisor of the management. The items for *effort* originate from a scale developed by Haalien and Huse (2005). The items for the two board task variables, *monitoring* and *advising*, are taken from scales developed by Judge and Zeithaml (1992) and Pearce and Zahra (1991), respectively.

2.3 Results

2.3.1 Measurement Model

The procedure of the evaluation of the measures used for each latent construct involved reliability analysis using SPSS, followed by confirmatory factor analysis using LISREL to

determine one-dimensionality. In general, after modifications for double loading and non-loading items, all measures demonstrated acceptable levels of overall model fit, construct reliability, and convergent and discriminant validity. The results and the final sets of measurement items for each latent construct are depicted in Table 2.1.

The overall fit of the measurement model was satisfactory (goodness-of-fit statistics ($n = 378$): $\chi^2_{[df=94]} = 214.80$, $p < 0.01$; CFI = 0.97; standardized RMR = 0.046; RMSEA = 0.061, $p < 0.05$), according to the norms taken from Hair et al. (2006: 753).

TABLE 2.1

Test of the Measurement Models

Construct	Items ^a
	Please indicate to what extent you agree with the following statements:
<i>Proximity</i> (3 items) $\alpha = .73^b$ VEE = .59 CR = .83 $\lambda_{av} = .76$	The CEO and the board chairperson ... <ul style="list-style-type: none"> ▪ have the same values and principles (norms) about ethics, justice, corporate social responsibility, etc. ▪ have mutual expectations about each other's future actions. ▪ want to preserve good long term personal relations.
<i>Disclosure trust</i> (2 items) $\alpha = .84$ VEE = .81 CR = .79 $\lambda_{av} = .90$	The board is willing to ... <ul style="list-style-type: none"> ▪ advise the CEO related to personal knowledge and views of board members. ▪ provide the CEO with special and creative advice.
<i>Reliance trust</i> (3 items) $\alpha = .74$ VEE = .56 CR = .78 $\lambda_{av} = .75$	The board is willing to ... <ul style="list-style-type: none"> ▪ base their evaluations on the CEO's knowledge and insight. ▪ mandate the CEO to be the spokesperson for the firm, including the board. ▪ accept strategic decisions made by CEO.
<i>Effort</i> (3 items) $\alpha = .82$ VEE = .69 CR = .83 $\lambda_{av} = .83$	All board members are actively involved during board meetings. Board members ... <ul style="list-style-type: none"> ▪ fully use their knowledge and skills. ▪ give sufficient priority to the board tasks.
<i>Monitoring</i> (2 items) $\alpha = .83$ VEE = .80 CR = .84 $\lambda_{av} = .89$	The board often asks critical questions about ... <ul style="list-style-type: none"> ▪ proposals initiated by the management. ▪ information from the management.
<i>Advising</i> (3 items) $\alpha = .67$ VEE = .46 CR = .77 $\lambda_{av} = .68$	Please indicate to what extent you agree with the following statements on the <u>contribution</u> made by the board members: The board members give advice in ... <ul style="list-style-type: none"> ▪ general management questions. ▪ legal questions. ▪ financial questions

Notes: Questions have been translated from Norwegian to English. Goodness-of-fit statistics ($n = 378$): $\chi^2_{[df=94]} = 214.80$, $p < .01$; CFI = .97; Standardized RMR = 0.046; RMSEA = .061, $p < .05$.^a All measures employ five-point scales (anchors: disagree / agree).^b α = Cronbach's alpha coefficient of reliability; CR = Construct Reliability; VEE = Variance-Extracted Estimate; λ_{av} = Average indicator loading.

Convergent validity was evaluated in terms of Cronbach's alpha, the factor loadings of the measures on the latent construct, variance-extracted and construct reliability (Hair et al., 2006). The reliabilities of all measures, as indicated by Cronbach's alpha, meet or exceed the lower limit of acceptability ($\alpha \geq 0.60-0.70$). All factor loadings of the 16 measures loaded significantly (t-value for all $\lambda_s > 2.00$) on their intended latent construct. All loadings exceed the lower limit of acceptability ($\lambda > |0.50|$) and 13 loadings exceed the ideal limit of $|0.70|$, demonstrating convergent validity. Average lambda-values range from 0.90 for the measures of disclosure trust to 0.68 for the advising measures. However, two of the six item sets contained less than the minimally recommended three items, although this did not result in identification problems. An examination of the variance-extracted estimates (VEE, see Table 2.1) shows that all measures except one meet the norm ($VEE \geq 0.50$), indicating that a substantial amount of the variance in the measures is captured by the latent constructs, again showing convergent validity. Advising ($VEE = 0.46$) deviates marginally from the norm, probably due to the heterogeneous nature of the items. According to the construct reliability statistics (CR), all measures exceed the recommended lower limit of acceptability ($CR \geq 0.70$). In sum, convergent validity was deemed to be good.

Discriminant validity of the constructs was evaluated by a comparison of the variance-extracted percentages for any two constructs with the square of the correlation estimates between these two constructs (Hair et al., 2006: 778). Based on the idea that a latent construct should explain its item measures better than it explains another construct, the variance-extracted estimates should be greater than the squared correlation. For all comparisons – except one – this holds.

In sum, the measurement models of the latent constructs fit the data satisfactorily, and show adequate reliability and validity. Some constructs exhibit minor weaknesses, which might be remedied in future research. As the dependent and independent variables were taken from the same data collection instrument, concerns over common-method variance may arise (Podsakoff, MacKenzie, Lee and Podsakoff, 2003). We thus performed a Harmon single factor test and found that the 16 items load on 5 factors with an eigenvalue over 1, where the first factor accounts for 29 per cent of the variance in the items. These findings do not cause great concern for common-method variance. Moreover, it is unlikely that respondents have the cognitive abilities to grasp the meaning of our model when filling out the questionnaire. Also, through pre-testing and careful wording, measures have been taken to reduce the probability of common-method biases.

2.3.2 Structural Model

The second step in the two-step estimation procedure entails the test of the proposed and the rival structural model. Table 2.2 shows the usual descriptive statistics, correlations, variances, and covariances for the latent variables. Table 2.3 shows the results of the model tests.

Proposed model. The proposed model (see Figure 2.2 and Table 2.3) fits the data well (Hair et al., 2006: 753). The goodness-of-fit statistics are as follows ($n = 378$): $\chi^2_{[df = 94]} = 219.20$, $p < 0.01$; CFI = 0.97; standardized RMR = 0.047; and RMSEA = 0.059, $p < 0.10$). The results for the model indicate that all except one (H_{4b}) of the 10 hypothesized paths are significant ($p < 0.05$) and in the hypothesized direction (see Figure 2.2). Apparently, reliance trust has no discernible relationship with advising. Therefore, our argument that if board members rely on managers to do a good job their advice task performance is lower does not receive any support.

TABLE 2.2
Correlation / covariance matrix of latent variables

	Mean	SD	1.	2.	3.	4.	5.	6.
1. Proximity	4.02	.68	<i>.96</i>	.42	.61	.53	.06	.40
2. Disclosure trust	3.88	.82	.62	<i>2.26</i>	.31	.53	.30	.74
3. Reliance trust	3.96	.67	.61	.47	<i>1.05</i>	.26	-.10	.19
4. Effort	3.97	.79	.56	.87	.29	<i>1.17</i>	.30	.57
5. Monitoring	3.37	.92	.09	.61	-.14	.44	<i>1.85</i>	.26
6. Advising	3.44	.85	.34	.99	.17	.55	.32	<i>.78</i>

Notes: Mean = composite mean (where all $\lambda \equiv 1$). SD = standard deviation of composite mean. Correlations are above the diagonal, variances on the diagonal (in italics), and covariances below the diagonal. Correlations $> |.10|$ are significant at the $p < .05$ level and correlations $> |.18|$ are significant at the $p < .01$ level ($n = 378$). Correlations in shaded areas are not significant.

TABLE 2.3
Tests of the proposed and rival structural model

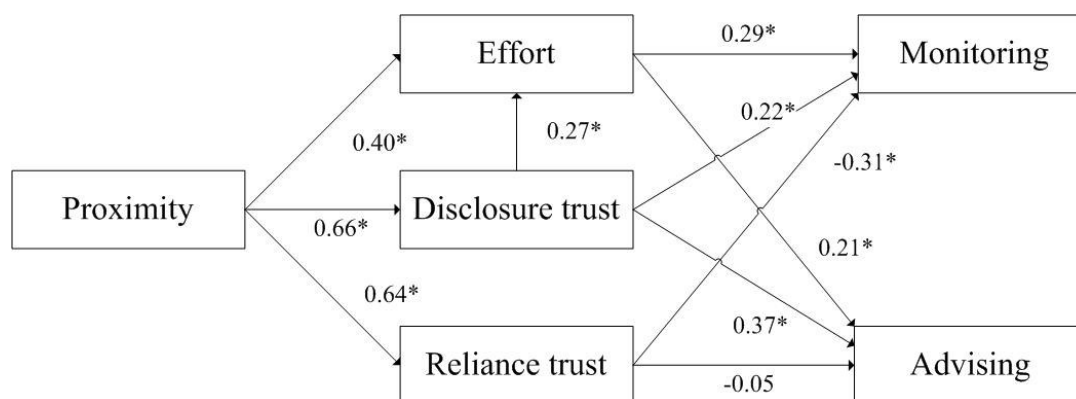
	Hypothesis	Proposed model	Rival model
Path		Estimate	Estimate
Proximity → Effort	H _{1a}	.40** ^a	.59**
Proximity → Disclosure trust	H _{1b}	.66**	
Proximity → Reliance trust	H _{1c}	.64**	
Disclosure trust → Effort	H _{1d}	.27**	
Effort → Monitoring	H _{2a}	.29**	.47**
Effort → Advising	H _{2b}	.21**	.40**
Disclosure trust → Monitoring	H _{3a}	.22**	
Disclosure trust → Advising	H _{3b}	.37**	
Reliance trust → Monitoring	H _{4a}	-.31**	
Reliance trust → Advising	H _{4b}	-.05	
Proximity → Monitoring			-.19**
Proximity → Advising			.11
Variance explained in the endogenous constructs (R²)			
Effort		.39	.28
Disclosure trust		.19	
Reliance trust		.37	
Monitoring		.17	.11
Advising		.60	.33
Model goodness-of-fit statistics (n = 378)			
Chi-square _[degrees of freedom]		219.20 _[94] **	99.85 _[40] **
Relative Chi-square (χ^2 / degrees of freedom)		2.33	2.50
Comparative Fit Index (CFI)		.97	.98
Standardized Root Mean Square Residual (Std. RMR)		.047	.051
Root Mean Square Error of Approximation (RMSEA)		.059 ⁺	.063 ⁺
Parsimony Normed Fit Index (PNFI)		.75	.70

Note: A blank indicates that this parameter was not estimated for this model.

^a **: $p < .01$; *: $p < .05$; ⁺: $p < .1$.

The squared multiple correlations (R²) for the structural equations for the mediating constructs – effort, reliance trust and disclosure trust – are moderate to high (see Table 2.3). The variance in effort is explained for 39 per cent by direct effects of proximity and disclosure trust. Disclosure and reliance trust are explained by direct effects of proximity for 37 and 19 per cent, respectively. The variance in monitoring is explained relatively less well (17 per cent). Advising is well-explained by the model (60 per cent). The model, in sum, explains a substantial amount of the variance in the endogenous constructs.

FIGURE 2.2
Test of the proposed structural model

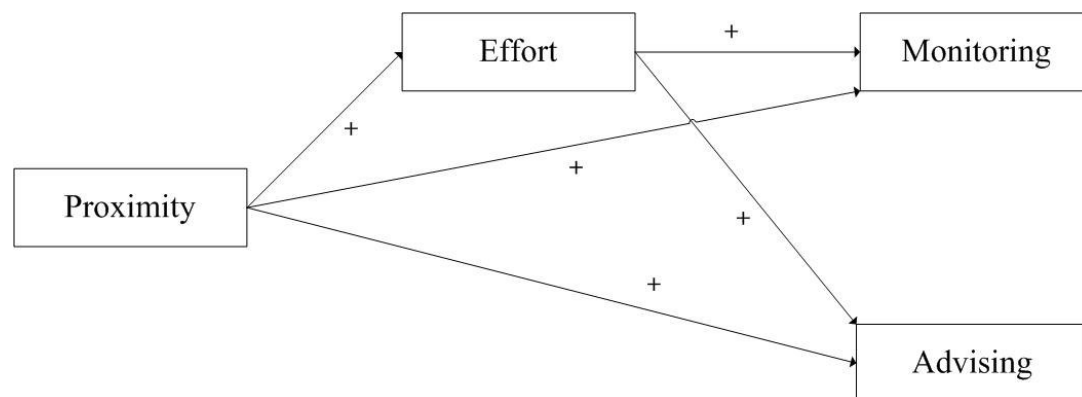


* $p < 0.01$; $n = 378$

Rival Model. To determine the relative strength of the proposed model in general, and the importance of the mediating role of trust in particular, the model is compared to a rival model. In this model, both the reliance and disclosure trust constructs are excluded, and monitoring and advising are directly and indirectly influenced by proximity and effort (see Figure 2.3). If we should conclude that our proposed model (Figure 2.2) outperforms this rival model significantly, this would provide additional support for our argument that trust mediates between proximity and board task performance.

The validity of the proposed model is tested by comparing it with the rival model on the following criteria: (1) overall fit statistics, (2) percentage of the models' hypothesized paths that are significant, (3) ability to explain the variance in the outcomes of interest, as measured by squared multiple correlations (R^2) of the endogenous variables and (4) parsimony, as measured by the parsimonious normed fit index (James, Mulaik and Brett, 1982). Table 2.3 also shows the results of this comparative test. Overall, both models exhibit adequate fit. The overall fit of the rival model seems superior in terms of absolute overall fit ($\chi^2_{[df=40]} = 99.85$ vs. $\chi^2_{[df=94]} = 219.20$ in the proposed model), but relative fit of both models is equal (χ^2 over degrees of freedom: 2.50 vs. 2.33). Both models show similar good performance on other criteria of absolute fit (standardized RMR = 0.051 vs. 0.047; and RMSEA = 0.063 vs. 0.059) and incremental fit (CFI = 0.98 vs. 0.97). Although both models show high parsimony levels, the rival model performs slightly worse (0.70 vs. 0.75). Thus, the models are comparable in terms of model fit.

FIGURE 2.3
Test of the rival model



On the criterion of the percentage of significant paths, 4 of the 5 tested paths of the rival model are significant, whereas this holds for 9 out of 10 tested paths in the proposed model. Most importantly, however, although the rival model explains a substantial amount of the variances in the endogenous constructs, the proposed model outperforms it on all constructs. In sum, although both models represent the data adequately, the proposed model outperforms the rival model somewhat in explanatory power, emphasizing the additional role of trust in board processes and monitoring and advising. At least, the rival model still supports our core argument that proximity leads to improved board monitoring task performance. The positive effect of proximity through effort outweighs the negative direct effect and therefore proximity positively affects monitoring performance.

2.4 Conclusion and discussion

In business practice and policy discussions, director independence has become the holy grail directors should search for when trying to establish effective board task performance. Empirical evidence, however, does not support the hypothesis that distant, independent directors are better able to monitor managers. In this chapter, we argue that this lack of empirical support may be due to a false assumption in the principal-agent model. Agency theorists assume that the relationship between directors and managers is discrete and impersonal – that is, rational and self-centered principles drive individuals' behavior. Contract-related norms, such as effectuation of consent and implementation of planning, which operate in a discrete and impersonalized context, thus best describe the interaction among directors. Empirical studies are at odds with this assumption, as several authors have

suggested that top managers and directors are part of one, common, social class (e.g., Pennings, 1980).

Instead, we argue, interactions in the boardroom do not take place in a relational vacuum. The exchanges between directors and managers are embedded in long-standing relationships, and are thus better captured in what MacNeil (1980) calls relational exchange. Under this perspective, relationships are governed by norms such as the desire to preserve a good (working) relationship, and the desire to harmonize conflicts. In line with this starting position, we develop a rudimentary theory of what board behavior may look like, building on such studies as Westphal (1999) and Roberts et al. (2005). We argue that perceived proximity, as opposed to distance, may foster board effort as directors feel more comfortable putting effort into a relationship which they value. Board effort is subsequently suggested to lead to both monitoring and advice task performance. We find evidence for these hypotheses.

We further argue that the main mediator between proximity and board task performance – that is, the main catalyst for proximity – is trust. Whereas, as Ghoshal (2005) contends, agency theory's distance concept is based on distrust between directors and managers, the opposite would apply to a model based on proximity. However, agency theory takes trust to imply reliance on managers and consequent passiveness from the directors' side. We, on the contrary, use a recent conceptualization of trust (Gillespie, 2003) that allows for positive, cooperative, outcomes of trusting behavior. We acknowledge that proximity may lead to so-called reliance trust, reducing the perceived need of directors to be involved with the firm, but we also hypothesize that proximity may foster the development of disclosure trust. As the output of boards is entirely cognitive (Forbes and Milliken, 1999), the key to establishing meaningful discussions in the boardroom is to elicit the private knowledge of the non-executive and combine this with the company-specific knowledge of the manager (Huse, 2007). Disclosure trust refers to the willingness to share information and loose face in discussions. We find support for the hypotheses that proximity produces both reliance and disclosure trust.

Finally, we argue that reliance trust leads to passiveness, in line with the traditional conceptualization of trust in the economic governance literature. Thus, we expect board task performance to decrease when reliance trust is present. We indeed find that directors perform their monitoring tasks less well, but we do not find that directors do not perform their advice duties well when they rely on management to do a good job. This may be explained by the fact that monitoring is built on adversarial relations: directors are expected to control management, which comes at a disutility as directors and managers are part of the same social class. Advising managers, however, does not come at this same disutility. Additionally, if management is believed to be very competent at what it does, there may be no need to monitor, yet advice on other strategic courses may still be warranted. Disclosure trust is

hypothesized to increase the quality of discussions in the boardroom, and thus board task performance. We find support for these hypotheses in our empirical test.

Although our theory is supported by the results, several limitations remain, suggesting that future research efforts are fruitful. Methodologically, two qualifications are to be mentioned. The extensive testing of our model has been performed on the same dataset as the estimation of the proposed model. Also the factor analyses that lead to the definition of the latent constructs were performed on this dataset. Thus, firstly, tests on other datasets may further corroborate our findings. Secondly, we test an essentially dynamic model with a cross-sectional dataset. Both trust, processes, and performance are measured at one point in time. This introduces the possibility of reversed causality: it may well be that trust causes proximity, instead of the hypothesis suggested by our model. A test of whether current trust and performance levels lead to subsequent conflict would also be more in line with the timeline that underlies our theory.

The results of the SEM estimations support our hypothesis that, in the Norwegian context, proximity may well lead to improved monitoring performance. We have interpreted this result as evidence for the weakness of the discrete interactions assumption in agency theory, yet an alternative interpretation would be that in Norway, the agency theory model simply is not applicable. Contextual differences between Norway and the Anglo-American countries may make opportunistic behavior less salient in Norway, or the decision-making culture may be such that even with close relationships, independent judgments are easily made. In terms of national differences, it has been documented that in Norway, shareholders are less well protected than in the US (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998), and that the country is more prosocial than the United States (Lubatkin et al., 2005). Indeed, the Hofstede (2005) model of national culture shows that US citizens tend to be more individualistic and very much more masculine than their Norwegian counterparts. The long-term orientation of Norwegians is also (slightly) stronger than that of Americans. All this indicates that the agency problem may be less salient in Norway, as short-termism is not likely to dominate, and conflicts of interests are more likely to be solved collectively (through negotiations) than through power struggles. In line with the prosocial culture, corporate governance codes – detailing rules as to how interactions among executives, directors, and shareholders should be – have not been as extensively developed as elsewhere in the world, particularly the United States and the United Kingdom. Finally, it follows from our description of the data that firms tend to be smaller and CEO ownership more substantial in Norway vis-à-vis the United States. This is likely to make the agency problem inherently less problematic, as monitoring is less complicated and CEO incentives are likely to be more aligned with those of the shareholders. A comparative management analysis may yield

additional insights in whether our results reflect an improvement of agency theory, or provide an alternative model in contexts where the agency problem is less important.

On a theoretical level, several other interesting issues remain as well. Firstly, we have shown that proximity increases both types of trust, which, subsequently, have various effects on performance. An interesting question is then to ask whether different sub-factors can be distinguished in the proximity factor. From the literature on team heterogeneity, for example, it is known that the easier it is to observe that another person is proximate, the larger the effect on the performance of the individual is (Williams and O'Reilly, 1998). An interesting future research avenue is to see whether the process of trust-building is more readily affected by homogeneity in composition than by homogeneity in norms.

Secondly, it is quite likely that our treatment of board processes is too parsimonious. We have hypothesized that disclosure trust activates boards, whereas reliance trust decreases board activity. The exact effects of trust on board effort, use of knowledge and conflict, processes distinguished by Forbes and Milliken (1999), may provide further insights in the mediation process that operates between proximity and board task performance. This may, in turn, make the proposed and rival model in Table 2.3 more distinctive.

Thirdly, it is suggested that game theory may have important prospects to offer to the model. Like social contract theory, game theory allows for trust to emerge in situations of repeated interactions (van Witteloostuijn, 2003). Although the development of a game that reflects the negotiations among executives and directors is tedious – involving multiple objectives (monitoring and advice), bargaining over outcomes, and asymmetric information –, it is suggested that particularly horizon effects are worthy of investigation. In game theory, when actors have to decide to either take the risk of trusting or assume non-cooperative behavior (with associated losses, as in our model), trust will not emerge when the number of rounds is fixed. In management terminology, directors will not trust the CEO when the length of the CEO term is fixed. After all, a CEO will not trust directors in the final year he is appointed, since the opportunistic behavior may result in a high payoff and the consequences of being fired are limited. Backward induction is then applied (van Witteloostuijn, 2003), which shows that CEOs will never behave trustworthily, and thus directors will never trust. Only when tenure is potentially infinite, trust may emerge. This effect of the length of CEO terms is likely to affect the extent to which the agency problem is apparent, and thus our model may only apply – according to game theory – in the early years of CEO's appointments, or not at all when the term is fixed. Furthermore, the retaliation strategy directors may use (that is, their way of punishing the CEO and re-establishing trust after opportunistic behavior is disclosed) is subject to future research, which may well fit in a game-theoretical framework.

Finally, we have not denied that opportunistic behavior does occur, yet that it cannot be taken as a basic postulate to explain the behavior of directors and managers in general. Our model offers an alternative for these cases, but it would be interesting to see if and how the proximity model may encapsulate and neutralize the opportunistic acts some managers may wish to commit in some circumstances. In this respect, it may be easier to build such exceptional cases into a general, behavioral, model, than to extend the principal agent model to situations where transactions are neither discrete nor among anonymous parties. Including contextual variables that would proxy for the extent to which opportunistic behavior is salient in specific countries, industries or even firms, would be an important way to further develop our argument.

