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van der Laan, G.

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6. Conclusion and Appraisal

This chapter summarizes the main findings reported in the empirical chapters. As each of the chapters contains a summary already, the emphasis here is on key findings, contributions and directions for future research. Section 6.1 summarizes the findings. In Section 6.2, the contribution to the behavioral perspective on corporate governance (see Section 1.2) is discussed. Section 6.3, finally, offers some directions for future research.

6.1 Summary

Chapter 2 provides a qualification of agency theory's discrete interactions assumption. It is assumed in the agency perspective on the tasks of boards that directors and managers always act as if they meet for the first time. In this context, directors are likely to perceive the least disutility of taking negative decisions about, for example, executive compensation or dismissal. We argue, on the contrary, that directors in practice value the relationship with management as such, and aspire to remain on good terms. These social contracting norms foster the development of trust, which, in turn, positively affects board tasks performance. In line with the theory, we indeed find that social norms among the board chairperson and the CEO are associated with board effort and the development of two types of trust: reliance and disclosure trust. Reliance trust refers to the willingness of directors to assume that managers will do a good job. This makes directors less vigilant in monitoring management. Disclosure trust refers to the willingness to share information and lose face in a discussion. When disclosure trust is present, directors are assumed to actively participate in board meetings with management. It is subsequently found that disclosure trust positively affects board effort, and also has a positive impact on board tasks performance. Reliance trust, on the contrary, is negatively related to board monitoring performance, and has no discernible effect on board advice task performance. Consequently, Chapter 2 offers support for the notion that a model of board behavior in which the preservation of a good relationship between the CEO and the board chairperson is emphasized, may well contribute positively to board tasks performance. We thus offer an alternative for agency theory that also encompasses board advice task performance, and is empirically validated, at least in a setting where opportunistic behavior is not expected to dominate.

In Chapter 3, the relationship between a firm and its stakeholders is studied. Two key arguments have been tested. First, it is argued that primary stakeholders, as they have frequent exchanges with the firm, do not need to rely on a reputation for the company's well-doing with respect to their demands. Through their exchanges, the company's stances will become

clear to these stakeholders much more directly. For secondary stakeholders, who do not have frequent exchanges with the company by definition, such a reputation is much more crucial. Thus we expect that a reputation for good corporate social performance (CSP) is stronger related to corporate financial performance (CFP) when secondary stakeholders are concerned. We do not find evidence for this hypothesis, however, and it appears that the strength of the relationship between stakeholder CSP and firm financial performance is primarily driven by the proximity of the stakeholder to the core business processes. Second, we use insights from prospect decision theory, and argue that in the evaluation of company's CSP, a negative reputation is given more weight than a positive reputation. As the evaluation of a company's CSP may impact the extent to which a firm has access to resources, it is argued that positive CSP scores are unrelated to financial performance, whereas negative reputations are strongly and negatively related to CFP. The implication of the findings with respect to the first set of hypotheses as discussed above is that the relationship between CSP and CFP is not expected to be significant in the short run. In the long run, however, companies may suffer from maltreating secondary stakeholders. Indeed, we do not find evidence for the hypothesis that a negative CSP reputation is related to CFP for secondary stakeholders. However, for primary stakeholders, our hypothesis is supported. It is indeed true that employees, customers and the like respond strongly to a negative reputation for CSP, yet once the company has lined up with the norms as to what is socially responsible, there are no short-term financial benefits to be gained by further improving the CSP reputation.

Chapter 4 studies compliance with corporate governance codes. These codes may be conceived of as a collection of stakeholder claims, namely those formulated by shareholders. Since compliance with these codes is voluntary, firms may resist implementation of some provisions. Moreover, as codes contain many recommendations, non-compliance with some provisions may be hidden behind compliance with many other recommendations. We argue that a proper analysis of drivers of compliance starts with a decomposition of the code itself. A classification is developed, in which recommendations are considered accepted, debated or contested by managers, based on the extent to which implementation of a provision would affect the managers' utility. Accepted best practice provisions would, in this classification, not affect the managers' utility, debated provisions have an indirect effect, and contested best practice provisions directly impact upon the managers' well-being. The first hypothesis is that managerially contested corporate governance provisions are complied with the least. A comparison of some provisions that evidently affect managerial well-being, those relating to executive compensation, to all other provisions indeed provides support for this hypothesis. We proceed by arguing, given that managers are likely to resist the implementation of these recommendations, that several counter-forces may increase the compliance rates with contested provisions. It is argued that when a firm is central in a network of directors, this

network is likely to exert normative pressure on the firm to comply. Furthermore, we hypothesize that board independence is associated with increased compliance rates. Evidence for these hypotheses is found. The chapter supports claims made in the recent stream in the corporate governance codes literature that seeks explanations of compliance, and adds to it that a more fine-grained analysis of best practice provisions is required.

Chapter 5, finally, empirically tests the existence of a relationship between CEO power and CEO compensation. We build on the managerial power theory, in which it is assumed that powerful CEOs are able to secure high and performance-insensitive compensation. Power may be relevant when the arms' length bargaining assumption, similar to the argument presented in Chapter 2, does not hold. Directors may not be able to negotiate a contract with a CEO at arms' length when CEOs have a substantial influence over who gets appointed on the board of directors. Power also is of interest to optimal contracting scholars, as powerful CEOs may have to be compensated for their ability to behave opportunistically. Our hypotheses hold that powerful CEOs manage to (1) secure compensation contracts that allow for large payments, (2) obtain higher levels of compensation than CEOs who have less bargaining power, and (3) reduce the performance sensitivity of their compensation. We find that power is unrelated to the design and the level of executive compensation, however. Performance only weakly explains some elements of compensation levels. The performance sensitivity of compensation is not strongly influenced by CEO power either. Instead, it appears that firm size, ownership concentration and having a listing on a US stock exchange have a much more substantial effect on CEO compensation.

Chapters 2, 4, and 5 all relate to bargaining over different solutions. In Chapter 5, the bargain concerns the executive compensation contract, whereas Chapter 4 involves the implementation of managerially contested corporate governance provisions. Chapter 2 directly deals with the bargaining process, and tests whether proximity and trust are likely to yield satisfactory solutions (as opposed to distance and distrust). The power that accrues to each stakeholder appears to be of importance in determining the outcome of the bargaining process, a finding which is further supported in Chapter 3. Thus, power – and its cousin, independence – are key concepts throughout this book. Therefore, the contributions section below focuses on these two concepts.

6.2 Contribution to the behavioral perspective on corporate governance

Power and independence have been treated differently in the academic literature. Conceptually, the distinction among the two concepts is clear, yet empirically the differences

turn out to be elusive. As I will argue later (Section 6.3), a lack of theoretical development of concepts is a fundamental problem in the behavioral perspective on corporate governance. Consequently, the literature develops in separate yet related streams, and it is sometimes unclear to what extent arguments relating to the same topic are actually comparable. Moreover, due to a shortage of theoretical guidance, a body of empirical papers relating to a topic tends to give a cluttered image with regards to measures and variables, as is apparent from the many meta-analyses with regards to board structure, composition and director contingencies, on the one hand, and board or firm performance, on the other hand.

Conceptually, power is the ability of an individual to exert her/his will upon somebody else (e.g., Finkelstein, 1992). Independence refers to the distinction between decision management and decision control, as introduced by Fama and Jensen (1983). Decision control refers to the ratification of decision proposals, and the control to the implementation of ratified proposals. An independent board is able to minimize the role of management in decision control (Maassen and Van den Bosch, 1999). This suggests a theoretical link between power and independence, which is yet to be explored: a powerful board would be able to ratify management's proposals and control its implementation without the management's will being exerted upon the directors. Board power would thus be a prerequisite for board independence.

Udueni (1999), however, argues that independence is a prerequisite for power. The empirical operationalization of the power and independence concepts is, to my opinion, what causes this argument to be different from the one above. Legislators see independence as an objectifiable characteristic, and define it – simply put – as the absence of financial and family ties between directors and managers (Rodrigues, 2008). Such a formal definition of independence only captures some elements of this key feature of relationships. Indeed, in some US jurisdictions (e.g., Delaware) directors who have no financial and family ties to the firm are considered outside board members, or non-executive directors, yet courts evaluate independence in specific conflicts inside a boardroom based on the problem itself, using a wider set of dependence factors (Rodrigues, 2008). Therefore, if a board is independent according to the law, this does not imply that it has the power to perform its decision control tasks outside the influence of managers. In this sense, legal independence may be conceived of as a prerequisite of power, in line with Udueni (1999). Power measures suffer from the same issues, as objectifiable indicators such as tenure and stock holdings in the company are commonly used to proxy for power (Finkelstein and Mooney, 2003). Such structural measures, again, may only be a prerequisite for directors to be able to exert their will on management. In terms of the classification in Table 1.1, current measures of power and independence are indicators of formal structures. It is exactly the assumption that setting the formal structures right does not imply that the desired outcomes will not be achieved, that is

the key distinction between behavioral and legal/economic approaches to corporate governance. In the empirical behavioral literature, it seems that the assumption that is so strongly criticized in the economic perspective has not been replaced by behavioral assumptions.

In Chapters 4 and 5 in this book, it is indeed assumed that power and independence are essentially two sides of the same coin, similar to what Pettigrew and McNulty (1998: 200) argue: “[f]or boards to exercise their vigilance role over the CEO, the board needs power.” In Chapter 4, it is argued that independent boards are more likely to emphasize the interest of the firm in the boardroom, and such boards will thus achieve a higher compliance rate with managerially contested best practice provisions. In Chapter 5, it is assumed that when directors depend on the CEO for their reappointment, they will not have the power to achieve optimal contracting solutions with respect to executive compensation. The latter conceptualization of power is similar to Emerson’s (1962) dependency framework, where the power of actor A over B is directly related to the dependency of B on A (see also Wenstøp, 2008). The measure of power, however, remains mostly structural, and fails to capture interpersonal dynamics inside the boardroom. In terms of results, it is striking, as the studies use almost identical samples, that board independence does affect compliance rates (Chapter 4), whereas no effect of CEO power on decision-making is found (Chapter 5). That is, whilst formal independence does affect outcomes, an effect of power measures could not be found. This offers support for the notion that both cannot be seen as highly related concepts. Obviously, the different findings may also be due to the different measures of power and independence. The independence of the board is measured by means of several criteria relating to whether the board contains no more than one (formally) dependent member, whether the board committees are composed of only (formally) independent members, et cetera. It appears to be the case that such formal independence results in decisions that are in the interest of the firm. In Chapter 5, power was measured according to Finkelstein’s (1992) classification, based on a multidimensional conceptualization of power. Although these measures also refer to structural, formal, sources of power, it is not found that CEO power leads to more opportunistic behavior, as it is not observed that CEO power affects the level and performance sensitivity of compensation. However, it is not found either that, for the firms in this sample, CEO compensation is strongly tied to performance. This decoupling of pay from performance is, however, not related to CEO power. These findings support the study by Udueni (Udueni, 1999) in its call for a separation of power from independence in theory and measurement.

In Chapter 2, independence is given a completely different interpretation, namely the absence of social contracting norms. In this situation, directors would not be proximate to CEOs, and would be able to take tough decisions. Indeed, from Chapter 4 it seems that some

tough decisions – implementing managerially contested corporate governance provisions – are established in this context. Yet, the absence of social contracting norms also generates an environment in which director effort is reduced and distrust is emphasized. On the contrary, for some tough decisions, it may be better to develop a context in which trust and mutual problem-solving are central. In that sense, non-linearities in the relationship between trust and board tasks performance, as contained in Chapter 2, may model this initial benefit of trust, whereas too much trust may result in dependence and opportunistic CEO behavior. In the literature, this curvilinear effect of trust has been identified before (Langfred, 2004). Additionally, it suggests a relationship between trust and power (Van der Laan and Zhang, 2007), which may succinctly be summarized as "trust me, I'm your boss" (Willemyns, Gallois and Callan, 2003). All in all, the thesis documents the importance of a relational lens on corporate governance problems. Relational characteristics such as power, independence and trust are suggested to provide insights into board effectiveness.

6.3 Future research

The classification of perspectives on corporate governance (Table 1.1) points to the need to study formal and informal structures, and board processes. The economic perspective on corporate governance has, in the past few decades, developed theory as to how formal structures would affect outcomes under the rationality assumption. A behavioral perspective on corporate governance could aim to study the consequences of dropping the rationality assumption, which would lead to the consideration of micro and macro-social forces on board tasks performance (Zajac and Westphal, 1998). Several authors have identified key concepts and tried to link structures, processes and outcomes (Forbes and Milliken, 1999; Huse, 2005). Also, empirical tests of the hypotheses generated by these models have been presented.

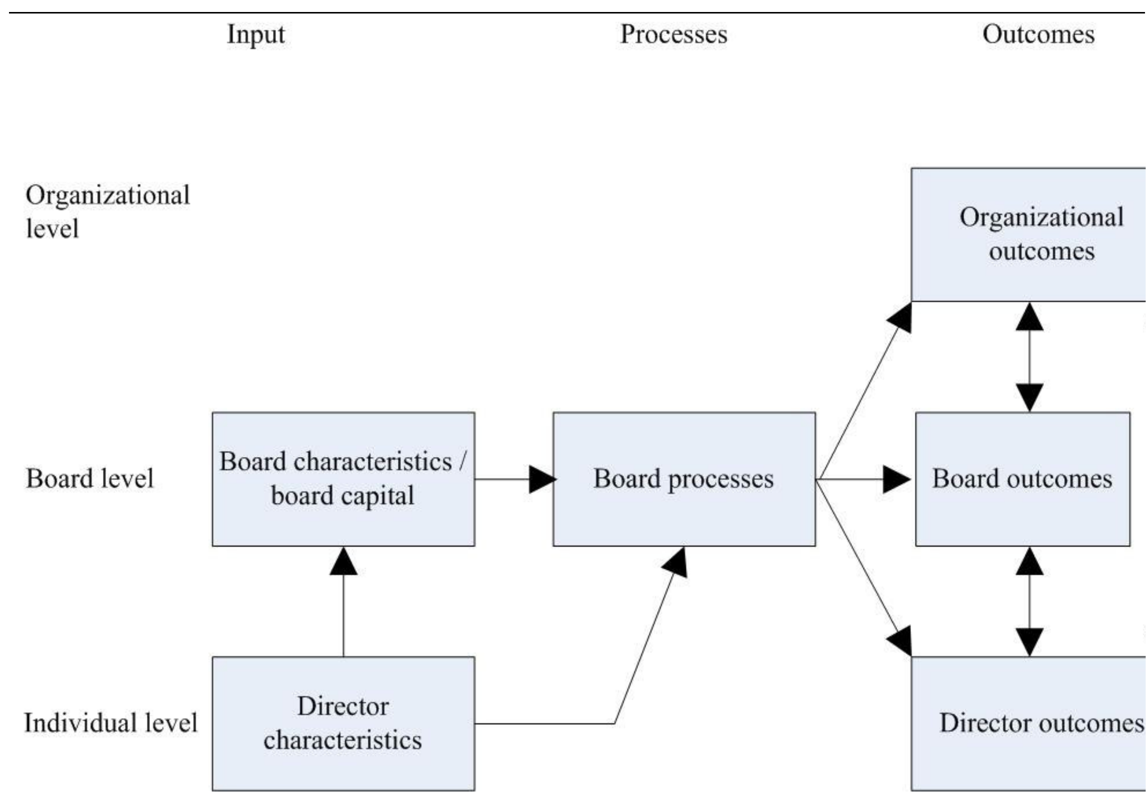
The behavioral models, however, tend to be difficult to test empirically, as they contain many concepts and interrelations. While this could be addressed by studies of partial models, focusing on, for example, the effect of informal structures on a selected behavioral process, it is more troubling that the theoretical development of the literature appears to result in divergent instead of convergent contributions. For example, the model of Forbes and Milliken (1999) distinguishes three behavioral processes: effort norms, cognitive conflict, and use of knowledge and skills. These processes are argued to relate to board tasks performance. Huse's (2007) model, however, discusses effort norms under the heading of preparation and involvement, and use of knowledge and skills under the heading of openness and generosity. Additionally, criticality and creativity are added as characteristics of the board decision-making culture. Although the underlying relationships assumed by the authors may be the

same, empirical scholars are likely to look for different sets of measures to proxy for norms regarding board work (effort norms) than when trying to proxy for director preparation. Consequently, subtle differences among concepts may cause the development of different streams in the behavioral perspective to address similar topics, but departing from similar assumptions. This complicates the development of a behavioral perspective, as has been illustrated for the case of power and independence in Section 6.2.

Next to conceptual clarity, I feel that the behavioral perspective could benefit from two additional insights. Figure 6.1 presents a framework that does not have as its purpose to provide yet another web of relationships, but rather to show that behavior takes place at different levels of analysis, and that structures, processes and outcomes can and should be separated. These aspects have not frequently been taken into account so far. Clearly, this does point to interesting avenues for future research, of which I will briefly discuss a few issues I believe deserve priority.

FIGURE 6.1

A multil-evel input-process-output model of board task performance



First and foremost, the behavioral corporate governance literature, to date, largely ignores multi-level issues. Although studies exist that link board-level capital to the capital of individual directors (Oh, Labianca and Chung, 2006), research would yield improved insights when board processes were explained by both director characteristics and board features. This

notion builds on the work of Hillman and Dalziel (2003), who give primary importance to board capital when seeking an explanation for board tasks performance. Relating, for example, to the earlier discussion on power and trust, it may well be that board effectiveness is greatly enhanced when a powerful director (individual characteristic) can rely on a board where trust among directors is present (board-level characteristic). Thus, next to the central tendency (mean or median) of the distribution of a single input variable, such as directors' knowledge or skills, it may be worthwhile to study the effects of the joint shape of the distribution of various input variables on board tasks performance. It has been found in the literature with regards to team diversity, for example, that gender heterogeneity affects team performance differently when men represent the dominant coalition as compared to women (Williams and O'Reilly, 1998). Also, tenure heterogeneity is argued to affect communication among directors (Williams and O'Reilly, 1998). The study of the joint distribution of gender and tenure diversity may yield additional insights into the issue of what makes a board effective.

Second, it may well be recognized that the board's working style has effects on all three levels of analysis. Board working style affects board performance, as is frequently hypothesized in the behavioral perspective on corporate governance (e.g., Zona and Zattoni, 2007), and also affects firm performance, as is frequently suggested in the economic literature, although processes tend to be treated as a black box in this literature (e.g., Barnhart, Marr and Rosenstein, 1994). Finally, board working processes affect individual-level outcomes, such as the probability that a director will be slated for board provisions in other firms (Westphal and Khanna, 2003). The decisions directors make may well be a trade-off among their tasks as stewards of the firm (organizational-level outcomes), their norms and values with respect to board work (board-level outcomes) and their personal agendas (individual-level outcomes). The intricacies implied by this bargaining over objectives has, to my knowledge, not been addressed in the corporate governance literature yet.