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Citation for final published version:

Goergen, Marc and Renneboog, Luc 2014. Inside the board room. *Journal of Corporate Finance* 26 , pp. 1-5. 10.1016/j.jcorpfin.2014.05.004

Publishers page: <http://dx.doi.org/10.1016/j.jcorpfin.2014.05.004>

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Inside the Board Room

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Since the Cadbury Report was published in 1992 in the UK, there has been increasing emphasis not just by UK regulators but also by regulators from other countries, including the USA and Continental Europe, on the role of boards of directors in corporate governance. However, more than 20 years down the line it is still uncertain whether boards of directors are able to fulfil the important role they have been assigned by regulators. For example, the academic literature on the impact of board composition, in particular the proportion of outside, non-executive directors, is as yet inconclusive as very few studies have found a link between the two. In addition, the financial crises that started in 2007 suggest that boards of directors have failed in their role of monitoring the executives and managing risk across the organization. For example, when Barclays Bank was fined US\$450m as a result of the LIBOR-fixing scandal the non-executive chairman of the board, Marcus Agius, decided to resign, willing to take all the blame while CEO Bob Diamond refused to resign. At the time Agius resigned, some of Barclays' shareholders were said to have stated that "[Agius] he was not tough enough to stand up to the headstrong Mr Diamond". This example suggests that all too often relations between various members of the board of directors are too cosy. More generally, the recent events suggest that there is still a lot we do not know about board dynamics as well as other issues relating to the functioning, the effectiveness and efficiency of corporate boards. This special issue comprises studies on the managerial labor market, including CEO successions, the gender balance on the board, directors' independence, corporate culture and its effects on board turnover, and the role of corporate networks.

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CEO Successions and CEO Turnover

Ansari et al. (this issue), Andres et al. (this issue) and Berger et al. (this issue) all focus on issues relating to CEO successions and CEO turnover. Ansari et al. (this issue) study the determinants of the choice of CEO successor for the case of French, German and UK family firms. They define family firms as those firms that have a family exercising at least 25% of the votes and whose incumbent CEO is a member of the controlling family. They study the impact of the following five determinants on the choice between a CEO not related to the family and a CEO from the controlling family. The first determinant is family power. Family power is measured in three different ways, including the percentage of voting rights held by the family, family stock ownership and the wedge between the former and the latter, which acts as a proxy for private benefits of control. The second determinant is the family's generation relative to the generation of the founder. The third determinant is directors' independence. The study uses both directors' independence as reported in the sample firms' company reports as well as in an adjusted way, which takes into account links between the director and the controlling family which may impinge on the independence of the former. The fourth determinant is minority shareholder protection. In line with Coffee's (2002) bonding hypothesis, French and German firms may improve the shareholder protection they provide by cross-listing in the UK or USA, thereby opting into a more stringent legal system. The final determinant is past firm performance. The authors find that reported board independence does not have an impact on the choice of CEO successor. However when reported board independence is adjusted for links that independent directors have with the controlling family, it has a significant and consistent impact on the choice of CEO successor. More specifically, the Ansari et al. study finds that an increase in the adjusted measure of board independence reduces the likelihood of the incumbent family CEO being replaced by another family member. Ansari et al.'s (this issue) evidence is in line with Chahine and Goergen (2013) who find that family ties between the top management team and the board of directors, that compromise directors' independence, reduce performance for the case of US initial public offerings. Ansari et al.'s result has important policy implications: it suggests that the definition of directors' independence in the corporate governance codes of all three countries should be revised to take into account the particular case of family firms. Finally, Ansari et al. (this issue) also find that greater shareholder protection, as measured by a UK or US cross-listing, reduces the likelihood of the CEO being replaced by another family member.

Andres et al. (this issue) study the impact on firm performance and executive pay of a unique feature of the German corporate governance system. Germany has a two-tier board system with a separate management board where the executives sit and a separate supervisory board where the non-executives and employee representatives sit. Frequently, the retiring CEO becomes a member, or even the chair, of the supervisory board. This has been causing controversy and has been fuelling an ongoing public debate in Germany, mainly because of the potential conflicts of interests this may cause. As one of the roles of the supervisory board is to monitor the management board, there is indeed the danger that management oversight may be negatively affected if the former CEO ends up monitoring former colleagues. In particular, such conflicts of interests may result in an increase in executive pay. While the authors find some weak evidence of increases in executive pay when the CEO becomes a member or the chair of the supervisory board, the increases are only weakly significant. Importantly, the stock market reaction of the appointment of the retiring CEO to the supervisory board is typically positive, suggesting that investors

do not foresee any conflicts of interests. Consequently, Andres et al. (this issue) argue that a new law which came into effect in 2009 and delayed CEO transitions to the supervisory board is not justified.

Fiordelisi and Ricci (this issue) study the impact of corporate culture on CEO turnover. Based on Cameron et al. (2006), they distinguish between two corporate cultures with an internal focus and two corporate cultures with an external focus. The former two include the collaboration-oriented culture and the control-oriented culture. In organizations with a collaboration-oriented culture cohesion, consensus and collaboration are paramount. Such organizations tend to invest in their employees' human capital and employee voice and involvement in the organization also tends to be much greater. The other corporate culture with an internal focus, i.e. the control-oriented culture, tends to emphasize control, hierarchy and efficiency. Organizations with such a culture tend to be rule and procedure driven, and uniformity and standardization are important. The two corporate cultures that focus on the outside world are the competition-oriented culture and the creation-oriented culture. Organizations having adopted the former tend to focus on their customers and shareholders, emphasizing metrics such as shareholder returns, market shares and growth in profitability. The latter culture tends to focus on constant transformation and entrepreneurship. In such an organizational culture rules do not matter and are merely seen to be barriers that employees need to climb.

Fiordelisi and Ricci (this issue) use a text analysis approach to class firms, based on official company documents, into one of the above four types of corporate cultures. In line with the existing literature, they find a negative link between industry-adjusted firm performance (as measured by the return on assets (ROA)) and CEO turnover. More importantly, the type of corporate culture also matters. CEO turnover is found to be greater when the culture focuses on the outside world, i.e. when it is competition-oriented or creation-oriented. Nevertheless, an organization with a creation-oriented culture is less likely to choose an outsider as its new CEO compared to an organization with a competition-oriented culture.

Boards of Financial Institutions

Two of the papers in this special issue, i.e. Berger et al. and Calluzzo and Dong, investigate how board characteristics affect risk taking and corporate governance quality of financial institutions, respectively. Berger et al. (this issue) focus on the impact on portfolio risk of the composition and the demographic characteristics of the members of the management board of German banks. The demographic characteristics they study include age, gender and education. They hypothesize that age has a negative effect on portfolio risk. Based on their reading of the existing literature, they argue that neither gender nor education has been shown to have a consistently positive or negative impact on risk taking. Hence, they formulate a set of competing hypotheses for each of the latter two demographic characteristics as to their effect on portfolio risk. They find confirmation of their first hypothesis as portfolio risk decreases with the age of the bank's executives. While they find that banks with more female executives have greater portfolio risk, this effect is only marginally significant. However, once the authors adjust for the lower experience of female executives there is no longer a gender effect. Finally, they find evidence that better education – as reflected by a greater proportion of the bank's executives having a PhD – reduces portfolio risk. Although the effect of education on portfolio risk is relatively small, it tends to be highly significant from a statistical point of view.

Calluzzo and Dong (this issue) study corporate governance contagion in the US mutual fund industry. One of the characteristics of the boards of directors of mutual funds is that their members are typically executives or directors of other funds or stock-exchange listed firms operating in other industries. Calluzzo and Dong investigate whether the corporate governance quality and practices of the latter are transmitted to the fund. They find evidence of such corporate governance contagion and there is contagion for both bad and good corporate governance. More precisely, funds are more likely to have weaker corporate governance if their directors are from firms with weak corporate governance, as measured by a high G-index (see Gompers et al., 2003), firms that have been the subject of scandals and financial firms. There is also corporate governance contagion across funds as fund families whose directors are employed by shareholder unfriendly funds tend to have weaker corporate governance. Finally, funds with directors from firms with good corporate governance and those from non-financial firms tend to have better corporate governance.

Board Independence

Borokhovich et al. (this issue), Crespí-Cladera and Pascual-Fuster (this issue) as well as White et al. (this issue) study different aspects of board independence. The first two papers focus on directors that are not strictly independent whereas the latter paper studies the demand for outside, academic directors. Borokhovich et al. (this issue) analyze the incentives of so called affiliated or grey directors in the context of unexpected executive or board turnover in US firms. Grey directors, while being outside directors, are not truly independent as they have past or existing business or employment relationships with the firm. Examples of grey directors include retired executives of the firm and executives of financial firms sitting on the firm's board. Given that grey directors are neither inside directors nor truly independent directors, their motivations are less clear compared to inside directors and outside directors. On one side, grey directors with business links with the firm may be tempted to vote with the executives. On the other side grey directors that are executives of other firms may be concerned about their reputation as independent decision makers and therefore be more tempted to side with the shareholders. Stock ownership by the grey directors in the firm may further strengthen their incentives to vote in the interests of the shareholders. Borokhovich et al. assess the grey directors' incentives by studying the market reaction to the unexpected death of top executives and the chair of the board of directors. They take into account grey directors' stock ownership as well as the existence of succession plans within the firm. They conjecture that the existence of a succession plan makes it more likely that the grey directors side with the inside directors rather than the shareholders. Indeed, a dissenting vote could jeopardize their business ties with the firm. The findings from this study are as follows. First, there is a positive relationship between the stock market reaction to the sudden death and grey directors' stock ownership. Second, this positive link is only observed for firms without a succession plan. The authors interpret this as evidence that, when there is a succession plan, grey directors will focus on protecting their business ties with the firm, voting with the majority of the board, disregarding their ownership. This is especially the case when there has been a sudden death of a top executive. In contrast, when there is no internal successor the incentives of the grey directors are driven by their stock ownership. Finally, grey directors' stock ownership does not seem to drive the decision to appoint an outsider to replace the deceased executive or chair.

Crespí-Cladera and Pascual-Fuster (this issue) assess whether directors of Spanish firms that are reported as being independent are truly independent. They base themselves on the eight criteria of independence stated in the Unified Good Governance Code. They find that, while a panel of 752 Spanish firm-year observations for 2004-2009 reports that 32.5% of their directors are independent, actual board independence is only 14.2%. Importantly, the misreporting of board independence is more likely when managerial control over the firm is strong. Their proxies for managerial control include a dummy variable which indicates duality of the chair-CEO, the size of the board to proxy for board effectiveness (which has been shown to be inversely related to board size), a dummy variable indicating a voting cap, the percentage of busy non-executive directors, i.e. those with at least three directorships, and the percentage of executives that are interlocked, i.e. that are non-executives on another firm's board whose executives in turn sit on the firm's board. Apart from the latter proxy, all the proxies of managerial power increase the likelihood of misreported independent directors. Nevertheless, when Crespí-Cladera and Pascual-Fuster investigate the impact of misreported board independence on future operating performance they only find a weakly significant and negative relationship.

White et al. (this issue) investigate the reasons behind the appointment of academics to boards of directors of US firms. They also study the market reaction to such appointments. They report that academics are typically appointed by small and medium-sized firms that are in the process of expanding their boards. They distinguish between three types of academics: academic administrators, i.e. those with leadership experience (such as presidents, chancellors and deans), business academics (i.e. professors of business schools), and specialized professors (i.e. those with expertise in medicine, science and engineering). The authors find that the factors driving an academic appointment vary across the three types of academics. Firms that are subject to more scrutiny (as reflected by e.g. a NYSE listing) or that advertise more are more likely to appoint an academic administrator, who typically already sits on other boards and is affiliated to a non-top 25 university which is geographically close to the firm. Further, there is a significant and positive stock market reaction to the appointment of academic administrators who work in business schools and who expand the board. For all other academic administrators, those that are not local and those that replace an existing director, the market reaction is negative. Firms that are less well known are more likely to appoint business academics from a top-25 university, even if that university is not local. However, the market reaction to such appointments is typically not significant. This suggests that the lower visibility of these firms may make it difficult to recruit non-executives with the right experience and expertise, but that the market expects that these appointees are unlikely to be very effective. Finally, high-growth firms and firms operating in industries where knowledge is important are more likely to appoint specialized professors. The market reaction to these appointments is significantly positive and it tends to be greater when the specialized professor is farther away, suggesting that the appointment may enable the firm to tap into knowledge that is not available locally.

Gender Balance on the Board

Over the past two decades, press articles on the glass ceiling and pay discrimination of female employees and managers have put gender balance on the political agenda which in some countries has resulted in anti-discriminatory legislation and the incorporation of equal gender treatment in codes of good corporate governance practice. In this respect, the Scandinavian countries are the front runners (see e.g. Goergen,

2012). Using responses to mandated changes to Norwegian boards, Ahern and Dittmar (2012) demonstrate that the mandatory quota for female representation on corporate boards – the law was passed in 2003 with a transition period until 2008 – is negatively correlated with corporate performance. Bøhren and Staubo (this issue) revisit this issue and raise the question as to whether the mandatory gender quota is costly for Norwegian firms. They report that the introduction of the law mandating at least 40% of women in Norwegian boardrooms is indeed costly as reflected by a change in the legal form of the organization. They find that half of the firms subject to the quota chose to change their organizational form to a form not subject to the law. This implies that these firms perceive the cost of the new regulatory constraint to be higher than the cost from changing their organizational form. The average firm, which changes its legal form and thus avoids the quota, is profitable, small, young, and unlisted, has concentrated ownership and few female directors. A recent paper on Norway by Matsa and Miller (2013) shows that the presence of more female directors influences corporate decision making as such firms experience employee layoffs and higher labor costs, which results in lower profits. Most other countries considering gender balance regulation tend to favor the comply-or-explain approach over a hard law, as long as progress is made towards improving female representation on corporate boards. This approach leaves the choice of gender balance to the firm's discretion.

Most of the studies investigating gender diversity and firm performance find a negative correlation between the two. Adams and Ferreira (2009), for instance, attribute this negative relation for the US to over-monitoring by female directors. As little is known about how female directors in Asia affect corporate performance, Liu, Wei and Xie (this issue) study this issue for Chinese firms over the past decade. While controlling for endogeneity, they report that firm performance is positively related to gender diversity. However, the mere presence of female directors is not sufficient, but there also needs to be a critical mass of at least three to obtain a positive effect. The authors state that one is a token, two is a presence, and three is a voice. As in Chinese firms, where the state holds majority control or a substantial minority stake, the appointment of managers and of 'independent' directors is politically determined (see e.g. Hao, Renneboog, and Sun, 2013), Liu, Wei and Xie (this issue) therefore distinguish between state-owned enterprises (SOEs) and other firms. They show that the positive impact of board gender diversity on corporate performance only extends to non-SEOs. This may be due to either the ineffectiveness of a gender balance in SOEs or the fact that SEOs are less profit-driven and focus more on the goals set by the provincial and state political leadership.

A large body of literature relates gender to corporate policies and leadership. Female employees and managers seem to suffer from glass ceilings (or sticky floors) which hinder their promotions. For example, Geiler and Renneboog (2013) show that female top executive directors (other than the CEO) receive lower compensation (including the salary, bonus, and equity-based pay) than their male peers (who work at firms with a similar size and in the same industry, and have a similar position and tenure). Part of the explanation may be that differences in gender promotion rates and pay are due to differences in the attitude towards intra-firm competition. Men are twice as likely to engage in corporate tournaments compared to women. This is also reflected in the type of compensation packages: Kulich et al. (2011) document that compensation packages for male executives are more performance sensitive than those of their female counterparts. The greater risk aversion of women may explain this difference. Although the psychology literature suggests that female leaders face prejudices because of their supposedly lower

ability to lead (see e.g. Eagly and Karau, 2002), in reality female directors seem to be more conscientious corporate monitors (as reflected by greater attendance of board meetings and membership of board committees). Levi, Li and Zhang (this issue) examine whether the presence of female directors on corporate boards has an impact on firms' takeover policies (as measured by firms' tendencies to make acquisition bids and by the level of the bid premium offered). They investigate whether the acquisitiveness of corporate boards that include female directors and the bid terms are consistent with women being less overconfident than men. They report that the fraction of female directors and the number of acquisitions are negatively related. This relation is also economically significant as female directors curb acquisition frequency by almost 8%. Furthermore, bidders with female directors also seem to be more cautious as reflected by significantly lower (more than 15%) bid premiums as compared to bidders with exclusively male boards. However, one has to be careful with the interpretation of these findings in terms of causality as it may be the case that firms with male CEOs who are not interested in growing their firms through acquisitions attract more female directors to their board. Via an instrumental-variable approach and propensity-score matching, the authors attempt to overcome such endogeneity problems and conclude that their results hold.

Directors' Networks

Traditionally, research on director networks has concentrated on the direct relations formed by executive and non-executive directors sitting on corporate boards. Company networks through directors' relations can be mapped by means of the number of direct links or by more sophisticated measures. Such measures include those proposed by graph theory and topology concepts. For example, the former proposes the shortest or geodesic path, which is used to calculate several network centrality measures. These include the eigenvector of the connections matrix, the closeness measure (the importance of a vertex or node expressed in terms of its minimal distance to all other vertices or nodes), and the betweenness measure (the number of geodesic paths on which a vertex is situated and which captures its relative importance in e.g. an information chain). These centrality measures also make it possible to distinguish between weak and strong links (reflecting e.g. the power of a company director within a network). Director connections usually capture current and past shared employer as well as shared educational, cultural, or social background. Corporate networks are frequently created to exploit strategic alliances and to share resources across the network. Networks may generate (i) direct power or influence (that may yield private benefits of control to a director) or (ii) informational advantages (that may benefit the corporation and its managers).

A large number of papers have examined directors' networks, but disagree as to their impact on corporate performance. Given that there is slightly more evidence on the detrimental effects of such networks, it may be the case that such networks generate mostly private benefits of control for the directors involved rather than informational advantages for the corporations involved. More precisely, a small body of the literature studies the impact of networks on the managerial labor market, including hiring and firing decisions, as well as the design of compensation packages. For example, Renneboog and Zhao (2011) find that a CEO's compensation increases with his centrality in the network. They find slightly more evidence that this is due to CEO power rather than informational advantages derived from the network. Liu (this issue) takes a very different perspective: she argues that directors with more extensive networks

have a greater opportunity set. She finds that a well-connected CEO is more likely to depart from his current position because his connectedness enhances the probability of getting an outside job offer. She also demonstrates that firms recruiting a new CEO also take the candidate's connectedness into account (while controlling for a CEO's education, professional and social background): a director with a larger network may actually be less likely to be appointed because firms are concerned about the retention and future replacement costs when selecting such a CEO.

Renneboog and Zhao (this issue) study whether directors' connections generate information for the firm that may be valuable in terms of the identification of takeover targets and the merger process. They examine the effect of connected directors which are both on the acquirer and target firms' boards. They study whether such connections are related to M&A frequency, the M&A negotiation success and duration, the means of payment in the offer, the expected performance at the M&A announcement, the bidder's CEO compensation subsequent to the M&A, and the target director retention rate in the merged company. They hypothesize that direct connections enable both bidder and target to gather information more easily on the counterparty, which creates trust, and that the overall network enables firms to scout for suitable takeover targets and collect relevant information on the whole takeover market. Renneboog and Zhao (this issue) find that takeovers are more frequent between related firms than between unrelated ones. Furthermore, shared directors make it more likely that the takeover succeeds and reduce the duration of the negotiation process. However, the market reaction to the M&A announcement of the bidder is not related to connected takeovers. This suggests that either the market does not pick up that the two parties are connected or does not believe this to be important information. Finally, target directors have a better chance to move to the board of the merged firm if the bidder and target were directly connected.

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