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Seven Myths of Boards of Directors

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SEVEN MYTHS OF BOARDS OF DIRECTORS

BY DAVID F. LARCKER AND BRIAN TAYAN
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INTRODUCTION

Corporate governance experts pay considerable attention to issues involving the board of directors. As the representatives of shareholders, directors monitor all aspects of the organization (its strategy, capital structure, risk, and performance), select top executives, and ensure that managerial decisions and actions are in the interest of shareholders and stakeholders. Because of the scope of their role and the vast responsibility that comes with directorships, companies are expected to adhere to common best practices in board structure, composition, and procedure. Some of these practices are mandated by regulatory standards and stock exchange listing requirements; others are advocated by experts, practitioners, and observers who may or may not have a stake in the outcome. While some common practices contribute to board effectiveness, others have been shown to have no or a negative bearing on governance quality. We review seven commonly accepted beliefs about boards of directors that are not substantiated by empirical evidence.[1]

MYTH #1: THE CHAIRMAN SHOULD ALWAYS BE INDEPENDENT

One of the most widely held beliefs in corporate governance is that the CEO of a company should not serve as its chairman. Over the last 10 years, companies in the S&P 500 Index received more than 300 shareholder-sponsored proxy proposals that would require a separation of the two roles. Prominent corporations including Walt Disney, JP Morgan, and Bank of America have been targeted by shareholder groups to strip their CEOs of the chairman title. According to one investor, "No CEO, no matter how magical, should chair his own board."[2] Companies, in turn, have moved toward separating the roles. Only 53 percent of companies in the S&P 500 Index had a dual chairman/CEO in 2014, down from 71 percent in 2005. Similarly, the prevalence of a fully independent chair increased from 9 percent to 28 percent over this period (see Exhibit 1).[3]

Despite the belief that an independent chair provides more vigilant oversight of the organization and management, the research evidence does not support this conclusion. Boyd (1995) finds no statistical relationship between the independence status of the chairman and operating performance.[4] Baliga, Moyer, and Rao (1996) find no evidence that a change in independence status (separation or combination) impacts future operating performance.[5] Dey, Engel, and Liu (2011) find that forced separation is detrimental to firm outcomes: Companies that separate the roles due to investor pressure exhibit negative returns around the announcement date and lower subsequent operating performance.[6] The evidence therefore suggests that the benefits and costs of an independent chair likely depend on the situation.[7] According to Sheila Bair, former head of the Federal Deposit Insurance Corporation (FDIC), "Too much is made of separating these roles. ... It's really more about the people and whether they are competent and setting the right tone and culture."[8]

MYTH #2: STAGGERED BOARDS ARE ALWAYS DETRIMENTAL TO SHAREHOLDERS

Another widely held belief is that staggered boards harm shareholders by insulating management from market pressure. Under a staggered (or classified) board structure, directors are elected to three-year rather than one-year terms, with one-third of the board standing for election each year. Because a majority of the board cannot be replaced in a single year, staggered boards are a formidable antitakeover protection (particularly when coupled with a poison pill), and for this reason many governance experts criticize their use. Over the last 10 years, the prevalence of staggered boards has decreased, from 57 percent of companies in 2005 to 32 percent in 2014. The largest decline has occurred among large capitalization stocks (see Exhibit 2).[9]

While it is true that staggered boards can be detrimental to shareholders in certain settings—such as when they prevent otherwise attractive merger opportunities and entrench a poorly performing management—in other settings they have been shown to improve corporate outcomes. For example, staggered boards benefit shareholders when they protect long-term business commitments that would be disrupted by a hostile takeover or when they insulate management from short-term pressure

thereby allowing a company to innovate, take risk, and develop proprietary technology that is not fully understood by the market. To this end, Johnson, Karpoff, and Yi (2015) find that staggered boards are more prevalent among newly public companies if the company has one or more large customers, is dependent on one or more key suppliers, or has an important strategic alliance in place. They also find that long-term operating performance is positively related to the use of staggered boards among these firms.[10] Other studies also suggest that staggered boards can benefit companies by committing management to longer investment horizons.[11] Research evidence therefore does not support a conclusion that a staggered board structure is uniformly negative for shareholders.

MYTH #3: DIRECTORS WHO MEET NYSE INDEPENDENCE STANDARDS ARE INDEPENDENT

A third misconception is that directors who satisfy the independence standards of the New York Stock Exchange (NYSE) behave independently when it comes to advising and monitoring management.[12] While some evidence does suggest that representation by outside board members improves governance quality, it is not clear that the independence standards of the NYSE reliably measure independence.[13]

For example, Hwang and Kim (2009) examine whether situational or psychological factors beyond NYSE guidelines can compromise a director's judgment. The authors distinguish between directors who are independent according to NYSE standards ("conventionally independent") and those who are independent in their social relation to the CEO ("socially independent") based on education, experiences, and upbringing—positing that people who share social connections feel psychological affinity that might bias them to overly trust or rely on one another without sufficient objectivity.[14] The authors examine a sample of directors of Fortune 100 companies between the years 1996 and 2005, of which 87 percent are conventionally independent but only 62 percent are both conventionally and socially independent. They find that social dependence is correlated with higher executive compensation, lower probability of CEO turnover following poor operating performance, and higher likelihood that the CEO manipulates earnings to increase his or her bonus. They conclude that social relations compromise the ability of the board to maintain an arm's-length negotiation with management, even if they are independent by NYSE standards.[15]

Other studies reach similar conclusions. Coles, Daniel, and Naveen (2014) find that directors appointed by the current CEO are more likely to be sympathetic to his or her decisions and therefore less independent ("coopted"). The greater the percentage of the board appointed during the current CEO's tenure, the worse the board performs its monitoring function—measured in terms of pay level, pay-for-performance sensitivity, and the sensitivity of CEO turnover to performance. They conclude that "not all independent directors are effective monitors" and "independent directors that are coopted behave as though they are not independent."[16] Conversely, Fogel, Ma, and Morck (2014) show that independent directors who are "powerful" (i.e., have large social networks) more constructively contribute to firm outcomes than those who are not.[17] That is, while independence is an important quality for an outside director to have, NYSE standards do not necessarily measure its presence (or absence).

MYTH #4: INTERLOCKED DIRECTORSHIPS REDUCE GOVERNANCE QUALITY

A fourth misconception about boards is that interlocked directorships reduce governance quality. Interlocked directorships occur when an executive of Firm A sits on the board of Firm B while an executive of Firm B sits on the board of Firm A. Corporate governance experts criticize board interlocks as creating psychological reciprocity that compromises independence and weakens oversight. While some evidence suggests that interlocking can create this effect, research also suggests that interlocking can be beneficial to shareholders.[18]

Interlocking creates a network among directors that can lead to increased information flow, whereby best practices in strategy, operations, and oversight are more efficiently transferred across companies. Network effects created by interlocked directorships can also serve as an important conduit for business relations, client and supplier referrals, talent sourcing, capital, and political connections. For example, Hochberg, Ljungqvist, and Lu (2007) find that network connections improve performance among companies in the venture capital industry.[19] Fracassi and Tate (2012) find that companies that share network connections at the senior executive and the director level have greater similarity in their investment policies and higher profitability. These effects disappear when network connections are terminated.[20] Cai and Sevilir (2012) find that board connections between firms lead to higher value creation in mergers and acquisitions.[21] And Larcker, So, and Wang (2013) find that companies with a well-connected board have greater future operating performance and higher future stock price returns than companies whose boards are less connected. These effects are most pronounced among companies that are newly formed, have high growth potential, or are in need of a turnaround.[22] Shareholders should therefore evaluate the quality of director connections in the companies they are invested

in to determine whether their impact is potentially positive or negative.

MYTH #5: CEOS MAKE THE BEST DIRECTORS

Many experts believe that CEOs are the best directors because their managerial knowledge allows them to contribute broadly to firm oversight, including strategy, risk management, succession planning, performance measurement, and shareholder and stakeholder relations. Shareholders, too, often share this belief, reacting favorably to the appointment of current CEOs to the board.[23]

However, the empirical evidence on CEO-director performance is less positive. Fahlenbrach, Low, and Stulz (2010) find no evidence that the appointment of an outside CEO to a board positively contributes to future operating performance, decision making, or monitoring.[24] Faleye (2011) finds that active CEO-directors are associated with higher CEO compensation levels.[25] A survey by Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University finds that most corporate directors believe that active CEOs are too busy with their own companies to be effective board members. Respondents criticize active CEOs for being unable to serve on time-consuming committees, unable to participate in meetings on short notice, and for being too bossy, poor collaborators, and not good listeners.[26]

Over the last 15 years, the percentage of newly recruited independent directors with active CEO experience has declined. Companies instead are recruiting new directors who are executives below the CEO level or who are retired CEOs (see Exhibit 3).[27]

MYTH #6: DIRECTORS FACE SIGNIFICANT LIABILITY RISK

A sixth myth is that corporate directors face significant personal legal and financial risk by serving on boards. A 2009 survey finds that two-thirds of directors believe that the liability risk of serving on boards has increased in recent years; 15 percent of directors have thought seriously about resigning due to concerns about personal liability.[28]

However, the actual risk of out-of-pocket payment is low. Directors are afforded considerable protection through indemnification agreements and the purchase of director and officer liability insurance (D&O insurance). Indemnification agreements stipulate that the company will pay for costs associated with securities class actions and fiduciary duty cases, provided the director acted in good faith. D&O insurance provides an additional layer of protection, covering litigation expenses, settlement payments, and, in some cases, amounts paid in damages up to a specified limit. These protections have been shown to be effective in protecting directors from personal liability. Black, Cheffens, and Klauner (2006) find that in the 25 years between 1980 and 2005, outside directors made out-of-pocket payments—meaning unindemnified and uninsured—in only 12 cases. Three of these cases were extremely visible (Enron, WorldCom, and Tyco), perhaps contributing to the broad perception that the risk of directorship is high (see Exhibit 4).[29] A follow-up study of lawsuits filed between 2006 and 2010 finds no cases resulting in out-of-pocket payments by outside directors, although some of these cases are still ongoing.[30] The authors conclude that "directors with state-of-the art insurance policies face little out-of-pocket liability risk. ... The principal threats to outside directors who perform poorly are the time, aggravation, and potential harm to reputation that a lawsuit can entail, not direct financial loss."[31]

MYTH #7: THE FAILURE OF A COMPANY IS ALWAYS THE BOARD'S FAULT

A final misconception is that when a company fails it is necessarily the fault of the board. In order for a company to generate acceptable rates of returns, it must takes risks, and risks periodically lead to failure. Before attributing blame to a board it is important to identify the root cause of failure. To the extent that failure was the result of a poorly conceived strategy, excessive risk taking, weak oversight, or blatant fraud, the board can and should rightly be blamed for failing in its monitoring function. However, to the extent that failure resulted from competitive pressure, unexpected shifts in the marketplace, or even poor results that fall within the range of expected outcomes, then blame lies with management, or poor luck. The board might still rightly be said to have fulfilled its duties.

Furthermore, even within the scope of its monitoring obligations, it is not realistic that the board will detect all instances of malfeasance before they occur. The board has limited access to information about the operations of a company. In the absence of "red flags," it is allowed to rely solely on the information provided by management to inform its decisions. The board generally does not seek information beyond this, with some exceptions. One, if the board receives credible information of unusual activity within the firm (e.g., through a whistleblower hotline or internal audit report), it is expected to follow up on this information. Two, if an unrelated company gets in trouble over a unique issue (e.g., the credit card breach at Target in 2013), the board might bring in an outside consultant to present on the issue and ask management to report on the procedures and systems in place to prevent a similar problem from occurring in the company. Three, if the board believes management is not setting the right "tone at the top" through its words or behaviors, it is expected to communicate its concerns to management and increase monitoring. Absent

"red flags" such as these to trigger deeper scrutiny, it is unlikely that the board will detect all occurrences of malfeasance within a company.[32]

Still, the evidence suggests that boards are punished for losses. Srinivasan (2005) finds that director turnover increases significantly following both minor and major financial restatements and that board members of firms that overstate earnings tend to lose their other directorships as well.[33] Similarly, directors who served on the boards of large financial institutions during the financial crisis (such as Bank of America, Merrill Lynch, Morgan Stanley, Wachovia, and Washington Mutual) became the target of a "vote no" campaign to remove them from other corporate boards where they served.[34] According to one activist, "There is an appetite ... in the institutional investor community to hold directors accountable. At the end of the day, governance comes down to the board, and individual director performance matters."[35] The degree to which a director should be held accountable depends on a fair-minded assessment of whether and how the director might have contributed to the failure and whether it is reasonable to believe that he or she could have prevented it.

WHY THIS MATTERS

1. The board of directors is often described—and criticized—in terms of its salient structural features, such as its independence and the composition of its members. However, the empirical evidence suggests that many of these features have uncertain or negligible impact on governance quality. Why isn't more attention paid to the *process* by which the board fulfills its obligations to shareholders rather than its *structure*?
2. Most features of the board are required by legal, regulatory, and listing exchange requirements. Given the lack of empirical support, why aren't more governance practices voluntary and adopted at the discretion of the corporation and its shareholders rather than imposed by rigid standards? Would flexible standards lead to more suitable market-based solutions, or to more failures?
3. The board of directors is often blamed following the failure of a corporation. When is blame warranted? When is failure the fault of management, the marketplace, or bad luck? How can shareholders, as outsiders, more effectively evaluate the performance of the board and its members? ■

[1] For a detailed review of the research on board structure, see David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*, 2nd edition (New York, NY: Pearson Education, 2015).

[2] Joann S. Lublin and Ben Fritz, "Disney Chief Under Fire Over Pay, Dual Roles," *The Wall Street Journal* (February 28, 2013).

[3] A third category is the executive chairman, whereby a (non-independent) executive other than the CEO holds the chairman position. Data on chairman independence is from Spencer Stuart Board Indices for the years 2005 to 2014.

[4] Brian K. Boyd, "CEO Duality and Firm Performance: A Contingency Model," *Strategic Management Journal* (1995).

[5] B. Ram Baliga, R. Charles Moyer, and Ramesh S. Rao, "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal* (1996).

[6] Aiyesha Dey, Ellen Engel, and Xiaohui Liu, "CEO and Board Chair Roles: To Split or Not to Split?" *Journal of Corporate Finance* (2011).

[7] For example, a corporation might separate the roles after promoting an inside executive to the CEO position to give this individual time to gain experience as chief executive without having to focus on managing the board. The company might also appoint an independent chairman if company performance has declined and significant organizational and managerial changes are required.

[8] Adam Samson, "Bair: 'Too Much Is Made' of Bank Chair, CEO Debate," *Yahoo Finance!* (September 4, 2015).

[9] Sample includes companies in the S&P 1500 Index. Source: SharkRepellent, FactSet Research Systems, Inc.

[10] William C. Johnson, Jonathan M. Karpoff, and Sangho Yi, "The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms," *Journal of Financial Economics* (forthcoming, 2015).

[11] Martijn Cremers, Lubomir P. Litov, and Simone M. Sepe, "Staggered Boards and Firm Value, Revisited," *Social Science Research Network* (2014), available at: http://ssrn.com/abstract=2364165. See also Weili Ge, Lloyd Tanlu, and Jenny Li Zhang, "Board Destaggering: Corporate Governance Out of Focus?" AAA 2014 Management Accounting Section (MAS) Meeting Paper, *Social Science Research Network* (2014), available at: http://ssrn.com/abstract=2312565.

[12] The NYSE defines independence as having "no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company)." A director is not considered independent if the director or a family member has been employed as an executive officer at the company within the past three years; has earned direct compensation in excess of $120,000 from the company in the past three years; has been employed as an internal or external auditor of the company in the past three years; is an executive officer at another company where the listed company's present executives have served on the compensation committee in the past three years; or is an executive officer at a company whose business with the listed company has been the greater of 2 percent of gross revenues or $1 million within the past three years. See NYSE, "Corporate Governance Listing Standards, Listed Company Manual Section 303A.02—Corporate Governance Standards," (January 11, 2013).

[13] The NYSE acknowledges this risk: "It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company. ... Accordingly, it is best that boards making 'independence' determinations broadly consider all relevant facts and circumstances." Ibid.

[14] Specifically, they measure whether a director and CEO have in common the following: 1) served in the military, 2) graduated from the same university (and were born no more than three years apart), 3) were born in the same U.S. region or the same non-U.S. country, 4) have the same academic discipline, 5) have the same industry of primary employment, or 6) share a third-party connection through another director to whom each is directly dependent.

[15] Byoung-Hyoun Hwang and Seoyoung Kim, "It Pays to Have Friends," *Journal of Financial Economics* (2009).

[16] Jeffrey L. Coles, Naveen D. Daniel, and Lalitha Naveen, "Co-opted Boards," *Review of Financial Studies* (2014).

[17] Note that it might be the case that better companies attract more powerful directors. See Kathy Fogel, Liping Ma, and Randall Morck, "Powerful Independent Directors," European Corporate Governance Institute (ECGI)—Finance 404, *Social Science Research Network* (2014), available at: http://ssrn.com/abstract=2377106.

[18] For example, Hallock (1997) finds some weak evidence that CEOs of companies with interlocked boards earn higher compensation than the CEOs of companies with non-interlocked boards. Nguyen (2012) finds that CEOs whose firms are connected through interlocked boards are less likely to be fired following poor performance. Santos, Da Silveira, and Barros (2009) provide evidence that companies with interlocked boards in Brazil have lower market valuations. Their results are especially strong for boards that are both interlocked and "busy." See Kevin F. Hallock, "Reciprocally Interlocking Boards of Directors and Executive Compensation," *Journal of Financial and Quantitative Analysis* (1997); Bang Dang Nguyen, "Does the Rolodex Matter? Corporate Elite's Small World and the Effectiveness of Boards of Directors," *Management Science* (2012); and Rafael Liza Santos, Alexandre Di Miceli Da Silveira, and Lucas Ayres B. de C. Barros, "Board Interlocking in Brazil: Directors' Participation in Multiple Companies and Its Effect on Firm Value," *Social Science Research Network* (2009), available at http://ssrn.com/abstract=1018796.

[19] Yael Hochberg, Alexander Ljungqvist, and Yang Lu, "Whom You Know Matters: Venture Capital Networks and Investment Performance," *Journal of Finance* (2007).

[20] Cesare Fracassi and Geoffrey A. Tate, "External Networking and Internal Firm Governance," *Journal of Finance* (2012).

[21] Ye Cai and Merih Sevilir, "Board Connections and M&A Transactions," *Journal of Financial Economics* (2012).

[22] David F. Larcker, Eric C. So, and Charles C. Y. Wang, "Boardroom Centrality and Firm Performance," *Journal of Accounting and Economics* (2013).

[23] Eliezer M. Fich, "Are Some Outside Directors Better than Others? Evidence from Director Appointments by Fortune 1000 Firms," *Journal of Business* (2005).

[24] Rüdiger Fahlenbrach, Angie Low, and René M. Stulz, "Why Do Firms Appoint CEOs as Outside Directors?" *Journal of Financial Economics* (2010).

[25] These results are consistent with O'Reilly, Main, and Crystal (1988) who find a strong association between CEO compensation levels and the compensation levels of outside directors, particularly members of the compensation committee. They explain their results in terms of "social comparison theory," whereby committee members refer in part to their own compensation levels as a benchmark for reasonable pay, leading to a distorted view of "fair market value" when approving CEO pay packages. See Charles A. O'Reilly III, Brian G. Main, and Graef S. Crystal, "CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories," *Administrative Science Quarterly* (1988); and Olubunmi Faleye, "CEO Directors, Executive Incentives, and Corporate Strategic Initiatives," *Journal of Financial Research* (2011).

[26] Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, "2011 Corporate Board of Directors Survey" (2011).

[27] Spencer Stuart U.S. Board Indices (2007-2014).

[28] Corporate Board Member and PricewaterhouseCoopers LLP, "What Directors Think, 2009: Annual Board of Directors Survey. A Corporate Board Member/PricewaterhouseCoopers LLP Research Study. Special Supplement," *Corporate Board Member* (2009).

[29] Bernard S. Black, Brian R. Cheffens, and Michael Klausner, "Outside Director Liability," *Stanford Law Review* (2006).

[30] Michael Klausner, Jason Hegland, and Matthew Goforth, "How Protective is D&O Insurance in Securities Class Actions? — An Update," Rock Center for Corporate Governance at Stanford University Working Paper No. 144 (2013), available at: http://ssrn.com/abstract=2260815.

[31] Black, Cheffens, and Klausner (2006), loc. cit.

[32] The external auditor faces similar limitations in detecting fraudulent reporting activity.

[33] Suraj Srinivasan, "Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members," *Journal of Accounting Research* (2005).

[34] George Anders, "Cleaning House on Wall Street May Not Extend to Directors," *The Wall Street Journal* (April 2, 2008).

[35] Martha Graybow, "Lifting the Lid: U.S. Activists Target Boards Amid Mortgage Fallout," *Reuters* (March 14, 2008).

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EXHIBIT 1 — INDEPENDENT CHAIR: SUMMARY STATISTICS

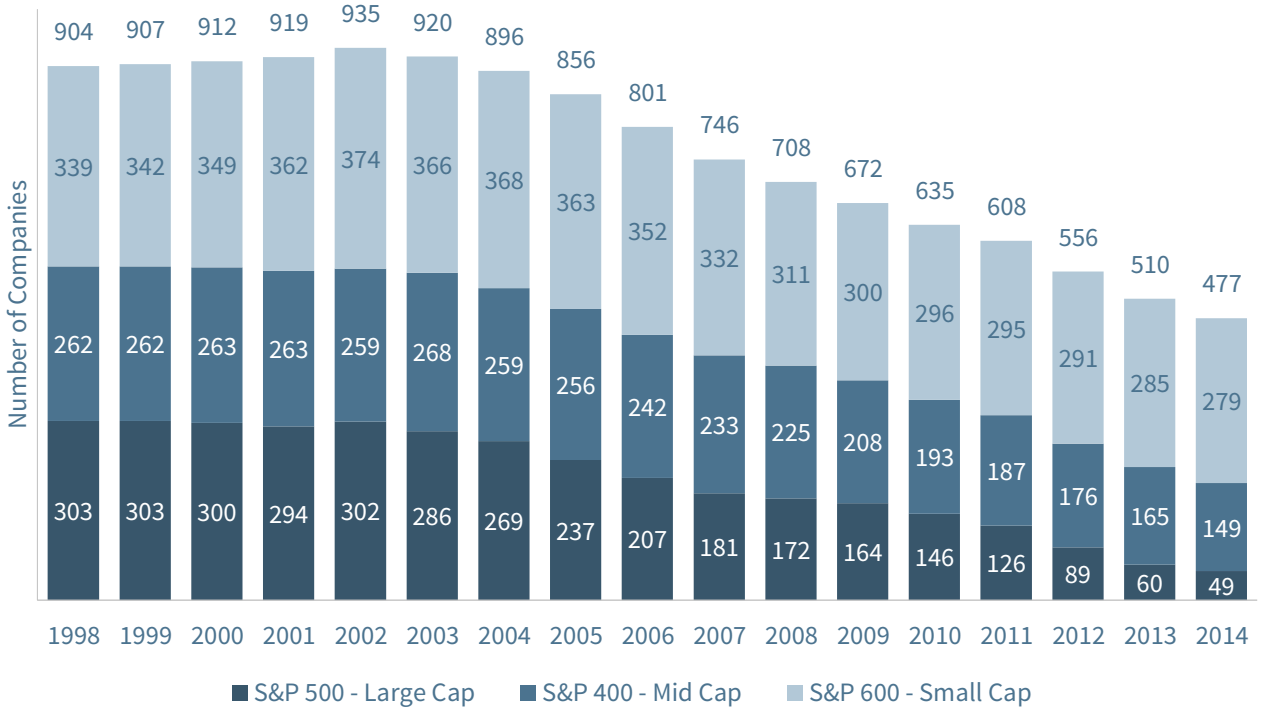
Year	Dual CEO / Chairman	Independent Chair	# Proposals Requiring Separation	# Passing	% Votes "For"
2014	53%	28%	47	2	31%
2013	55%	25%	46	4	33%
2012	57%	23%	43	3	34%
2011	59%	21%	24	3	32%
2010	60%	19%	34	0	28%
2009	63%	16%	28	2	32%
2008	61%	16%	23	0	29%
2007	65%	13%	30	4	27%
2006	67%	10%	38	1	30%
2005	71%	9%	18	1	32%

Note: Sample includes companies in the S&P 500 Index.

Sources: Spencer Stuart Board Index. FactSet Research Systems.

EXHIBIT 2 — STAGGERED BOARDS: SUMMARY STATISTICS

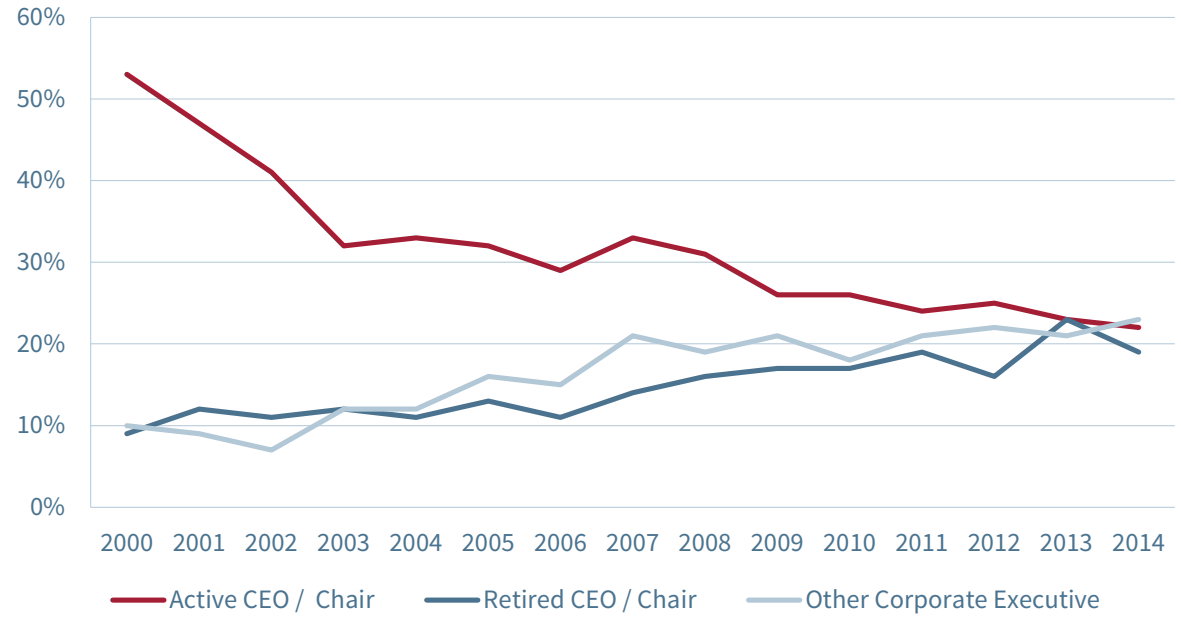
PREVALENCE OF STAGGERED BOARDS



Source: Adapted from SharkRepellent, FactSet Research Systems, Inc.

EXHIBIT 3 — DIRECTORS WITH EXECUTIVE EXPERIENCE: SUMMARY STATISTICS

PERCENTAGE OF NEWLY ELECTED INDEPENDENT DIRECTORS WITH EXECUTIVE EXPERIENCE



Note: Sample includes companies in the S&P 500 Index.

Source: Spencer Stuart Board Index.

EXHIBIT 4 — OUT-OF-POCKET PAYMENTS BY OUTSIDE DIRECTORS: SUMMARY STATISTICS

Company	Year	Type of Case	Total Payment by Outside Directors
WorldCom	2005	Oversight failure	$24.75 M
Enron	2005	Oversight failure	$13 M
Enron	2004	Oversight failure	$1.5 M
Independent Energy Holdings	2003	Oversight failure	< $2 M
(Confidential)	2000	Oversight failure	Low millions
Van Gorkom	1985	Oversight failure	$1.35 M
Ramtek	1992	Oversight failure	$0.3 M
Baldwin-United	1985	Oversight failure	Unknown
(Confidential)	2000	Oversight failure	$50 K
(Confidential)	mid-2000s	Oversight failure	$0.3 - $0.4 M
Peregrine	mid-2000s	Oversight failure	Unknown
Tyco	2002	Self-dealing and duty of loyalty	$22.5 M
Fuqua	2005	Self-dealing and duty of loyalty	< $7 M
Lone Star Steakhouse	2005	Ultra vires transaction	$54 K

Source: Bernard S. Black, Brian R. Cheffens, and Michael Klausner, "Outside Director Liability," *Stanford Law Review* (2006).