

---

# BOARD OF DIRECTORS

## STRUCTURE AND CONSEQUENCES

David F. Larcker and Brian Tayan  
Corporate Governance Research Initiative  
Stanford Graduate School of Business

STANFORD  
BUSINESS

GRADUATE  
SCHOOL OF

Corporate Governance  
Research Initiative



## BOARD STRUCTURE

- Boards are often described in terms of their salient structural features: size, independence, committees, etc.
- Do these attributes have an impact on the board's ability to monitor and advise the corporation?
- Do companies with certain structural features perform better/ worse than those who lack them?
- A determination of how to structure the board should be based on rigorous statistical evidence.
- At the same time, it should allow for situational differences across companies.



# BOARD STRUCTURE

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

BOARD ATTRIBUTE	U.S. AVERAGE
NUMBER OF DIRECTORS	11
NUMBER OF MEETINGS PER YEAR	8
INDEPENDENT DIRECTORS	85%
INDEPENDENT CHAIRMAN	25%
DUAL CHAIR/CEO	55%
LEAD DIRECTOR	90%
INDEPENDENT AUDIT COMMITTEE	100%

BOARD ATTRIBUTE	U.S. AVERAGE
INDEPENDENT COMP COMMITTEE	100%
INDEPENDENT NOM/GOV COMMITTEE	99%
AVERAGE AGE	63
MANDATORY RETIREMENT	72%
MANDATORY RETIREMENT AGE	72
FEMALE DIRECTORS	18%
AT LEAST ONE FEMALE DIRECTOR	93%



# CHAIRMAN OF THE BOARD

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

---

**No research evidence that an independent chairman improves or destroys shareholder value.**

---

Boyd (1995); Brickley, Coles and Jarrell (1997)



## LEAD INDEPENDENT DIRECTOR

- The lead independent director presides over executive sessions of the board.
- The lead director may play a prominent role in evaluating corporate performance, succession planning, director recruitment, and board evaluation.
- The lead director serves as a single point of contact between nonexecutive directors and management, institutional investors, and the media.



# LEAD INDEPENDENT DIRECTOR

- Does the lead independent director add value?

(+) Counterbalances a strong Chairman/CEO.

(+) Provides leadership during a crisis.

(+) Brings clarity of communication.

(-) Responsibilities of the role vary widely.

(-) May be a superficial designation.

- 
- Modest evidence that a lead director can improve corporate outcomes.
  - The effectiveness of the lead director will depend on the definition of the role and the authority granted.
- 

Larcker, Richardson, and Tuna (2007)



# INDEPENDENT DIRECTORS

- Independent directors are those who “have no material relationship” with the company (as defined by the NYSE).
- A director is **not** independent if the director or a family member has, in the last three years:
  - Served as an executive of the listed firm.
  - Earned compensation > \$120,000 from the firm.
  - Served as an internal or external auditor of firm.
  - Served as executive at another firm where CEO of listed firm was on compensation committee.
  - Served as executive of another firm whose business with the listed firm is \$1 million or 2% of revenue.



# INDEPENDENT DIRECTORS

- Independent judgment is critical to the advisory and monitoring functions of the board.
  - (+) Offer objective evaluation of company and management.
  - (+) Allow for arms-length negotiation of compensation.
  - (+) Make decisions solely in the best interest of the company.
  - (-) Directors who meet NYSE standards may not be independent.
  - (-) Social ties may compromise judgment.
  - (-) Only effective if they are qualified and engaged.

- 
- Outside directors improve some governance outcomes, such as M&A premiums.
  - Little evidence they improve long-term performance.
  - Social relationships to the CEO tend to weaken “independence”.

---

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



# INDEPENDENT COMMITTEES

- Committees of the board deliberate topic-specific issues that are critical to the oversight of the company.
- Directors are selected to committees based on their qualifications and domain expertise (generally).
- The audit, compensation, and nominating/governance committees are required to be independent (Sarbanes Oxley).
- Specialized committees (strategy, finance, technology, and environmental, etc.) have no independence requirements and may include executive officers.



# INDEPENDENT COMMITTEES

- Are committees more effective when they are independent?

(+) Objective advice and oversight.

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

(-) Decision making may suffer.

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

(-) Management brings important firm-specific knowledge.

- 
- Some evidence that independent audit committees improve earnings quality. 100% independence is no better than majority independence.
  - Specialized committees benefit from **insider** knowledge (not independence).
  - Whether a committee is independent should depend on its function.
- 

Klein (2002); Klein (1998)

# BUSY BOARDS

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

NUMBER OF DIRECTORSHIPS	DIRECTORS	%
1 BOARD SEAT	31,102	78.6%
2 BOARD SEATS	6,035	15.3%
3 BOARD SEATS	1,794	4.5%
4 BOARD SEATS	464	1.2%
5 BOARD SEATS	119	0.3%
6 OR MORE	33	0.1%
TOTAL UNIQUE DIRECTORS	39,547	100.0%

} Potentially busy directors

Equilar data, fiscal years ending June 2012 to May 2013



# BUSY BOARDS

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

- 
- Companies with busy boards tend to have worse long-term performance and worse oversight.
  - Busy boards are less likely to fire an underperforming CEO.
  - Busy boards award higher compensation.
- 

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



# INTERLOCKED BOARDS

- Interlocked boards: the CEO of Firm A sits on the board of Firm B, while the CEO of Firm B sits on the board of Firm A.
  - (+) Creates a network between companies.
  - (+) Facilitates the flow of information and best practices.
  - (-) Creates a dynamic of reciprocity.
  - (-) Can compromise objectivity and weaken oversight.

- 
- Both positive and negative practices spread through network connections.
  - Network connections generally lead to improved operating performance.
  - Interlocking can also lead to decreased monitoring.
  - Companies must balance the trade-off.
- 

Larcker, So, and Wang (2010); Hallock (1997); Nguyen (2012)



## BOARD SIZE

- Board size tends to be correlated with company revenue.
  - Small companies (<\$10 million): **7 directors**, on average.
  - Large companies (>\$10 billion): **12 directors**, on average

(+) Large boards have more resources.

(+) Allow for greater specialization.

(-) Greater cost (e.g., compensation, scheduling conflicts, etc.).

(-) Slow decision making.

- 
- Larger boards tend to provide worse oversight (when company size is held constant).
  - Large “complex” firms (those with multiple business segments) benefit from larger board size while large “simple” firms do not.
- 

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



# DIVERSE BOARDS

- Do diverse boards provide better advice and oversight?

- (+) Broader array of knowledge, experience, and perspective.

- (+) Lessens “groupthink” (premature consensus).

- (+) Encourages healthy debate.

- (+) Important social value, consistent with equality.

- (-) Diverse groups exhibit lower teamwork.

- (-) May lead to “tokenism.”

- 
- Evidence on the relation between diversity and performance is inconclusive.
  - Modest evidence that female representation improves governance quality.
  - Diversity for the sake of meeting quotas is detrimental (the cost of inexperience outweighs the potential benefits).

---

Wang and Clift (2009); Adams and Ferreira (2008); Ahern and Dittmar (2012)



## SUMMARY OF EVIDENCE

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

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

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



# BIBLIOGRAPHY

Spencer Stuart. Spencer Stuart U.S. Board Index. 2013.

Brian K. Boyd. CEO Duality and Firm Performance: A Contingency Model. 1995. Strategic Management Journal.

James A. Brickley, Jeffrey L. Coles, and Gregg A. Jarrell. Leadership structure: Separating the CEO and chairman of the board. 1997. Journal of Corporate Finance.

David F. Larcker, Scott A. Richardson, and Irem Tuna. Corporate Governance, Accounting Outcomes, and Organizational Performance. 2007. Accounting Review.

James F. Cotter, Anil Shivdasani, and Marc Zenner. Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers? 1997. Journal of Financial Economics.

Ran Duchin, John G. Matsusaka, and Oguzhan Ozbas. When Are Outside Directors Effective? 2010. Journal of Financial Economics.

Byoung-Hyoun Hwang and Seoyoung Kim. It Pays to have Friends. 2009. Journal of Financial Economics.

Jeffrey L. Coles, Naveen D. Daniel, and Lalitha Naveen. Co-opted Boards. 2014. Review of Financial Studies.

April Klein. Audit Committee, Board of Director Characteristics, and Earnings Management. 2002. Journal of Accounting & Economics.

April Klein. Firm Performance and Board Committee Structure. 1998. Journal of Law and Economics.

Equilar directorship data, computations by the authors. Fiscal year ending June 2012 to May 2013.



# BIBLIOGRAPHY

Eliezer M. Fich and Anil Shivdasani. Are Busy Boards Effective Monitors? 2006. Journal of Finance.

John E. Core, Robert W. Holthausen, and David F. Larcker. Corporate Governance, Chief Executive Officer Compensation, and Firm Performance. 1999. Journal of Financial Economics.

David F. Larcker, Eric C. So, and Charles C.Y. Wang. Boardroom Centrality and Stock Returns. 2010. Rock Center for Corporate Governance at Stanford University Working Paper.

Kevin F. Hallock. Reciprocally Interlocking Boards of Directors and Executive Compensation. 1997. Journal of Financial and Quantitative Analysis.

Bang Dang Nguyen. Does the Rolodex Matter? Corporate Elite's Small World and the Effectiveness of Boards of Directors. 2012. Management Science.

David Yermack. Higher Market Valuation of Companies with a Small Board of Directors. 1996. Journal of Financial Economics.

Jeffrey L. Coles, Naveen D. Daniel, and Lalitha Naveen. Boards: Does one size fit all? 2008. Journal of Financial Economics.

Yi Wang and Bob Clift. Is There a "Business Case" for Board Diversity? 2009. Pacific Accounting Review.

Renée B. Adams and Daniel Ferreira. Women in the Boardroom and Their Impact on Governance and Performance. 2009. Journal of Financial Economics.

Kenneth R. Ahern and Amy K Dittmar. The Changing of the Boards: The Impact on Firm Valuation and Mandated Female Board Representation. 2012. Quarterly Journal of Economics.