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Board composition, grey directors and corporate failure in the UK[☆]

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ABSTRACT

This study examines the effect of board composition on the likelihood of corporate failure in the UK. We consider both independent and non-independent (grey) non-executive directors (NEDs) to enhance our understanding of the impact of NEDs' personal or economic ties with the firm and its management on firm performance. We find that firms with a larger proportion of grey directors on their boards are less likely to fail. Furthermore, the probability of corporate failure is lower both when firms have a higher proportion of grey directors relative to executive directors and when they have a higher proportion of grey directors relative to independent directors. Conversely, there is a positive relationship between the likelihood of corporate failure and the proportion of independent directors on corporate boards. The findings discussed in this study support the collaborative board model and the view that corporate governance reform efforts may have over emphasised the monitoring function of independent directors and underestimated the benefits of NEDs' affiliations with the firm and its management.

1. Introduction

A series of unexpected corporate failures has reignited and increased concerns regarding the effectiveness of board oversight. Since the Cadbury Report was published in 1992, governance reformers in the UK have continued to emphasise the importance of independent directors who enhance the monitoring function of boards (e.g., UK Corporate Governance Code, 2012). The term "independent director" generally refers to non-executive directors (NEDs) who are free from personal or economic ties with the firm and its management.[1] NEDs who have such ties are classified as non-independent NEDs and are also known as "grey" directors. Corporate governance reformers typically argue that the existence of affiliations between NEDs and the firm diminishes the effectiveness of NED monitoring because such affiliations may result in conflicts of interest

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[1] In this study we refer to 'personal or economic ties (affiliations) between NEDs and the firm' and intend it to include NEDs' affiliations with both the firm and its management.

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with shareholders. Despite the widespread belief among regulators that a higher proportion of independent directors on a board is good for governance, little is known regarding whether the increased focus on board independence is able to prevent corporate failure in the current corporate governance framework.

This study considers the effectiveness of independent and grey directors and investigates the association between board composition and the likelihood of corporate failure. Corporate governance theorists have diverse perspectives on the ties between NEDs and the firm. From the agency perspective, independent directors are central to the effective resolution of agency problems between managers and shareholders. Their independence from the firm places them in a good position to engage in monitoring and enables them to exercise independent judgement in evaluating managerial performance (Fama & Jensen, 1983). In contrast, NEDs personally or economically tied to the firm and the firm's management have less incentive to challenge top management, as they may have common interests with management, which could lead to conflicts of interest with shareholders and adverse organisational outcomes. According to this view, independent directors can improve firm performance by monitoring management on behalf of shareholders.

Alternatively, the advocates of the collaborative board model argue that the agency perspective only provides a partial basis for understanding the impact of board composition on corporate strategy and performance (Adams & Ferreira, 2007; Westphal, 1999). They suggest that board composition should optimise collaborative working relationships among its members (Almazan & Suarez, 2003). Ties between NEDs and the firm's management can enable mutual trust and effective communication, which may facilitate information flow and advisory interactions in the boardroom (Westphal, 1999). Additionally, as NEDs typically serve on a part-time basis, the presence of such ties may align the interests of the NEDs and the company and increase the NEDs' incentives to offer advice and resources to maximise firm performance. According to this model, grey directors are more likely to be involved in strategic decision-making through their affiliations with the firm, which may lead to favourable organisational outcomes. However, grey directors have received little formal recognition in the literature.

Previous studies have acknowledged that the board's functions of advising, providing resources and monitoring are essential to a firm's survival (Hambrick & D'Aveni, 1992), but they have not devoted sufficient attention to how ties between NEDs and the firm influence board effectiveness and the performance of firms. As noted, independent and grey directors act in inherently different ways to fulfil those different board tasks. It is possible that independent directors could perform best in a monitoring role, while grey directors could play important advising and resource dependence roles (Baysinger & Butler, 1985; Westphal, 1999). Underrepresentation of either independent or grey directors on the board may affect the firm's ability to survive. We therefore argue that current governance practice, which inherently favours stacking NED positions with independent directors rather than grey directors, is likely to compromise the advisory and/or resource dependence roles of a board and make firms more susceptible to failure.

This study employs a matched-pairs research design using a sample of 234 companies comprising117 failed firms and 117 non-failed control firms. The findings indicate that firms with greater proportions of grey directors are less likely to fail, while there is a positive association between the proportion of independent directors and the likelihood of corporate failure. Furthermore, comparing the failed firms to the non-failed firms, the failed firms have lower percentages of grey directors relative both to executive and independent directors on their boards. Overall, the findings support the collaborative board model (Adams & Ferreira, 2007; Westphal, 1999) and echo recent concerns that overemphasis on the monitoring and control roles of independent directors undermines the contributions NEDs can make to the advising and resource dependence functions of the board (Adams & Ferreira, 2007; Faleye, Hoitash, & Hoitash, 2011).

This study seeks to contribute to the existing literature in three ways. First, this study contributes to the debate over how close ties between NEDs and a firm affect the firm's value. We award equal consideration to the effectiveness of independent and grey directors. Although a large number of studies depart from the agency perspective to examine the effects of independent directors, existing studies remain largely silent regarding the roles and effectiveness of grey directors. This study extends the collaborative board model to address this gap.

Second, this study addresses the lack of discussion in the existing literature on the link between corporate failure and the composition of the board of directors (Daily, McDougall, Covin, & Dalton, 2002). Filatotchev, Toms, and Wright (2006) conceptually argue that a firm requires different corporate governance functions at different stages of the corporate lifecycle. To continue to survive, a distressed firm requires a greater degree of the strategic and resource functions of corporate governance. However, the effects of corporate governance mechanisms on firm survival are under-researched. By focussing on the context of corporate failure, this study adds to our understanding of corporate governance at the final stage in the corporate lifecycle.

Third, the results of this study have important public policy implications. UK governance codes were developed in response to a series of unexpected failures, and many other countries have subsequently introduced new rules and practices. The context of corporate failure in the UK therefore provides a unique ground to examine regulators' concerns regarding the contributions of independent and grey directors. While there has been a widespread increase in the independence of boards and NEDs in the UK over the previous two decades, little consensus has been reached as to how to prevent corporate failure under the current corporate governance framework. Evidence collected from this setting is particularly salient.

The remainder of this study is structured as follows. In the following section, we outline the extant literature concerning the roles and effectiveness of independent and grey directors and develop our hypotheses. The sample selection procedure and research design are described in the Section 3. The results are then presented and discussed. The final section draws conclusions.