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Boardroom centrality and firm performance ☆

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ABSTRACT

Firms with central boards of directors earn superior risk-adjusted stock returns. A long (short) position in the most (least) central firms earns average annual returns of 4.68%. Firms with central boards also experience higher future return-on-assets growth and more positive analyst forecast errors. Return prediction, return-on-assets growth, and analyst errors are concentrated among high growth opportunity firms or firms confronting adverse circumstances, consistent with boardroom connections mattering most for firms standing to benefit most from information and resources exchanged through boardroom networks. Overall, our results suggest that director networks provide economic benefits that are not immediately reflected in stock prices.

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1. Introduction

Social and economic networks are a central feature of virtually all economic activities. These networks serve as a conduit for interpersonal and interorganizational support, influence, and information flow. The links between individuals in these networks are the channels by which information is communicated, resources are exchanged, new relationships are formed, and existing relationships are leveraged. Economists and sociologists have long studied the influence of social networks on labor markets, political outcomes, and information diffusion.

One important network in corporate finance is the boardroom network formed by shared board directorates. While several studies examine the structure of boardroom social networks, why they form, and their theoretical impact on firm performance, relatively few studies provide empirical evidence to assess the net economic impact of these networks on firm performance. In this paper, we directly investigate the empirical relations between a board's well-connectedness and the firm's future performance.

Our empirical investigation is important because, *ex-ante*, there are no clear predictions on the relation between a firm's performance and its board's well-connectedness. A vast literature in organizational sociology, economics, and finance highlights both potential benefits and costs associated with being well-networked. The potential benefits of having

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well-connected boards can take several forms. First, directors possess a wealth of information on industry trends, market conditions, regulatory changes, and other key market data, which can flow across the boardroom network. Well-connected boards may have better access to this information and a comparative advantage in making strategic decisions (Mizruchi, 1990; Mol, 2001). Second, boardroom networks allow firms to leverage social relationships and reduce asymmetric information when designing contracts (Schoorman et al., 1981). Both factors may improve the terms of contracts between firms. Third, directors possess important and useful business contacts accessible through the boardroom network, contacts that can be sources of useful business relationships (e.g., clients, suppliers) or sources of other economic benefits and resource exchange (e.g., personal and political favors) (see, for example, Mol, 2001; Nicholson et al., 2004). Fourth, the boardroom network may be a mechanism of information transmission through which value-improving business innovations can spread (Haunschild and Beckman, 1998). For example, firms may learn about effective corporate governance mechanisms, efficiency-enhancing technology, and innovative compensation structures through the boardroom network. Finally, the boardroom network represents a channel of communication or resource exchange between companies and can facilitate collusive competitive behavior and yield economic benefits for a set of closely linked firms (Pennings, 1980).

The existing literature also highlights several reasons why having a well-connected board may adversely affect firm performance. First, the boardroom network may propagate value-decreasing management practices. For example, the boardroom network has been found as an important explanation for the spread of options backdating (Bizjak et al., 2009; Snyder et al., 2009; Armstrong and Larcker, 2009). Second, to the extent that having a well-connected board requires its members to serve on many board seats, directors of well-connected boards may devote limited attention to the monitoring and strategic advising of each company. Therefore, there may be a trade-off between well-connectedness and monitoring effort or intensity. This is consistent with the idea that the number of board positions a director holds (or busyness) is negatively associated with monitoring efforts and shareholder wealth (Core et al., 1999; Fich and White, 2003; Loderer and Peyer, 2002; Fich and Shivdasani, 2006). Third, misleading or incorrect information may spread though the board network, resulting in value-decreasing strategies and investments. Finally, although collusion can have a positive impact on shareholder value, the resulting regulatory, litigation, and reputation costs can produce net losses of shareholder value.

The collective arguments from the literature on boardroom networks highlight the *ex-ante* ambiguity regarding the net economic impact of a board's well-connectedness, and this association is therefore an open empirical question. Resolution of this ambiguity is hampered by the fact that most empirical network studies focus on interpersonal relationships between specific agents within an isolated context, such as between a firm and a lender in determining credit terms or a manager and a security analyst in determining analyst recommendations (e.g., Engelberg et al., 2012; Cohen et al., 2010). An innovation of our paper is that we take a macro-level (or ''bird's eye'') view of the association between boards' well-connectedness and firm performance. As we explain below, we build the corporate network of shared directorates and measure the relative positioning of boards in the network as a means to aggregate the micro foundations established in prior research. We then assess the balance of the potential costs and benefits associated with a board's ''centrality'' in the networks and establish several important regularities regarding the relation between board centrality and multiple measures of firm performance.

The construct of interest in our study is the ''well-connectedness'' of boards established by their directors' formal or professional ties. We conceptualize shared directorates between two boards as channels of information or resource exchange, and study a board's well-connectedness through such channels using standard tools of analysis developed by social network theory. A well-connected board is one that is central to the network's aggregate flow of information and resources.

The concept of well-connectedness is inherently multidimensional. Network theory has developed multiple related but distinct notions of well-connectedness. First, a board may be well-connected if it possesses relatively many channels of communication or resource exchange, yielding such a board more opportunities or alternatives than otherwise comparable firms (measured by DEGREE centrality). Second, a board may be well-connected if it possesses relatively closer ties to outside boards (i.e., there are fewer steps between boards), making information or resource exchange quicker and more readily available (measured by CLOSENESS centrality). Third, a board may be well-connected if it lies on relatively more paths between pairs of outside boards, making such a company a key broker of information or resource exchange (measured by BETWEENNESS centrality). We consider a fourth and related notion, stemming from a refinement of DEGREE centrality, which recognizes that having more direct connections is more influential when such connections can reach or influence more outside boards. In other words, a board is well-connected when its direct contacts are also well-connected (measured by EIGENVECTOR centrality).[1]

Using a comprehensive sample of 115,411 directors from 2000 to 2007, we build the U.S. corporate boardroom network formed by shared directorates in each year. For each year, we measure each board's well-connectedness in the aggregate boardroom network using the four standard measures from the networks literature described above, as well as a composite score, which we call ''N-Score,'' based on the average of the four standard measures.

[1] The concept of well-connectedness is also relational. The extent to which a board can obtain special advantages by leveraging its professional network depends on whether it is better connected than its peers. In other words, the net economic benefits derived from a board's network depend on how other boards are connected to each other. For this reason, a firm only has limited control over its board's well-connectedness.

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