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Determinants of board structure: Evidence from Australia

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ABSTRACT

Linck et al. (2008) investigate the determinants of board structure in the US, an environment that features high litigation risk and low ownership concentration. In contrast, using a hand-collected data set that includes information from more than 1000 firms, this paper investigates the determinants of board structure in Australia, an environment that features low litigation risk and high ownership concentration. Multivariate analyses suggest that whereas board size and board independence increase with firm size, CEO duality decreases with firm size. Additional tests suggest that high ownership concentration increases board size, decreases board independence and increases CEO duality. These results imply that if high litigation risk against directors (as in the US) plays a monitoring role in corporate governance, ownership concentration appears to offer an alternative governance mechanism in countries such as Australia, which feature low litigation risk.

1. Introduction

Corporate governance and its role in firm behavior came under intense scrutiny following the major corporate collapses that occurred during 2001–2002 (Clarke and Dean, 2007). New legislation and governance codes have emerged around the world that are intended to improve governance practices (Demirag and Solomon, 2003; Clarke and Dean, 2007). Correspondingly, the research on corporate governance has experienced phenomenal growth in recent years. In particular, researchers have examined the role of corporate governance in business financing, firm performance, executive compensation, organizational structure, and firm value (see, e.g., Gompers et al., 2003; Lemmon and Lins, 2003; Bhagat and Bolton, 2008; Bowen et al., 2008; Brown and Caylor, 2009; Giroud and Mueller, 2010; Chen et al., 2011; Larcker et al., 2011). Nevertheless, a central research question that has received very limited attention is that of how firms structure their board of directors (see Linck et al., 2008). Given that the board of directors is the highest executive committee in the firm, understanding what determines board structure is fundamental to understanding what role boards can play in firm behavior. Using a large set of hand-collected data for more than 1000 firms from 2006, this paper investigates board structure in Australia and its cross-sectional determinants.

The literature on board structure is not yet extensive, and the bulk of the evidence is based on US data (e.g., Boone et al., 2007; Coles et al., 2008; Linck et al., 2008). Linck et al. (2008) is the most comprehensive study so far, as it examines 6931 firms using data from 1990 to 2004. Linck et al. conclude that firms choose board structures based on the perceived costs and benefits of the monitoring and advising roles of boards, which tend to vary significantly across large and small firms. In particular, firms with high growth opportunities, high R&D expenditures, and high stock return volatility tend to have smaller and less independent boards, whereas larger firms tend to have larger and more independent boards (Linck et al., 2008). Furthermore, high levels of managerial ownership are associated with less independent boards, and the CEO occupies the role of board chair in large firms and when the CEO is older and has had a longer tenure (Linck et al., 2008).

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Aguilera and Jackson (2003) argue that isomorphic processes drive corporate governance practices to become more *similar within* countries and to *differ across* countries whose institutional environments are distinct. There are several differences between the institutional environments of the US and Australia. Hence, the findings of Linck et al. (2008) and similar US studies on board structure are not generalizable to Australia. For instance, although Australia and the US are both Anglo-Saxon countries, the corporate legal environments of these two countries differ in several fundamental ways.

First, '…the legal environment in the United States is uniquely hospitable to litigation against directors' (Cheffins and Black, 2006, p. 1393). Unlike in Australia, litigants in the US pay their own legal expenses regardless of the outcome of court cases. Moreover, the US legal system uniquely treats the attorneys of the plaintiff as entrepreneurs who search for legal violations and suitable clients rather than waiting for clients to come to them (Cheffins and Black, 2006). Attorneys in the US also usually recover their legal fees from settlements in successful class actions (Cheffins and Black, 2006). As a result, shareholder litigation is quite common in the US.[1] In contrast, Australian company directors face a low-litigation environment. In particular, Australia has 'loser pays' civil litigation rules (Thai, 2002), and any damages recovered in a successful suit are paid to the company rather than to the shareholders (Ramsay and Saunders, 2006). In addition, there is no US-style provision for the recovery of attorneys' fees from the company (Cheffins and Black, 2006). Furthermore, there are restrictions on contingency fees, and the viability of a class action suit will be highly uncertain unless each member of the plaintiff class has a claim against each defendant (Cheffins and Black, 2006). All of these factors discourage securities lawsuits in Australia (Cheffins and Black, 2006). To the extent that legal and financial systems lead to disparities in corporate governance systems (Gillian and Starks, 2003), important differences between the US and Australia in corporate legal environments suggest differences between the governance practices of the two countries.

Second, prior research suggests a strong connection between ownership structure and corporate governance practice. La Porta et al. (1998) argue that differences in legal environments may help explain why firms are financed and owned differently in different countries. The researchers find a strong negative correlation between ownership concentration and the quality of the legal protection of investors. Furthermore, Durnev and Kim (2005) provide evidence of the association between ownership concentration and corporate governance structures. Ownership is significantly more concentrated in the non-US countries than it is in the US (Denis and McConnell, 2003). Based on their sample of 49 countries, La Porta et al. (1998) report that the ownership concentration in Australia is much higher than it is in the US.[2] Thus, to the extent that ownership structure influences board structure, the latter is likely to differ for Australia and the US.

Third, among the countries with legal systems that follow the English model, the US features significantly larger firms. Australia, Canada, Hong Kong, India, Malaysia, New Zealand, Singapore, and South Africa, for instance, feature smaller firms (La Porta et al., 1998). There is strong empirical evidence that corporate governance structure is influenced by firm size (Linck et al., 2008). Fourth, the labor market conditions in these two countries are remarkably different. Most large corporations in Australia are highly unionized, and trade unions play an active role in wage negotiations, management monitoring, and even shareholder activism (Rawling, 2006). Australia has ratified six of the eight core labor conventions identified by the ILO as conferring fundamental labor rights, including the freedom of association, whereas *the US has ratified only two conventions and has not affirmed the freedom of association* (Adie and Sonder, 2004).[3] In summary, due to the significant differences between the institutional environments of Australia and the US in terms of corporate litigation risk, ownership structure, firm size and labor market conditions, the findings regarding board structure in the US cannot be entirely generalized to Australia.[4]

As discussed above, the role of ownership structure in corporate governance is likely to be different for environments with high versus low litigation risk. If high litigation risk deters rent-seeking behavior among managers, high ownership concentration may plausibly discourage such behavior in an environment that features low litigation risk. Furthermore, ownership concentration is one way of enhancing the private benefits of control for those who currently have control under the existing structure (Bebchuck and Roe, 1999).

In a firm with a high ownership concentration, large-block shareholders have an incentive to join the board of directors to enhance both their shared benefits and the private benefits of control (Holderness, 2003). Hence, firms with a high ownership concentration may be governed by large boards. Furthermore, because high ownership concentration permits close monitoring of the firm's management, it may reduce the demand for alternative monitoring mechanisms such as board independence and the separation of the board chair from the CEO. In particular, ownership concentration may lead to a board structure that cannot be explained by the economic characteristics of a firm. That is, firms with a high ownership concentration may have large but less independent boards, and the CEO may also be the board chair.

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[1] During the 1991–2004 period, 3263 federal securities class action cases were filed in the US federal courts, with an average of more than 230 cases each year (Cheffins and Black, 2006).

[2] La Porta et al. (1998) report that the mean (median) ownership concentration, measured as the ownership of the three largest shareholders, is 28% (28%) in Australia and 20% in the US (12%).

[3] In total, as of March 2004, Australia has ratified 58 conventions (with 48 in force), whereas the US has ratified only 14 conventions (with 12 in force) (Adie and Sonder, 2004). Arguably, the working class has always been a dominant political and social force in Australia. The labor movement in Australia gave rise to its largest political party, the Australian Labor Party.

[4] There are other differences between the institutional environments of Australia and the US. Since the time of Federation, tariffs have been a contentious issue in Australian politics (Lloyd, 2008). Unlike in the US, Australian businesses have always enjoyed high tariff protection against foreign competition. In this environment, close links between a director and the government would be more valued by a firm than general business acumen. Moreover, the levels of sophistication of the managerial labor market and the market for corporate control, which likely affect corporate governance practice, are likely to differ for the US and Australia. Finally, the Australian capital market has a shorter history and is much smaller than the US capital market.