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Director and CEO pay reciprocity and CEO board membership[☆]

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ABSTRACT

This study examines the relation between changes in non-executive director compensation and changes in CEO compensation. Consistent with norms of reciprocity, we report a positive relationship between changes in director pay and change in CEO pay for those firms where the CEO is also a board member. The results support the view that when a CEO who is also a board member validates increases in director pay, directors respond in kind, approving increases in CEO pay. This reciprocity does not benefit shareholders by improving subsequent firm value. We report that excess change in CEO and director compensation reduces subsequent change in firm value for firms where the CEO is a board member.

1. Introduction

Directors are elected to the board by shareholders. Shareholders expect directors, especially non-executive directors, to exercise their fiduciary responsibility representing their best interests by advising and monitoring the top management. However, non-executive directors may fail to effectively monitor the top management for reasons such as asymmetric information between the board and the management, and board culture that suppresses constructive criticism (Jensen, 1993). One mechanism to incentivise directors is via director compensation (Chung, Judge, & Li, 2015; Yermack, 2004). Yet, research on director compensation is limited and the scant research on director compensation is primarily US dominated (Ryan and Wiggins, 2004; Yermack, 2004). As raised by Bugeja, Fohn, and Matolcsy (2016), the gap in the literature is puzzling. Non-executive directors, who are independent representatives of shareholders and hence are expected to provide more

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effective monitoring, constitute a greater proportion of the board after various corporate governance codes recommended or mandated a minimum level of board independence.[1]

The size of the New Zealand managerial labour market means that there is a limited pool of skilled individuals that qualify for CEO and director appointments. The commonality of business acquaintances within the business environment together with the importance of social connections makes the sample of firms from New Zealand well suited to test for any association between director and CEO pay.

Director pay in New Zealand is not well understood. Recently, New Zealand director compensation has attracted attention and debate.[2] The Institute of Directors (IOD) reports that non-executive directors in New Zealand receive a significantly lower level of pay compared to their international counterparts. On the one hand, the IOD believes that given the increasing liabilities, responsibilities and risks that directors face due to regulations, the lower pay may result in a talent shortage. On the other hand, many argue that current NZ director fees are fair for the market and payments reflect the “size, scale, sophistication and complexity of the market here.”

Although IOD reports a far lower level of a non-executive director pay compared to other countries,[3] Boyle and Ji (2013) document non-chair, non-executive director pay increased by more than 60% between 1995 and 2010. Evidence of increasing non-executive director fees in New Zealand from 1995 to 2010 indicate the growing importance of the role that boards play in firms (Boyle and Ji, 2013).[4] This increase meant that, on average, director fees almost doubled making the cost of appointing and maintaining a board a nontrivial amount of money for firms and their shareholders. Certainly the higher director pay levels, while still well below those of CEOs and executive managers, are now large enough to attract greater scrutiny from other stakeholders (Boivie, Bednar, & Barker, 2015).

While evidence shows that directors' fees are positively associated with CEO compensation in the US (Boivie et al., 2015; Brick, Palmon, & Wald, 2006), there is little evidence to support what factors influence increases in director fees in New Zealand and more importantly whether this increase in pay enhances shareholder value. Following prior work by Boivie et al. (2015) and Brick et al. (2006), we make the connection between director compensation and CEO compensation and examine how the norm of reciprocity can shape CEOs' and directors' decisions concerning pay increases. Due to the clear demarcation of CEO board involvement for New Zealand firms, we also examine the role that CEO board membership plays in reciprocal pay relationships between the CEO and the board.

Although the board is often involved in determining CEO compensation, Bebchuk and Fried (2006) argue that CEOs have considerable influence over their boards that can be used to secure excessive compensation and directors have few incentives to curb higher CEO pay. While directors are elected to represent the shareholders, they also need to take care in maintaining a good working relationship with the CEO and the other directors, especially if they want to be re-elected to the board (Main, O'Reilly, & Wade, 1995). Bebchuk and Fried (2006) point to the effects of friendship and social connectedness on CEO-director interactions. Prior evidence also shows that directors appointed by the CEO are swayed by notions of reciprocity (Main et al., 1995) and indebtedness (Hermalin and Weisbach, 1988) in their deliberations concerning CEO compensation. The norm of reciprocity implies that actions will be returned in kind (Gouldner, 1960). If this is the case, directors and CEOs have incentives to support mutual pay increases if reciprocity dynamics contribute to increases in their own pay. Indeed, Brick et al. (2006) and Boivie et al. (2015) find a positive relationship between the level of director compensation and CEO compensation and change in director compensation and CEO compensation, respectively.

The motivation for this study is to build on earlier US-based evidence (Brick et al., 2006; Ryan and Wiggins, 2004; Yermack, 2004) and to shed light on director compensation in a setting with different governance and institutional features. First, compared to other countries such as the US, New Zealand is often viewed as a small country with a high degree of connectedness and familiarity within the business community. While the local supply of directors in the US director labour market plays an important role in affecting directors' actions and board structure (Knyazeva, Knyazeva, & Masulis, 2013), this mechanism may not be as effective in New Zealand. Prior literature has documented the small and close-knit nature of the New Zealand business community (Jesson, 1987; Stablein, Cleland, Mackie, & Reid, 2004), which is often referred to an “old boys” network (Dalton, 2007).[5] The small supply of local directors may hinder board independence, compromising the effectiveness of outside directors in the pay-setting process. Second, contrary to the US where “(i)t is almost unheard of for the chief executive officer of the corporation not to be a member of the board of directors” (LeBlanc and Gillies, 2005, p. 92), approximately two thirds of the sample appoint the CEO to the board, while the remaining one third have no

[1] For example, Cadbury Committee issued the Code of Best Practice in 1992, which recommends at least three outside directors for UK listed firms; Dahya and McConnell (2005, 2007) document since 1992, at least 15 other countries have adopted recommendations that require minimum number of outside directors on a corporate board; major US stock exchanges require at least 50% outside director representation on the board of listed firms; Chinese Securities Regulatory Commission mandated at least one-third of independent directors on the board of listed companies.

[2] http://www.stuff.co.nz/business/industries/82938482/NZ-directors-fees-unfair-compared-with-international-standards-IOD.

[3] The IOD reports that while an average director fee for NZ non-executive directors is NZ$55,843 for 2016, that for UK and Australian non-executive directors are NZ$199,000 and NZ$100,000 (for directors of companies ranked between 201 and 300 in Australia and $268,000 for top 50 companies), respectively.

[4] Boyle and Ji (2013) report mean director fees increased from $25,897 to $48,787 during the 15-year period. The differences in pay levels are statistically significant at the 1% level.

[5] There are 386 individual outside directors in our sample while Ferris, Jagannathan, and Pritchard (2003) document 23,673 individual directors for the US sample in 1995.