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The costs of a (nearly) fully independent board[☆]

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ABSTRACT

A significant and growing percentage of U.S. firms now have boards where the CEO is the only employee director (hereinafter fully independent boards). This paper studies whether and how this practice impacts board effectiveness. I find that fully independent boards are associated with a significant reduction in firm performance. Further tests suggest two channels for this effect. First, full independence deprives the board of spontaneous and regular access to the firm-specific information of other senior executives. Second, full independence eliminates the first-hand exposure of future CEOs to board-level discussions of strategy, which steepens the learning curve for eventually promoted candidates.

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1. Introduction

American corporate boards have undergone significant changes in recent times, with a trend toward smaller and more independent boards. According to the 2012 Spencer Stuart Board Index,[1] 86% of the boards of Standard and Poor's (S&P) 500 companies had 12 or fewer directors in 2012, compared with 68% in 2002. Similarly, the percentage of independent directors increased from 79% in 2002 to 84% in 2012 while the proportion of chief executive officers (CEOs) who also chaired their boards declined from 75% to 57% during the same period. Perhaps the most significant of these trends is the exclusion of all employees but the CEO from serving on the board of directors. In 1998, only 36% of S&P 1500 firms had no other employee directors besides the CEO. The proportion of such firms has increased steadily each year since then, reaching 70% in 2011. In this paper, I study whether and how excluding non-CEO executives from the board impacts board effectiveness and firm performance.

The primary benefit of excluding employees other than the CEO from the board is that doing so allows the firm to increase the number of outside directors without enlarging the board. This can enhance board effectiveness because a smaller size allows the board to avoid the communication and coordination costs associated with larger boards and also reduces the potential for free-rider problems (Jensen, 1993; Yermack, 1996). More importantly, the substitution of outside directors for insiders increases board independence, which can lower agency problems because independent directors are less beholden to top management. In addition, recent regulatory mandates (Sarbanes–Oxley Act of 2002 as well as New York Stock Exchange and NASDAQ listing requirements) have significantly increased the monitoring duties of independent directors. As shown by Faleye et al. (2011), this intense focus on board monitoring hinders overall board effectiveness but the negative impact is attenuated when the board reduces the

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[1] Available on the internet at http://www.spencerstuart.com/research/bi.

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involvement of individual independent directors in oversight duties by increasing the number of such directors. Thus, substituting employee directors with independent directors allows the board more freedom in allocating oversight duties, which can enhance the effectiveness of board monitoring.

Resource dependence theory (see, e.g., Pfeffer (1972)) views the corporate board as a provider of resources to the firm. According to Hillman and Dalziel (2003), these resources include human capital (experience, expertise, and reputation) as well as relational capital (connections to other firms and external contingencies). Thus, increasing the number of independent directors can enhance board effectiveness by magnifying the firm's access to essential external resources that complement the skills and competencies of corporate insiders. Moreover, an increase in the number of independent directors is likely to shift the balance of power on the board away from the CEO, which increases his willingness to seek and utilize board counsel (Golden and Zajac, 2001) and potentially improves board effectiveness.

Nevertheless, the exclusion of other top executives from the board can hurt board effectiveness and firm performance in several ways. First, it reduces the proximity between the board and the sub-CEO layer of corporate leadership. This denies the board of spontaneous access to the firm- and position-specific information of these executives. Since such information is costly to transmit through others (Fama and Jensen, 1983), excluding non-CEO executives from the board can negatively impact the formulation and execution of corporate strategies and weaken the effectiveness of board monitoring. At the same time, this lack of proximity to independent directors can hinder the CEO succession process by diminishing the board's ability to evaluate internal candidates before promoting them. Finally, internally promoted CEOs without prior board service are likely to face a steeper learning curve than those who served as directors prior to promotion because such service provides valuable learning opportunities via regular exposure to board-level discussions of corporate strategy.

I study these issues using the sample of all firms covered in the Riskmetrics directors' database over 1998–2011. I find that firms where the CEO is the only employee director earn significantly lower operating profits than other firms and suffer from depressed firm values. Specifically, their return on assets (ROA) and Tobin's q are lower by 78 basis points and 4.2%, respectively. An extensive battery of additional tests confirms that these results are robust to reverse causality and other endogeneity issues.

Next, I examine potential channels for this effect by focusing on two complementary explanations. First, I investigate the hypothesis that firms where the CEO is the only employee director underperform because their boards are denied regular and unfiltered access to the firm-specific information possessed by other senior executives. Prior research on board composition (e.g., Boone et al., 2007; Linck et al., 2008; Raheja, 2005) suggests that employee directors are more valuable when a firm's projects are costly for outsiders to evaluate and monitor. This literature also suggests that the skills and expertise of independent directors are less valuable when the firm's need for board advising is low. Therefore I construct an index that measures project verification costs and advising needs based on firm size, scope of operations, asset characteristics, and dependence on external financing. Since their need for employee directors is higher and their need for independent directors is lower, the information hypothesis predicts that firms with higher project verification costs coupled with low advising requirements will experience more negative performance effects if such firms limit employee board membership to their CEOs. Consistent with this, I find that fully independent boards are associated with a reduction of 88 basis points and 5.6% in operating profitability and Tobin's q among these firms, compared with a reduction of 47 basis points and 1.4% among firms with a lower need for employee directors.

Next, I examine the hypothesis that the poorer performance of firms where the CEO is the only employee director is explained in part by the loss of board-level experience for their future CEOs. Here, I distinguish between two alternative (though not necessarily mutually exclusive) channels. First, lack of board experience for top executives can diminish directors' ability to select the best CEO candidate since the board lacks direct observation of and continuous interactions with potential successors (Fama and Jensen, 1983). Second, eventual CEO appointees with no prior experience on the firm's board may experience initial missteps due to a steeper learning curve. Empirically, these explanations can be separated from each other in that the former predicts sustained inferior performance when an internally promoted CEO lacks pre-appointment experience on his firm's board because such CEOs are more likely to be poorer fits. In contrast, the latter predicts that such performance differentials will be temporary, lasting only for as long as it takes the CEO without prior board service to bridge his experience and/or learning gap. Consistent with the latter, I find that internally promoted CEOs without prior board service underperform those with such experience only in the first two post-promotion years; thereafter, the two groups perform equally.

These results fill an important gap in the literature. Prior research (see Adams et al. (2010) for a recent review) has long established the value of independent directors as arm's length monitors and advisors. Yet recent mandates requiring increased board independence raise the question of whether independent directors can fully substitute for employee directors. By focusing on what is plausibly the limit of such substitution, this paper demonstrates the potential costs of an (almost) fully independent board. In particular, firm performance diminishes when the board does away with the skills and idiosyncratic information of employee directors, especially when the firm's projects are difficult for outsiders to monitor and its advising needs are lower.

My results also raise the question of why firms adopt fully independent boards when the structure is detrimental to firm performance and value. First, it is likely that the effect of these boards is not yet widely known because they became widespread relatively recently and academic research on their impact is sparse. This explanation is consistent with the evolution of changes in other board structures following academic research into such structures. For example, average board size among S&P 500 firms was 15 in the years before Yermack's (1996) finding of an inverse relation between board size and firm value. By 2002, average board size among these firms has declined to 11. Similarly, 60% of directors of S&P 500 firms were elected to staggered terms in 2003 prior to the publication of Bebchuk and Cohen (2005) and Faleye (2007) documenting the negative effects of a classified board on firm value and board

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