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Board composition and CEO power ☆

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A B S T R A C T

We study the optimal composition of corporate boards. Directors can be either monitoring or advisory types. Monitoring constrains the empire-building tendency of chief executive officers (CEOs). If shareholders control the board nomination process, a non-monotonic relation ensues between agency problems and board composition. To preempt CEO entrenchment, shareholders may assemble an adviser-heavy board. If a powerful CEO influences the nomination process, this may result in a more monitor-heavy board. Regulations strengthening the monitoring role of boards can be harmful in precisely those cases in which agency problems are severe or in which CEO entrenchment is a threat to corporate governance.

1. Introduction

The board of directors performs the dual function of monitoring the firm's management and advising it on key decisions. In the wake of major corporate governance failures, commentators have questioned the effectiveness of boards in performing these tasks, especially the monitoring task. This concern is rooted in the inherent information asymmetry between board and management and in the widely held belief that powerful chief executive officers (CEOs) use their (often significant) influence over the board's composition to ensure a pliable board: “Managers value … lenient oversight” (Tirole, 2001, p. 5). The Sarbanes-Oxley Act of 2002 (SOX) was designed in part to strengthen the monitoring function of the board. Recent evidence in Faleye, Hoitash, and Hoitash (2011b) suggests, however, that this has come at the expense of a diminished advisory role. In this paper, we develop a model to study the link among board composition (holding the board size constant), the assignment of decision-making authority, and the flow of information within a firm. We then employ this model to assess how CEO power affects these constructs, in particular, the board composition.

We model a firm whose CEO has private information about the net present value (NPV) maximizing scale of investment but is an empire builder. Board members, while internalizing the shareholders' objective, have an information disadvantage at the outset. They are either *monitoring* or *advisory* types. The primary task of the monitors is to uncover the CEO's information, and that of the advisers is to discover incremental decision-relevant

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information unknown even to the CEO. In practice, most board members engage in both monitoring and advising. Yet, they allocate their time across the two tasks according to their respective background and expertise (Klein, 1998; Faleye, Hoitash, and Hoitash, 2011a; Schwartz-Ziv and Weisbach, 2013). For instance, board members who are financial experts (e.g., accountants or former chief financial officers) spend more of their time monitoring and often serve on the audit committee. Former CEOs, consultants, or technology and marketing executives spend more time advising and often serve on the mergers and acquisitions (M&A) or investment committee, a typical advisory function. Our model adopts a reduced-form approach by letting the board composition parameterize the monitoring intensity. As a result, the information collectively available to the parties is endogenously determined by the board composition: the more advisers are on the board, the more likely new decision-relevant information will be discovered, but the less effective is the board monitoring, holding constant the board size.

To study the interplay of board composition and decision making, we consider two organizational modes. Under *centralization*, the board makes the decision. Under *delegation*, the CEO makes the decision but is potentially constrained in exercising this authority by board monitoring. If the board has uncovered the CEO's information, it would punish the CEO in case the CEO were to act according to his bias. Only if board monitoring has failed can the CEO truly choose his preferred project. Consistent with earlier models that have treated the information environment as exogenous (e.g., Dessein, 2002; Harris and Raviv, 2005; Adams and Ferreira, 2007), we find that the less biased the CEO, the more the board delegates.[1] This finding holds regardless of the board composition. Exploiting the endogenous nature of information in our model, we show that adviser-heavy boards and centralization of authority are complements. Under centralization, the board can perfectly adjust the investment decision to its own information; under delegation, part of the information is lost in the process of noisy cheap-talk communication. Hence, any new information an adviser-heavy board may discover is more valuable under centralization.

In reality, firms choose the board structure and allocation of authority jointly. In that case, we establish a non-monotonic relation between CEO bias and board composition. For small biases, as they increase, the firm sticks to delegation but adds monitors to the board, as the value of constraining the CEO upon successful monitoring grows larger. As the CEO's bias increases further, the firm eventually centralizes investment decisions. This, in turn, raises the value of board-generated new information, which calls for more advisers (i.e., fewer monitors) on the board. As CEO bias increases even further, the firm again adds more monitors to the board, because a highly biased CEO submits noisy signals about his information to the board. Empirically, this non-monotonicity can render the relation between agency problems and monitoring intensity of boards locally decreasing in the data, if researchers fail to control for the allocation of decision rights within firms.

An often-voiced concern is that CEOs who can influence the board composition nominate fewer monitors to have an agreeable board (e.g., Hermalin and Weisbach, 1998; Tirole, 2001). For instance, former Hewlett-Packard CEO Leo Apotheker was widely seen as having unduly influenced the board nomination process (Bloomberg, 2011). Recent regulations, such as SOX, aim to enhance the monitoring role of boards, among other things. Ironically, our results suggest that for such regulations to increase shareholder value, CEO bias has to be small. Only then does the conventional wisdom prevail that the CEO prefers less board monitoring than do shareholders. In contrast, we show that CEOs who are more biased may have incentives to nominate a more monitor-heavy board, because such a board is more likely to delegate. The CEO prefers delegation, even if subject to greater scrutiny by a vigilant board, to having authority outright centralized by an activist board that is prone to learning valuable information of its own. Regulations fostering greater monitoring scrutiny can thus exacerbate imbalances in board composition precisely in those circumstances (severe agency problems) for which these regulations were designed.[2]

Short of influencing the board nomination process, CEOs have more subtle means of entrenching themselves and securing authority within the firm, e.g., by choosing investment projects that equip them with an information advantage (see also Harris and Raviv, 2005). We refer to such projects as “complex.” To prevent such entrenchment, shareholders can be better off committing to an adviser-heavy board at the outset. This constitutes a credible commitment to centralize decisions at a later stage even if the CEO in the interim were to choose a complex project. Still, even if CEO entrenchment can be preempted in equilibrium, the specter of such behavior creates additional costs to shareholders, again, in the form of an imbalance between the two desired board activities.

Taken together, our results demonstrate that caution is in order when interpreting observed patterns of board composition. Adviser-heavy boards could indicate either negligible agency problems, if entrenchment is not an issue, or more severe agency problems, if shareholders need to actively preempt entrenchment by a highly biased CEO. From an empirical perspective, this highlights the need for careful contextual analysis and the inclusion of proxies for CEO power (e.g., chairman duality, tenure, founder status) as control variables.

The view of boards serving a dual role as advisers and monitors dates back to Mace (1971). Most of the literature has focused on the relationship between inside and outside board members (e.g., Raheja, 2005; Adams and Ferreira, 2007; Linck,

[1] Harris and Raviv (2008) also endogenize the board's information in that acquiring new information is individually costly to board members. They study the associated free-rider problem. However, the board (outsider) in their model never attempts to uncover the CEO's (insider's) information; i.e., there is no board monitoring in the sense of our model.

[2] Numerous studies consider the welfare effects of SOX, mostly on the direct compliance costs associated with certain SOX provisions, such as Section 404 on internal controls, e.g., Zhang (2007). Our results demonstrate an additional opportunity cost of strengthening the monitoring role of boards: the board becomes less productive as a source of strategic advice.