WHO GETS AHEAD IN THE MARKET FOR CORPORATE DIRECTORS: THE POLITICAL ECONOMY OF MULTIPLE BOARD MEMBERSHIPS

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ABSTRACT

This study examines the factors that influenced the number of new boards joined by directors of the largest U.S. corporations in 1982. Social connections had by far the greatest impact on joining new boards, while the performance of the firms on whose boards directors sat had little discernible effect.

INTRODUCTION

Substantial research has documented the existence of an interlocking directorate network linking virtually all large American corporations into a single social structure through shared board members (Mintz and Schwartz, 1985). Two firms are said to interlock when one or more individuals sits on both of their boards of directors. The median Fortune 500 firm in 1986 shared directors with seven other large firms, indicating the pervasiveness of interlocks. Moreover, several studies in the past few years have documented that shared directors act to influence top management salaries (O'Reilly, Main, and Crystal, 1988) and to spread organizational structures (Palmer, Jennings, and Zhou, 1993), strategies to defend against takeover (Davis, 1991), acquisition strategies (Haunschild, 1992), and political strategies (Mizruchi, 1992). Thus, interlocks are both pervasive and causally significant, providing an influential social context for corporate governance. But while researchers have focused on the organizational purposes that may be served by sharing a director with a particular firm--cooptation of a supplier of a critical resource or infiltration of a dependent firm--we have little systematic evidence on how individuals come to serve on multiple boards. Yet the question of how individuals become central in the network is of considerable theoretical and practical importance, as these individuals are the raw material of the intercorporate network.

The market for directors can be analyzed like other labor markets. Joining new boards is the only unambiguous indicator of how well a director is regarded by this market. Thus, determining who gets asked to join additional boards and why indicates what the political economy of the network rewards. Moreover, becoming a multiple director is the gateway to serving on business policy organizations and governmental advisory boards, as demonstrated by the marked differences in participation on these bodies between members of single and multiple boards (Useem, 1984).

Three rather different characterizations of the board of directors in the research on corporate governance suggest different factors leading to multiple board memberships. Agency theorists argue that directors are agents serving the interests of their shareholder principals by monitoring top management (e.g., Fama and Jensen, 1983). Directors that promote better corporate performance enhance their human capital and thus are more likely to be rewarded by being asked to join additional boards. Conversely, managerialists argues that boards are in essence social clubs sponsored by top management. Thus, directors get ahead by being socially prominent, well-connected, and compliant with the requests of the managers that appointed them. Finally, bank control theory sees boards as instruments of intercorporate domination (Kotz, 1978). In particular, banks place representatives on the boards of their subject firms in order to maintain their position of control over corporate decision making. This study compares these three perspectives by examining the factors influencing the number of new board memberships attained between 1982 and 1990 by a comprehensive panel of over 6000 directors that sat on the boards of the 648 largest U.S. industrial and service corporations in 1982.

HYPOTHESES

The board of directors is elected by the shareholders to represent their interests in the corporation. In particular, the board functions to monitor top management--selecting managers, setting their salary, and firing them if necessary--and to ratify important decisions. Thus, in theory the board serves an essential function as the shareholders' check on top management (Fama and Jensen, 1983). However, "Although legally the board is elected by shareowners, as a practical matter boards are pretty much self-perpetuating bodies...The chairman often dominates the decisions with respect to new board members, and the full board is effectively precluded from participating in the selection process" (Anderson and Anthony, 1986: 93). Moreover, directors typically receive generous fees and perquisites for what is effectively a part-time job. Thus, while in theory boards should act as agents of shareholders, in practice they may act as agents of the top managers that appointed them.

The question of whose interests are served by boards can be approached by studying who gets ahead in the corporate director labor market. The market for directors is like the market for marriage partners--potential board members have

to be asked, and they have to accept--with the proviso that polygamy is not just allowed but desirable. The time commitment required of directors rarely exceeds ten full days per year, and the compensation and benefits are typically generous. Moreover, membership on multiple boards is a helpful if not indispensable method of career advancement for corporate managers (Useem, 1984). Thus, membership on several boards is common. For example, Vernon Jordan sat on the boards of at least eight large firms in 1986--American Express, Bankers Trust New York, Celanese, Corning, Dow Jones, J. C. Penney, RJR Nabisco, and Xerox. Thus, one can determine which factors lead to success in the market for directors by tracking the new board memberships held by directors over time. I discuss these factors under the rubrics of agency theory, managerialism, and bank control theory.

Agency theory

Agency theorists argue that the human capital of directors is in part determined by the performance of the firms with which they are associated (Fama and Jensen, 1983). In this view, the market for directors rewards directors whose firms are better performers. Firms looking for new directors should most sensibly seek directors of firms that have done well in the past. Thus:

H1: Directors of better-performing firms will join more new boards than directors of poorer performers.

Membership on the board of a firm that becomes a takeover target is a particularly strong signal that can affect membership on new boards. Fama and Jensen (1983: 315) argue that "there is substantial devaluation of human capital when internal decision control breaks down and the costly last resort process of an outside takeover is activated." Therefore:

H2: Directors of hostile takeover targets will join fewer new boards than directors of non-targets.

Managerialism

While agency theory focuses on the role of board members as agents of shareholder interests, managerialist theorists have focused on the board as a social institution. The ability to serve shareholders takes a back seat to social connections and the ability to serve managerial interests in this view. Social connections serve a critical role in labor market mobility, and in general more connections lead to greater mobility (Granovetter, 1986). Anecdotal evidence suggests that this is true in the market for directors as well. Useem (1984: 50) finds that "Invitations to join a particular company board...tend to move along the networks of ancient friendships and personal connections." In particular, serving on one firm's board with the chairman or other director of another firm is a common source of invitations to join the other firm's board. Thus, the social connections that come from sitting on multiple boards should lead to more invitations to join additional boards. Furthermore, sitting on the board of a firm that is central in the interlock network (that is, a firm whose directors sit on numerous other boards) should also lead to more invitations to join additional boards.

H3: Directors that sit on multiple boards will join more new boards than directors that sit on one board.

H4: Directors of firms that are more central in the interlock network will join more new boards than directors of less central firms.

In addition to social connections, directors can get ahead through compliance with top management. To the extent that invitations to join the board come from the CEO, one should expect that directors from boards with a history of serving management interests would be more appealing candidates than directors that have opposed management.

H5: More compliant directors will join more new boards than less compliant directors.

A final appealing feature of a director from the point of view of top management is the ability to defend the firm against outside threats. The most prominent threat during the 1980s was that posed by hostile takeovers. A large number of firms faced unwanted takeovers during the study period, and directors that demonstrated their ability to fend off takeovers should have been particularly attractive candidates from management's perspective.

H6: Directors of firms that have successfully defended against hostile takeover will join more new boards than those that have not.

Bank Control Theory

The final hypothesis comes from bank control theory, which argues that banks play a particularly crucial role in the intercorporate network by virtue of their control over capital flows (Kotz, 1978). Bank power is exercised both through ownership and through placing representatives on the boards of subject firms to insure that these firms maintain profitability. Because of the uniquely powerful role commercial banks play in the economy, they have an enhanced ability to place their representatives on boards. Thus:

H7: Bank executives will join more new boards than other directors.

Because directors of larger firms are likely to be more visible on the market for directors, I controlled for firm size using total assets.

DATA

The initial sample for this study included all directors that sat on the boards of firms in either the 1980 or 1986 Fortune 500 largest

industrials or the 50 largest commercial banks, 25 largest financial service firms, 25 largest retailers, or 25 largest transportation firms during 1982. 6505 individuals occupied 8625 board memberships on the boards of the 648 firms in this universe for which data were available in 1982.

Board data for the sampled firms were collected for 1982, 1986, and 1990. Due primarily to mergers and takeovers, the sample of firms dropped in size from 648 in 1982 to 592 in 1986 and to 456 by 1990. 1982 board data came from Standard and Poor's Directory of Corporations, Directors, and Executives. 1986 and 1990 board data came from Compact Disclosure. I used several techniques to ensure the quality of the data and its comparability across years, including numerous computerized routines and hand-checks. For each of the three panel years I calculated the number of boards each director sat on as a measure of individual network centrality. I also determined which new boards (if any) each director sat on in 1986 and 1990. The dependent variable was calculated as the count of new board memberships in 1986 or 1990. Finally, I coded a dummy variable for being an executive of a commercial bank.

Firm centrality was measured for 1982 and 1986 as the number of unduplicated interlocks each firm had with other firms in this population, that is, the number of other firms with which the focal firm shared at least one director. Directors were assigned a score for the mean centrality (number of interlocks) of the boards on which he/she served in 1982 and 1986.

Corporate performance and size data came from Compustat for 1982 and 1986. I used two measures of performance, return on equity, which measures year-to-year performance, and market-to-book ratio, which measures the stock market's evaluation of the firm's long-term prospects. Size was measured using total assets. Directors were assigned the average value of these measures over each of the firms on whose board he/she sat.

Data on takeover attempts came from 14D1 (tender offer) filings reported in the SEC News Digest for 1980-1985 and Compact Disclosure for 1986-1989. Hostile takeover attempts were those tender offers made by an outside party that were resisted by the board of directors, according to reports in the Wall Street Journal. Directors were given count variables for the number of firms on whose board they sat that were subject to hostile takeover attempts between 1980 and 1985 (for the 1982-1986 analyses) and between 1986 and 1989 (for the 1986-1990 analyses). Directors were also given count variables for the number of hostile takeover attempts that they successfully fended off during the same periods, that is, the number of hostile takeover attempts that ended with the firm remaining independent rather than being acquired either by the original raider or by another acquirer.

I used two measures of director compliance. Boards of a large number of firms adopted "golden parachute" contracts that compensated top managers if the firm was taken over. Golden parachutes were quite controversial during the 1980s--while managers found them appealing for obvious reasons, shareholders were less convinced, and some have argued that adopting a golden parachute is a good indicator of board compliance (e.g., Wade, O'Reilly, and Chandratat, 1990). "Poison pills" were also adopted by the boards of most large firms during the 1980s. Like parachutes, pills were quite controversial and generated substantial opposition from shareholders because they made hostile takeover more difficult, thus potentially depriving shareholders of the premium that accompanies successful takeover (Davis, 1991). Because both pills and parachutes are broadly favored by management but not by shareholders, sitting on boards that adopted these measures can be taken as a measure of director compliance. Thus, I calculated count variables for the number of boards on which a director sat that adopted parachutes and pills, respectively, between 1980 and 1985 (for the 1982-1986 analysis) and between 1986 and 1989 (for the 1986-1990 analysis). Data on the adoption dates of poison pills by firms in this population came from the Investor Responsibility Research Center (IRRC), while data on the adoption dates of golden parachutes came from IRRC and proxy statements.

METHOD

The dependent variable of interest was the number of new boards that directors joined. Because this is a count variable (i.e., only non-negative integers are possible values) and because the distribution is highly skewed, the assumptions of OLS regression are violated, and thus Poisson regression is appropriate (McCullagh and Nelder 1983). The Poisson regression model estimates the incidence rate, that is, the rate at which events (such as joining new boards) happen, given a set of independent variables. The model takes the form

$$C_j = exp\{\beta' X_j\}$$

where C_j is the expected number of new board memberships, X_j is a vector of covariates, and β' is a vector of coefficients. This model is distinguished by the fact that it is log-linear; thus, the effects of the covariates combine multiplicatively rather than additively. Exponentiating a coefficient gives the estimated multiplier effect that a one-unit change in the covariate has in the expected rate of new board memberships.

I estimated two models, one for the number of new board memberships attained between 1982 and 1986 and one for memberships added between 1986 and 1990. The model assumes that the number of new boards a director sat on in 1986 depended on the number of boards he/she sat on in 1982, the average performance, size, and centrality of the firms on whose boards he/she sat in 1982, whether he/she was a bank executive in 1982, and the number of poison pills adopted, golden parachutes adopted, hostile takeover bids

received, and takeover attempts successfully defended against between 1980 and 1985.

RESULTS AND DISCUSSION

The results, presented in Table 1, indicate that firm performance, as measured by mean ROE and market-to-book, had no discernible effect on subsequent board memberships. Unreported analyses using stock market returns also showed no significant effect. These null findings failed to support H1 from agency theory. Surprisingly, the number of hostile takeover attempts a director faced bore a positive and significant relation to the number of new board memberships held. This is quite contrary to H2, as well as to common sense. Further investigation suggested an explanation for this anomalous result: directors of targets that were successfully taken over were often (although by no means always) subsequently asked to sit on the board of the acquiring company, whether the acquirer was the raider that originated the bid or a white knight acquirer sought by management. For example, two members of the board of St. Regis in 1982, which faced hostile takeover in 1984 and was ultimately acquired by Champion International, ended up on Champion's board in 1986. An alternative analysis, in which the dependent variable was the total number of boards sat on (rather than new board memberships) indicated that, as expected, board members of firms that faced hostile takeover subsequently sat on fewer boards, although surprisingly this effect was only significant for the 1986-1990 period.

As predicted by H3 and H4, directors that sat on more boards and directors of more central firms experienced significantly higher rates of new board memberships. An individual that sat on two boards in 1982, for example, joined new boards at a 38% higher rate than an individual that only sat on only one board in 1982. Moreover, individuals that sat on the boards of heavily interlocked firms were substantially more likely to be asked to sit on additional boards than directors of non-central firms.

The results gave modest support to H5: directors that sat on boards adopting golden parachutes between 1986 and 1989 subsequently joined more boards, although there was no discernible effect for adopting poison pills in either period or for parachutes in the 1982-1986 period. This result is broadly consistent with the notion that directors that serve managerial interests are more highly prized by the director market, although the lack of consistency across indicators suggests that caution in interpreting these results is warranted.

H6, that directors skilled at battling hostile takeovers would be highly valued by the director market, received no support. Directors of firms that received unwanted takeover bids but successfully fended them off were no more likely to join new boards, and in fact experienced a lower rate during the 1982-1986 period, although this effect was only marginally significant. This effect must be interpreted in light of the fact that the model controls for hostile bids received, which had a positive effect on new board memberships. Thus, for example, the two St. Regis directors that joined the board of Champion International would not have done so if St. Regis had avoided acquisition entirely.

Finally, there was no support for H7. Bank executives did not join boards at a higher rate than other directors in the 1982-1986 period, and joined at a significantly lower rate in the 1986-1990 period. This finding gives little reason to believe that bank executives occupy a privileged position in the interlock network.

TABLE 1
Determinants of New Board Memberships

	1982-1986	1986-1990
Variable	**Coeff.**	**Coeff.**
Return on equity (avg)	0.0007 (0.49)	-0.0005 (-0.52)
Market/Book (avg)	-0.0139 (-0.31)	0.0000 (0.00)
Hostile takeover bids	0.3868* (3.02)	0.2327 (1.90)
Number of board memberships	0.3257* (8.14)	0.2143* (4.40)
Interlock network centrality (avg)	0.0591* (10.27)	0.0676* (11.08)
Golden parachutes adopted	0.0345 (0.54)	0.1887* (2.17)
Poison pills adopted	-0.0273 (-0.47)	-0.0340 (-0.53)
Successful takeover defenses	-0.4400 (-1.79)	-0.0442 (-0.17)
Bank executive	0.0747 (0.35)	-0.5451* (-2.04)
Total assets (avg)	-0.0000* (-2.03)	0.0000 (0.69)
Intercept	-3.2328* (-33.11)	-3.3160* (-29.65)
Chi^2	386.56*	300.13*
df	10	10
n	6236	5228

t-statistics in parentheses
* $p<.05$

The results overall suggest that success in the market for directors is determined overwhelmingly by social connections and to some degree by compliance with management. I found no evidence that directors of more successful firms were asked to join more new boards than directors of less successful firms, using several measures of performance. Rather, the single best way to get appointed to multiple new boards was to join the board of a firm that shared directors with a large number of other firms, which exposed one to more opportunities to be invited onto additional boards. While these results are entirely consistent with an extensive literature on the role of social networks in labor market mobility (Granovetter, 1986), they indicate that even at the top of the labor market, connections count for more than merit in determining advancement.

This conclusion must be tempered by the fact

that this study only had access to corporate-level data. It may be that potential directors are evaluated not on the performance of the firms on whose boards they already sat but on some other criteria for merit, such as educational background. Yet in many cases educational background, such as attendance at elite universities, can be simply another proxy for social connections. Moreover, it is reasonable to suppose that corporate performance is a more direct indicator of the quality of a director than personal characteristics.

This study is also limited by the fact that the data are highly aggregated. The reported results only indicate broad tendencies in the market for directors and preclude inferences in any particular case. More importantly, recent tumult in the boardrooms of such prominent corporations as General Motors, American Express, and Sears Roebuck, prompted in part by large institutional investors demanding more active board oversight, indicate that the rules of the game in the market for directors may be changing in ways that could challenge the results reported here in the future.

CONCLUSION

This study sought to determine how directors get ahead in the intercorporate network by examining the factors influencing the number of new boards joined by a large and comprehensive panel of directors between 1982 and 1990. I contrasted approaches that suggest different success factors--agency theory, which argues that directors are rewarded for sitting on the boards of successful firms, and a managerialist approach that sees rewards emanating from social factors such as one's position in social networks and directors' compliance with managerial interests. The results provide no support for the agency theory notion that advancement depends on corporate performance. By far the most important factors determining whether a director joined new boards was how many boards he/she already served on and how well-connected those boards were. As with other labor markets, social connections took precedence over demonstrated merit in determining success in the market for directors. There was also modest support for the notion that willingness to serve managerial interests (by agreeing to golden parachutes) aided advancement into the inner circle.

This study provides the first systematic evidence on how directors move into the inner circle of the intercorporate network. The results indicate that the political economy of the network advantages directors that are connected and compliant, while directors that sit on the boards of poorly-performing firms--even targets of hostile takeovers--are not punished. The market for directors does not reward vigilant agents of shareholder interests, as hypothesized by agency theorists, but rather those best able to serve managerial interests, as suggested by organization theorists in the managerialist tradition.

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