The Significance of Board Interlocks for Corporate Governance

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Boards of directors of large American corporations are marked by a surprising degree of overlap in their memberships. The median Fortune 500 firm "interlocked" (shared directors) with seven other large firms during the mid-1980s, although this prevalence dropped slightly by the mid-1990s. In contrast to Japan, interlocks among American firms are rarely linked to banking relationships or vertical (buyer-supplier) relationships; rather, they reflect the embeddedness of corporate governance in social structures (e.g., friendship or other ties). Recent empirical research has linked interlocks to almost every important aspect of corporate governance, from executive compensation to strategies for takeovers and defending against takeovers. These findings suggest that proposals for reforming boards of directors through changing incentive structures (e.g., paying directors in equity rather than cash) are likely to have little effect because they misconstrue the role of the board as a social institution.

Key words: Interlocking directorships; Incentive structures; Boards.

One of the most striking features of corporate boards is the extent of multiple board memberships. Directors of the median Fortune 500 firm during the 1980s collectively sat on the boards of seven other Fortune firm boards, and some firms – notably commercial banks, but also some industrials such as AT&T – shared directors ("interlocked") with 40 or more large firms. The aggregate result is the creation of an interlocking directorate linking virtually all large American firms into a single network based on shared board members. While the ubiquitousness of board interlocks is apparent, however, their significance for corporate governance is not. Interlocks have been claimed to be devices for intercorporate collusion or cooptation (e.g., Pfeffer and Salancik, 1978), for bank control over corporate decision making (Kotz, 1978), and for the aggregation and advancement of the collective interests of the corporate elite (Useem, 1984). Conversely, critics have charged that interlocks are largely irrelevant and that research on the interlock network represents the dominance of method (and readily-available data) over substance (e.g., Stinchcombe, 1990).

Interlocks provide social influences

This paper argues that the primary significance of interlocks in the 1990s is not in their overlaps with industrial organization or capital flows but as traces or indicators of the social embeddedness of corporate governance. With rare exceptions, large U.S. firms, including banks, do not share directors in order to exercise power nor to coopt powerful external actors, and thus interlocks do not map onto inter-industry exchange or banking relationships. But neither are interlocks irrelevant for issues of corporate governance, as the past five years' research has shown them to be related to changes in corporate structure (Palmer, Jennings, and Zhou, 1993), acquisition strategies (Haunschild, 1993), tactics for defending against takeover (Davis, 1991), and compensation levels (O'Reilly, Main, and Crystal, 1988). The effects of interlocks are best thought of as "mundane but consequential": through their experiences on other boards, interlocking directors provide a conduit for social influences that create an informational and normative context – an "embeddedness" – for board decisions (Granovetter, 1985). Decisions at one board in turn become part of the raw material for decisions at other boards. In the aggregate, the structure of the network – the process of creating connections, the density of connections, and the centrality of firms taking particular actions – will influence how the field as a whole evolves, including (for example) the prevalence of hostile takeovers (see Haunschild, 1993).

The embeddedness framework suggests an explanation for the patterns of findings of the past several years' research on interlocks as well as a perspective for thinking about governance reform that contrasts with approaches focusing on incentives. Recent proposals to make boards more effective by requiring outside directors to own more stock misconstrue the motivations of individual directors as well as the role of the board as a social institution. Incentive-based governance reforms will be "filtered" through the social structures in which the board is embedded, and thus are unlikely to have the direct intended effect.

The state of the interlock network in 1995: dispelling popular theoretical misconceptions

It is useful to have a good description of the interlock network before thinking about its prescriptives implications. Much of what we think we know about the causes and consequences of interlocks among U.S. firms has derived from two theoretical perspectives emphasizing the organizational role played by interlocks. Resource dependence theory argues that a focal organization invites interlocks with critical buyers, suppliers, or competitors in order to co-opt them. A representative of such an organization sitting on the focal organization's board presumably becomes more empathic with the concerns of the focal organization, in the case of powerful buyers and suppliers, or makes it easier to collude, in the case of competitors (Pfeffer and Salancik, 1978). Either way, the focal firm uses interlocks to manage its resource interdependencies. Bank control theory portrays interlocks as one means by which banks can exercise influence over firms (Kotz, 1978), while financial hegemony theory sees bank interlocks as a more diffuse source of information flows overlaid on capital flows (Mintz and Schwartz, 1985). In either case, large commercial banks form a "stable core" of the interlock network due to their centrality in directing investments (Mintz and Schwartz, 1985: 182).

The implication of these theoretical approaches is that the interlock network should closely map onto buyer-supplier relations and capital flows, with the executives of powerful firms sitting on the boards of dependent buyers and suppliers, and banks occupying particularly central (heavily interlocked) positions. Such a situation does exist; however, it is in Japan, not the United States. As of the beginning of 1995, there was almost no overlap between the interlock network and either industrial organization or capital flows in the U.S. To discover this, I assembled data on interlocks among the publicly-traded members of the 1994 Fortune 500 largest industrials, 100 largest commercial banks, 50 largest diversified financials, 50 largest service firms, 50 largest life insurance companies, 50 largest retailers, and 50 largest transportation firms, a total of 786 firms. I also used the most recent available 6-digit industry input-output tables from the Survey of Current Business to determine significant buyer/supplier relations among industries, where "significant" is defined as 5% or more of the volume of extra-industry consumption or sales. Here is what I found: there are zero horizontal interlocks (ties among competitors), indicating that the Clayton Act of 1914 has been entirely effective in eliminating such ties. No more than 4% of industrial firms have an executive of a firm in a major buyer or supplier industry on their boards. And only about one of twelve large firms has an executive of one of the 100 largest banks on its board. The vast majority of firms themselves report having no representatives of significant buyers or suppliers on their board, with the exception of suppliers of legal services (Bacon, 1990). In short, either interorganizational interdependencies have disappeared, or large firms don't use interlocks to manage them. (It is also possible that previous research finding links between inter-industry exchange and director interlocks, based as it was on highly-aggregated industry data rather than firm-level data, was guilty of the "ecological fallacy," inferring that what was true at the industry level was also true of individual firms; see, e.g., Pfeffer and Salancik, 1978.)

US interlocks not buyers or suppliers

Banks have also become increasingly peripheral in the interlock network and can no longer be said to occupy a "stable core" at the center. A comparison of the relative centrality of banks over the past 12 years indicates a fairly dramatic decline: of the ten most heavily-interlocked U.S. firms, seven were banks in 1982, four were banks in 1986 and only two were banks in 1990. In 1994, only three of the top ten firms were banks, and commercial banks did not differ significantly from industrial firms in their overall levels of centrality; indeed, the majority of commercial banks had no executives sitting on the boards

US interlocks not with banks

of other Fortune firms. Interlocks therefore are not a means of significant bank control in the 1990s, and the banks' declining positions in the network parallel their overall sagging fortunes – their share of financial assets in the U.S. dropped from nearly 40% 20 years ago to 24.5% today (Wall Street Journal, July 9, 1993).

Interlocks and embeddedness

If interlocks do not map onto inter-firm relations, then what do they map onto? One easy answer is "Nothing." It is entirely possible that they are epiphenomenal, having no real impact on what firms do (Hirsch, 1982). Perhaps interlock research is simply a methodologically more sophisticated version of standard paranoid conspiracy theories – say, believing that the Illuminati gather at the Trilateral Commission to impose the New World Order on a hapless populace, starting with fluoridated water. But several studies in the recent past have documented that interlocks have a substantial effect on governance issues. Just as firms typically find new employees through the social contacts of current employees, boards often recruit new directors through interlocks and other social ties (Davis, 1993). This should not be surprising – personal contacts provide the kind of rich information not available through other sources such as resumes. Interlocks also influence compensation levels, as the salaries of compensation committee members at their own companies set a reference point for how well they should reward the firm's CEO (O'Reilly, Main, and Crystal, 1988) – just as anyone familiar with research on social comparison processes would anticipate. And interlocks influenced firms' propensities to adopt a poison pill (Davis, 1991), take on a multidivisional structure (Palmer, Jennings, and Zhou, 1993), or make acquisitions (Haunschild, 1993). Again, this should not be surprising – when evaluating whether it is appropriate to adopt an innovation such as a poison pill, it only makes sense that directors who have experience with such decisions will bring their experience to bear on the decision, and that those who sit on the boards of highly-regarded firms will be particularly influential in the decision process (Davis and Greve, 1995). To believe otherwise would be to imagine that directors sit silent while decisions with which they have direct experience are made.

Call for a cadre of professional directors

Far from being signs of a sinister conspiracy, then, interlocks are best thought of as more mundane conduits of information. What does the "embeddedness" of corporate governance look like in real life? Several recent incidents provide useful examples. In responding to Kirk Kerkorian's takeover bid, members of the Chrysler board were in a position to draw on a large pool of experience, both in defending against takeovers (two members had been on the boards of takeover targets) and in the tactics of acquirers (three members had served on the boards of firms doing takeovers themselves). Analysts regarded this normative background as a point in Kerkorian's favor: "Obviously, these are guys who aren't personally offended at the thought that somebody would make a bid" stated a member of Kerkorian's team ("Chrysler directors' takeover experience could be a factor in Kerkorian's favor," Wall Street Journal, April 17, 1995).

Interlocking directors can also provide a direct form of legitimation for controversial practices. When IBM announced its hostile takeover bid for Lotus, it signalled that the once scandalous action was now fully legitimate – as prominent takeover attorney Joseph Flom put it, "Hostile takeovers are a normal part of thinking about corporate growth now. Blue-chip companies think this is appropriate behavior" ("Suddenly, the hostile takeover is a benevolent act," New York Times, June 7, 1995). The process of legitimation – inducting takeovers into the repertoire of "appropriate behavior" – is considerably speeded by the fact that the directors of IBM sit on the boards of more than 20 other large firms, where they can explain in greater detail IBM's rationale for its actions. While anyone who reads the business press would be aware of IBM's hostile takeover of Lotus, moreover, interlocking directors can transmit "important data concerning costs, problems, political risks, likelihood of opposition from interest groups, efficacy of the innovation when initiated, and so forth – a kind of information only available from peers who have already adopted" a practice (Becker, 1970: 269). The firms tied to IBM through shared directors are in turn more likely to do hostile takeovers themselves (see Haunschild, 1993), increasing the general prevalence of the practice. This is the microstructure of legitimation.

Interlocks thus highlight the embeddedness of corporate governance in social structures. The embeddedness perspective emphasizes that "who knows who" matters for corporate governance and other economic action, often more than individual attributes (e.g., expertise) and incentives. Indeed, from some perspectives, the social embeddedness of boards is itself perhaps the major factor limiting their effectiveness (e.g., Jensen, 1993). The process of director recruitment, for instance, overlays boards with a "web of obligations" that plainly influences governance and mutes the impact of incentives. New directors are commonly recruited through friends or acquaintances that are already on the board, often the CEO (Davis, 1993). Few directors join boards primarily for the money; rather, they do so because they can learn from the experience, they owe favors, or because they feel an obligation to do so – "Why should others serve on mine if I avoid it?" (Hirsch, 1982: 11). Thus, Peter Lynch, perhaps the most renowned mutual fund manager in history, was recruited to the board of Morrison-Knudsen by his friend CEO Bill Agee in 1988 and to the board of W.R. Grace by his friend Chairman J. Peter Grace in 1989. In addition to their friendship, all three (as well as several other members of both boards) were members of the Knights of Malta, a Roman Catholic charitable organization. While few would doubt that Lynch should have great expertise in looking out for shareholder interests, both boards came under fire by shareholders, who regarded them as being overly compliant with Agee and Grace, respectively, allowing Morrison-Knudsen to deteriorate perilously close to bankruptcy and W.R. Grace to provide extravagant perquisites to the Grace family. If one took board vigilance to be a simple function of the expertise of the board's members and the incentives they face, the actions (and inactions) of these two boards would be puzzling. From an embeddedness perspective, they are entirely predictable. Boards, as Willie Ocasio (1994) puts it, are "normative arenas," and their actions reflect logics of honor, obligation, and appropriateness. To treat them as sites where incentive structures play out their inevitable consequences is to miss the point of embeddedness and, not incidentally, to overstate the possibilities for reform.

Prospects for reform

Any attempt at governance reform, and any effort to predict the future of boards in the 21st century, must reckon with the fundamental fact that governance is embedded in social relationships, including most visibly the interlock network. As a result, efforts to "fix" boards by changing incentives – for instance, the National Association of Corporate Directors' recent proposal to have directors compensated in stock and to require them to buy more shares using their own money – are unlikely to have the intended effect because they misconstrue the motivations of directors and the role of the board as a social institution.

There is an old anecdote that George Bernard Shaw asked a society lady if she would be willing, hypothetically, to sleep with him for £10 million. For £10 million, she averred that she would. "How about for £5 upstairs in ten minutes?" "What do you take me for?" she asked, incredulous. "We've already established that; now we're simply haggling over the price." In short, at some point honor and obligation may give way to incentives, but that point is often far enough out to be essentially irrelevant.

By many accounts, the most useful outside directors are other CEOs (Lorsch and MacIver, 1989). Although they are unlikely to have relevant industry background (as horizontal ties are illegal), such individuals have hands-on experience and credibility as peers that others (such as college professors) do not. CEOs do not join outside boards for the money: the average Fortune 500 CEO made roughly $1.5 million in cash compensation in 1993 (not including options, benefits, and deferred compensation; the median was about $1 million), while the estimated total direct compensation for the average large firm director last year was $56,200 ("Are directors overpaid? The answer varies widely," New York Times, June 27, 1995). A simple thought experiment will make clear that few of us would go to the effort of attending 10 out-of-town board meetings per year and take on the potential liabilities of corporate directors just for 3–5% of our salaries. It therefore should be unsurprising that only about half of the CEOs of Fortune 500 firms currently sit on the boards of other Fortune firms[1], and that a substantial majority of surveyed CEOs have turned down offers to join boards (Lorsch and MacIver, 1989: 19). Surveyed directors rank pecuniary incentives – compensation or being a stockholder – as the least important reasons for joining a board, while the quality of the firm's management and the opportunity to learn were at the top; as one CEO put it, "Serving on a board is a way to see how somebody else is doing the same thing you're doing" (Lorsch and MacIver, 1989: 27). In other words, CEOs join other boards (and thereby create interlocks) specifically to "embed" what they're doing.[2]

Governance is embedded in social relationships

In light of this, what are the likely impacts of paying directors in stock rather than cash, or requiring directors to buy shares with their own money? Assuming that the amounts being paid are not increased greatly in order to represent an even larger fraction of the typical CEO's salary, paying directors in stock will have no impact. As the general counsel of one firm that had added stock-based compensation to its directors' fees put it, "You will hear comments here and there 'now that I've got an incentivized directors' fee, I really think like a shareholder now.' It makes good press, but you just don't hear that in the board room," and it had no detectable influence on directors' attitudes (quoted in Useem, 1995). Requiring directors to purchase shares with their own money will, if anything, discourage even more potentially valuable directors from joining boards, exacerbating the already difficult problem of attracting qualified directors. (The 1994 Korn/Ferry International survey of boards of directors found that the proportion of boards that had been turned down by prospective directors had increased from 24.9% in 1989 to 65% in 1993.) For the small number of directors who are motivated primarily by the compensation available, or for those who use their board positions to generate business for their consulting or legal practices, as long as invitations to join boards and consulting contracts come from the firm's management, using a different medium of payment is unlikely to turn them into vigilant agents of shareholders. (There are exceptional cases when stock ownership by directors will have a significant impact – decisions that directors make which could allow them to retire comfortably on their earnings, as in the case of some takeovers, are an example – but these are not day-to-day occurrences, and reforms predicated on what might happen in exceptional cases will have little impact for most firms.)

Difficulty of attracting directors

In short, incentives are the wrong way to think about the problem. Because of the embeddedness of corporate governance, reforms must take into account the fact that directors are more likely to respond to concerns about honor, obligations, and notions of appropriateness than to crude pecuniary incentives – at least the level of incentives contemplated in "reasonable" governance reform proposals. Using incentives to solve the "problem" of embedded boards would be like paying people to have more healthy family relations – money is not the currency that matters in this domain. According to a study of multiple directors being done by Elizabeth MacIver, shareholder pressure (e.g., from activist institutional investors) also has relatively little direct impact on directors, at most modestly hastening processes that were already underway. Unlike those of "traditional" owners, the concerns of institutional investors are easy to dismiss. "Can you apply the word 'owner' to a 26-year-old pension-fund trader sitting at his CRT screen and trying to outperform the woman down the hall?" asked Andrew Sigler, CEO of Champion International and head of the Business Roundtable's corporate responsibility task force in 1986 (Wall Street Journal, November 12, 1986). Public fund executives, the primary source of shareholder pressure, are also seen by some as mere grandstanding civil servants (O'Barr and Conley, 1992). Whereas the opinions of shareholders count for little, however, the opinions of their fellows count for much. As one director put it, the pressure for "accountability" (or the stigma for a job poorly done) is felt most acutely at the country club. Thus, to the extent that incentives or shareholder pressures are to be effective, it is through their impact on the social relations among peers. It is not the firm's appearance in a negative article in the Wall Street Journal that matters so much as having to explain it to friends in similar positions.

Unfortunately, it is easier to describe what will not work than what will from this perspective, and it is beyond the scope of this paper to suggest a "cure" for poor corporate governance. Absent a wholesale change in the process by which directors are elected, however, it is clear that simply changing incentives, without increasing them substantially, will have little impact on corporate governance. One could seek to bring back "shame" and "stigma" for poor corporate performance, but this is about as realistic as Republican efforts to re-attach stigma to unwed mothers: it is conceivable that it would work if it were possible, but it is only possible in extreme cases of governance failure. Again, hard cases make bad law, and it would be unwise to base reforms on what works for extreme cases.

Conclusion

My purpose has been to give a general sense of the impact of the interlock network – ties among firms through shared directors – on corporate governance. With rare exceptions, interlocks are not used to co-opt powerful buyers or suppliers, or to gain sympathy from commercial banks, or for banks to exercise a form of hegemony over the economy. They are an overlay of social relations that embed corporate governance in a network of information flow and norms, and, although they are not created specifically for this purpose, they provide a mechanism for practices to be legitimized and spread. Perhaps more importantly, the interlock network makes clear that the board is a social institution with its own culture, and that efforts at transforming boards through shareholder pressure or changing incentives will only have their effects as they are reflected in this culture. There is a workable blueprint for reform, articulated by Ronald Gilson and Reinier Kraakman (1991), which would overcome the inertia created by the current system of corporate governance: institutional investors could nominate and elect a cadre of "professional directors" who would sit on multiple boards and would have an appropriate background in corporate law and finance to act as genuinely independent monitors. Until such time as this proposal is implemented, however, there is little realistic prospect for a transformation of corporate governance in the United States.

Notes

1. Ever the optimist, I checked whether it was those CEOs whose firms' performance was above the median who were electing to serve on outside boards. Perhaps above-average CEOs charitably sit on the boards of below-average CEOs in order to spread their talents. In fact, there was no difference between the return on equity of firms whose CEOs served on outside boards and those whose CEOs did not.
2. Although CEOs may join outside boards to learn from high-quality management, the correlation between a corporation's reputation (as ranked by the annual Fortune survey) and its number of interlocks is surprisingly low, with an absolute value of less than 0.2.

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Interlocks provide conduits for information

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