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Bias in the boardroom

Effects of bias on the quality of board decision-making

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Abstract

Good boardroom decision-making can be facilitated by appropriate policies and processes. However, even when combined with well-intentioned and competent directors, such policies and processes may not be sufficient to ensure that good decisions are being made. The paper argues that board decision-making is negatively affected by behavioural factors including conflicts of interest, emotional attachments, dominant personalities, anchored attitudes, a reluctance to meaningfully involve independent directors, implicit 'no-go' areas, and unwarranted reliance on prior experience and decisions. This study calls attention to the impact of bias on boardroom decision-making and argues that social-psychological factors undermine corporate governance mechanisms designed to monitor and control CEO behaviour. Bias in the boardroom particularly weakens the contribution to corporate governance of the independent director. Mechanisms and processes to mitigate the impact of bias in the boardroom are suggested.

Key issues

In view of widespread perceptions that current governance principles all too frequently fail to prevent significant destruction of shareholder value, the central focus of this contribution relates to making boards, as a key element of governance, more effective. Hence, the discussion centres on issues relating to:

- The quality of board decision-making;
- The impact of dominant senior managers;
- Poor board leadership and lack of independent voice;
- The role of the Chair and the Senior Independent Director;
- Behavioural impacts on board decision-making.

Key questions to be discussed include:

- What is the correct boardroom behaviour and board culture?
- How can we enhance the quality of board decision-making?
- How do we ensure that boards are and remain accountable and in control of the organization?

Main arguments

i. Bias in the boardroom is inevitable and frequently underestimated.

ii. Bias plays a significant role in poor board decision-making.

iii. Bias particularly undermines the perceived benefits of independent directors.

iv. Governance regulation needs to emphasize the effects of bias on decision-making and mandate the use of de-biasing procedures.

Introduction

The paradigmatic approach to 'good' corporate governance for companies in terms of an overall focus on appropriate internal control and risk management procedures, places the responsibilities for such procedures firmly with the board, supported by a formal structure of board committees (Cadbury, 1992; Gwilliam and Marnet, 2010). Reflecting on the board's responsibilities, the Companies Act 2006 (UK, 2006), for example, refers to the duty of directors to exercise independent judgment (Companies Act 2006 SS.173), while the ICSA Review (ICSA, 2010) of the *Higgs Guidance on the Role and Effectiveness of Non-Executive Directors* (Higgs, 2003) notes the importance of the quality of board decision-making and the particular weight given in governance to independent judgement. The contribution of the independent director to the quality of board decision-making is of critical importance given the large proportion of independent directors on the board and board committees in reaction to high-profile corporate scandals earlier this decade.

Calls for more diligent stewardship of the corporation, in part a reaction to recent high-profile corporate scandals, but also arising from a long-standing dissatisfaction with conventional responses to destructive leadership (Clarke et al., 2003; Marnet, 2008; Forbes and Watson, 2010), would appear to increasingly require a radical rethink of corporate governance principles and philosophy. While existing corporate governance mechanisms and the market for corporate control eventually act to shield the majority of firms from the worst consequences of poor executive decisions and failed monitoring by the board, this frequently occurs only after the destruction of significant corporate value (Forbes and Watson, 2010). Research into the causes of high-profile corporate scandals and details emerging on the global financial crisis would seem to reinforce the impression that independent judgement, constructive debate and challenge in the boardroom remain the exception (Gwilliam and Marnet, 2010).

Serving on a board inherently creates the risk of a biased decision-maker, and extant research suggests that bias in perception and judgement is an

inescapable factor of human choice-behaviour (Bazerman and Malhotra, 2006). Flawed decisions can be made with the best of intentions, and competent individuals can believe passionately that they are making a sound judgment when they are not. Factors known to distort judgment include conflicts of interest, deference to authority, peer pressure, emotional attachments, and inappropriate reliance on previous experience and previous decisions (ICSA, 2010).

The remainder of the paper discusses the impact of bias on the quality of board decision-making and argues that common social-psychological factors undermine the monitoring function of boards, with a particularly negative impact on the functional independence of non-executive directors. The article is informed by participant-observer research on the governance failures of an organization that suffered significant adverse performance resulting in its near collapse (Marnet, 2010a,b), which mirror insights by Forbes and Watson (2010), who note that organizations characterised by "*strong managers and weak owners*" (Roe, 1994) expose themselves to "*destructive leadership*" risks (Padilla, et al., 2007) due to board loyalty biases, little mitigated by current corporate governance codes.

Bias in the boardroom

In deriving a theory of governance based on incentives, disclosure and monitoring, a typical normative assumption in corporate governance is that of the self-interest of agents to guide their actions, protect shareholder's equity and act in their own best long-term interest. This approach has the flaw of being based on a poor model of human choice behaviour, a model which can be extended to provide for better descriptions of actual agent behaviour (Marnet, 2008). The shortcomings of the rational actor model as a basis for the description of human choice behaviour are, however, increasingly recognized by regulators and those tasked to improve on existing guidelines. The ICSA Review of the Higgs guidance (2003) suggests that appropriate policies and processes facilitate good decision-making, but are likely to be insufficient in the presence of behavioural factors that can lead to flawed

decisions (ICSA, 2010). The ICSA Review calls particular attention to the detrimental impact of social and psychological factors on the quality of boardroom decision-making and the effect of bias on the contribution of the independent director.

Central to the scores of corporate disasters in recent years has been the failure of the monitoring function of boards, the entity that holds management accountable (Collier, 2005). These scandals are typically seen as a problem of corruption and/or incompetence. No doubt, this is part of the story, but the bigger story is likely one of bias of key governance agents (Bazerman and Watkins, 2004; Coffee, 2001, 2003b, Prentice, 2000, 2003). Biased decisions in the boardroom are suggested to be a major contributing factor to what ultimately is seen as fraudulent, imprudent and/or destructive behaviour of executive management and the acquiescence to such activities by the board (and other gatekeepers). It will come as no surprise that people are affected by group loyalties, friendship, and non-pecuniary self-interest. Nevertheless, these potential sources of bias are typically ignored or deemed to be of only minor importance by courts and standard setters who seem to share a widespread presumption that independent directors can make decisions without being affected by their own preferences, motivations, social ties, and peer pressure, or that directors acting in good faith are capable of overcoming their biases (Marnet, 2008).[1] Such interpretations rely on the assumption that rational and competent individuals will make objective analyses and utilize all available information to ensure the best outcome for the firm.

In contrast, behavioural research on decision-making shows that bias can significantly affect the judgement of agents in governance and the quality of decisions made at board level (Prentice, 2003; Marnet, 2010a,b). Social-psychological factors may significantly undermine the work of the board as a mechanism ostensibly designed to monitor, guide and control CEO behaviour.

[1] For example, the Delaware Supreme Court suggested that “most” friendships were not of a sufficiently “bias-producing nature” to negate a director’s independence (Beam *ex rel*. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004). If the courts do recognize these biases, they typically assume that a director’s good faith efforts or competing interests, such as a director’s reputational interest, will prevent biased decision making.

The impact of bias on decision-making particularly questions the contribution of the independent director, who is given key importance in the mitigation of agency problems by the current governance paradigm (Higgs, 2003; Gwilliam and Marnet, 2010). Widespread board acquiescence to what subsequently is revealed as poor corporate decision-making or fraud would indicate a need to explore key behavioural effects on the quality of decision-making in the boardroom (Gwilliam, 2009). The more obvious and highly publicised cases of destructive (and fraudulent) leadership such as Enron and WorldCom are, thankfully, quite rare, although bias undoubtedly played a role in the (poor) decisions of the respective boards. A more insidious and widespread problem is the potential for massive destruction of shareholder value stemming from common behaviour patterns of corporate elites and board members where fraud do not play a major role (or indeed none at all), but changes in leadership do not take place before significant damage has occurred (Marnet, 2008; Gwilliam and Marnet, 2010; Forbes and Watson, 2008).[2]

Challenges to the dominant governance paradigm have come from those who question the ability of independent directors to satisfactorily perform the variety of roles expected from them[3], and from those who argue that the 'approved' governance mechanisms put in place have been demonstrably ineffective in checking corporate irregularity to date and are unlikely to be any more effective in the future (Clarke et al, 2003; Gwilliam and Marnet, 2010). An example of related research is given in Marnet (2007, 2008) who cautions against the exclusive use of the rational choice model of decision-making in explaining agent behaviour in corporate governance and proposes the use of psychologically more realistic assumptions. Prentice (2003) examined Enron's collapse using a behavioural perspective, to arrive at more realistic policy prescriptions than those that can be derived from a strict reliance on the

[2] Examples of non-rational (in the economists' interpretation) behaviour include commitment to lost causes, belief perseverance, and the underestimation of risk. Cognitive dissonance (the clash between conduct and principles), frequently leads to beliefs being adapted to conform with own conduct, which further distorts perception and judgment. A further complication is that preferences and beliefs may not be formed prior to observations of own behaviour. Hence the causation may, at times, run from behaviour to beliefs (see Bazerman and Malhotra, 2006).

[3] See for example Ezzamel and Watson (1997), see also Spira (2003) and Spira and Bender (2004) for further discussion of this issue.

rational actor model. These authors argue that conventional law and economics theory still largely ignores behavioural insights which forceful demonstrate how law and economics (and much extant governance regulation) is built on a raft of inaccurate assumptions on human judgement and decision-making behaviour, leading to ineffective and potentially counterproductive policy prescriptions.[4] Such insights have profound implications on the definition of director independence. In definitions of director independence, the standard governance paradigm focuses on issues related to business and family relationships, and is essentially based on financial incentives. The inconclusive relationship found in research between corporate performance and the proportion of independent directors on the board or the various committees supports the argument that the benefits of independent directors, as traditionally defined, are limited (Mehran, 1995; Klein, 1998; Bhagat and Black, 1999, 2002; Larcker et al. 2007).

Based on a synthesis of more than four decades of social psychology research (see, inter alia, Jolls et al., 1998; Thaler, 2000; Rabin, 2002), the presumption of independence based on simple metrics focusing on the absence of financial and family ties would appear to be inadequate. Regardless of a director's good faith, subconscious and, to a significant extent, uncontrollable cognitive processes prevent a director's decisions from being unaffected by their preferences and board loyalties. Biased decision-making can thus occur in the absence of direct or indirect monetary incentive and it can be shown that individuals can often neither identify nor control their own biases. Gatekeepers may unknowingly favour themselves, friends and in-groups, to the detriment of the firm and its various stakeholders. The broad argument is that parties with an interest in viewing facts in a certain light are not capable of independent and objective judgment (Moore and Lowenstein, 2004; Moore et al., 2003).

[4] See Prentice (2000) for a detailed application of behavioural insights to auditing and accounting. Also, Coffee (2003a,b) who investigates behavioural and regulatory causes of the failures of gatekeepers in corporate governance.

Functional independence, in the sense of directors being professional referees (Fama, 1980), board monitors (Fama and Jensen, 1983a,b) and gatekeepers (Coffee, 2001, 2002, 2003a, 2003b), remains an elusive goal (Clarke et al., 2003). Indeed, some scholars would argue that initiatives such as increasing the proportion of independent directors on a board and board subcommittees are manifestations of the agency problem rather than a solution to it (Bebchuk and Fried, 2003). While controlling for managerial conflicts of interest is one of the essential monitoring functions of the board (Langevoort, 2001a) a board operates within a framework of dependence, social ties, loyalties, and behavioural norms which forms an environment where critical assessment of managerial actions may be neglected. Jensen (1993, p. 863) reflects on board culture as an important component of failure of board function when he describes an atmosphere of: "… *courtesy, politeness and deference at the expense of truth and frankness during board meetings, reflecting a general reluctance of confronting a CEO regarding management decisions, which is seen as both a symptom and cause of failure in the control system."* (Jensen, 1993, p. 863). Such a culture may be perpetuated by the typical selection for membership on boards of directors based on compatibility, fit, consensus, and cooperation (Langevoort, 2001b).

An overly strong emphasis on teamwork, conflict-avoidance, and consensus opinion may be a contributing factor to board capture by the CEO, providing executive management with significant powers to engage in activities to the detriment of stakeholders (Bebchuk et al., 2002). Such an interpretation of managerial power would seriously undermine the arm's length model of boards and their crucial gatekeeper function, and is in stark contrast to the optimal-contracting view where directors take an adversarial position against management (Bebchuk et al., 2002). Board capture is not the only, nor a necessary, influence bearing against independence. Groups such as boards of directors, are highly subject to groupthink (Janis, 1972; 1989) and polarization (McHoskey, 1995), with potentially negative effects on the quality of decisions. While an ideal board would act to counter the groupthink tendencies of an in-group, group social effects are a potent influence against critical opinion. The social dynamics that exist in any group motivate

members to arrive at a consensus, which may negate the potential for group decision making to moderate extreme views, and can instead lead to increased polarization (Janis, 1972; Myers, 1982; McHoskey, 1995). Board deliberations may increase biased pre-decision processing, the biased processing before committing a consequential decision (Brownstein, 2003).[5]

Poor board decision-making may be less of a question about integrity, but more a case of the 'objective', 'rational', 'competent', and 'honest', director falling prey to the powerful effects of psychological bias. If bias can result not only from corruption or intentional malfeasance, but rather from unintentional (and often subconscious) motivational and cognitive processes, unbiased decision making may be beyond the best of directors' abilities. Subtle conflicts of interest, like those involving directors' indirect personal and social benefits, may not be obvious to directors who interpret their situations differently from impartial observers. To compound the problem, even where people allow for the possibility of their judgement and decisions being biased, they typically underestimate the effect, and insufficiently adjust for this. If lack of conscious awareness of the impact of bias is a major problem, and this paper suggests it is, this has the further implication that the solution cannot be based on conscious cost-benefit analysis. This would greatly diminish the impact of sanctions as a guide to behaviour.[6] The explicit view, based on people knowing their preferences, yields the traditional, but arguably ineffective, regulatory and legal response to corporate scandals such as the imposition of sanctions on violations of professional standards, more rules, disclosure of conflicts of interest, and other interventions aimed at changing the cost/benefit calculation of the decision maker towards compliance with rules. If most of the problem is implicit, with people largely unaware of what guides their judgement and behaviour, these explicit barriers to corruption will have limited impact. It is particularly difficult to maintain a duty of

[5] Human inference is subject to a set of cognitive and motivational filters which persistently interfere with an objective interpretation of information, including over-optimism; escalation of commitment; prior views, decisions and experience; emotional attachment; confirmation bias; a preference for the status quo; obedience to authority.
[6] Bazerman and Watkins (2004). Predictable surprises: The disaster you should have seen coming and how to prevent them (arguing that recent financial scandals were caused in significant part by auditors' lack of independence).

independence and objectivity where unanimity in boardroom decision-making is emphasized. The expression of independent judgement is actively inhibited where this openly conflicts with the views of executive management and the Chair. Accountability under such pressures is then severely undermined, which will directly impact on a board's judgement of the appropriateness and effectiveness of the organization's risk management and internal control systems.

Biased judgement contributes to the phenomenon of destructive leaders (Forbes and Watson, 2010). Padilla et al. (2007) argue that for destructive leadership to take hold and to generate extreme negative outcomes there typically needs to be a 'toxic triangle' consisting of 'destructive leaders, susceptible followers and conducive environments'. All three of these elements are present in the widely-held corporation. Executive leaders frequently cultivate susceptible followers and create the necessary conducive environment through their exploitation of a pronounced loyalty bias (Forbes and Watson, 2010). This may lead in even formally 'independent' boards of directors displaying excessive loyalty towards their CEO's long after it has become apparent to outsiders that the incumbent CEO is destroying corporate value and ought to be replaced.

Finally, induction sessions, and recommendations to regularly update and refresh skills and knowledge, as suggested in the Higgs Guidance (Higgs, 2003) and discussed in the current ICSA Review (ICSA, 2010) of the latter are necessary ingredients to promoting board effectiveness. Nevertheless, formal training in important areas where a minimum amount of expertise is deemed instrumental to support governance by directors, will not inevitably lead to better decision-making if the effects of bias are ignored or acknowledged in passing only. Appeals to 'objective', 'rational', 'independent', and 'informed' decisions will largely fail to have the desired effect where board processes and procedures are actively aimed at minimizing the impact of bias on individual and group judgement.

Conclusion

This paper suggests that critical assessment of, and dissent to, poor decisions by executive management is typically undermined by common social and psychological factors present in the boardroom. Despite best intentions, bias in the boardroom is inevitable, board dominance by executive managers remains wide-spread, and independent judgment by non-executive directors more evident in its absence. Constructive debate and challenge remain elusive in boardroom deliberations, with detrimental effects on the quality of decision-making. The perceived benefit of independent directors—unbiased judgment – may be achievable in the exception only, which makes the independent director, in its present form, a weaker component of good governance than commonly assumed. This highlights the need to implement guidelines for board procedures which aim to de-bias decision-making.

One recommendation is to frequently change the decision maker to minimize the bias introduced by being responsible for a prior decision and to allow for the emergence of a different perspective. This has implications for the rules and guidelines on board membership, the rotation of board members, stricter rules on tenure and the re-election, the need for outsiders to come on a board, and cross-membership. It is imperative to separate the decision-maker from the performance monitor. The same board (or board members/committees) cannot reliably form judgement over the performance of a project or decision for which it was originally responsible.

The election of strictly time-limited directors, without possibility for renewal or subsequent re-election, with the explicit task to identify weaknesses in the governance of the firm, would further support the emergence of an independent view on the board. True outsiders can act as a potent guard against the inevitable in-group tendencies which diminish the benefits of non-executive directors. Since a single dissenting individual may find it difficult to be heard, and may be particularly reluctant to voice concerns when the board seems to display unanimous consent to a particular proposal, especially where a dominant CEO appears to be supported by a respected Chair, it is

suggested to elect two or three such outsider directors at a time, to allow the creation of a critical mass as a counterweight to established views on the board.

It is here where the senior independent director can have a significantly positive impact on the quality of board decision-making, in normal times, but particularly also when the board is undergoing a period of stress. To encourage independent thinking, a senior independent director should be cautious of bias in the decision-making process, promote the diversity of views, and employ means to institutionalize (legitimate) dissent. It would be of immense additional benefit for a board to have a number of meetings without executive management present, and for meetings between the board and the external auditor, again without the presence of executive management. The senior independent director may wish to hold regular meetings with other independent directors to discuss important decisions and proposals. The senior independent director might also be called upon to act as co-Chair in setting agendas and in the guidance of the general tone on boardroom deliberations to ensure that dissenting voices are heard.

Boards may wish to consider a number of decision-making strategies that can reduce the impact of unconscious bias. Such approaches include dividing the task into an information search, a general discussion and then a decision by different group members or separate committees (the ICSA Review notes: "*Some chairs favour, for example, three separate discussions for important decisions – concept; proposal for discussion, proposal for decision*"); seeking the advice of non-traditional outsiders; requiring decision makers to justify their information choices; appointing a 'devil's advocate', thereby ensuring opposing arguments are given more consideration; deliberately framing a decision problem in multiple ways; seeking dis-confirmatory information (i.e. to look for information and arguments which do not support a proposal); documenting the process that was used to arrive at and challenge a proposal prior to and during board deliberations; and establishing a sub-committee to assess the appropriateness of the decision process, in addition to assessing the merits of the proposal itself.

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