1986

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RESEARCH NOTES

© *Academy of Management Journal*
1986, Vol. 29, No. 4, 789–799.

BOARD COMPOSITION AND THE COMMISSION OF ILLEGAL ACTS: AN INVESTIGATION OF *FORTUNE* 500 COMPANIES

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Corporate boardroom processes and board composition have long been topics of interest and debate for both organizational researchers and practitioners. In recent years, however, criticism of corporate boards has increased dramatically, as evidenced by the comments of former International Telephone & Telegraph chairman, Harold Geneen. According to Geneen, "the boards of directors of U.S. industry include numerous first-rate people doing what amounts to a second-rate job" (1984: 258). In defense of his position, he brought up many points, but board composition is the most central to his argument. Essentially, Geneen and other critics have argued that the designs of corporate boards restrict their members' independence and render them ineffective when it comes to monitoring top management and protecting stockholders' interests (Anshen, 1980; Drucker, 1973; Mace, 1971; Mintzberg, 1983).

The reform that critics of boardroom processes most frequently offer involves increased representation by outsiders, directors who are not members of management. According to these advocates, a higher proportion of outside members strengthens a board's independence and broadens its base of power and knowledge. What is perplexing, however, is that although accepted as common knowledge and adopted in the rules and regulations of various stock exchanges and government agencies, this position remains virtually untested. Thus, despite a clear trend in U.S. firms toward greater outside representation (Heidrick & Struggles, Inc. 1979, 1980: Herman, 1981; Korn/Ferry International, 1981; National Association of Corporate Directors, 1982; Securities and Exchange Commission, 1980; Smith, 1978; Vance, 1983), we still do not know if organizations with greater proportions of outsiders on their boards are more effective in terms of serving stockholders than those companies dominated by insiders.

This study was funded in part by a grant from the Business Foundation of North Carolina, Inc.

OUTSIDER DOMINANCE PERSPECTIVE

The name frequently given to this strategy for boardroom reform is the outsider dominance perspective. According to supporters of this position, outsiders should be in the majority on corporate boards, because they offer greater breadth of knowledge and experience (Bacon & Brown, 1973; Firstenberg & Malkiel, 1980; Securities and Exchange Commission, 1980; Williams & Shapiro, 1979). More important, advocates of this position consider outsiders a vital board resource because of two issues—independence, and the dual roles of many chief executive officers (CEOs) (Berg & Smith, 1978).

In over 75 percent of large U.S. firms, the CEO serves simultaneously as board chairman (Heidrick & Struggles, Inc. 1981; Korn/Ferry International, 1981; National Association of Corporate Directors, 1982). Yet, despite its prevalence, this arrangement has met with severe criticism for two reasons. First, it represents a conflict of interests. According to Geneen, "the board's responsibility is to sit in judgment on the management, especially on the performance of the chief executive, and to reward, punish, or replace the management as the board . . . sees fit" (1984: 252). The chief executive, on the other hand, is a professional manager. Geneen's point is that chairmen/CEOs cannot represent the shareholders in the first role and at the same time impartially sit in judgment on their own performance in the second role.

In agreement with Geneen is former Securities and Exchange Commission (SEC) chairman, Harold Williams. According to Williams, the chairman and CEO perform two very different roles. It is a CEO's job to speak on behalf of management, but it is a chairman's job to question management (Williams & Shapiro, 1979). Palmieri (1979) also agreed, noting that a board chairman should strive to create an environment where questioning and in-depth discussion are valued. A CEO, however, despite appreciating the board's function, wants to "get the meeting finished so the organization can get on with its business" (1979: 48).

A second problem brought on by unitary leadership is that it forces inside or management directors into an uncomfortable position. As noted, it is a board's responsibility to monitor management's performance. Consequently, insiders are being asked to evaluate the individual who on a day-to-day basis acts as their boss. Supporters of outsider dominance suggest that outside directors, because of their independence, can better serve the interests of stockholders. Unlike their inside counterparts, who are a CEO/chairman's subordinates, outsiders can freely evaluate management's performance and act to remedy inappropriate or unacceptable situations.

Strongly backed by advocates of boardroom reform, the notion of outsider dominance has received support from other sources as well. Beginning in the late 1960s, for example, both the New York Stock Exchange (NYSE) and American Stock Exchange (ASE) ruled that all firms listed on the exchanges must have a minimum of two outside board members (Securities and Exchange Commission, 1980).

Also during this time, Williams, then chairman of the SEC, actively promoted a more stringent proposal, suggesting that outsiders and CEOs be the sole members of boards (Firstenberg & Malkiel, 1980; Securities and Exchange Commission, 1980; Vance, 1983). Recently, there has been renewed interest in this proposal (Anshen, 1980; Geneen, 1984). Although never adopted as a rule by the SEC, Williams's idea did seem to have a profound effect on the composition of boards. A dramatic shift took place between 1970 and 1980 (Heidrick & Struggles, Inc., 1979, 1980; Herman, 1981; Korn/Ferry International, 1981; National Association of Corporate Directors, 1982; Securities and Exchange Commission, 1980; Smith, 1978; Vance, 1983). One report that surveyed 1,300 large firms found an increase in the percentage of outsider representation from 59.6 percent in 1971 to 65.9 percent in 1979, and in a 1981 update of the study, the percentage climbed to an even higher 72.2 percent (Heidrick & Struggles, Inc., 1979, 1981). In still another study examining 887 firms, 71 percent of the directors were outsiders (National Association of Corporate Directors, 1982).

In recent years, efforts to bolster the position of outsiders on corporate boards have continued. The stock exchanges and the SEC have adopted a number of new rules and regulations regarding board committees. For example, the SEC, NYSE, ASE, and National Association of Securities Dealers all advocate that outsiders should represent a significant portion of the membership of audit committees. In fact, the NYSE, which has the most stringent regulations of these groups, insists that all firms listed on the exchange must maintain an audit committee "comprised solely of directors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment" (National Association of Corporate Directors, 1982: 46).

The SEC appears to agree with the NYSE's position, noting that having an audit committee whose members have vested interests related to those of management may be worse than having no audit committee at all, because a firm thus creates the appearance of having an effective body, but it in fact lacks substance (Securities and Exchange Commission, 1980). According to these regulators, the sensitive nature of such a committee's monitoring tasks makes it unlikely that insiders can maintain the needed independence. The duties and responsibilities of other groups, such as compensation and nominating committees, also illustrate why many boards strive for, if not require, outside dominance on key committees.

RESEARCH HYPOTHESES

Although the outsider dominance perspective has been popular since the 1960s, and the subject of numerous rules and regulations, there has been surprisingly little empirical research on the topic. Of the few studies that have been conducted, virtually all have used the performance of firms as their dependent variable (Schmidt, 1975; Smith, 1978; Vance, 1955, 1964). Moreover, their findings have been mixed. In fact, in many of the studies, high proportions of insiders, not outsiders, are associated with high levels of performance (e.g., Vance, 1955, 1965), and thus their conclusions oppose the outsider dominance perspective and prevailing business sentiment.

Although these findings may appear perplexing to some advocates of outsider dominance, others might question if these empirical studies have in fact captured the true question. After all, critics and supporters alike acknowledge that a board's role is to monitor and evaluate a firm and its top management. If directors affect the operations and performance of a company, it is only indirectly, through such acts as the hiring or firing of CEOs. Most advocates of boardroom reform readily acknowledge that it is not a board's responsibility to serve in an operating or functional capacity (Herman, 1981; Vance, 1983).

Issues of legality appear to be an area over which boards have more direct control and interest (Mueller, 1979). Thus, an important test of the outsider dominance perspective might be to examine the relationship between board composition and a firm's involvement in illegal activities. Since boards of directors are legally responsible (Committee on Corporate Laws, 1976), its members may be more likely to monitor their firm's actions to insure that management is not acting illegally than they are to monitor functional operations in general. Although directors might not know about a firm's involvement in illegal actions, ignorance of such matters places them in a very precarious, and possibly severely damaging, legal position.

This research question, which is substantially different from previous tests of the outsider dominance perspective, may help to clarify earlier findings. Rather than suggesting that outsiders strengthen firms through positive effects on certain outcome or dependent variables like overall performance, this study considers whether outsiders strengthen firms by preventing certain negative actions, specifically, illegal activities.

Hypothesis 1: There is an inverse relationship between the proportion of outsiders on its board and the number of illegal acts committed by a firm.

This first hypothesis suggests that although both insiders and outsiders might be aware of a firm's involvement, or planned involvement, in illegal actions, insiders, because of their subordinate position, are less likely to speak up against management and a CEO/chairman despite sharing legal accountability. Outsiders, who do not work daily under the CEO, may be more likely to bring such actions to the attention of other board members and to object to the firm's planned or actual involvement.

Although Hypothesis 1 addresses the direct relationship between the proportion of outsiders and a firm's involvement in illegal actions, it does not consider a simple majority effect. The key issue may not be the number or percentage of outsiders, but whether outside directors represent a minority or a majority. In the first case, the outsiders may choose to remain silent, not voicing concerns over the legality of certain actions or questioning the CEO; in the second, they might be more willing to speak up.

Hypothesis 2: Firms with a majority of outsiders on their boards will engage in fewer illegal acts than those firms with a majority of insiders on their boards.

These two hypotheses address the basic relationship between board structure and illegal acts, but neither considers the possibility of a causal lag, whereby earlier illegal acts have lead to changes in board structure. After a firm's involvement in illegal acts, its board as a whole may seek to strengthen outside representation in an effort to improve its monitoring function and enhance stockholders' confidence. Altering a group's composition is a means to reassure various regulatory agencies and key constituents that a board intends to make changes so that this type of involvement will no longer be tolerated. Even if no actual modifications of the roles, responsibilities, and conduct of board members occur, a change in composition can serve as a symbolic action, signaling that the board will no longer condone such activities; in some respects such a change resembles the ritual scapegoating often described in the literature on executive succession (Brown, 1982; Eitzen & Yetman, 1972; Gamson & Scotch, 1964; Lieberson & O'Connor, 1972; Pfeffer & Salancik, 1978). This notion that board composition and corporate illegal activities may be causally linked suggests that:

Hypothesis 3: The greater a firm's involvement in illegal activities, the more likely it is to increase the proportion of outside directors on its board.

Finally, given earlier arguments concerning the conflict of interests that might result when CEOs simultaneously serve as board chairmen, we suggest:

Hypothesis 4: Firms with a single individual serving in the roles of CEO and chairman are more likely to commit illegal acts than firms with two separate individuals serving in these roles.

RESEARCH DESIGN

The objective of this research was to test the relationship between board composition and the occurrence of illegal corporate acts. The population we used included all companies continuously listed on the *Fortune* 500 between the years 1980 and 1984 ($N = 384$). Most firms that were dropped from that list during this period were objects of corporate mergers and acquisitions. Staw and Szwajkowski (1975) provided information about types of illegal activities committed by these firms and *Trade Cases* (Commerce Clearing House, Inc., 1980–84) provided information concerning involvement in legally questionable activities. This publication reports decisions and consent and litigation decrees entered in federal and state courts for cases involving possible violations of antitrust laws and the Federal Trade Commission Act.

As did Staw and Szwajkowski (1975), we considered these areas of litigation: price discrimination, tying arrangements, refusal to deal, exclusive dealing, franchise violation, price fixing, foreclosure of entry, reciprocity, allocation of markets, monopoly, conspiracy, and illegal mergers and acquisitions. We also used the same criteria, with the dependent variable represented by the total number of instances in which firms were found guilty in litigated cases, were parties to nonlitigated consent decrees, or involved in unsettled cases in which the court found substantial merit to the charges against the cited firms.

Our classification of board members as insiders or outsiders also followed previous research (Pfeffer, 1972; Schmidt, 1975; Vance, 1964). We considered current or retired managers of an organization or of one of its subsidiaries to be inside directors. Outside directors did not currently hold, nor had they previously held, management positions within the company for which they were serving as director. Consulting *Standard & Poor's Register of Corporations* (1981–85), which lists directors either as members of management or outsiders, we divided the numbers of outside members by the total numbers of directors to obtain a proportion for each firm. However, because these data are longitudinal, and slight changes in board composition are common from year to year, it was necessary to average percentages of outsiders from 1980 to 1984.[1] Thus, the proportion of outsiders represents the average proportion for each firm during the five years under investigation. For Hypothesis 2, the independent variable is binary, so we used a dummy variable, with firms having a majority (> 50%) of outsiders on their boards coded 1, and firms where outsiders were a minority coded 0 (Schmidt, 1975).

Finally, to test Hypothesis 4, we needed to distinguish firms with a single individual serving as both CEO and chairman from those firms in which separate individuals held these positions. Once again, the relevant information was in *Standard & Poor's Register of Corporations* (1981–85). We compared names and titles to determine whether there was dual or separate leadership between 1980 and 1984. As might be expected, changes took place over time, with firms going from separate to dual leadership, or vice versa. Thus, in an effort to remain as conservative as possible, we used for further analysis only those firms that consistently maintained either dual or separate status throughout the relevant dates ($N = 274$).

RESULTS

For the companies in our population, the average number of directors between 1980 and 1984 ranged from a high of 40 to a low of 5 ($\overline{x}$ = 13). The proportion of outsiders to total directors ranged from a high of 100 to a low of 12 percent, with the mean at 70 percent. The last figure is similar to earlier estimates regarding percentages of outsiders (Heidrick & Struggles, Inc., 1981; Korn/Ferry International, 1981; National Association of Corporate Directors, 1982). The numbers of illegal acts over the period ranged from a high of 17 to a low of 0. Although the mean for all firms was less than 1 (0.90), the mean for those firms that were involved in some type of illegal activity was 3. The numbers of firms with consistent dual and separate leadership

[1] We divided the proportion for each year by the number of years.

throughout the period were 245 and 29, respectively. Thus, for those firms that maintained a consistent leadership status, 89 percent had single individuals serving in the roles of CEO and chairman, a figure consistent with earlier findings (Heidrick & Struggles, Inc., 1981; National Association of Corporate Directors, 1982).

Results offered no support for Hypothesis 1. The proportion of outsiders was not significantly related to the number of illegal acts ($r = -.012$, n.s.). Similarly, the results of a one-way analysis of variance indicated no significant relationship consistent with Hypothesis 2 ($F = .07$, n.s.). Firms with a majority of outsiders were not involved in fewer illegal acts than those represented by a majority of insiders.

After these initial analyses, we considered two additional variables, organizational size and governmental regulation, either of which could have a substantial effect on the relationship under investigation. For example, some industries, such as defense, broadcasting, and oil and gas, are subject to greater regulation than others; this may, in turn, influence the number of illegal acts in which they are involved. We use partial correlation to control for size, measured in terms of firms' assets, and governmental regulation of industries defined as high or low, depending on the number of federal agencies monitoring the activities of the industry. Despite this additional control, the overall results remained the same ($r = -.010$, n.s.).

Although no significant relationship was found when illegal acts were assessed in the aggregate over time, it is possible, as Hypothesis 3 suggests, that previous commission of illegal acts may have lead to changes in the structures of boards. In particular, the boards of firms that have been exposed to prosecution for illegal acts may recruit more outsiders to improve monitoring and enhance stockholders' confidence. To test this causal lag, we divided the years under examination into two equal periods—1980 to the second quarter of 1982, and the third quarter of 1982 to 1984—and calculated both the numbers of illegal acts and the percentages of outsiders on boards of directors for each subperiod. We then modeled the possible causal determinants of board structure as a series of regression equations.

TABLE 1
Correlations Between Proportion of Outside Directors and Number of Illegal Acts[a]

	Proportion of Outside Directors	Majority of Outside Directors	Number of Illegal Acts
Proportion of outside directors	–	.650***	−.012
Majority of outside directors		–	.013

[a] N=384
* $p < .05$
** $p < .01$
*** $p < .001$

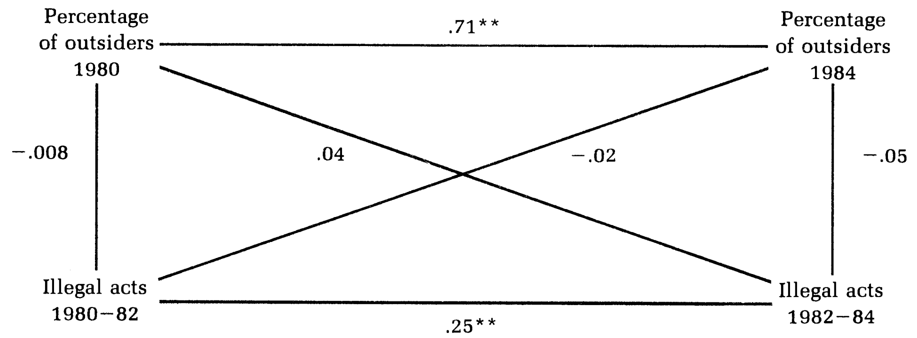
Figure 1 displays the results of these analyses, and Table 2 presents the detailed results of the regression equations. The findings indicate that both board structure and the commission of illegal acts were consistent over time. No support emerged for the proposition that commission of illegal acts leads to changes in the structures of boards, either directly or indirectly. Similarly, there is no evidence that board structure directly or indirectly leads to the commission of illegal acts.

Finally, one-way analysis of variance was used to test Hypothesis 4. The results indicate that firms where one individual serves as both CEO and chairman are no more likely to be associated with illegal acts than those firms in which separate individuals hold these positions (F = 1.82, n.s.).

DISCUSSION

The results of this investigation are important for several reasons. First, this work adds to the existing research, much of which has failed to support the outsider dominance perspective (Schmidt, 1975; Vance, 1955, 1964). The findings of this study do not suggest that adding outsiders to corporate boards will lessen a firm's involvement in illegal activities. Similarly, there is no evidence that firms dominated by outsiders are more likely to engage in illegal acts. In addition, this study represents a novel test of the outsider

FIGURE 1
Board Composition and Illegal Acts, Cross-Lagged Panel Analysis[a]



[a]Illegal acts 1980–82 refers to the number of illegal acts between the first quarter of 1980 and the second quarter of 1982. Illegal acts 1982–84 refers to the number of illegal acts between the third quarter of 1982 and the fourth quarter of 1984. Values on paths are standardized coefficients (β's).

* $p < .05$
** $p < .01$

TABLE 2
Results of Regression Analysis of Determinants of Illegal Acts and Board Composition

	Percentage of Outsiders, 1984		Numbers of Illegal Acts			
			1980		1984	
Independent Variables	β	*t*	β	*t*	β	*t*
Percentages of outsiders						
1980	.680	19.80**	−.006	−.16	.13	.21
1984					−.49	−.75
Numbers of illegal acts						
1980	.003	.97			.19	5.10**
1984	.003	−.75				
R^2	.51		.0001		.06	
F	131.18		.03		8.67	

* $p < .05$
** $p < .01$

dominance perspective. Previous examinations of this issue have focused on the relationship between board composition and performance, addressing the question of whether outsiders have a positive effect on firms by strengthening positive outcomes. This study, however, approached the issue from a different perspective, asking if outsiders help to minimize or prevent certain negative outcomes. Taken together, the results of these two types of studies lead us to question whether the objectives of outsider dominance, or conceptual arguments for this strategy, are legitimate. The evidence to date does not seem to support the belief that stockholders are better served by boards dominated by outsiders.

For the most part, the outsider dominance perspective has remained unchallenged since its conception over 20 years ago. Moreover, given the recent and rather dramatic increase in criticism of corporate boards, it has been the basis of a highly recommended strategy for improving poor boardroom processes and enhancing stockholder representation. This study, however, raises questions as to whether this method of reform reaches desired ends.

In the future, researchers may want to investigate what types of boardroom reforms will improve corporate performance and reduce firms' involvement in illegal activities. These reforms might include placing greater attention on such background characteristics of directors as their experience and education, or focusing on their financial involvement in a company, such as stock ownership. Still other research efforts might examine the roles of board committees in efforts to improve the monitoring function of directors and reduce involvement in illegal actions. In sum, despite the popularity of the idea of outsider dominance and its adoption as the basis of certain rules and regulations of various government agencies and stock exchanges like the SEC, NYSE, and ASE, the findings of this and prior studies suggest that we should reexamine this approach to boardroom reform.

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