Behavioral corporate governance

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Behavioral Corporate Governance:

Four Empirical Studies

Gerwin van der Laan

RIJKSUNIVERSITEIT GRONINGEN

BEHAVIORAL CORPORATE GOVERNACE:

Four Empirical Studies

Proefschrift

ter verkrijging van het doctoraat in de

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aan de Rijksuniversiteit Groningen

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Preface

Upon finishing my masters studies in 2005, I was awarded the Dutch *doctorandus* title. Doctorandus is Latin for 'he who has to become a doctor', i.e. he who still has to obtain his PhD degree. The process of obtaining this degree is called *promoveren* and those involved in it are *promovendi*, i.e. 'those who have to move forward'. Since I had enjoyed some education in Latin, I could obviously not ignore the fact that all I had become after five years in university was someone who should aspire to become still somebody else. Thus, I applied for a PhD position at the University of Groningen. Now, three years later, I move forward to defend this thesis, which is evidence of the studies I have made in the past three years.

This book would not have existed, however, without the assistance of some mentors, whose help I wish to acknowledge in this preface. First, my two supervisors, Hans van Ees and Arjen van Witteloostuijn, contributed to this thesis in many ways. They signaled my ambition and sensed some abilities, helped me in framing problems and finding solutions, and provided me with expert advice throughout the years. Often, their comments on drafts made me fear that the fruits of my efforts had just imploded, but then they directed my attention to a small contribution that was hidden somewhere in the paper, and had 'only' to be elicited. Second, I am grateful to the professors Igor Filatotchev, Niels Hermes, and Morten Huse, for agreeing to be on my reading committee. Reading through the whole piece must certainly have been time-consuming, and I thank you for investing your time and effort. I am grateful to you, both for your enthusiastic evaluations, and for the questions I received.

Third, in addition to the names mentioned above, I am grateful to many colleagues, not only for a pleasant atmosphere in the office, but also for their suggestions when I was struggling with statistics or looking for that one key reference. In particular, the members of the corporate governance insight centre at the university of Groningen – Dirk Akkermans, Reggy Hooghiemstra, and Theo Postma – not only made chapters 4 and 5 possible because of joint data collection, but also discussed the ideas developed in the chapters. Chapter 5 also benefits from the help of Eric Engesaeth and Camiel Selker from the Amsterdam office of Towers-Perrin, who participated in the research project that underlies the data collection. Their in depth knowledge of the Dutch executive compensation practices greatly enhanced my understanding of the topic. I also benefited from Gijsbert Willenborg's knowledge of LISREL, as he ran the first analyses for chapter 2, which I later corroborated. Padma Rao Sahib's knowledge of statistics has guided me in making econometric choices. Finally, as part of my PhD training, I spent a month at the Norwegian School of Management BI in Oslo, and was warmly welcomed by Cathrine Hansen and Pingying Zhang.

Finally, my friends and family contributed to the delivery of this thesis, through ways of which they themselves may not be much aware. By raising me to do something well once you have decided to do it in the first place, by diverting me away from the office – and thus allowing me a fresh look when I returned –, and by putting my mind at ease in the evenings and weekends, I was almost always in a good mood when I returned to my desk, regardless of how I had left it. My parents and Marjolein deserve to be mentioned here in particular. Marjolein frequently asked me to study women directors, a group which is underrepresented in the Dutch corporate elite. I have not (yet) been able to do so, but the reader may thank her for the fact that in this thesis, all chief executive officers are referred to as 'she'.

Nieuwegein, October 2008.

1.   Introduction

In 1602, the frontrunner of the modern enterprise was established with the incorporation of the Dutch East India Company, VOC (example taken from Frentrop, 2002: 55-111). Earlier, the journeys of Dutch vessels exploring trade opportunities had been financed through debt-like arrangements where investors recollected their contribution plus an interest payment. The VOC, however, was financed through contributions that would be reinvested rather than being returned to the investors when the ships reached their home base. Instead, a dividend was paid when VOC profits were substantial enough. The securities through which the East India Company was financed can, therefore, be considered the first equity stakes in a public company. Although managers of the VOC were required to hold some shares, most were held by outside investors. Berle and Means (1932) would, some 330 years later, characterize this situation as a modern corporation with a separation of ownership and control. Another forty years thereafter, the problems associated with such a separation would be formalized by Jensen and Meckling (1976), since then known as the principal-agent problem.

The shareholders of the East India Company were not in need of the elegant math with which Jensen and Meckling (1976) derived the potentially detrimental effects of the separation of investors from managers on their return. They would themselves experience these problems. The managers of the VOC, each of whom ran a trading company of his own, realized that their private benefits were greatly enhanced when the spices, imported from what now is the Republic of Indonesia, were sold to their own trading company below the market price, instead of being offered on the market by the VOC. Obviously, the effects of this transfer pricing policy on VOC profits were noticeable, and dividends could soon not be distributed anymore. Some shareholders did revolt against this practice, but their efforts were without effect as the managers of the VOC also had important positions in local government offices. Effectively, state intervention was thus minimal as the governors preferred to remain on good terms with VOC management rather than with the revolting shareholders. Finally, when there was insufficient capital to finance another trading company, the West India Company, the national government intervened in VOC governance. Some years later, a steady flow of dividends appeased shareholders (Frentrop, 2002).

The VOC case excellently shows that corporate governance problems are not restricted to recent headline-hitting scandals, such as those surrounding Enron, Tyco, or the Dutch food retailer Ahold. Corporate governance refers to "the system by which companies are controlled and directed" (Charkham, 1994: 1). It is straightforward to phrase the East India Company problems in terms of modern-day corporate governance vocabulary. On the

one hand, managerial *agents* did not have the appropriate *incentives* to maximize *total shareholder return* as they held only a fraction of company stock. On the other hand, they did perceive the full benefits of their *consumption of perquisites*, and were thus tempted to sell company products to their own trading companies below the market price. *Minority shareholders* did not have the *voting power* to affect company practice. Moreover, as the agents held *interlocking directorates* with governmental bodies, these were potentially co-opted and courts would not rule in the benefit of the shareholders. Finally, however, *shareholder activism* did result in a continuous stream of dividends, appeasing investors' demands, as other firms sought funding in the capital market as well.

While the governance problems associated with large corporations may not have changed fundamentally in the past centuries, the academic debate has experienced a significant development over the past few decades. In the next section, I discuss an economic perspective on corporate governance. Subsequently, I discuss a behavioral perspective, which is central to the chapters developed in this book. Finally, I outline the organization of the book, and locate the chapters in the behavioral perspective.

1.1   An economic perspective on corporate governance

With technology improvements and mass production, the minimum efficient scale of operations increased during the 19th and 20th centuries. Consequently, entrepreneurs were increasingly unable to finance the assets out of their own pockets, and ownership of corporations became separated from control over the assets. Corporations are managed by individuals who have superior knowledge to efficiently succeed in the marketplace, yet these managers lack the resources to finance the operations. Investors have sufficient resources yet they lack the skills or motives to do business. With the transfer of resources from investors to managers also comes the problem of how to safeguard the interests of the investor. What guarantees that the manager (agent) would use the investors' (principal) resources to the purpose that has been stipulated in the articles of incorporation? This problem is known in economics as the principal-agent problem. Agency theory was developed mainly in the 1970s and 1980s (Eisenhardt, 1989; Fama and Jensen, 1983; Jensen and Meckling, 1976). Corporate governance, in this tradition, is defined as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997: 737).

The core concern in the economic perspective on corporate governance is to find feasible solutions for the agency problem. As firms are conceived of as a nexus of contracts, these solutions are sought after in the manager's employment contract. In an ideal world, with

perfect knowledge and costless enforcement of contracts, the contract would stipulate exactly how the manager would act in each contingency. There are several problems associated with this ideal world. First, if investors would know (beforehand) how to act in each contingency, there would be no need for an agent to manage the corporation. In practice, however, asymmetric information affects both the extent to which contracts can be prescriptive as to the agent's behavior and the extent to which the investor is able to control whether the articles of the contract have been lived after. Second, enforcement is costly, and agents would thus have some leeway in implementing the agreement after it has been signed, a phenomenon known as moral hazard (Milgrom and Roberts, 1992). If moral hazard is substantial, investors may factor in the expected disobedience and decide not to hire an agent in the first place, implying that economic rents would not be realized. In a second-best world, investors provide the agent with incentives to act in line with the shareholder's demands. These incentives are, for example, contained in a compensation contract, which stipulates that the highest pay level is associated with high firm performance. Also, boards of directors monitor managerial behavior, and outside markets, such as the market for corporate control, may restrict the extent to which managers engage in opportunistic activities. Board monitoring in this perspective thus solves for the collective action problem that minority investors in widely held firms face.

The economic approach to corporate governance lends itself well to the analysis of contract designs and bargaining games. The literature has resulted in several strong policy prescriptions that have increasingly been implemented in hard and soft laws. Economists suggest that boards of directors be installed which monitor management on the shareholders' behalf (Fama and Jensen, 1983). Moreover, such directors should be independent from the management of the company for them not to perceive a disutility of making tough decisions (Dalton, Hitt, Certo and Dalton, 2008). Furthermore, executive compensation would better be tied to company performance through long-term incentive plans (Hall and Liebman, 1998; Jensen and Murphy, 1990). Unfortunately, decades of empirical studies do not corroborate these findings as meta-analyses of board composition, independence, size, leaderships structure, and equity compensation, on the one hand, and firm performance, on the other hand, do not demonstrate robust causal relationships (e.g., Dalton, Daily, Ellstrand and Johnson, 1998; Dalton, Daily, Johnson and Ellstrand, 1999; Dalton et al., 2008; Hermalin and Weisbach, 2003; Tosi, Werner, Katz and Gomez-Mejia, 2000).

As a consequence, some scholars have called for approaches to corporate governance that relax some of the assumptions common to the economic perspective. Table 1.1 presents a classification of perspectives on corporate governance, which is taken from Hambrick, Von Werder and Zajac (2008). The table combines two dimensions in a 2x3 matrix. The first dimension entails whether the perspective takes relationships inside the corporation

(organization inward) as its key focus, or whether these relationships are with outside constituents (organization outward). The second dimension deals with the topic under study: formal structure, behavioral (informal) structure, or behavioral processes. Cross-tabulating these dimensions yields a classification which is instructive, yet does not suggest that, for example, legal scholars exclusively look at external corporate governance structures

TABLE 1.1

Classification of Perspectives on Corporate Governance

	Formal structure	Behavioral structure	Behavioral processes
Organization inward Organization outward	Economics Legal/Economics	Power Social Networks	Social psychology Symbolic Management

Loosely based on Hambrick et al. (2008).

According to Table 1.1, the economic perspective is well-suited for the focus on structural aspects of internal corporate governance relations. Economic modeling is able to derive empirical predictions regarding the optimal design of the contract between the manager and the investor. Economists have also studied legislation and codes, for example in the area of corporation law or stock exchange listing requirements. It is argued, however, that for the study of informal structures and behavioral processes inside and outside the boardroom, other approaches are better equipped (Van Ees, Gabrielsson and Huse, 2005; Zajac and Westphal, 1998). In the next section, I sketch some key concepts in a behavioral perspective on corporate governance. It is postulated that this perspective may add to our understanding of governance problems and their solution.

1.2   A behavioral perspective on corporate governance

A large literature developed in the 1990s enriching each of the cells in Table 1.1 with insights from behavioral theories. These theories have their roots in psychology, and sociology, and are brought to the corporate governance field through the behavioral theory of the firm (Cyert and March, 1963), resource dependence theory (Pfeffer and Salancik, 1978), the resource-based view (Barney, 1991) and others. It is beyond the scope of this introduction

to review this literature.[1] Several differences with the economic perspective are noteworthy, though.

Firstly, and foremost, behavioral studies do not focus as much on contracts. Instead, an input-throughput-output model is implicit in most studies. These studies target informal structures and behavioral processes (Table 1.1). The focus lies on antecedents and consequences of decisions made by chief executive officers (CEOs), non-executive directors, and other key constituents of the firm (Huse, 2007). The problems under study depend on the actors who are deemed salient, and the behavioral approach thus fits a stakeholder model (Freeman, 1984) better than a shareholder supremacy model. Actors' personalities, knowledge, positions and the like impact on their decisions (Forbes and Milliken, 1999). As decisions at the top of firms tend to be taken by teams, interactions inside these teams are relevant. Finally, decisions have effects on corporate outcomes, and are interpreted by individuals (Huse, 2007). In the economic perspective, the rationality assumption implies that when the formal structures are adequate, outcomes will follow automatically, and thus there is no need for studying informal structures and behavioral processes when trying to gain insight in board effectiveness.

Secondly, due to the multitude of mediating and moderating effects, and the endogenous nature of the relationships under study, there tends to be less of an emphasis on mathematical modeling than is the case under the economic perspective. Instead, theoretical models are developed, where the key skill of the researcher is to formulate a model which includes all relevant concepts, while keeping a keen eye on the complexity of the framework. Finally, the purpose of the corporate governance system is not necessarily to safeguard the interests of the shareholders alone. Rather, the support of other internal and external contingencies is considered vital for the prosperity of the firm.

A behavioral perspective on corporate governance acknowledges that micro-social forces, derived from social psychology, and macro-social forces, derived from sociology, affect board outcomes (Zajac and Westpahl, 1998; see also Daily, Dalton and Cannella, 2003). Micro-social forces refer to interpersonal influencing tactics, which are not present in economic modelling as rational self-serving behavior implies the absence of relationships. If a relationship between the CEO and the board would exist, concerns over the preservation of this relationship would cause deviations from rationally derived solutions. For example, whereas economic principles prescribe that the best candidate is selected to fill a board position, it has been shown that individuals prefer to nominate demographically similar

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[1] As there are 6,700 academic papers on corporate governance included in the EBSCO database (as of June 2008), it is virtually impossible to give a review of the literature pertaining to even one cell of Figure 1.1.

candidates (Westphal and Zajac, 1996), and that flattery and ingratiation among directors affect the probability that future positions will be secured (Westphal and Stern, 2007). These forces may cause deviations from contracting solutions, but these are not necessarily inefficient. After all, the partial contracting solution is (also) costly, and it may be that keeping individuals in line through social tactics is superior in terms of a cost-benefit trade-off as to solving the principal-agent problem than a contracting solution (Zajac and Westphal, 1998). A behavioral perspective on corporate governance from the micro-social point of view thus calls for the inclusion of social psychological insights and power relations (see Table 1.1). Next to formal structures, board performance is affected by informal structures (power relations) and behavioral processes.

Macro-social forces may also influence board performance. A behavioral perspective acknowledges that not only is the firm embedded in and interdependent with other organizations (Pfeffer and Salancik), but also that directors, CEOs and other top individuals are part of a social elite. When the assumption of self-interest maximization is dropped, and replaced with, for example, satisficing behavior, the optimal outcome is no longer defined. Outcomes are the result of a bargaining process among interested parties, and change only occurs when problems are deemed salient (Cyert and March, 1963; Van Ees et al., 2005). Consequently, norms as to what outcomes are desirable are no longer objectively derived, and members of the corporate elite may compare their own outcomes to those of other members they deem socially comparable to themselves. It has indeed been shown that such social comparison takes place in the area of director compensation (O'Reilly, Main and Crystal, 1988). Thus, norms that operate within the context of social elites may function as devices of normative pressure on decision-makers (DiMaggio and Powell, 1983). The study of the managerial elites has frequently taken place through interlock research, where individuals who hold multiple positions within an elitist community (for example, CEO of one company and outside director of another) spread practices throughout the network (e.g., Pennings, 1980).

Applying this behavioral perspective to corporate governance has important implications, of which a few are mentioned here. First, as organizational change is only expected in cases of obvious problems, it is expected that no benefits are derived from costly investments in strategies that will raise outcomes even further above the aspiration level. This relates to perceptional framing, a notion that has been implemented in prospect decision theory (Kahneman and Tversky, 1979). According to this theory, which will be used in one of the thesis' chapters, the status quo affects firm strategic decisions. Thus, although a corporate governance practice may be considered best by some stakeholders, its implementation does not necessarily have a positive affect on firm outcomes, if the status quo is not considered problematic by other stakeholders.

Second, as bargaining takes place among relevant actors, the decision of which stakeholder will be included in a research endeavor becomes salient. In this thesis, the core focus is on relationships among managers, shareholders, and outside directors. For the purpose of one of the chapters, other stakeholders are also – and jointly – considered. I do not, however, focus on suppliers of intermediate products, and creditors to the firm. Depending on the selection of stakeholders, topics may be considered problematic or not. The main message of a behavioral perspective on corporate governance is, however, that next to formal decision making structures, informal structures and behavioral processes are to be considered in order to gain insights into what boards actually do.

1.3   Organization of the book

The four subsequent chapters are academic papers in the tradition of the behavioral perspective on corporate governance. The chapters all focus on different research problems, and concern relationships between different stakeholders in the organization. Common to the chapters is that they all are empirical in nature, and that they focus on relationships at the top of corporations. Figure 1.1 presents an overview of the relevant actors included in the chapters, and their possible interrelations. The figure holds that the interactions among executives – including the CEO –, non-executive directors, shareholders and other stakeholders jointly determine firm-level outcomes.

Chapter 2 analyzes the relationship between the CEO and the board chairperson (line 3 in Figure 1.1). According to Zahra and Pearce (1989), this relationship serves two purposes. First, directors owe it to the shareholders to monitor managers' behavior, and to check whether this is in line with the investors' expectations. Second, directors are expected to provide expert advice on strategic matters to the executives. The main argument in this chapter relates to the assumption in (economic) agency theory that independence is the key to board monitoring. Our[2] argument criticizes the fundamental assumption of the arms-length bargain as the most appropriate description of the interaction between the board and the management. Here, every single board decision is conceptualized as a discrete event, and therefore dependence will not occur. We argue, on the contrary, that this description is not accurate as a conceptualization of interactions inside the boardroom. Rather, it is suggested that boards engage in a social contract (Huse, 1993; MacNeil, 1980), in which norms relating to the preservation of the relationship are present. These norms facilitate the development of trust, and this is, among other effects, good for information exchange. Thus, we argue that

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[2] As the underlying papers are joint work, with the exception of Chapter 5, I use the 'we' form throughout the chapters to acknowledge the contribution of the co-authors.

there may actually be a positive relationship between proximity and board monitoring performance. While proximate boards are suggested to be less independent from management than distant boards, they have superior access to information which can subsequently be applied to the job. These arguments are tested, using Huse's 2003 survey data for Norwegian boards in both stock-listed and private firms.

FIGURE 1.1
Relevant actors
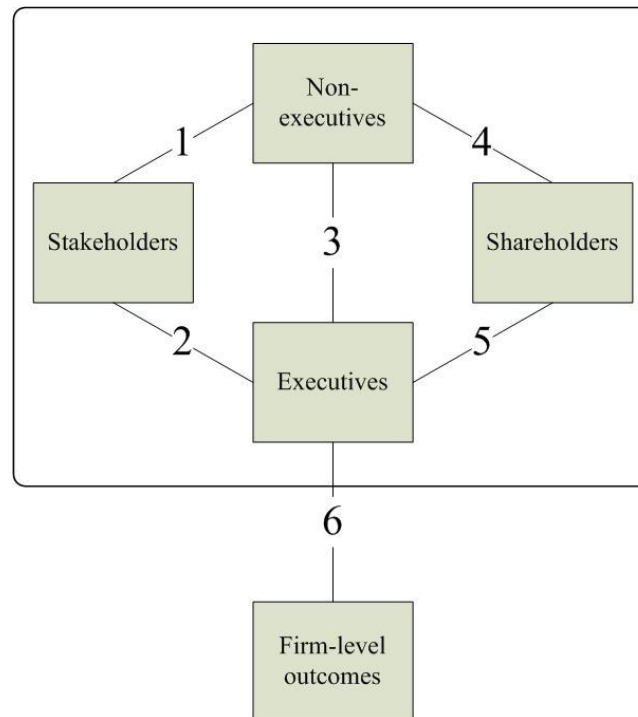
Chapter 3 concerns perceptional framing and stakeholder exchanges with the corporation, and is particularly focused on line 2 in Figure 1.1. The argument combines prospect decision theory (Kahneman and Tversky, 1979) and the corporate social performance-financial performance literature (Margolis and Walsh, 2003). The argument, in line with a behavioral perspective on the governance of these relationships, is that managers are more likely to respond to negative reputations for their involvement in social relations than to positive reputations. When the aspiration level has been reached, corporate social performance (CSP) is simply not seen as a problem anymore, and managers will not search for additional improvements. The second line of argumentation builds directly on stakeholder theory's distinction between primary and secondary stakeholders (Clarkson, 1995). Secondary stakeholders are those who are affected by the firm, whereas primary stakeholders also have an effect on the firm. It has commonly been argued that primary stakeholders are more important to the firm, and therefore that the firm would be more responsive to their needs

(Hillman and Keim, 2001). Notwithstanding this argument, we suggest that a reputation for social performance is more relevant for secondary stakeholders. Primary stakeholders, after all, have frequent exchanges with the company, by definition. From these exchanges, information is obtained, and thus a reputation for CSP provides little additional information as to how the company deals with them. For example, employees experience safety in the workplace themselves, and are not in need of an externally constructed reputation for employee relations in order to evaluate the company's involvement in their concerns. We test these arguments with Kinder, Lydenberg and Domini (KLD) social performance ratings for 1997-2002, including all Standard & Poors 500 firms.

Chapter 4 takes the decision whether or not to comply with soft law as its topic. The relationships under study are those between managers, on the one hand, and shareholders and non-executives, on the other hand (lines 3 and 5 in Figure 1.1). Corporate governance codes are a type of soft laws introduced by, usually, stock exchanges, governments or employer's associations. These codes contain many provisions as to how the rights and duties of executives and non-executives vis-à-vis each other and the investors are specified. Whether or not firms comply with these so-called best practice provisions, is conceived of, in this chapter, as a bargaining game. We introduce a classification of provisions, based on the extent to which managers will feel restricted in their discretion by implementing the provision. Subsequently, we argue that in the bargain over the implementation of these provisions, managers will contest the usefulness of doing so. Whether or not implementation is observed is then argued to depend on the extent to which other parties have power over the CEO. Specifically, we argue that powerful and independent boards of directors will be able to force CEOs to implement these practices. Also, when a firm takes a central position in a network of firms, we contend that peer pressure will also be a source of compliance. The argument is tested using a database with compliance information for the Dutch corporate governance code in 2004 (Akkermans et al., 2005).

Chapter 5 studies executive compensation, which has been a hotly debated issue in the corporate governance discussion for ages.[3] The chapter, in a way, is an extension of Chapter 2 and focuses on the relations among non-executives, shareholders, and the CEO (thus the lines 3 and 5 in Figure 1.1). The economic model of executive compensation contends that bargaining over the CEO compensation contract takes place at arms' length. Directors propose a contract to the CEO(-candidate), which is attractive enough for the CEO

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[3] Literally so, since the revolting VOC shareholders mentioned earlier in this introduction were upset over information disclosure, their inability to fire managers, and the remuneration of these managers (Frentrop, 2002). Thus, the topics that agitate shareholders these days, also agitated their ancestors four centuries ago.

just not to refuse it. An alternative hypothesis is based on the managerial power theory (Bebchuk and Fried, 2004), in which it is argued that CEOs have substantial power over their boards. Thus, bargaining over the compensation contract does not take place at arms' length. Consequently, the CEO is able to affect the design, level, and performance sensitivity of the compensation. We test the hypothesis that power is related to compensation with an extensive dataset for The Netherlands for 2002-2006 (Van Ees, Van der Laan, Engesaeth and Selker, 2007).

TABLE 1.2

Thesis Chapters and the Classification in Table 1.1

	Formal structure	Behavioral structure	Behavioral processes
Organization inward	–	Chapter 5	Chapter 2
Organization outward	Chapter 4	Chapter 4	Chapter 3

Referring back to the classification presented in Table 1.1, it is clear that the various chapters cover many cells in this table, as is apparent from Table 1.2. The study contains no real assessment of internal formal governance structures, although one may conceive of Chapter 5 (about incentive contracts) as one. It is not placed in this cell, however, as the focus is on power struggles between the directors and the CEO, and is thus better seen through the lens of informal structures inside the corporation. Chapter 2 also involves an inward perspective on the company, since it deals with norms and trust inside the boardroom. Chapter 4 is placed in two cells. Mainly, it concerns the informal structures that regulate the adoption of provisions contained in corporate governance codes. As these micro-level decisions also have bearing on the macro-level compliance figures with national corporate governance codes, contained in soft law, the chapter is also mentioned in the formal structure column. Finally, Chapter 3 focuses on the interactions among the firm's managers and the outside stakeholders, and therefore falls in the category of behavioral processes targeted at external relations. Obviously, this classification is not as distinctive as it may seem, since Chapter 3 also includes internal stakeholders (notably, the employees), and since depending on whether one reckons shareholders and directors as internal or external actors, the chapters in the behavioral structure column may switch places.

It is, finally, worth mentioning that two relationships have not been dealt with in this PhD thesis, namely relations 1 (stakeholders and non-executive directors) and 4 (shareholders and non-executive directors) in Figure 1.1. It is striking that in spite of the large literature discussing the principal-agent problem, there is hardly any discussion of the motives of outside directors to satisfy the shareholders' mandate to control managers. There is a large literature on how formal structures affect firm performance, focusing on the number of non-

executive directors, for example, but this literature is largely inconclusive (Hermalin and Weisbach, 2003). Also, and particularly since there are some indications that outside directors are more tuned into social responsibility issues than managers (Ibrahim, Howard and Angelidis, 2003), there is a lack of understanding as to what role outside directors may play in the corporate social responsibility strategy of a firm.

2. Qualifying Agency Theory's Discrete Interactions Assumption: A Reassessment of Calls for Independent Boards of Directors[4]

It is almost an understatement to conclude that the literature on boards and corporate governance has abundantly addressed the boards' ability to control top managers and to protect the interests of shareholders. To illustrate the issue at hand, in their review of 127 empirical papers in prestigious academic journals, Gabrielsson and Huse (2004) find that 54 per cent apply agency-theoretical arguments addressing these topics. Also in business practice, the focus has been on the conflict of interests between managers and shareholders (Ghoshal, 2005). In line with agency theory, not very surprisingly, calls for independent boards abound. The business world includes many examples of boards that have been called upon to appoint unaffiliated members, from various functional backgrounds, having different personalities, and without shared interests with (the management of) the firm. This chapter focuses on relationship 3 in Figure 1.1, the one between executive and non-executive directors.

The underlying assumption in agency theory is that close ties between non-executives and managers impair the possibility of the board to ask critical questions or make tough decisions (e.g., Baysinger and Butler, 1985). In line with these calls, one would have expected that independent boards contribute unambiguously to corporate performance and value creation, either by means of the improved efficiency of corporate decision-making, or at least in terms of the investor appreciation of the value of the firm in the equity market. However, meta analyses do not find a significant association between corporate performance and a variety of indicators of board independence, such as CEO non-duality and outsider dominated boards (Dalton, Daily, Ellstrand and Johnson, 1998; Dalton, Daily, Johnson and Ellstrand, 1999). So far, conclusive evidence that independence contributes to the performance of the board or the firm does not exist (Hermalin and Weisbach, 2003).

One possible explanation for this ambiguity may be that agency theory only addresses a particular part of the behavior of the board. Indeed, it is considered appropriate to understand the virtues of the monitoring tasks of the board, but boards do generally fulfill other tasks as well (Zahra and Pearce, 1989). To analyze these resource, service and strategy

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[4] This chapter draws heavily on a manuscript with the same title, co-authored with Gijsbert Willenborg, Hans van Ees, and Morten Huse. The paper has been presented at the Academy of Management Annual Meeting (Philadelphia, 2007), and the European Academy of Management Meeting (Paris, 2007). It appeared in the EURAM corporate governance track best paper proceedings in 2007.

tasks, alternative theoretical perspectives such as stewardship theory (Davis, Schoorman and Donaldson, 1997) and resource dependence theory (Pfeffer and Salancik, 1978) are perhaps better equipped. Recently, efforts have also been made to embrace these other board tasks, for example through the lens of resource dependence theory (Hillman and Dalziel, 2003). In addition, it has been observed that it may be difficult for a director to separate monitoring from resource-provision activities. Therefore, we concur with Roberts, McNulty and Stiles (2005) that a more comprehensive picture of board behavior is needed.

The purpose of this chapter is, however, not merely to point at the complex and multiple tasks of the board of directors, but to question the suitability of agency theory as the appropriate framework to understand the monitoring tasks as such. Our argument criticizes the fundamental assumption in agency theory of the arms' length bargain as the most appropriate description of the interaction between board and management. Here, every single board decision is conceptualized as a discrete event. This ideal-typical representation of decision-making in the boardroom does not accurately reflect actual board behavior. By contrast, board members, executives and non-executives alike, are more likely to engage in a social contract (Huse, 1993). Both actors value the cooperation as such, engage in trusting behavior, and put effort into the preservation of the boardroom relationship and agreement on shared values, norms and working procedures. Following agency theory, such a similarity in values and norms could only harm board monitoring. Contrary to what agency theory predicts, we hypothesize and observe that proximity and trust-building do not only positively affect the advisory tasks, but also the monitoring tasks of the board. We thus build on Westphal's (1999) finding that the collaborative board model fosters board service tasks performance, yet we also apply this model to the monitoring activities. The bottom line of our argument is that a cooperative work attitude stimulates mutual information exchange and commitment to all board tasks. Consequently, the board's commitment to the monitoring activities is increased as well, which will have a positive impact on the monitoring task performance as such.

The core of this argument rests upon a distinction between two alternative types of trust (Gillespie, 2003): reliance and disclosure trust. These two trust types permit us to disentangle two consequences of trust. Reliance trust, on the one hand, entails the situations where a board trusts management to do what is good for the company. With reliance trust present, the perceived need to monitor is lower and boards are likely to be less involved. It is this type of trust that is referred to when agency theorists mention the downside of dependence. Disclosure trust, on the other hand, involves directors in decision-making because this type of trust concerns the willingness to share sensitive information or knowledge, and the willingness to loose face in discussions. A key advantage of using this trust construct is its measurement of trusting behavior, instead of trustworthiness. We

formulate hypotheses on both trust types, and how these are related to board task performance. This focus on behaviors instead of intentions to trust matches our aim to focus on what boards actually do, which is in line with a behavioral perspective on corporate governance.

In brief, this chapter offers two contributions to the literature on boards and corporate governance. First, we illustrate that interdependence and proximity between directors and managers may contribute to effective board behavior, in particular board monitoring, building upon the theory of contractual relations (Macaulay, 1963; MacNeil, 1980). Specifically, we show that proximity breads trust, and that a trusting board engages more in both monitoring and advising. Second, we incorporate a multidimensional conceptualization of trust in the literature on boards and corporate governance. These concepts allow for both productive (i.e. disclosure) and unproductive (i.e. reliance trust) trusting behaviors caused by proximity.

In the next section, we develop our hypotheses. We first discuss the agency view on distance, and present a qualification. Subsequently, we build our hypotheses concerning trust and board task performance. Section 2.2 presents the data and methodology. The results of our estimations are contained in Section 2.3. We test our hypotheses on a unique dataset comprising 378 Norwegian companies. The results of simultaneous equation modeling efforts provide support for the core of our argument. A final section concludes and discusses the most important findings of this chapter.

2.1   Theory development

In the literature on corporate governance, board output is described in terms of two generic sets of tasks: the monitoring or control tasks and the resource, service and strategy tasks (Zahra and Pearce, 1989). The monitoring tasks of the board rest in agency theory, reflecting internal control mechanisms that safeguard the interests of shareholders. Board decision-making relates to corporate decision-making *ex post*, with a clear separation of management and board duties. From an agency theory perspective, the arms' length relationship between board and management creates independence, which facilitates corrective action and effective control by the board. However, proximity and close involvement create information advantages that can also improve board control (Adams and Ferreira, 2007). This is what may be called the independence paradox (Boot and Macey, 1999; Hooghiemstra and Van Manen, 2004). The effective balance between proximity and objectivity will have to be continuously redefined in the context of the working relationships between the management and the board or between board executives and non-executives.

The service and strategy tasks of the board concern the board's provision of essential resources in strategic decision-making, such as offering advice, legitimacy and counsel as well as links to other organizations (Tricker, 1994). The effectiveness of the board's strategy and service tasks will be enhanced if board members are more closely involved in the strategy formation process (McNulty and Pettigrew, 1999). Directors may establish strategic links to the external environment and secure critical resources, including prestige and legitimacy. Following upon this distinction between two sets of board tasks, we discern two generic types of board activities: monitoring and advising activities.

2.1.1 Agency theory

Principal-agent theory developed in the 1970s as a response to the key governance problems inherent to the public corporation. These problems originate from three sources, at least: first and foremost, the separation of ownership and control; second, the perspective that self-serving managers maximize private benefits without considering other interests; and third, the incentive of minority shareholders to free-ride on the monitoring activities of other shareholders (Jensen and Meckling, 1976). Consequently, the public corporation is not able to survive without knowledgeable managers and dispersed ownership, whereas these managers will not necessarily act in the interest of the firm, and the minority shareholders will not find it in their best interest to closely monitor the activities of their top managers. To cut through this dilemma, several internal governance mechanisms have been developed. Management compensation structures are designed to align the interests of the managers and shareholders *ex ante*, and shareholders are better off delegating their monitoring efforts to an independent board of directors that ratifies management decisions and monitors implementation *ex post* (Fama and Jensen, 1983).

The principal-agent perspective on the distribution of tasks at the strategic apex of the corporation naturally leads to a dominant monitoring task for directors in the interest of the principals – i.e., the shareholders. As a first line of criticism, it can be observed that this exclusive focus on the board's monitoring tasks is at odds with both corporate law and corporate practice. Blair and Stout (1999) analyze US corporate law and argue that although it may be most efficient to have directors elected by shareholders, their fundamental responsibility is with the corporation itself. Hence, the principal-agent representation of the corporation is at odds with the legal description of the corporation as an independent entity. Similarly, the shareholders cannot be formally taken as principals. On the contrary, the board of directors itself is better conceived of as representing the top of the corporate hierarchy, and the board's fundamental role is to mediate between all corporate stakeholders in situations

where stakeholder interests do not necessarily coincide (Kostant, 1999). This is also in line with corporate practice, as Lorsch and MacIver (1989) find that directors who feel that shareholders' concerns are their first and foremost responsibility are a true minority. A broader view of director responsibilities is likely to lead to inclusion of strategic tasks as well. Therefore, a study of what boards actually do, and how independence affects these tasks, calls for a broader conceptualization of board tasks.

A second line of criticism addresses two fundamental assumptions of the principal-agent model. Firstly, interactions between board members and management are essentially seen as discrete events in agency theory. Consequently, decision-making in discrete settings is most efficient in case all actors act as if they meet for the first time. In particular, the disutility of monitoring perceived by board members should be minimal and in no way be affected by the interests of the managers. Hence, independent boards are required to optimize the quality of board decision-making.

Obviously, this decision-making structure is only implicit and the emphasis of the principal-agent perspective is not on the process of decision-making itself, but on the (efficiency of the) decision of the board as such. Nevertheless, in case the interaction in the boardroom is conceived of as part of a long-standing relationship, the costs of organizing decision-making are lower if bargaining is based on informal trust instead of formal contracting (Griesinger, 1990; Huse, 1993). The costs of contracting, as opposed to the costs of trusting, have been wrongly ignored in theorizing efforts on the benefits of independence.

Secondly, human nature in agency theory is at odds with real-world observations. Human beings are assumed to be fully rational, capable and self-interested agents. Although corporate governance scandals have shown that self-interest exists, as a description of human behavior the definition misses its empirical counterpart (Etzioni, 1988; Griesinger, 1990). In his critique on why people strive for non-material goals, Etzioni (1988: 90) writes: "people often make non- or sub-rational choices, first because they build on their normative-affective foundations, and only secondly because they have weak and limited intellectual capabilities." Consequently, the assumption that all deviations from goals are due to misappropriation requires qualification (Hendry, 2005). This also implies that boards can be called upon to provide their expert advice to management.

Our starting point is that the assumption of the arms' length bargain underlying the classical principal-agent model, as the fundamental conceptualization of the board-management exchange relationship, does not capture the social dynamics inside the boardroom. In addition, dispersed corporate ownership cannot be regarded as a sufficient condition for the conclusion that the interactions between the board and managers are best conceived of as discrete events between anonymous actors. At best, the emphasis on board independence as a precondition of optimal control can be regarded as only one element of a

more comprehensive picture of social interaction. Indeed, "the challenge for directors is to build and maintain trust in their relationships with executives, but also to maintain some distance so that effective monitoring can be achieved" (Daily, Dalton and Cannella, 2003: 376). Therefore, following Forbes and Milliken (1999), we consider boards as special working groups, of executives and non-executives, characterized by a cognitive output, complex decision-making, and restrictive communication and operating procedures. The individual expertise and knowledge as well as the relational capital of board members serve as inputs for the decisions of the board.

2.1.2   Relaxing the discrete interactions assumption

Our main qualification of agency theory lies in abandoning its assumption of discrete interactions. The typical principal-agent model depicts the contract and related exchanges between the shareholders, or the board, and the manager as concluded in a relational vacuum. The contextual absence of relationships in the principal-agent model arises because the foundation for the theory lies in the exchange problem between managers and a large number of anonymous shareholders. The fact that a board consists only of a small number of individuals to represent the anonymous mass of shareholders is assumed not to affect the nature of the exchange. In such a discrete and impersonalized context, MacNeil (1980) argues that the interaction between the two parties is built on norms primarily related to implementation of planning and effectuation of consent – i.e., contract-related activities concentrate on the effectuation and enforcement of what was formally agreed upon. Hence, the emphasis in principal-agent theory on monitoring and discretion is perfectly consistent with MacNeil's contract-based representation of discrete transactions.

However, interactions in the boardroom do not take place in a relational vacuum between anonymous individuals. Therefore, the exchanges between the non-executives and executives are better captured by what MacNeil depicts as relational exchange. In such a context, the relational contract between board and management will be built on relational norms, such as role integrity, preservation of the relation and harmonization of relational conflict (MacNeil, 1980). Consequently, when analyzing the activities of the board, including the monitoring tasks, the assumption of discrete interaction is flawed and the context of the boardroom is better captured by taking a relational lens. Thus, directors' personalities and relationships as well as company characteristics shape the decision-making inside the boardroom (Forbes and Milliken, 1999). These board processes, or board working style, determine board task performance (Zona and Zattoni, 2007). The decisions of the board (i.e., board output) are part of the strategic decision-making of the company, which – ultimately –

affects corporate performance. The two sets of board tasks among which we distinguished before – monitoring and advising – call for a board that is both dependent upon and interdependent with management, because of the independence paradox (Boot and Macey, 1999; Hooghiemstra and Van Manen, 2004). Non-executive directors need information from management to perform their monitoring tasks. So, management partly controls the flow of information upon which the board decides the compensation of the CEO, but also the desirability of extending the CEO's contract. The realization that the decision of management to share information with the board can result in both positive and negative performance feedback (Adams and Ferreira, 2007), creates a necessary interdependence among the two parties. Effective boards are, therefore, able and willing to combine the knowledge and expertise of executives with the wider and more general knowledge and experience of non-executive directors.

In this chapter, we will denote this shared understanding of relational norms between the CEO and the board and, in particular, the board's chairperson proximity, as opposed to distance, is critical. (Huse, 1993; MacNeil, 1980). These concepts reflect perceptions of proximity rather than observable distance measures, which have commonly been used in the literature that seeks to establish a relationship between independence and performance. The above gives

> *Hypothesis 2.1a: Proximity between the CEO and the board chairperson is positively related to board effort*

The full conceptual model is depicted in Figure 2.1.

In our hypotheses, the relationship between the CEO and the board chairperson is emphasized, yet agency theory assumes that all interactions of directors and executives, regardless of their position, are discrete in nature. As a focus on the interactions of all board members would call upon the literature of intra-board and intra-management working relationships, substantial additional theorizing would be necessary. Moreover, this theorizing would not contribute substantially to the central argument, namely that social contract norms rather than discrete interactions govern the relationship between board members and executives. As, finally, the literature on intra-board relations, notwithstanding the intra-management process literature, is fairly underdeveloped (Hambrick, Von Werder and Zajac, 2008), we argue that a focus on a dyadic relationship keeps the arguments as simple as possible. The CEO – board chairperson nexus is the straightforward dyad to consider, as the CEO is generally the most powerful individual inside the firm (Finkelstein, 1992). Other executives are likely to feel subordinate obedience towards the CEO. In Norway, the country in which the empirical testing of this chapter takes place, the board chairperson is granted significant authority as "[m]atters to be considered by the board are prepared by the chief executive in collaboration with the [board] chairman, who chairs the meetings of the board. In

practice, the chairman carries a particular responsibility for ensuring that the work of the board is well organized and that it functions effectively" (Norwegian Corporate Governance Board, 2007: 35). Thus, the relationship between the CEO and the board chairperson is allegedly the key relationship to consider.

FIGURE 2.1

Theoretical Model
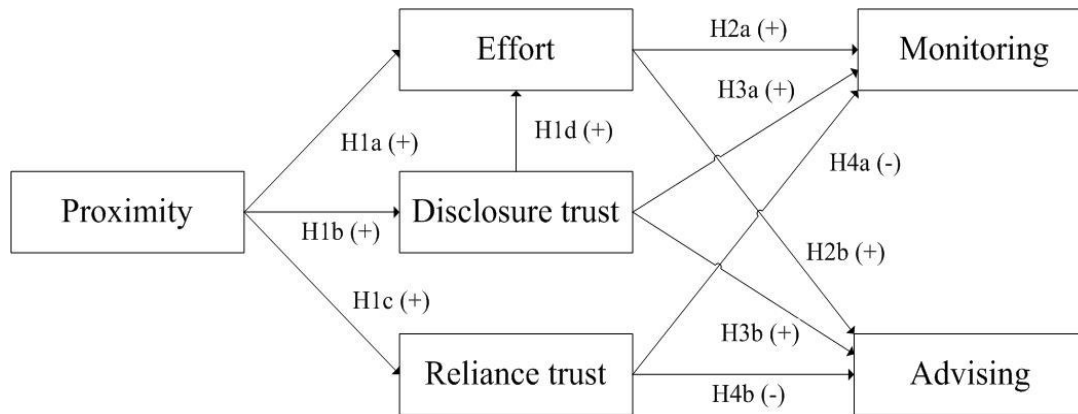
2.1.3 Effects of long-standing relations on trust and board performance

Due to incomplete information and complex decision-making, board-management relations are characterized by uncertainty and risk. Adopting Das and Teng's (2001) analysis of risk in strategic alliances to the decision-making context of boards, we argue that the relationship between the CEO and the board chairperson is characterized by performance risk and relational risk. Performance risk represents the variation in business outcomes, whereas relational risk refers to the probability that the cooperation is not satisfactory. The complexity of the task environment as well as information asymmetries are among the causes of both risk types. Since there is a difference between actual risk and the perception of risk (Das and Teng, 2001), and since people's risk-taking behavior depends on their perception of the riskiness of the various options (Mayer, Davis and Schoorman, 1995), mechanisms that mitigate the perception of risks induce risk-taking behavior.

Trust mitigates perceptions of risk (Das and Teng, 2001; Mayer et al., 1995; Van Ees, Van der Laan and Postma, 2008b). In a cross-disciplinary review of trust, Rousseau, Sitkin, Burt and Camerer (1998: 395) offer the following definition: "Trust is a psychological state comprising the intention to accept vulnerability based upon positive expectations of the

intentions or behavior of another." In a state of interdependence characterized by risk, a trusting relationship involves the expectation that the trustee will not select uncooperative options. This ruling out of uncooperative behavior increases the perceived likelihood of cooperative behavior, and thereby the trustor is more likely to engage in cooperative, risk-seeking behavior herself.

Despite the convergence on the definition of trust, various measurement scales have been used throughout the literature. As Gillespie (2003: 5) notes, "the large majority of empirical studies examining interpersonal trust in organizations measure perceptions of trustworthiness as a proxy for trust." Trustworthiness, however, has been shown to be a distinct concept, being an imperfect measure of the intention to accept vulnerability. Based on the work of Mayer et al. (1995) and Zand (1972), Gillespie developed and validated the so-called Behavioral Trust Inventory (BTI), which aims to measure behavioral intentions (see also Dietz and Den Hartog, 2006; Lewicki, Tomlinson and Gillespie, 2006). This conceptualization of trust is more in line with our aim, to proxy for actual board behavior, than scales of trustworthiness.

The BTI distinguishes between reliance and disclosure trust. The former refers to "relying on another's skills, knowledge, judgments or actions, including delegating and giving autonomy," whereas disclosure trust relates to "sharing work-related or personal information of a sensitive nature" (Gillespie, 2003: 10). Implicitly, when agency theorists mention trust, they refer to reliance trust: a trusting board relies on management to do a good job, therefore underperforming its monitoring tasks. We distinguish among both types of trust and thus allow for cooperative behavior as a result of trust alongside this negative effect. In the context of our study, distinctive concepts for trust types that make board members active (disclosure trust) and passive (reliance trust) parallel the distinction between dependent and independent boards, as independent boards are assumed – in agency theory – to deliver more value. This reinforces our choice for the behavioral trust inventory.

In Figure 2.1, we postulate two hypotheses on the antecedents of trust and three on the consequences. Various studies into the antecedents of trust have been conducted, leading to a plethora of possible causes. Butler (1991) derives ten factors from 84 interviews, ranging from discreteness and openness to receptivity and availability. Other researchers use three factors that supposedly lead to a willingness to be vulnerable: ability, benevolence, and integrity (Davis, Schoorman, Mayer and Tan, 2000; Mayer et al., 1995). Other causes have been identified as well (e.g., Gulati, 1995; Jones and George, 1998; Whitener, Bordt, Korsgaard and Werner, 1998). Several scholars have pointed out that proximity, particularly shared norms and values, is likely to be the most important driver of trust (Gillespie and Mann, 2004; Jones and George, 1998; Lewicki, McAllister and Bies, 1998). A norm is an expectation that another individual will act in a certain way. Acting in line with the value of

relationship preservation implies that trusting behavior is expected, for distrust will lead to a disruption of the relationship. Consequently, shared social norms may foster the development of trust (Casadesus-Masanell, 2004). Thus, we suggest

> *Hypothesis 2.1b: Proximity between the CEO and the board chairperson is positively related to disclosure trust*

> *Hypothesis 2.1c: Proximity between the CEO and the board chairperson is positively related to reliance trust*

We finalize our conceptual model by defining consequences of trust (see Figure 2.1). Disclosure trust is activating: board members are willing to share their private information with the CEO. Directors who exhibit disclosure trust, accept the risk that private information will become public and may affect their reputation. This risk is likely to make the director more involved in monitoring activities. Also, they are likely to seek application of knowledge in corporate strategy (Forbes and Milliken, 1999). The above suggests that proximity not only directly affects effort (Hypothesis 1a), but also generates a willingness to be active. This provides

> *Hypothesis 1d: Disclosure trust is positively related to board effort*

Further, in line with previous research (Olson, Parayitam and Bao, 2007; Van Ees, Van der Laan and Postma, 2008a), we hypothesize that disclosure trust, by activating non-executives, relates positively to both types of task performance. For monitoring tasks, the willingness to disclose alleviates the problem of information asymmetry. Moreover, for advising tasks, knowledge of outside directors is applied, which increases the quality of decision-making. So, we have

> *Hypothesis 2.3a: Disclosure trust is positively related to monitoring task performance*

> *Hypothesis 2.3b: Disclosure trust is positively related to advice task performance*

Due to the interdependence relationship mentioned above, board members also need to build upon the quality and expertise of management. Reliance trust is the board members' subjective expectation that management is able and competent, and will strive for good company performance. This reduces the perceived need to be actively engaged with the behavior of management. The CEO may thus feel less scrutinized, and is more likely to behave opportunistically. Also, the reliance on the knowledge of executives reduces the application of the more general knowledge of non-executives to corporate strategy and may negatively affect the quality of decision-making. Therefore, we suggest

> *Hypothesis 2.4a: Reliance trust is negatively related to monitoring task performance*

> *Hypothesis 2.4b: Reliance trust is negatively related to advice task performance*

For the sake of completeness, and in line with Forbes and Milliken (1999), Van Ees, Van der Laan and Postma (2008a), and Zona and Zattoni (2007), we include the following hypotheses, which are also intuitively appealing.

Hypothesis 2.2a: *Board effort is positively related to monitoring task performance*

Hypothesis 2.2b: *Board effort is positively related to advice task performance*

In brief, we thus argue that perceived proximity between the CEO and the chairperson's norms and values affects effort, both directly and indirectly. If actors are more similar on these aspects, they will find it easier to cooperate. Simultaneously, they will develop trust, which contributes further to the effort that is put into their relationship. Trust comes in two forms. Traditionally, directors have been assumed to become passive when trusting managers. The concept of reliance trust captures this downside of trusting relationships. Simultaneously, however, trust creates an environment in which directors are willing to share their information and engage in discussions. This positive effect of trust is captured in the concept of disclosure trust. Thus, when relaxing the assumption of discrete interactions inside the boardroom, a relational model (Figure 2.1) can be developed which relates proximity – as opposed to distance or independence – to monitoring (and advice) task performance, through activating trusting behavior.

2.2 Data and method

2.2.1 Data

To test the proposed model in Figure 2.1, a database of Norwegian companies in 2003 was used (Haalien and Huse, 2005). The Norwegian context is studied, first, because corporate governance codes did not have a profound impact here at the time of study, contrary to many other countries (Aguilera and Cuervo-Cazurra, 2004). Such codes may distort economic efficiency, as suggested by Hermalin and Weisbach (2006). Particularly, we are concerned that the emphasis of codes on monitoring activities may bias the hypothesized relationship between board effort and board task performance, because directors – facing time constraints – cannot optimally allocate their effort to the various tasks if regulations primarily require them to fulfill their monitoring duties. Thus, a country in which codification has not developed too extensively is to be preferred in a study of board relations. Second, the Norwegian corporate governance system is rather prosocial compared to, for example, the United States (Lubatkin, Lane, Collin and Very, 2005). This may impair the findings' external validity, but it also positively affects response rates, an issue which traditionally complicates the application of a survey methodology to the study of boards (Pettigrew, 1992).

The database comprises 488 CEO-respondents, who filled out the 'innovation survey'[5] of the Norwegian School of Management BI (Haalien and Huse, 2005: 15-17). Questionnaires were sent out to 762 large companies and a sample of 968 SMEs. The response rate for the large companies was higher (33 per cent) than the response rate for SMEs (25 per cent), partly because boards were sometimes non-existent in SMEs. Two reminders were sent out, the second of which was accompanied by a small questionnaire asking for the reason of non-response. 75 CEOs replied to this smaller survey, indicating predominantly that time constraints and a lack of incentives to fill out the 200-item questionnaire caused their non-response. Noting that similar studies have achieved much lower response rates, we further conclude that the reasons for non-response appear to be unrelated to the topic of the survey. After deletion of cases with missing observations, 378 respondents remained for testing the proposed model, an effective sample size well above the recommended size for structural equation modeling, generally considered to be about 200 (Boomsma, 1983; Hair, Black, Babin, Anderson and Tatham, 2006: 741).

The data represent a variety of individuals and organizations from various corporate environments. Firm size, measured by both operating income and equity, has a mean of NOK 1 billion (perating income) and NOK 111 million (equity), and the standard deviation of both measures is substantial (NOK100 is roughly equal to USD15). The organizations represent a variety of industries as well: finance and real estate make up 14 per cent of the data, service firms 28 per cent, industrial and production companies 32 per cent, and other industries 26 per cent. The richness of the data extends to other variables as well, notably firm age and the number of employees. In a general study of board behavior, such contextual diversity enhances the external validity of the findings. Based on the above, we conclude that our data is representative for Norwegian medium and large-sized corporations.

Board size varies from 1-3 members (23 per cent), to 4-6 (52 per cent), and 7-12 (25 per cent). Norwegian boards are therefore smaller, compared to their American counterparts. This may partly be due to a size effect: even the largest Norwegian company is relatively small from a US perspective. Almost all CEOs are male (97 per cent), relatively young (mean age 49) and hold roughly one quarter of company stock (including stockholdings by family members and other top managers and their families). More than half of the board chairpersons do not have shareholdings in the company (mean board chairperson shareholdings is 17 per cent of company stock).

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[5] The questionnaire is available at www.bi.no/boards (last accessed: June 2008).

2.2.2 Analysis and Variables

The latent nature of the constructs and complex relationships in our study call for structural equation modeling (SEM) to be applied. Structural equation modeling takes measurement error into account when estimating relationships among latent variables, instead of fixing the parameters as usually happens when exploratory factor analysis and regression analysis are combined. Furthermore, the model is able to include multiple endogenous variables (Hulland, 1999). In fact, the standard OLS-model is nested within the structural equation model, when only one endogenous variable is assigned and the measurement model parameters are set to a predefined value. The use of moderation variables in SEM is somewhat more complicated, yet in a first estimation of our argument we deem it unnecessary to take contextual variation into account.

The data were analyzed using SPSS and LISREL 8.54 (Du Toit, Du Toit, Jöreskog and Sörbom, 1999; Jöreskog and Sörbom, 1999). The measurement and structural models were tested using the two-step estimation procedure advocated by Anderson and Gerbing (1988; see also Hair et al., 2006: 848). The advantage of this approach is that interpretational confounding will not occur. That is, the interpretation of relationships is separated from the establishment of a sound measurement theory (Anderson and Gerbing, 1988: 418). The covariance matrix was used as input matrix and maximum likelihood estimates were obtained.

The latent variables in our study are linear combinations of Likert-scaled items in the survey. *Proximity* measures the agreement on the goals and the work processes between the CEO and the board chairperson. Items were taken from a validated scale of Huse (1993: 238). *Disclosure trust* and *reliance trust* were taken from the Behavioral Trust Inventory (Gillespie, 2003). However, as the original BTI scale was intended to measure trust in employee-supervisor working relationships, the questions of the BTI were adopted to the board-management context. In this respect, the board is taken as the supervisor of the management. The items for *effort* originate from a scale developed by Haalien and Huse (2005). The items for the two board task variables, *monitoring* and *advising*, are taken from scales developed by Judge and Zeithaml (1992) and Pearce and Zahra (1991), respectively.

2.3   Results

2.3.1   Measurement Model

The procedure of the evaluation of the measures used for each latent construct involved reliability analysis using SPSS, followed by confirmatory factor analysis using LISREL to

determine one-dimensionality. In general, after modifications for double loading and non-loading items, all measures demonstrated acceptable levels of overall model fit, construct reliability, and convergent and discriminant validity. The results and the final sets of measurement items for each latent construct are depicted in Table 2.1.

The overall fit of the measurement model was satisfactory (goodness-of-fit statistics (n = 378): $\chi^2_{[df = 94]}$ = 214.80, $p < 0.01$; CFI = 0.97; standardized RMR = 0.046; RMSEA = 0.061, $p < 0.05$), according to the norms taken from Hair et al. (2006: 753).

TABLE 2.1

Test of the Measurement Models

Construct	Items [a]
	Please indicate to what extent you agree with the following statements:
Proximity (3 items) α = .73 [b] VEE = .59 CR = .83 λ_{av} = .76	The CEO and the board chairperson … ▪ have the same values and principles (norms) about ethics, justice, corporate social responsibility, etc. ▪ have mutual expectations about each other's future actions. ▪ want to preserve good long term personal relations.
Disclosure trust (2 items) α = .84 VEE = .81 CR = .79 λ_{av} = .90	The board is willing to … ▪ advise the CEO related to personal knowledge and views of board members. ▪ provide the CEO with special and creative advice.
Reliance trust (3 items) α = .74 VEE = .56 CR = .78 λ_{av} = .75	The board is willing to … ▪ base their evaluations on the CEO's knowledge and insight. ▪ mandate the CEO to be the spokesperson for the firm, including the board. ▪ accept strategic decisions made by CEO.
Effort (3 items) α = .82 VEE = .69 CR = .83 λ_{av} = .83	▪ All board members are actively involved during board meetings. Board members … ▪ fully use their knowledge and skills. ▪ give sufficient priority to the board tasks.
Monitoring (2 items) α = .83 VEE = .80 CR = .84 λ_{av} = .89	The board often asks critical questions about … ▪ proposals initiated by the management. ▪ information from the management.
Advising (3 items) α = .67 VEE = .46 CR = .77 λ_{av} = .68	Please indicate to what extent you agree with the following statements on the contribution made by the board members: The board members give advice in … ▪ general management questions. ▪ legal questions. ▪ financial questions

Notes: Questions have been translated from Norwegian to English. Goodness-of-fit statistics (n = 378): $\chi^2_{[df = 94]}$ = 214.80, $p < .01$; CFI = .97; Standardized RMR = 0.046; RMSEA = .061, $p < .05$. [a] All measures employ five-point scales (anchors: disagree / agree). [b] α = Cronbach's alpha coefficient of reliability; CR = Construct Reliability; VEE = Variance-Extracted Estimate; λ_{av} = Average indicator loading.

Convergent validity was evaluated in terms of Cronbach's alpha, the factor loadings of the measures on the latent construct, variance-extracted and construct reliability (Hair et al., 2006). The reliabilities of all measures, as indicated by Cronbach's alpha, meet or exceed the lower limit of acceptability ($\alpha \geq 0.60\text{-}0.70$). All factor loadings of the 16 measures loaded significantly (t-value for all λs > 2.00) on their intended latent construct. All loadings exceed the lower limit of acceptability ($\lambda > |0.50|$) and 13 loadings exceed the ideal limit of $|0.70|$, demonstrating convergent validity. Average lambda-values range from 0.90 for the measures of disclosure trust to 0.68 for the advising measures. However, two of the six item sets contained less than the minimally recommended three items, although this did not result in identification problems. An examination of the variance-extracted estimates (VEE, see Table 2.1) shows that all measures except one meet the norm (VEE ≥ 0.50), indicating that a substantial amount of the variance in the measures is captured by the latent constructs, again showing convergent validity. Advising (VEE = 0.46) deviates marginally from the norm, probably due to the heterogeneous nature of the items. According to the construct reliability statistics (CR), all measures exceed the recommended lower limit of acceptability (CR ≥ 0.70). In sum, convergent validity was deemed to be good.

Discriminant validity of the constructs was evaluated by a comparison of the variance-extracted percentages for any two constructs with the square of the correlation estimates between these two constructs (Hair et al., 2006: 778). Based on the idea that a latent construct should explain its item measures better than it explains another construct, the variance-extracted estimates should be greater than the squared correlation. For all comparisons – except one – this holds.

In sum, the measurement models of the latent constructs fit the data satisfactorily, and show adequate reliability and validity. Some constructs exhibit minor weaknesses, which might be remedied in future research. As the dependent and independent variables were taken from the same data collection instrument, concerns over common-method variance may arise (Podsakoff, MacKenzie, Lee and Podsakoff, 2003). We thus performed a Harmon single factor test and found that the 16 items load on 5 factors with an eigenvalue over 1, where the first factor accounts for 29 per cent of the variance in the items. These findings do not cause great concern for common-method variance. Moreover, it is unlikely that respondents have the cognitive abilities to grasp the meaning of our model when filling out the questionnaire. Also, through pre-testing and careful wording, measures have been taken to reduce the probability of common-method biases.

2.3.2   Structural Model

The second step in the two-step estimation procedure entails the test of the proposed and the rival structural model. Table 2.2 shows the usual descriptive statistics, correlations, variances, and covariances for the latent variables. Table 2.3 shows the results of the model tests.

Proposed model. The proposed model (see Figure 2.2 and Table 2.3) fits the data well (Hair et al., 2006: 753). The goodness-of-fit statistics are as follows (n = 378): $\chi^2_{[df = 94]}$ = 219.20, $p < 0.01$; CFI = 0.97; standardized RMR = 0.047; and RMSEA = 0.059, $p < 0.10$). The results for the model indicate that all except one (H_{4b}) of the 10 hypothesized paths are significant ($p < 0.05$) and in the hypothesized direction (see Figure 2.2). Apparently, reliance trust has no discernible relationship with advising. Therefore, our argument that if board members rely on managers to do a good job their advice task performance is lower does not receive any support.

TABLE 2.2

Correlation / covariance matrix of latent variables

	Mean	SD	1.	2.	3.	4.	5.	6.
1. Proximity	4.02	.68	*.96*	.42	.61	.53	.06	.40
2. Disclosure trust	3.88	.82	.62	*2.26*	.31	.53	.30	.74
3. Reliance trust	3.96	.67	.61	.47	*1.05*	.26	-.10	.19
4. Effort	3.97	.79	.56	.87	.29	*1.17*	.30	.57
5. Monitoring	3.37	.92	.09	.61	-.14	.44	*1.85*	.26
6. Advising	3.44	.85	.34	.99	.17	.55	.32	*.78*

Notes: Mean = composite mean (where all λ ≡ 1). SD = standard deviation of composite mean. Correlations are above the diagonal, variances on the diagonal (in italics), and covariances below the diagonal. Correlations > |.10| are significant at the $p < .05$ level and correlations > |.18| are significant at the $p < .01$ level ($n = 378$). Correlations in shaded areas are not significant.

TABLE 2.3
Tests of the proposed and rival structural model

	Hypothesis	Proposed model	Rival model
Path		Estimate	Estimate
Proximity → Effort	H_{1a}	.40** [a]	.59**
Proximity → Disclosure trust	H_{1b}	.66**	
Proximity → Reliance trust	H_{1c}	.64**	
Disclosure trust → Effort	H_{1d}	.27**	
Effort → Monitoring	H_{2a}	.29**	.47**
Effort → Advising	H_{2b}	.21**	.40**
Disclosure trust → Monitoring	H_{3a}	.22**	
Disclosure trust → Advising	H_{3b}	.37**	
Reliance trust → Monitoring	H_{4a}	-.31**	
Reliance trust → Advising	H_{4b}	-.05	
Proximity → Monitoring			-.19**
Proximity → Advising			.11
Variance explained in the endogenous constructs (R^2)			
Effort		.39	.28
Disclosure trust		.19	
Reliance trust		.37	
Monitoring		.17	.11
Advising		.60	.33
Model goodness-of-fit statistics (n = 378)			
Chi-square[*degrees of freedom*]		$219.20_{[94]}$**	$99.85_{[40]}$**
Relative Chi-square (χ^2 / degrees of freedom)		2.33	2.50
Comparative Fit Index (CFI)		.97	.98
Standardized Root Mean Square Residual (Std. RMR)		.047	.051
Root Mean Square Error of Approximation (RMSEA)		.059[+]	.063[+]
Parsimony Normed Fit Index (PNFI)		.75	.70

Note: A blank indicates that this parameter was not estimated for this model.
[a] **: $p < .01$; *: $p < .05$; [+]: $p < .1$.

The squared multiple correlations (R^2) for the structural equations for the mediating constructs – effort, reliance trust and disclosure trust – are moderate to high (see Table 2.3). The variance in effort is explained for 39 per cent by direct effects of proximity and disclosure trust. Disclosure and reliance trust are explained by direct effects of proximity for 37 and 19 per cent, respectively. The variance in monitoring is explained relatively less well (17 per cent). Advising is well-explained by the model (60 per cent). The model, in sum, explains a substantial amount of the variance in the endogenous constructs.

FIGURE 2.2

Test of the proposed structural model
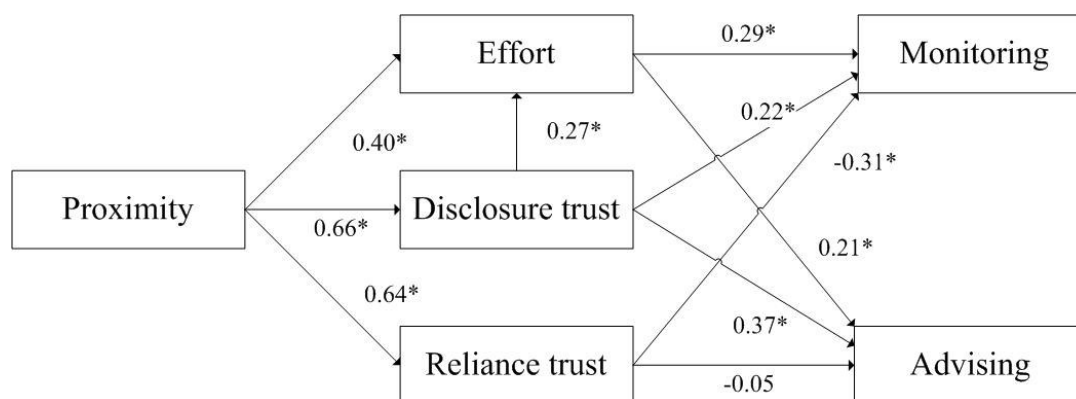
* $p < 0.01$; n = 378

Rival Model. To determine the relative strength of the proposed model in general, and the importance of the mediating role of trust in particular, the model is compared to a rival model. In this model, both the reliance and disclosure trust constructs are excluded, and monitoring and advising are directly and indirectly influenced by proximity and effort (see Figure 2.3). If we should conclude that our proposed model (Figure 2.2) outperforms this rival model significantly, this would provide additional support for our argument that trust mediates between proximity and board task performance.

The validity of the proposed model is tested by comparing it with the rival model on the following criteria: (1) overall fit statistics, (2) percentage of the models' hypothesized paths that are significant, (3) ability to explain the variance in the outcomes of interest, as measured by squared multiple correlations (R^2) of the endogenous variables and (4) parsimony, as measured by the parsimonious normed fit index (James, Mulaik and Brett, 1982). Table 2.3 also shows the results of this comparative test. Overall, both models exhibit adequate fit. The overall fit of the rival model seems superior in terms of absolute overall fit ($\chi^2_{[df = 40]} = 99.85$ vs. $\chi^2_{[df = 94]} = 219.20$ in the proposed model), but relative fit of both models is equal (χ^2 over degrees of freedom: 2.50 vs. 2.33). Both models show similar good performance on other criteria of absolute fit (standardized RMR = 0.051 vs. 0.047; and RMSEA = 0.063 vs. 0.059) and incremental fit (CFI = 0.98 vs. 0.97). Although both models show high parsimony levels, the rival model performs slightly worse (0.70 vs. 0.75). Thus, the models are comparable in terms of model fit.

FIGURE 2.3

Test of the rival model
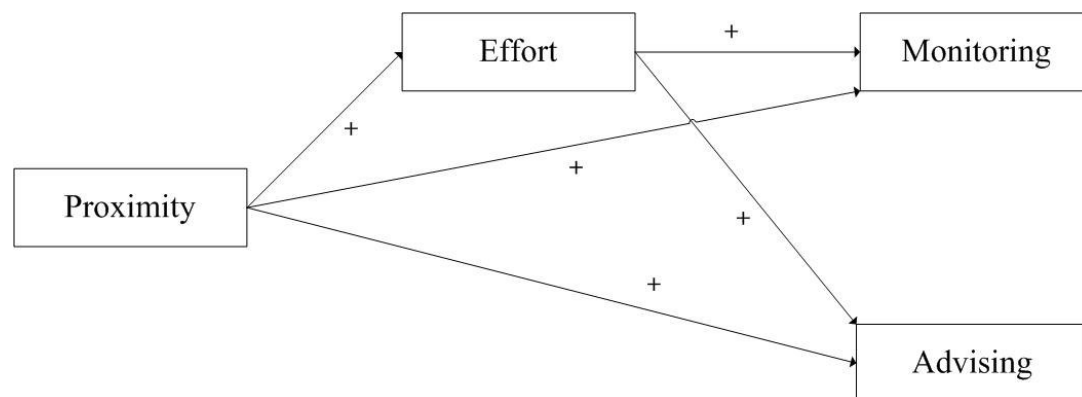
On the criterion of the percentage of significant paths, 4 of the 5 tested paths of the rival model are significant, whereas this holds for 9 out of 10 tested paths in the proposed model. Most importantly, however, although the rival model explains a substantial amount of the variances in the endogenous constructs, the proposed model outperforms it on all constructs. In sum, although both models represent the data adequately, the proposed model outperforms the rival model somewhat in explanatory power, emphasizing the additional role of trust in board processes and monitoring and advising. At least, the rival model still supports our core argument that proximity leads to improved board monitoring task performance. The positive effect of proximity through effort outweighs the negative direct effect and therefore proximity positively affects monitoring performance.

2.4   Conclusion and discussion

In business practice and policy discussions, director independence has become the holy grail directors should search for when trying to establish effective board task performance. Empirical evidence, however, does not support the hypothesis that distant, independent directors are better able to monitor managers. In this chapter, we argue that this lack of empirical support may be due to a false assumption in the principal-agent model. Agency theorists assume that the relationship between directors and managers is discrete and impersonal – that is, rational and self-centered principles drive individuals' behavior. Contract-related norms, such as effectuation of consent and implementation of planning, which operate in a discrete and impersonalized context, thus best describe the interaction among directors. Empirical studies are at odds with this assumption, as several authors have

suggested that top managers and directors are part of one, common, social class (e.g., Pennings, 1980).

Instead, we argue, interactions in the boardroom do not take place in a relational vacuum. The exchanges between directors and managers are embedded in long-standing relationships, and are thus better captured in what MacNeil (1980) calls relational exchange. Under this perspective, relationships are governed by norms such as the desire to preserve a good (working) relationship, and the desire to harmonize conflicts. In line with this starting position, we develop a rudimentary theory of what board behavior may look like, building on such studies as Westphal (1999) and Roberts et al. (2005). We argue that perceived proximity, as opposed to distance, may foster board effort as directors feel more comfortable putting effort into a relationship which they value. Board effort is subsequently suggested to lead to both monitoring and advice task performance. We find evidence for these hypotheses.

We further argue that the main mediator between proximity and board task performance – that is, the main catalyst for proximity – is trust. Whereas, as Ghoshal (2005) contends, agency theory's distance concept is based on distrust between directors and managers, the opposite would apply to a model based on proximity. However, agency theory takes trust to imply reliance on managers and consequent passiveness from the directors' side. We, on the contrary, use a recent conceptualization of trust (Gillespie, 2003) that allows for positive, cooperative, outcomes of trusting behavior. We acknowledge that proximity may lead to so-called reliance trust, reducing the perceived need of directors to be involved with the firm, but we also hypothesize that proximity may foster the development of disclosure trust. As the output of boards is entirely cognitive (Forbes and Milliken, 1999), the key to establishing meaningful discussions in the boardroom is to elicit the private knowledge of the non-executive and combine this with the company-specific knowledge of the manager (Huse, 2007). Disclosure trust refers to the willingness to share information and loose face in discussions. We find support for the hypotheses that proximity produces both reliance and disclosure trust.

Finally, we argue that reliance trust leads to passiveness, in line with the traditional conceptualization of trust in the economic governance literature. Thus, we expect board task performance to decrease when reliance trust is present. We indeed find that directors perform their monitoring tasks less well, but we do not find that directors do not perform their advice duties well when they rely on management to do a good job. This may be explained by the fact that monitoring is built on adversarial relations: directors are expected to control management, which comes at a disutility as directors and managers are part of the same social class. Advising managers, however, does not come at this same disutility. Additionally, if management is believed to be very competent at what it does, there may be no need to monitor, yet advice on other strategic courses may still be warranted. Disclosure trust is

hypothesized to increase the quality of discussions in the boardroom, and thus board task performance. We find support for these hypotheses in our empirical test.

Although our theory is supported by the results, several limitations remain, suggesting that future research efforts are fruitful. Methodologically, two qualifications are to be mentioned. The extensive testing of our model has been performed on the same dataset as the estimation of the proposed model. Also the factor analyses that lead to the definition of the latent constructs were performed on this dataset. Thus, firstly, tests on other datasets may further corroborate our findings. Secondly, we test an essentially dynamic model with a cross-sectional dataset. Both trust, processes, and performance are measured at one point in time. This introduces the possibility of reversed causality: it may well be that trust causes proximity, instead of the hypothesis suggested by our model. A test of whether current trust and performance levels lead to subsequent conflict would also be more in line with the timeline that underlies our theory.

The results of the SEM estimations support our hypothesis that, in the Norwegian context, proximity may well lead to improved monitoring performance. We have interpreted this result as evidence for the weakness of the discrete interactions assumption in agency theory, yet an alternative interpretation would be that in Norway, the agency theory model simply is not applicable. Contextual differences between Norway and the Anglo-American countries may make opportunistic behavior less salient in Norway, or the decision-making culture may be such that even with close relationships, independent judgments are easily made. In terms of national differences, it has been documented that in Norway, shareholders are less well protected than in the US (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998), and that the country is more prosocial than the United States (Lubatkin et al., 2005). Indeed, the Hofstede (2005) model of national culture shows that US citizens tend to be more individualistic and very much more masculine than their Norwegian counterparts. The long-term orientation of Norwegians is also (slightly) stronger than that of Americans. All this indicates that the agency problem may be less salient in Norway, as short-terminism is not likely to dominate, and conflicts of interests are more likely to be solved collectively (through negotiations) than through power struggles. In line with the prosocial culture, corporate governance codes – detailing rules as to how interactions among executives, directors, and shareholders should be – have not been as extensively developed as elsewhere in the world, particularly the United States and the United Kingdom. Finally, it follows from our description of the data that firms tend to be smaller and CEO ownership more substantial in Norway vis-à-vis the United States. This is likely to make the agency problem inherently less problematic, as monitoring is less complicated and CEO incentives are likely to be more aligned with those of the shareholders. A comparative management analysis may yield

additional insights in whether our results reflect an improvement of agency theory, or provide an alternative model in contexts where the agency problem is less important.

On a theoretical level, several other interesting issues remain as well. Firstly, we have shown that proximity increases both types of trust, which, subsequently, have various effects on performance. An interesting question is then to ask whether different sub-factors can be distinguished in the proximity factor. From the literature on team heterogeneity, for example, it is known that the easier it is to observe that another person is proximate, the larger the effect on the performance of the individual is (Williams and O'Reilly, 1998). An interesting future research avenue is to see whether the process of trust-building is more readily affected by homogeneity in composition than by homogeneity in norms.

Secondly, it is quite likely that our treatment of board processes is too parsimonious. We have hypothesized that disclosure trust activates boards, whereas reliance trust decreases board activity. The exact effects of trust on board effort, use of knowledge and conflict, processes distinguished by Forbes and Milliken (1999), may provide further insights in the mediation process that operates between proximity and board task performance. This may, in turn, make the proposed and rival model in Table 2.3 more distinctive.

Thirdly, it is suggested that game theory may have important prospects to offer to the model. Like social contract theory, game theory allows for trust to emerge in situations of repeated interactions (van Witteloostuijn, 2003). Although the development of a game that reflects the negotiations among executives and directors is tedious – involving multiple objectives (monitoring and advice), bargaining over outcomes, and asymmetric information –, it is suggested that particularly horizon effects are worthy of investigation. In game theory, when actors have to decide to either take the risk of trusting or assume non-cooperative behavior (with associated losses, as in our model), trust will not emerge when the number of rounds is fixed. In management terminology, directors will not trust the CEO when the length of the CEO term is fixed. After all, a CEO will not trust directors in the final year he is appointed, since the opportunistic behavior may result in a high payoff and the consequences of being fired are limited. Backward induction is then applied (van Witteloostuijn, 2003), which shows that CEOs will never behave trustworthily, and thus directors will never trust. Only when tenure is potentially infinite, trust may emerge. This effect of the length of CEO terms is likely to affect the extent to which the agency problem is apparent, and thus our model may only apply – according to game theory – in the early years of CEO's appointments, or not at all when the term is fixed. Furthermore, the retaliation strategy directors may use (that is, their way of punishing the CEO and re-establishing trust after opportunistic behavior is disclosed) is subject to future research, which may well fit in a game-theoretical framework.

Finally, we have not denied that opportunistic behavior does occur, yet that it cannot be taken as a basic postulate to explain the behavior of directors and managers in general. Our model offers an alternative for these cases, but it would be interesting to see if and how the proximity model may encapsulate and neutralize the opportunistic acts some managers may wish to commit in some circumstances. In this respect, it may be easier to build such exceptional cases into a general, behavioral, model, than to extend the principal agent model to situations where transactions are neither discrete nor among anonymous parties. Including contextual variables that would proxy for the extent to which opportunistic behavior is salient in specific countries, industries or even firms, would be an important way to further develop our argument.

3.　Perceptional Framing and Corporate Social Performance[6]

In this chapter, we focus on how the immediate and distant environment of the corporation affect decision-makers' attention to calls for satisfying social responsibility demands. Thus, we build on research about the relationship between corporate social performance (CSP) and corporate financial performance (CFP). The chapter relates mainly to the relationship among stakeholders – including shareholders – and executives in Figure 1.1 (relationship 2 and 5).

First, we analyze the effect of heterogeneity among corporate stakeholder groups on the CSP-CFP nexus, following Clarkson's (1995) distinction between primary or 'private' stakeholders, and secondary or 'public' stakeholders. Wood and Jones (1995) argued that there is a mismatch between the variables in previous research. For instance, employees and an NGO such as Greenpeace put different emphasis on issues of labor conditions and environmental pollution. With this critique in mind, we explicitly incorporate more fine-grained measures of corporate social performance into our analysis. After all, the question as to the relationship between corporate social and financial performance cannot be considered separately from the analysis of how corporations interact with different stakeholder groups that weigh the underlying CSP dimensions differently. Our hypothesis is that secondary stakeholders have to rely on a company's reputation for good CSP more than primary stakeholders, who have comparably direct exchanges with the firm. A CSP reputation should thus be related to CFP for secondary stakeholders more than for primary stakeholders.

We therefore contribute to the literature by showing that fine-grained decomposed measures provide insights into the costs and benefits of corporate social performance beyond those that composite measures have demonstrated in previous research. Notice that, by way of steppingstone, we only distinguish two larger stakeholder groups – primary and secondary ones. Consequently, in future research, efforts to further hypothesize upon lower-level relationships between the satisfaction of specific stakeholder demands (e.g., customers, employees, NGOs and shareholders) and corporate financial performance are required.

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[6] This chapter draws heavily on "Corporate social and financial performance: An extended stakeholder theory, and empirical test with accounting measures" (*Journal of Business Ethics* **79**: 299-310) co-authored with Hans van Ees and Arjen van Witteloostuijn. The paper has been presented at the SOM PhD conference (Groningen, 2006) and the Academy of Management Annual Meeting (Atlanta, 2006). We are grateful to Jan van Helden, Ayse Saka and Lammertjan Dam for valuable comments.

Second, we build upon Jawahar and McLaughlin's (2001) model in which prospect theory and the organizational life cycle approach are combined to demonstrate the importance of certain stakeholders in various business environments. We leave the life cycle hypothesis to future research, but take the prospect theoretical arguments from psychology on board. One of prospect decision theory's key predictions is that decision makers' perceptions are biased, implying an asymmetry in how they judge losses versus gains. In this chapter's context, following this logic, we argue that the effect on corporate financial performance of bad CSP can be expected to be larger than the impact of good CSP, *ceteris paribus*, because decision-makers evaluate the decision to invest in social performance differently in a situation in which they stand to loose a reputation for being a good corporate citizen, as compared to a situation where the company is to decide whether or not to build up such a reputation. We show that this is indeed the case for primary stakeholders.

We therefore contribute to the extant literature by pointing out the relevance of the decision-maker's perception of the business environment, which we hypothesize to be associated with an important bias in terms of a losses – gains asymmetry. We show that a good reputation for corporate social performance is not simply the mirror image of a reputation for substandard social performance. This builds on Hillman and Keim's (2001) finding that CSP is particularly relevant for primary stakeholders, by adding the impact of the decision-maker's framing of the business environment.

The chapter not only adds to the CSP-CFP literature, but has implications for the arguments explored elsewhere in this book as well. Specifically, we show that the more distant a stakeholder is to the firm's core business, the smaller its impact on firm performance. Indeed, we are incapable of identifying any framing effects for secondary stakeholders. We also show that for primary stakeholders framing does take place. Applying the model to the corporate social performance – financial performance context thus requires that attention is paid to the reputation a firm has for social performance citizenship. Future research could explicitly target the underlying decision-making processes. After all, in this chapter framing is assumed from the observed outcomes, which limits the extent to which the conclusions can be interpreted in light of a behavioral model. Such developments may yield conclusions as to symbolic management of stakeholder relations (Table 1.1).

The organization of the chapter is as follows. Section 3.1 presents the normative debate that has dominated theorizing up to the 1990s, at least. In section 3.2, the empirical literature is reviewed. Underlying these studies is the notion that if CSP is positively related to CFP. From this perspective, the normative literature is not so relevant because regardless of whether companies ought to behave socially responsive from a moral point of view, doing so is recommended from an economic perspective anyway. Sections 3.3 and 3.4 present our

theoretical arguments. The data and method are discussed in section 3.5, and the empirical results are presented in section 3.6. Section 3.7, finally, concludes.

3.1   Theory development

3.1.1   A fundamental debate

Much of the debate on corporate social performance is of a normative nature, building upon the idea that moral principles should or should not guide corporate decision making, and prescribing how managers should deal with social issues and corporate stakeholders. Margolis and Walsh (2003) summarize the economic arguments against business' involvement in social issues under two headings: misappropriation and misallocation. "When companies engage in social initiatives, the first concern is that managers will misappropriate corporate resources by diverting them from their rightful claimants … Managers also misallocate resources by diverting those best used for one purpose to advance purposes for which those resources are poorly suited" (Margolis and Walsh, 2003: 272). The classic work of Milton Friedman (1970), which holds that '[t]he social responsibility of business is to increase its profits', is the most prominent representative of the line of argumentation coined misappropriation. Friedman argues that spending corporate resources on social activities implies the imposition of taxes on constituents of the organization. These taxes are imposed on stockholders through reduced profits, on customers through increased prices, on employees through lower wages, et cetera. If individuals want to make a contribution to a social good, Friedman reasons, they can do so themselves.

Another well-known advocate of a Friedmanian view is the finance scholar Michael Jensen. Jensen (2002) further develops Friedman's logic by concluding that it is logically impossible to maximize multiple conflicting objectives simultaneously. Indeed, "value is created when a firm produces an output or set of outputs that are valued by its customers at more than the value of the inputs it consumes (as valued by their suppliers) in such production" (Jensen, 2002: 239). This implies that if the long-term market value of the firm is maximized, social welfare is automatically maximized as well. Accordingly, it is a waste of resources to divert money to socially responsible investments.

A counterargument, though, is that neither Friedman nor Jensen seems to acknowledge that the absence of corporate investments in social issues – for example, by neglecting the effect of pollution – can also be interpreted as imposing a tax on people's well-being if the harm cannot be undone by those people themselves. In the case of pollution, for instance, individuals may not be able to counter the discharge of toxic substances as

effectively as the corporation could prevent the emissions. In a similar vein, it might be that care for employees can be better organized directly within the boundaries of the firm. Put in this way, corporate social investments would be a more effective way of dealing with the negative externalities of corporate behavior than any outside correction or compensation mechanism.

Davis (1973) offers several additional arguments, the most convincing of which are: (1) that businessmen might not have the appropriate skills to tackle social problems; (2) that spending attention to an assumed social responsibility goes at the expense of the attention paid to the core function of a business organization – making profits; and (3) that if there is cross-national diversity in social demands, socially responsive behavior weakens the relative competitiveness of firms in high-pressure societies. Then, the internalization of dealing with the negative externalities of corporate behavior will turn out to be ineffective, and even counterproductive.

Margolis and Walsh (2003) oppose the misappropriation and misallocation arguments to three corporate moral duties that move beyond issues of effectiveness. Firstly, business activities certainly have an impact upon society: as an employer, a firm affects the conditions under which the employees live; as a producer, a firm's production process and usage of resources impacts upon the physical environment; and as a vendor, a firm influences the quality of the lives of its customers. Consequently, a firm might be held responsible for the harm it does to others, or – a term which is often used in the literature – the firm can be said to have a public responsibility. Secondly, a firm benefits from society as it is. Examples of this are a high educational level, which yields highly productive workers, and a good health system, which guarantees short sickness leaves. Society might expect firms to contribute to these conditions from which they benefit, just as individuals do. Thirdly, the duty of beneficence might be referred to, which is "the duty to promote the well-being of others, in particular to provide aid to prevent or relieve suffering or dire conditions" (Margolis and Walsh, 2003: 292). The obvious problem with this third duty is the seemingly endless reach it has, a problem which might also be associated with the second duty.

A final argument is that if stockholders hold a diversified portfolio, their interest coincides with that of society, which makes business' assumption of a social responsibility justifiable (Davis, 1973). This argument agrees with Keim's (1978) exposition of the enlightened self-interest model in which corporations make some investments that have a negative present (NPV) value for the firm, but a positive NPV for investors who hold a diversified portfolio. The firm needs not even be the cause of the social problem: if the firm considers itself capable of solving the problem, the enlightened self-interest criterion prescribes its involvement (Fitch, 1976).

A counterargument against this "the firm must behave socially responsible"-logic is that it might, in the end, be most effective to clearly separate the private roles of enterprises from those of public authorities. If the public cares about avoiding (or compensating) the negative externalities of corporate behavior or promoting (or rewarding) the positive externalities of corporate behavior, it should do so by designing appropriate instruments through the usual channels of public authorities. Environmental and labor laws can be installed, and subsidies or taxes can be introduced. Then, socially responsible corporate behavior is limited to obeying the laws of the society in which the private enterprises operate.

3.1.2   An instrumental solution

In addition to this more normative debate, the literature has produced a more positive approach to issues of corporate social performance by instrumentally addressing the relationship between corporate financial and social performance. In this approach, the latter is seen as instrumental to the former, based upon the fundamental assumption that success in business is somehow related to the extent to which the firm manages to deal with the different needs of its direct stakeholders and the wider social environment. Now, the argument is that a natural solution to the above tension emerges when socially responsible corporate behavior has a positive impact on the focal firm's financial performance. Then, after all, private enterprises are inclined to behave socially responsible out of self-interest anyway.

The proof of the pudding is in the eating, though: are CSP and CFP indeed positively associated, or can the CSP-CFP trade-off not be resolved that easily? The large body of empirical analyses that explore the relationship between corporate financial and social performance has been reviewed in a number of narrative literature reviews and a meta-analysis (Margolis and Walsh, 2003; Orlitzky, Schmidt and Rynes, 2003; Pava and Krausz, 1996; Wood and Jones, 1995). The narrative literature reviews engage in simple vote-counting and present a large number of studies in which a positive relationship between CSP and CFP is supported. For example, Pava and Krausz (1996) review 21 studies that appeared between 1972 and 1992. For 12 of these, a positive relationship was found, whereas in only one case a negative relationship was reported. The eight remaining studies showed no significant results. Margolis and Walsh (2003) analyze a larger set of studies (127) and also find many (54) in which the correlation between CSP and CFP is positive, and only a few (7) in which a negative coefficient is reported.

The disadvantage of reviews like these is that they summarize research in which the focus has been on controlling for type-I errors only. The possibility that a relationship is not detected is seldomly addressed in singular empirical analyses. However, a growing body of research suggests that these errors are becoming more and more pressing (Schmidt, 1992). A

meta-analysis can control for measurement and sampling error, and Orlitzky et al. (2003) provide such an analysis for the CSP-CFP relationship. In fact, such study artifacts as sampling and measurement error may account for 25 to 100 per cent of cross-study variance in their sample of studies. Notwithstanding their improved methodology, they do not draw different conclusions, though: the CSP-CFP correlation coefficient tends to remain positive.

Wood and Jones' (1995) review is based on counting votes, too, but does so at a lower level of aggregation. For various distinguishable dimensions of social performance, they observe and interpret the studies under review qualitatively. From their research, in combination with the relatively high numbers of studies reporting non-significant findings in the abovementioned meta-analyses, we conclude with Godfrey (2005) that there is still room for improvement, probably by assessing more complex relationships.

Theoretically, an abundance of hypotheses explaining the CSP-CFP nexus at a lower level of aggregation is yet to be expected. Godfrey (2005) develops a set of propositions asserting that good deeds lead to a positive reputation that the firm can subsequently use to achieve financial benefits. Hillman and Keim (2001) propose that there is a relationship between investments in issues with which primary stakeholders are concerned, but that this relationship does not extend to secondary stakeholders' social demands. We push this reasoning further by incorporating the concept of reputation into Hillman and Keim's (2001) argumentation. Specifically, we argue that a reputation for social performance is particularly relevant for secondary stakeholders, who do not have frequent and direct exchange with the firm. Customers, suppliers and other primary stakeholders, on the one hand, can infer the company's involvement in social activities from the terms of their exchanges. Secondary stakeholders, on the other hand, do not have these information sources at their disposal and rely on reputation measures to decide upon the extent to which they support the organization. Consequently, a reputation for CSP is argued to be related to CFP for secondary more than for primary stakeholders. The next section substantiates this argument.

Additionally, we argue that the effect on corporate financial performance of bad CSP can be expected to be larger than the impact of good CSP, *ceteris paribus*, because decision-makers evaluate the decision to invest in social performance differently in a situation in which they stand to loose a reputation for being a good corporate citizen as compared to a situation where the company is to decide whether or not to build such a reputation. Here, we apply insights from psychology's prospect decision theory. Again, we provide more details below.

3.1.3 Stakeholder and resource dependence theories

The most influential model used for the analysis of corporate social performance is the principles-processes-outcomes model, as formulated by Wood (1991a, 1991b). In this model, processes of social responsiveness are argued to result in outcomes: social impacts, programs and policies. Many studies continue by relating social performance outcomes to financial performance directly. Due to problems of observability, most rely on reputation measures, such as those developed by Kinder Lydenberg and Domini (KLD) or *Fortune*. However, as is apparent in Godfrey's (2005) arguments as well as Fombrun and Shanley's (1990) study, reputation is not a perfect function of a firm's strategic posture.

Not only can reputations be biased due to some firms being more visible than others and stakeholders misinterpreting corporate signals, but firm's management of a reputation can also lead to serious biases, as is evident from Westphal and Zajac's symbolic management studies (e.g., Westphal & Zajac, 1994, 1998; Zajac & Westphal, 1995). Since symbolic management is most salient where information asymmetries are present, and different stakeholders have different forms of exchange relationships (see below) with the corporation, we argue that there is a relationship between a reputation for corporate social performance and corporate financial performance that differs for various stakeholder groups.

The different intensity of the CSP-CFP link follows from a logic that is central to resource dependence theory (Pfeffer & Salancik, 1978). In order to safeguard against the loss of critical resources, the argument goes, an organization must develop tailor-made stakeholder relationships. For instance, a cooptation strategy can be used to tie a critical supplier to the firm by offering the CEO of this supplier a seat in the firm's non-executive board. Casciaro and Piskorski (2005) develop two conditions for such constraint absorption to occur – that is, for the internalization of constraints by a focal firm. If for two parties in a relationship mutual dependence is high and the power difference is low, one of the parties is likely to absorb the demand of the other party (Casciaro & Piskorski, 2005).

The characteristic that distinguishes primary from secondary stakeholders lies in the nature of the relationship with the firm. Primary stakeholders are those who have a reciprocal and direct exchange relationship with the corporation, whereas secondary stakeholders try to influence these exchange relationships much more indirectly. In terms of Casciaro and Piskorski (2005), mutual dependence and a balance of power are typical for a focal firm's relationships with primary stakeholders. For secondary stakeholders, in contrast, the stakeholders depend on the firm for the realization of their goals, but the firm is – by definition – not crucially dependent upon these stakeholder groups. Also, relationships of this sort are typically characterized by an imbalance of power.

Since primary stakeholders are involved in frequent exchanges with the corporation, it is likely that the terms of exchange are written down in explicit contracts (e.g., employees) and/or are developed in more frequent and repeated interaction and implicit contracting (e.g., customers). In other words, by making transactions the firm absorbs the constraint/social demand posed to it by the consumer, employee or investor. Corporate opportunistic behavior is restricted by the expectation of the losses that will emerge if this behavior – once detected – kills the exchange relationship: employees will leave, customers will go elsewhere, shareholders will sell their stocks, *et cetera*. Hence, the importance of a good relationship with primary stakeholders tends to be reflected in explicit contracts and/or direct exchanges. Therefore, the need for a favorable public reputation to signal a company's good care-taking for primary stakeholders is probably not that important.

This is not to say that the need for such a reputation is absent altogether: after all, reputations partly reflect actual business practices (Fombrun & Shanley, 1990). Moreover, reputations are important to attract new primary stakeholders – new clients, employees, shareholders, distributors, and suppliers. However, management may not need to invest that much in explicitly influencing the formation of a public reputation to maintain profitable exchange relationships with primary stakeholders. Also, since the primary stakeholder has more information than the secondary stakeholder about the extent to which the company meets its demands, symbolic management is less salient. Consequently, we suggest

Hypothesis 3.1a: Corporate social performance dimensions that concern primary stakeholders are unrelated to firm financial performance.

Corporations' dealings with secondary stakeholders are primarily aiming at gaining or maintaining legitimacy. In this context, it is argued that secondary stakeholders are capable of affecting the course of a business in the long run: "[t]hough the long run may require decades, or even centuries in some instances, history seems to confirm that society ultimately acts to reduce the power of those who have not used it responsibly" (Davis, 1973: 314). Interest groups can – in the end – influence customers' buying decisions or the attractiveness of a corporation to prospective employees or investors. However, contrary to primary stakeholders, the implicit exchange relationship of a corporation with its secondary stakeholders is not likely to be subject to explicit contracts or direct exchanges. Because the firm does not depend on the secondary stakeholder and has sufficient power to reduce the effect of their social demands on the firm, the demands posed by the secondary stakeholders are not absorbed by the firm.

Therefore, the corporation will invest in what Godfrey (2005) calls reputational moral capital. In dealing with the secondary stakeholders' demands, reputation is thus not only the unintended consequence or accounted-for by-product of managerial activities, but is also a purposeful instrument that can be effectively and strategically used to further corporate goals.

For instance, a firm may decide to invest in schools in the local community or in an advertising campaign emphasizing its good environmental policies purely for the sake of enhancing its reputation in the eyes of local citizens or environmental NGOs. In so doing, it hopes to avoid, e.g., legal procedures by local citizens to stop a site expansion or damaging protest campaigns by an NGO like Greenpeace. There is also ample room for a company to engage in symbolic management because the secondary stakeholders are at an informational disadvantage *vis-à-vis* the firm. We therefore propose

> *Hypothesis 3.1b*: *Corporate social performance dimensions that concern secondary stakeholders are related to firm financial performance.*

3.1.4   Stakeholder and prospect decision theories

Above, we explicitly acknowledged for stakeholder heterogeneity when discussing the importance for the corporation of maintaining good relationships with different groups of stakeholders. Below, in a similar way, we will incorporate insights from prospect decision theory (Kahneman and Tversky, 1979) into stakeholder reasoning. More specifically, we will add the arguments put forward by Jawahar and McLaughlin (2001) to develop the hypothesis that the responsiveness of corporations to various stakeholders' claims will, at least in part, depend upon the way in which managers perceive the business environment. We use this insight to argue why these responses are likely to be asymmetric – i.e., why a bad CSP reputation is viewed differently than a good one.

In prospect decision theory, two features of human perception are emphasized. The first core proposition is that an investor's estimate of the psychological value of an investment is systematically different from its actual value. This difference can be attributed to the so-called reference point that individuals take into account when assessing the value of an option. A typical reference point is one's current position in the market (Jawahar and McLaughlin, 2001: 403). For example, Greve (2003) showed that firm's rate of change is lower when a firm faces gains than when it faces losses. Hence, this reference point determines to what extent the (expected) outcomes are evaluated as losses or gains.

The second core proposition is that losses are weighted more heavily than equally-sized gains, which implies that individuals are risk-taking in loss situations and risk-averse in gain frames. Kahneman and Tversky (1979) have shown that people are risk-averse when they have to choose between two bets on losing something (cf. insurance), whereas they are risk-taking in a situation where the bets involve an opportunity to win the same amount of money. Therefore, prospect decision theory predicts that individuals are likely to accept more risk in situations that they frame as risky. Conversely, they perceive as relatively safe those situations in which they have the probability to realize gains.

Following prospect decision theory, Jahawar and McLaughlin (2001: 403) argue that in a situation where environmental threats dominate, corporations will be more willing to follow risky strategies than in situations where environmental opportunities are dominant, in which case risk-free or certain strategies will probably be chosen. This labeling of the environment in terms of threats or opportunities can be seen as framing strategic decision-making.

In the theory on corporate social performance (see, e.g., the review by Wood & Jones (1995)), indeed, a distinction has been made between positive and negative social performance. The classical example of negative CSP is the damaging reputational impact for those corporations that maintained their operations in South Africa in the *apartheid* period. Maintaining operations in South Africa clearly ignored the public opinion at that time. Hence, a large negative impact of this non-responsiveness, and hence bad CSP reputation, on the corporations' financial performance is to be expected. Conversely, the accommodative strategy of not having operations in South Africa is considered to be the more "normal" response. That is, the public expects the corporation to respond to its pressure by actively correcting the behavior that caused its bad CSP reputation in the first place. Consequently, accommodative strategies are expected to have a much smaller effect on CFP than comparable non-accommodative strategies.

The above example relates to the specific case of the reputational – and hence financial – effect of having business operations in controversial locations. Clearly, the above logic is specific to the CSP dimension involved. For other CSP dimensions, a positive reputation may be at stake – e.g., those relating to diversity and environmental issues. For example, the impact of discriminatory hiring will probably, according to our argument from prospect decision theory, have a larger impact on corporate reputation – and hence on CFP – than comparable positive responses that actively promote the creation of a diverse workforce, as the latter is more in line with the average public opinion than the former. This gives

Hypothesis 3.2:   *The effect on corporate financial performance of good corporate social performance reputation is smaller than the impact of bad corporate social performance reputation of equal magnitude.*

3.2   Data and method

3.2.1   Data sources and variable definition

The quality of a reputation index is a direct function of the consistency of the raters and the objectivity of the rating agency. Two sources of reputation indices have become

dominant in the field: the *Fortune* Corporate Reputation Index and the index constructed by the Kinder, Lydenberg and Domini corporation (KLD). Of these, KLD provides the largest dataset, covering many of the underlying dimensions of corporate social performance. Contrary to *Fortune*'s index (Fryxell and Wang, 1994), KLD passed several tests of construct validity (Sharfman, 1996). It has therefore been used as the primary data source for this study as well. Data for the period running from 1997 up to 2002 were explored to construct our independent CSP variables, and were subsequently connected with a separate database with financial and other business information that we used to calculate control and dependent (CFP) variables. With the large size of the panel, we also avoid another problem that occurs frequently in the field: too small samples make generalizations difficult (Orlitzky et al., 2003), and reduce the analyses' statistical power.

The KLD database consists of so-called qualitative and exclusionary screens. The latter assess whether a firm participates in a specific line of business that is considered socially harmful (e.g., tobacco or gambling). These screens thus only measure negative corporate social performance. In the context of our hypotheses, we must avoid such a bias. We will thus only take the qualitative screens into account, in which seven indicators (dimensions) of corporate social performance are distinguished: community, diversity, employee relations, environment, human rights, customers (in KLD terms: products), and investors (in KLD terminology: corporate governance). For each of these dimensions, a number of criteria, ranging from five to thirteen per dimension, are available on an annual basis. These measure either strengths or concerns, indicating a positive or negative reputation for corporate social responsiveness in the domain of that specific dimension.

We deal with the multi-dimensionality of CSP in two ways, calculating disaggregated and aggregated (composite) measures, respectively. Firstly, we constructed fourteen disaggregated measures, two for each of KLD's CSP dimensions. We calculated the percentage of criteria that are met for each of KLD's seven CSP dimensions, treating negative and positive criteria separately. Six of these fourteen variables refer to primary stakeholders (employees, customers, and investors), whereas the other eight represent secondary stakeholders (community, diversity, environment and human rights). Secondly, we constructed two composite CSP measures. We emphasize that these serve purely as a benchmark case against which we show that the dataset allows for cross-stakeholder heterogeneity. Since there is no study that provides objective weights to the underlying indicators of corporate social performance, we simply assume that all seven indicators are deemed equally important for a reputation of positive and negative social performance, respectively. Hence, we computed the overall mean over the seven positive indicators and over the seven negative indicators, which we coin positive and negative corporate social

performance, respectively. To avoid non-normality of the distributions, the natural logarithm of all CSP variables is used.

Corporate financial performance information is obtained from Thomson Financial's Datastream. We use return on assets (ROA) and earnings per share (EPS), ROA being measured as the ratio of pre-tax profits over the value of the firm's assets. Return on assets can be considered as an efficiency measure, whereas the earnings per share indicate firm effectiveness. Both variables are accounting measures, as we have not included investor perception in our theory. Moreover, we feel that it is not reasonable to assume efficient stock markets in our CSP context. To that end, an individual investor making a valuation decision should attach importance not only to his private social demands upon the firm, but to those of other stakeholders as well.

To analyze the CSP-CFP nexus, we included the following control variables, also drawn from the Datastream database. For one, the relative amount of debt in the firm's capital structure is taken on board. If a firm is more heavily indebted, the probability of an investor not receiving a return increases and, therefore, the required return on equity is higher. The relative amount of debt – proxied by the debt to equity ratio – is collected to account for this effect. Moreover, firm size is relevant as larger companies might well be more vulnerable to shifts in public opinion due to their larger visibility *vis-à-vis* smaller firms, although Orlitzky (2001) did not find a confounding effect of firm size on the relationship between investments in social performance and CFP. Firm size is measured with the natural logarithm of the number of employees. Inter-firm heterogeneity may not be taken into account sufficiently by these control variables, since data availability limited the possibility to include variables such as R&D (McWilliams and Siegel, 2001). To cope with this problem, we used firm fixed effects instead of industry dummies, so capturing intra-industry heterogeneity as well.

3.2.2 Method and descriptive statistics

The database is an unbalanced panel with 734 corporations for which observations for one to six years are available. Although the number of cross-sections is large, our time window is rather short from an econometric point of view. We thus relied on correlation coefficients between the independent variables and up to three leads of the dependent variables to investigate the lag structure. In a very limited amount of cases, the use of concurrent measures was open to discussion. Therefore, and because reputation can be considered to be a continuously updated cumulative measure of a firm's social performance, we feel that relying on concurrent measures is justified. We included a first-order autoregressive scheme since the Durbin-Watson statistic of analyses without such a scheme falls far short of the lower bounds (Bhargava, Franzini and Narendranathan, 1982).

In Table 3.1, we report the usual descriptives. All correlations are fairly low, including those between our two CFP measures, which indicate that the performance yardsticks measure different aspects of financial performance. Larger firms are less profitable if profit is measured by ROA, but perform better in terms of EPS. These bivariate relationships may vanish in a multivariate setting, as is argued by Orlitzky (2001). Debt is detrimental to financial performance, whilst larger firms tend to be more heavily indebted than their smaller counterparts, maybe due to low financial performance. We should emphasize, though, that profits are pre-tax, implying that the tax shield of debt is not included. The correlation between corporate social and financial performance is low. CSP is more strongly correlated with firm size than is CFP: larger firms seem to be more involved in both positive and negative dimensions of corporate social performance. Lastly, and strikingly, positive and negative CSP are positively correlated, which further justifies our approach to enter the underlying CSP variables separately in the regression analyses.

TABLE 3.1

Descriptive Statistics and Correlations

	Variable		Descriptives				Correlations		
		N	Mean	SD	1	2	3	4	5
1	Return on assets (%)	2,409	0.08	0.14					
2	Earnings per share	2,356	1.08	6.08	0.17				
3	Firm size (employees log)	2,377	9.90	1.41	-0.19	0.11			
4	Debt to equity ratio	2,401	0.41	0.40	-0.24	-0.03	0.10		
5	Positive CSP (log)	3,000	0.03	0.02	0.07	0.02	0.14	-0.07	
6	Negative CSP (log)	3,000	0.03	0.03	-0.14	-0.02	0.28	0.15	0.21

Notes: All correlation coefficients with absolute value above 0.03 are significant at $p < 0.01$; N is between 2,329 and 3,000.

The correlation among the CSP variables and between CSP and firm size may be indicative of an information bias: regardless of a firm's reputation for social performance, it may be that some firms provide more information based on which their social performance can be rated than others. If a firm discloses both its positive and negative CSP activities, a positive correlation between the two measures may be found. If, as is likely, larger firms disclose more than smaller firms, the correlation with firm size can be explained by this bias as well.

3.3   Results

We report the results from our hierarchical regression models in Table 3.2. The first and third column represent the benchmark case with the composite measures of CSP inserted. To reduce the asymmetry in the distribution of the error terms, two cases had to be dropped in the model for EPS. The firm fixed effects are significant in both models and the parameter estimates for the other control variables are in line with the correlation coefficients: larger firms perform better than their smaller counterparts if financial performance is measured by EPS. In the ROA model, there is no effect of firm size, which may be due to the dependent variable already being scaled by a measure of size (i.e., total assets). Debt hurts financial performance in both models. As to the CSP-variables, we observe that the coefficients are in line with expectations, although they reach statistical significance in the case of the negative measures only.

The composite measures of corporate social performance are replaced with the seven underlying dimensions in the second and fourth column of Table 3.2. All models are, again, statistically meaningful. The two models explain a significantly larger share of the variance in financial performance (for ROA, $F = 2.07$ and $p < 0.05$; for EPS, $F = 1.86$ and $p < 0.05$) than the models with composite measures only. Clearly, this shows that a decomposed treatment of CSP makes perfect sense, as predicted, offering more explanatory power and more substantive insight than models using composite CSP measures. The estimates for the control variables do not differ from the benchmark case.

Consider first the set of the three dimensions that refer to primary stakeholders: employees, consumers and investors. Disregarding their wishes contributes negatively to both performance measures. Moreover, the positive indicator for investor's social demands is significant in both models as well. Although the signs are in line with previous research, the results clearly reject Hypothesis 3.1a, which proposed that for these dimensions corporate social and financial performance are unrelated.

The community, diversity, environment and human rights dimensions represent the interests of secondary stakeholders. It is immediately apparent that the results lead to a rejection of Hypothesis 3.1b as well, in which we argued that the four dimensions would be related to CFP. Only two dimensions are related to ROA, the negative diversity measure even at a marginally acceptable significance level. The other dimension, measuring a firm's reputation for good environmental performance, is related to EPS as well. All other hypothesized relationships turn out to be insignificant.

TABLE 3.2

Regression Models

	ROA 1	ROA 2	EPS 1	EPS 2
Constant	0.10	0.14	-1.30	-0.60
Firm size	0.01	0.00	0.37**	0.30*
Debt to equity ratio	-0.09**	-0.09**	-1.63**	-1.58**
Positive CSP (composite)	-0.07		0.51	
Negative CSP (composite)	-0.40**		-5.30**	
Employees positive		0.00		-0.49
Employees negative		-0.16*		-2.15**
Consumers positive		-0.09		-0.10
Consumers negative		-0.08**		-0.85**
Investors positive		0.12*		2.57+
Investors negative		-0.06**		-1.29*
Community positive		0.04		0.75
Community negative		0.02		0.23
Diversity positive		-0.03		0.36
Diversity negative		-0.03^+		-0.80
Environment positive		-0.10**		-2.34**
Environment negative		-0.06		-0.39
Human rights positive		-0.08		0.45
Human rights negative		-0.02		1.13
AR(1)	0.19	0.18	0.04	0.04
# of cross-sections	478	477	470	469
# of observations	1,829	1,828	1,791	1,790
F-value	9.28**	9.16**	3.37**	3.31**
Adjusted R^2	0.69	0.69	0.39	0.39

Notes: firm fixed effects and AR(1) scheme included; White cross-section standard errors and covariance; $+ p < 0.10$, $* p < 0.05$, and $** p < 0.01$. The models denoted '1' use composite measures and serve as a benchmark case only; the models '2' use decomposed CSP measures

Strikingly, the environmental performance variable is negatively related to both CFP measures. Apparently, a good reputation for being concerned with the environment, leads to real monetary losses. One possible explanation for this finding results from the fact that of all secondary stakeholder issues we included, the environment is beyond doubt the area in which regulation has been developed the most. It may thus be that stakeholders value the

environment beyond the economically efficient level. Consequently, attaining a positive reputation requires investments up to a point where the marginal returns do not outweigh the marginal costs anymore.

Our Hypothesis 3.2 receives strong support from the data. We argued that an effect of negative corporate social performance on financial performance is much stronger than an effect of positive corporate social performance. Indeed, the *t*-tests show that positive social performance does not have a demonstrable effect on financial performance for five out of our seven dimensions. For a negative reputation on these dimensions, four (ROA) versus three (EPS) out of these dimensions reach statistical significance. If we accept that there is no demonstrable relationship between meeting secondary stakeholders' demands and financial performance, as our results and those of Hillman and Keim (2001) suggest, our argument receives even stronger support. For primary stakeholders, all negative dimensions reach statistical significance, all being substantively meaningful. As an example, not meeting consumer demands brings earnings per share down from $1.06 to $0.21 for the average firm, and return on assets from 8 to 0 per cent. Two out of three positive reputation variables are insignificant, and the third only reaches marginal significance in the EPS model and acceptable significance in the ROA model. This dimension, meeting investor demands, does have a substantial effect that outweighs the effect of a negative reputation. Overall, we find strong support for Hypothesis 3.2, especially in the case of primary stakeholders.

3.4   Conclusion and discussion

In this chapter, we consider two theoretical extensions to the study of the relationship between corporate social and financial performance, and provide preliminary evidence on the validity of these extensions for two accounting performance measures. Firstly, at the interface of resource dependence and stakeholder management theories, we claim that the relationship between CSP reputation and CFP – if any – depends on the nature of the relationship between the stakeholder and the firm, distinguishing primary (or private) from secondary (or public) stakeholder groups. Secondly, we draw from prospect decision theory to justify our claim that the impact of negative versus positive CSP is asymmetric: that is, the negative impact of bad CSP on CFP is expected to be larger than the positive effect of good CSP, due to asymmetry with which individuals tend to assess gains and losses. In line with the above, we argue that composite measures of social performance at the corporate level, which average out the impact of different stakeholder groups, are too crude to fully describe an alleged relationship between CSP and CFP.

Indeed, the fine-grained analyses with the seven underlying CSP dimensions reveal many more and more interesting results. We conclude from our analyses that a complex relationship between corporate social and financial performance is present, as we expected, albeit sometimes different from what we hypothesized. This may not come as a surprise, as most of our expectations were based on earlier work using composite CSP measures. So, our initial hypotheses must be regarded as first-guess conjectures. However, using the findings reported above, we are now in the position to develop second guesses.

Our first key argument was that the fundamental difference between primary and secondary stakeholders – the degree to which both parties in a stakeholder relationship depend on each other, and are involved in explicit contracts and/or direct exchanges – shapes the relationship between CFP and the specific dimension of CSP. More specifically, we hypothesized that for secondary stakeholders a reputation for good (bad) CSP is more relevant than it is for primary stakeholders (Hypotheses 3.1a and b). After all, primary stakeholders can protect their interests much more effectively by other means, through direct bargaining and exchanges with the focal firm, than can secondary stakeholders. Overall, our series of results are not in line with this argument.

Here, we would like to suggest three possible explanations for the latter finding. First, our sample's focus on the S&P 500 implies a size bias. For large corporations, which are much more in the public eye than their smaller counterparts, a bad or good 'secondary' corporate social performance is likely to spill over to their 'primary' CSP reputation. Second, the S&P 500 sample is associated with an age bias as well. As will be explained below, CSP is argued to be particularly important for mature firms. Third, we also have a period bias here. Our time window covers a period in which the *zeitgeist* was very much in favor of CSP. This reinforces the age and size biases. Hence, it would be interesting to replicate our study for younger and smaller firms in other time periods. Moreover, apart from this empirical extension, we believe that further disaggregation of our crude primary versus secondary stakeholder groups will be fruitful theoretically. Can a similar but more fine-grained logic be applied to lower-level stakeholders such as customers, employees, governments and stakeholders?

Our second key argument involves prospect decision theory, arguing that negative CSP will be evaluated differently than positive CSP. We find strong support for this theoretical extension. Especially for primary stakeholders, the coefficients for positive social involvement do not deviate from zero, whereas negative social involvement is shown to be detrimental to our pair of accounting performance measures. Our analysis suggests some promising future research opportunities. We especially suggest to incorporate the framing of stakeholders: we primarily focused on the managers' frames. However, the stakeholders'

perceptions are likely to be affected by framing effects, too, thus influencing their social demands.

We would like to conclude with two additional suggestions for future work. First, an interesting avenue for future research is to consider the moderating impact of the organizational life cycle. Jawahar and McLauglin (2001) claim that the stakeholders that really matter to an organization are different in the various stages of the life cycle. In empirical terms, this would suggest to add interactions of CSP indicators and firm age (not available in our dataset). In all likelihood, our sample is restricted to firms in the mature stage. Jawahar and McLaughlin (2001) reason that slack resources allow these firms to proactively deal with all stakeholders' desires. Our results are in line with previous research in this area, which tend to find a positive association between firm size and CSP. We cannot reproduce the finding that firm size – as measured by the number of employees – and firm profitability are positively correlated regardless of the profitability measure used. A related argument concerns Wood's (1991a; 1991b) that corporate social performance is an instrument for organizational legitimacy. Due to our sampling procedure, the ultimate consequence of socially unresponsiveness – i.e., organizational decline – cannot be observed. The consideration of firms in other stages of the life cycle will provide opportunities to test this type of logic.

Second, we would like to mention the role of the characteristics of the underlying processes, and the key decision-makers, in shaping the relationships between CSP and CFP. The literatures on board processes (e.g., Forbes and Miliken, 1999) and upper echelons (e.g., Hambrick and Mason, 1984) provide ample room for further theory development. Indeed, the conclusion on the sign and strength of a relationship between CSP and CFP, and their underlying dimensions and indicators, should ultimately be related to a careful analyses of the strategic processes that constitute these relationships. Currently, our chapter crosses several levels of analysis. Our knowledge of the CSP-CFP nexus would be improved upon if we could open this black box. Of course, deep-level studies like these require further data collection efforts, adding more detail to what we know about CSP, CFP, and their reciprocal relationships. Further efforts along this line could ultimately lead to a more comprehensive understanding of the mechanisms that drive the payoff to corporate well-doing.

4. Explaining Compliance with Corporate Governance Codes: Towards a Behavioral Compliance Theory[7]

All around the world, codes of corporate governance have flourished in the late 20th and early 21th centuries, and still are doing so. Whereas the US and the UK were the only countries involved in codifying the shareholder-management relationship in the early 1990s, 24 countries had at least one corporate governance code at the end of that decade (Aguilera and Cuervo-Cazurra, 2004), a number that has increased to more than 50 by the end of 2005. Codes of corporate governance have thus diffused rapidly across the globe, mainly due to the ever-increasing mobility of financial capital and the emergence of headline-hitting corporate scandals.

Not only have codes of corporate governance received ample media attention, scholars are likewise publishing research that aims to improve upon our understanding of the causes and effects of this proliferation of regulation and codification of management practice. Governance codes contain a wide variety of best practice provisions, relating to independence of non-executive directors, the length of the term of the executives, (the reporting upon) executive (and non-executive) remuneration, auditor independence, anti-takeover measures, and the organization of the annual meeting of shareholders, among many other topics. A large number of studies has appeared, detailing compliance with the best practice provisions contained in governance codes (e.g., Akkermans et al., 2007; Conyon and Mallin, 1997; Fernández-Rodríguez, Gómez-Ansón and Cuervo-García, 2004; Von Werder, Talaulicar and Kolat, 2005). Also, the effects of compliance on such corporate outcomes as managerial turnover and share performance have been widely studied (e.g., Alves and Mendez, 2004; Dedman, 2000, 2002).

The number of governance prediction studies that aims to explain *why* firms comply with the governance provisions is, however, fairly small. Institutional theories are invoked to identify macro-level factors that can be considered drivers of diffusion of codes (Aguilera and Cuervo-Cazurra, 2004; Haxhi and Van Ees, 2006; Thomsen, 2006) and several compliance studies report that compliance is higher in large firms, but a behavioral theory of compliance has yet to be developed – let alone tested. Such a theory first of all has to acknowledge the

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[7] This chapter draws heavily on a manuscript with the same title, co-authored with Hans van Ees and Arjen van Witteloostuijn. The paper has been presented at the International Association of Business and Society Conference (Florence, 2007), and the Academy of Management Annual Meeting (Philadelphia, 2007). A previous version appeared in the IABS conference proceedings in 2007 under the title "Adherence to societal norms: The case of the Dutch corporate governance code".

large variety in scope and content of the corporate governance best practice provisions. Thus, merely making a study of compliance at the aggregate level of the code is allegedly a rather meaningless effort. In this chapter, we develop such a fine-grained compliance theory, identifying managerial incentives to comply or not to do so. Moreover, we present a first empirical test for 130 Dutch stock-listed corporations for the fiscal year 2004. In terms of Figure 1.1, this chapter focuses on the relationship between executives, non-executives, and shareholders (relationships 3, 4, and 5).

In a nutshell, our argument runs as follows. In order to maintain support from key stakeholders – including shareholders and customers – managers want their firm to have a positive reputation, and thus are inclined to comply with corporate governance codes. In doing so, they seek to profile the firm in accordance with a norm, avoiding the negative consequences of not lining up. However, code compliance is a multidimensional concept. Since codes generally contain many best practice provisions, it is possible to comply with one provision, while not complying with another best practice. We argue that managers are inclined to resist the implementation of best practices that restrict their discretion to serve their personal interests the most. We refer to such best practices as managerially contested best practice provisions. We argue that executive compensation is the exemplary area in which such non-compliance will be predominant.

Subsequently, we draw arguments from agency and network theory to hypothesize on forces that counter this drive to serve these personally motivated self-interests. Based on agency theory, we argue that supervisory (non-executive) board power *vis-à-vis* management (executive) board power and the independence of these two boards from each other restrict the possibility of managers to act according to their personal interests. Based on network theory, we argue that if the firm takes a central position in the network of interlocking directorates, it is more likely to be forced to comply. After all, compliance is a societal norm that may be enforced through this intercorporate network to avoid more strict regulations from government or the stock exchange.

This chapter thus contributes to two literatures. First, compliance theories have focused mainly on hard laws, such as tax laws (e.g., Kirchler and Maciejovsky, 2001) or international treaties developed by supranational bodies (e.g., McLaughlin Mitchell and Hensel, 2007). Compliance with the latter is studied at the national level, whereas compliance to corporate governance codes takes place at the firm level. Non-compliance to the former (e.g., taxation laws) would be considered illegal, whereas non-compliance to governance codes is specifically allowed for through the 'comply or explain' mechanism, which offers firms the opportunity to legally motivate deviations from best practice provisions. We thus extend compliance theories into the realm of soft laws that apply at the corporate level. Second, governance prediction studies (Black, Jang and Kim, 2006) aim to explain why

companies adopt certain governance practices. For example, research has focused on the effect of a country's economic and financial development (Doidge, Karolyi and Stulz, 2004), a firm's growth opportunities, financing needs, and ownership structure (Durnev and Kim, 2005), and firm size and performance (Lang and Lundholm, 1993) on governance ratings. Also, the adoption of particular provisions such as poison pills or golden parachutes has been studied (Davis and Greve, 1997). We contribute to this literature by developing a behavioral compliance theory. We thus extend previous governance prediction studies by suggesting explanations that go beyond country and firm specific contingencies, such as a country's economic conditions and firm size.

4.1 Theory development

4.1.1 Corporate Governance Codes

A central assumption in agency theory is that managers, who own a small fraction of company stock, may behave in a self-serving manner, through diverting attention towards investments that are not in the company's best interest, or through suboptimal managerial investment of effort (Jensen and Meckling, 1976). Several external governance mechanisms, such as the market for corporate control, output markets, and the market for top managers, serve to discipline executives and align their interests with those of the owners of the company (Bhagat and Jefferis Jr., 2002). Internal governance mechanisms, such as monitoring by boards of directors and incentive contracts, serve a similar purpose. Legislation, however, applies a one-size-fits-all approach, by definition, as deviations from hard law are not permitted. In situations where this approach is considered inefficient to prevent managerial opportunistic behavior from occurring, codes are developed as a means to supplement national legislation.

The first corporate governance code was published by the US Business Roundtable in 1978, and concerned the role and composition of boards of directors in public corporations (Aguilera and Cuervo-Cazurra, 2004). In 1992, the British Cadbury committee brought governance codes to Europe (Cadbury committee, 1992), and with the publication of the Bulgarian code in October 2007, each European country has issued at least one code. Virtually all these governance codes aim to regulate the relationship between non-executive directors and executive top managers, on the one hand, ensuring independence, and the relationship between the firm and shareholders, on the other hand, creating accountability through transparency.

A key feature distinguishing corporate governance codes from hard law, for example the US Sarbanes-Oxley Act (SOx), is the so-called comply (or apply)-or-explain principle. Already Cadbury (1992: 16) "[…] recommend[s] that listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any area of non-compliance." Thus, corporate decision makers face a choice whether or not to live up to the best practice provisions. The Dutch corporate governance code, which is the focus of the empirical test in this chapter, refers to this choice, too: "Listed companies may depart from the best practice provisions. Non-application is not in itself objectionable and indeed may even be justified in certain circumstances." (Corporate Governance Committee, 2003: 4). Whether the reasons given for non-compliance are accepted, is up to the shareholders and other key stakeholders.

The comply-or-explain mechanism gives rise to a key follow-up question: what factors predict (non-)compliance? Although many studies have been conducted to assess the level of compliance, little is known about the drivers. In the sequel, we discuss several such predictors. The next section introduces reputation and profitability arguments, and also makes a case for observing non-compliance when managerial well-being is restricted the most. These insights may explain the high compliance levels, which are generally found in the literature, but also the lower compliance with a selected set of best practice provisions, which is also found across several European compliance studies. Subsequently, two forces pushing for compliance with best practice provisions, which restrict managerial well-being, are discussed: strong, independent supervisory boards, and pressure emanating from a network of interlocking directorates.

4.1.2   Compliance with Governance Codes

As several studies into the effects of the Sarbanes-Oxley Act (SOx) on corporate financial performance show, complying with the provisions contained in corporate governance codes is not costless. A survey of twenty of the largest US banks reveals that compliance costs grew with 159 per cent between 2001 and 2006 (Der Hovanesian, 2008). For the average US listed company, as a survey among financial executives demonstrated, audit fees went up $2.4 million in one year (Economist, 2005). Finally, Zhang (2005) estimates that the total net loss in US market value due to SOx equals $1.4 trillion. For codes that follow the comply-or-explain mechanism, costs are likely to be lower because managers are able to deviate from provisions that would require unprofitable investments. Still, the question remains that when compliance is costly and voluntary, why are high compliance rates observed? In this section, we develop three arguments that may explain this. We first

discuss two motives, profit and reputation seeking, which both may explain the generally high compliance levels. Subsequently, we qualify the concept of code compliance and present a classification of best practices that may explain the non-compliance that is consistently observed in several areas, notably executive compensation.

   Profit-motivated compliance. Firms may benefit economically from compliance. Appointing independent outside directors, assuring auditor independence from management, and increasing the influence of shareholders on strategy, have been said to reduce the extent to which executives may engage in opportunistic behavior. This, in turn, may reduce agency costs and positively affect profitability. An intriguing empirical question arising from this reasoning is whether corporate performance does increase after the introduction of governance codes, ceteris paribus, which would imply indirect evidence for the claim that they make agency problems less salient.

   Several studies have been conducted to test this hypothesis in a variety of national settings. Fernández-Rodríguez et al. (2004) show that the stock market reacts positively to compliance with Spain's governance code, but they could not nail down the specific recommendations that were the drivers of these wealth effects. Leverage and the relative number of executive directors were found to be important contingencies boosting the returns to compliance. Dedman (2002) reports that, for the UK, sales figures have increased after the implementation of the Cadbury code, and that the relationship between sales and financial performance became stronger in the post-Cadbury period. A positive relationship between compliance and performance has also been documented for the German governance code (Goncharov, Werner and Zimmermann, 2006). Alves and Mendez (2004) consider the Portuguese case, finding alternative results: specific recommendations have significant but not necessarily positive abnormal stock returns, whereas an overall compliance score is unrelated to stock market performance. Also, for The Netherlands, there are no strong performance consequences attached to the 1997 Peters' report (De Jong, DeJong, Mertens and Wasley, 2005). It has also been suggested, although results supporting this thesis have not been found, that from a signaling perspective, a negative relationship between compliance and performance may exist (Goncharov et al., 2006). The argument is that well-structured firms are able to show good performance and do not need to comply to easily applied provisions, whereas badly structured firms would comply to exactly these provisions. Overall, there does not seem to be strong evidence that codes are universally good for corporate performance.

   Reputation-based compliance. Firms need to maintain support from their environment – e.g., investors and customers – for the firm to remain going concern (Pfeffer and Salancik, 1978). According to this logic, therefore, a reputation for protecting investors is a condition that is positively affecting performance. Because stakeholders act upon their

perception of the firm in deciding whether or not to support the organization, the firm's reputation is an important asset to be considered in managerial decision-making. As Fombrun and Shanley (1990: 252) show "[p]ublics appear to construct reputations from a mix of signals derived from accounting and market [performance] information, media reports, and other non-economic cues. Firms' risk-return profiles, resource allocations, social responsiveness, institutional ownership, media exposure, and corporate diversification postures signal constituents about firms' prospects and generate reputations." Since compliance studies on corporate governance codes attract broad media attention and increase transparency about corporate operations, the strategy companies use to reply to the code's provisions is a factor shareholders may consider in determining the extent to which they will support the corporation. Thus, compliance may establish a reputation of being well-governed, which allows firms to secure stakeholder support. This may explain why high general compliance levels are found. However, thus argument cannot explain why specific best practice provisions are not complied with. Evidence has shown that non-compliance is observed for a specific set of best practice provisions in many countries (e.g., Akkermans et al., 2007; Conyon and Mallin, 1997; Fernández-Rodríguez et al., 2004; Von Werder et al., 2005).

Managerially contested corporate governance provisions. In managerial decision-making theory, two basic views of mankind have served as the basic postulate on which theories are built. On the one hand, neo-classical economic theories, and its current offsprings in principal-agency theory and transaction cost economics, assume that individuals maximize their private gains. On the other hand, stewardship theory argues that managers are intrinsically motivated to do good and to be a steward to the company (Davis, Schoorman and Donaldson, 1997). This distinction is in line with Etzioni's (1988) classification, who distinguishes collective rationality – reasoning aimed at group decision-making – from individual rationality. Etzioni (1988) acknowledges that collective rationality is to be preferred in some situations, whereas individual rationality is more efficient in other circumstances. We combine these two positions by hypothesizing that the extent to which managers act in line with company interest depends on the extent to which the activities they perform affect their private benefits.

Governance codes contain a wide variety of best practice provisions, relating to independence of non-executive directors, the length of the term of the executives, (the reporting upon) executive (and non-executive) remuneration, auditor independence, anti-takeover measures, and the organization of the annual meeting of shareholders, among many other topics. Consequently, it may be expected that compliance with these provisions depends not only on firm-specific contingencies, but also on the topic that is covered by the provision. For instance, some provisions require the installation of a procedure, of which the costs are

relatively fixed. Examples are the recommendation – in the Dutch governance code (Akkermans et al., 2007) – to webcast shareholder meetings, and the installation of board committees, as included in the German governance code (Von Werder et al., 2005). By the nature of the provisions, some firms – here, larger firms – are more likely to comply than others. However, for other provisions, firm-specific contingencies are less likely to explain (non-)compliance, and compliance behavior may be the consequence of general attitudes of decision-makers towards the recommendations.

In order to assess these general attitudes towards compliance with specific best practice provisions, we distinguish three types of best practices (see Table 4.1). This classification is based on the extent to which the recommendation affects the private gains of the executives, and acknowledges that the level of detail of the best practices as well as the variety in content and scope allows for compliance with selected parts of a corporate governance code. First, some governance codes prescribe practices that do not influence managerial discretion or private gains. Such managerially accepted corporate governance provisions may or may not be complied with, but a relationship among managerial discretion and compliance is not to be expected. For example, managers are not likely to have strong preferences over provisions that call upon supervisory boards to regularly evaluate their own performance. Such provisions do not enter the managers' utility function, and managers will not contest compliance with these recommendations.

TABLE 4.1

Classification of Corporate Governance Provisions

Type of provision	Examples	Types of behavior
Managerially accepted provisions	Supervisory board self-evaluation; auditor independence	Managers are stewards to the firm
Managerially debated provisions	Dismantling of anti-shareholder mechanisms; director independence	Managers trade-off preferences and pro-organizational behavior
Managerially contested provisions	Disclosure of remuneration; length of TMT contracts	Managers maximize private gains

Second, managerially debated governance provisions enter the utility function of the executive, but only do so indirectly. For example, provisions that relate to the market for corporate control do not directly affect executives' well-being. However, if executive performance is more directly scrutinized by hedge funds and activist shareholders, the probability of job loss after a takeover will increase. The difference with managerially accepted best practice provisions is thus that a self-interest maximizing individual would be

tempted not to comply with managerially debated provisions, if she would operate in a vacuum. However, the manager's "opportunity set is constrained by the perception that the utility gained from pro-organizational behavior is higher than the utility that can be gained from individualistic, self-serving behavior" (Davis et al., 1997: 25). Pro-organizational behavior comprises activities that benefit the organization as a whole. This is not only so because the manager derives utility from acting in line with the demands of other actors, but also because resistance to the implementation may result in arousal among these actors that negatively impacts upon managerial well-being. After all, "boards may be less likely to engage in self-serving behaviors … if they feel these actions are likely to be observed and discussed publicly" (Pollock, Fischer and Wade, 2002: 1175).

Third, managerially contested best practice provisions are those that directly and negatively affect the well-being of the executive. Examples are a requirement to fix the term of the contract with the executive, or the requirement to disclose the executive remuneration policy. Absent any pressure to comply, managers are likely to resist the implementation of these provisions the most. Facing a trade-off between benefits derived from adherence to others' demands, and private interests that go against these demands, managers are likely not to opt for pro-organizational behavior in this context. Overall, our classification approximates a continuum of provisions that trigger pro-organizational behavior based on the extent to which the compliance with the provision would go against the manager's self-interest. This gives

> *Hypothesis 4.1:* *Compliance is lower for managerially contested best practice provisions (relative to managerially accepted and debated provisions).*

We thus have outlined three arguments as to why compliance with specific best practice provisions may be observed. Note that, due to the relevance of such arguments, which depend on differential contingencies, it is not likely that studies trying to find explanations for overall compliance levels will have much predictive power. For any provision, compliance may yield financial benefits to the firm, may generate a reputation for being well-governed or may simply be the consequence of no objection against the implementation (i.e., managerially accepted best practice provisions). A combination of these factors may also be found. Particularly, we suggest that the extent to which managerially debated governance provisions are complied with, depends on the financial and reputation benefits that may be derived from compliance.

Our intent here is, however, not to show which combination of factors establish compliance to specific best practice provisions. Instead, we focus on managerially contested corporate governance provisions, and develop arguments as to why compliance may be observed in spite of the managerial intentions not to comply. The argument again takes a

behavioral lens, and acknowledges that managers do not operate in a social vacuum. The extent to which executives are able to oppose the compliance with managerially contested corporate governance provisions may depend on the power of opposing forces. Below, we discuss two such forces: normative pressure emanating from a network of interlocking directorates, and pressure from independent supervisory boards.

4.1.3   Opposing Forces

The extent to which managers are able to resist implementation of specific managerially contested best practice provisions depends on the extent to which other actors are able to strive for their implementation. We suggest two opposing forces that may establish high compliance levels with these provisions, regardless of their effect on managerial discretion and private gains. We do not aim to provide a full overview of all opposing forces that may operate, yet we wish to illustrate some main directions in which the theory can be further developed.

Normative pressure from other companies. Codes are generally developed by national bodies, and hence become a societal norm upon their publication. Compliance with best practice provisions is monitored strongly by both governments and stakeholder groups. When non-compliance is observed with a recommendation that is close to the interests of a stakeholder (group), this stakeholder is likely to call for more hard law on the topic. Since codes are self-regulatory devices, there is a need for managers who do not want corporate law to be developed such that the code's provisions become mandatory, to comply with the code to the extent that it at least appeases those parties who could otherwise enforce legislation. Thus, a dilemma emerges: although managers individually wish to resist implementation of certain provisions, collective non-compliance may result in stricter laws that force managers to implement the provisions. Networks of corporate directors have been suggested to serve as carriers of normative pressure (Mariolis, 1975; Mizruchi, 1996), and we suggest that managers who wish to both resist the implementation of a provision and prevent the development of additional legislation, are likely to press directors at other firms to enforce the implication of the provisions in those firms (DiMaggio and Powell, 1983). When a firm is thus central in a network of interlocking directorates (Pennings, 1980), it is more under pressure to comply to managerially contested corporate governance provisions. This suggests

Hypothesis 4.2:   *Firm embeddedness in the inter-corporate network is positively related to compliance with managerially contested best practice provisions*

Pressure from independent supervisory boards. Managers are more likely to provide detailed and transparent information supporting the proposals they present to the supervisory board if the latter is independent. An independent supervisory board is less open to deal-making behind closed doors, as it takes its responsibilities *vis-à-vis* the shareholders more seriously than a dependent board that is more willing to take the executive team's side. As Westphal (1998: 512) mentions, "structural board independence increases the board's overall power in its relationship with the CEO." The extent to which the board will allow managers to behave in line with their private interest is determined largely by the power balance between the two bodies. As Walker (1985) shows, less powerful team members are likely to adopt the cognitive perspectives of their more powerful counterparts. Hence, we propose

> <u>Hypothesis 4.3</u>: *Supervisory board independence is positively related to compliance with managerially contested best practice provisions*

4.2 Data and Method

To test our theory, we used the database collected by Akkermans et al. (2007), pertaining to compliance with the Dutch corporate governance code in 2004. The Dutch context is particularly suitable for our purpose for at least two reasons. Firstly, code development has been particularly strong in the US and the UK. In these countries, it is difficult to nail down one specific code and study compliance in isolation. The European Corporate Governance Institute, for example, lists more than 20 codes that appeared in the UK since the establishment of the Cadbury code in 1992. In the Netherlands, two main codes were introduced since 1997 (see below). It is thus easier to isolate compliance with the code under study. Secondly, the Dutch corporate governance system is characterized by a two-tier governance system in which the influence of investors on company policy was limited, at least up to 2004. For a first empirical test of our theory, it is helpful that the decision-making at the top of the firms under study involves fewer decision-makers. Also, the two-tier system guarantees a clear division of responsibilities at the top.

The next sub-section provides a brief overview of the empirical context. More extensive reviews are available elsewhere (e.g., De Jong et al., 2005; De Jong, 2001; Poutsma and Braam, 2005; Van Ees and Postma, 2005). Subsequently, the sample and the measurement of the variables is described. Finally, attention is devoted to some estimation issues.

4.2.1 Dutch corporate governance

The focal point of the Dutch corporate governance system is a two-tier board structure consisting of a management board in charge of the day-to-day operations of the firm in combination with a separate supervisory board. The supervisory board's scope of influence varies substantially, depending on which institutional governance regime the firm adopts. The so-called 'structural regime' applies to the majority of public limited liability companies listed on Euronext Amsterdam's stock exchange. Two-third of all Dutch firms listed on Euronext Amsterdam are required by law to follow the structural regime, whilst other firms may opt to do so.

The supervisory board has three primary functions: first, to appoint, monitor, suspend and dismiss members of the management board; second, to draft the annual financial statement for presentation at the annual shareholders meeting; and, third, to approve major business decisions proposed by the management board concerning, for example, expansions, acquisitions, restructurings or financing arrangements. Members of the supervisory board are appointed for four-year terms by the annual meeting of shareholders. The mean number of members on the supervisory and management boards is slightly more than 5 and 3, respectively. An individual cannot serve on both boards of the same company. Inside (managerial) ownership of listed firms is unimportant in the Netherlands.

At the annual meeting, the influence of investors is circumscribed under the structural regime in two ways. First, few important issues are brought forward to the annual meeting: the financial statement drafted by the supervisory board is voted on (amendments are not permitted), and nominations for the supervisory board may be proposed and rejected. Large investors can exert influence by refusing to approve the financial statements, however that rarely happens. Second, and more devastating to investors' voting rights, management can make use of several anti-investor devices for diluting voting power and separating control rights from cash flow rights.[8]

In 1997, the Peters committee was the first to explicitly discuss the roles, competences and responsibilities of the management and supervisory boards in the Netherlands. The forty best practice provisions formulated by the committee can be regarded as the first Dutch corporate governance code. De Jong and Roosenboom (2002) evaluated the extent to which Dutch companies complied with the provisions of the Peters report in the period 1997-2002. The results appeared to be disappointing: the information companies provided in their annual reports on compliance with the provisions of the Peters report turned

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[8] Employees are represented by a works council, which exists in virtually all large firms. From October 2004 onwards, the works council has the right to a binding nomination of at most one third of the supervisory board. Since the data collection took place over the financial year 2004, this right does not affect the results of this study.

out to be scant. Moreover, in most cases, companies seemed to comply only formally, without this having any major consequences for corporate activity. These disappointing findings led to the establishment of a new corporate governance committee: the Tabaksblat Committee. The committee, representing the Dutch government, the Dutch shareholder association, the Amsterdam Stock Exchange and the Dutch employers' organizations, was assigned the task to establish a new Dutch corporate governance code. This Tabaksblat code was presented in December 2003.

Based upon 21 principles of good governance, the committee formulated a detailed list of best practice provisions of corporate governance. According to the code, all companies listed on the Dutch stock exchange and foreign companies with a statutory residence in the Netherlands have to comply or explain non-compliance with the best practice provisions of the code. In addition, listed companies are required by law to report on their compliance with the code in their annual report, based upon the comply-or-explain principle. The principles of the code apply to five important aspects of corporate governance. These include: (I) compliance with and enforcement of the code, (II) the management board, (III) the supervisory board, (IV) the shareholders and general meeting of shareholders, and (V) financial reporting. On January 1 2004, the code came into force, implying that companies have to report on compliance from the fiscal year 2004 onwards.

4.2.2   Data

To test our hypotheses, we use the database that was constructed in the context of the study of compliance with the Dutch corporate governance code performed by Akkermans et al. (2007). This research, commissioned by the Dutch Ministry of Finance, concerns the 150 largest Dutch stock-listed corporations. For the current study, we included all firms from the major stock indices of Euronext Amsterdam in the Netherlands (130 firms, in total). This sample includes such well-known global players as Philips, ING and Unilever, but excludes firms with no business activity in the Netherlands.

To determine whether a company complied with a specific best practice provision, a data collection instrument was developed in which all provisions of the code were split up in single, one-dimensional propositions or statements. This was necessary because many provisions relate to multiple practices. The higher-level provisions were split up in up to 24 lower-level sub-provisions, yielding insights at a level of detail that is, to the best of our knowledge, unique. Subsequently, the company websites and annual reports were accessed to answer the following questions for each and every sub-provision: (i) is this best practice sub-provision relevant for the corporation (e.g., sub-provisions as to share options are only

relevant if the company indeed grants these options)?; (ii) if so, does the firm act in line with the sub-provision?; and (iii) if not, does the firm explain its non-compliance?

A pilot study was conducted, and about five meetings were held in which the researchers extensively discussed their experience with the data instrument, leading to iterative updates of both the data collection instrument and the assessment of the corporation's compliance. Another check of the validity of the data was conducted by providing the corporations the opportunity to respond to the assessment by email. The first round, concerning executive and non-executive compensation, yielded a response rate of 41 per cent, whereas a second round on the other provisions of the code resulted in a response rate of 27 per cent. We consider these response rates acceptable, given the difficulty of accessing managerial elites. Also, companies had fewer incentives to reply when they fully agreed with our assessment. The difference between the response rates can, to our opinion, be explained by the fact that executive compensation has received broad attention in the media, also in the Netherlands.

4.2.3   Variables

The dependent variable in all our hypotheses is overall compliance with a specific set of code provisions. We took the average of the compliance scores for all statements in a best practice recommendation to calculate compliance with that recommendation. Next, we averaged out – again, unweighted – the compliance rates at the recommendation level to the topics inside the code. We used this measurement method because the structure of the code implies a ranking of importance of specific topics: a subject is obviously more important if it is dealt with in a separate chapter of the code.

Next to a score for two topical areas, we computed overall compliance scores. The topical areas reflect managerially contested corporate governance provisions, namely disclosure of and accounting for executive compensation (the Appendix provides an overview of the provisions that are included in each variable). Following upon our argument, executive compensation is closely associated with the executive's private interests. To test the first hypothesis, overall compliance levels were also computed for other topics in the code (see below).

The independent variables are network centrality, board power and board independence. The websites of the corporations were used to determine who sits on the management and supervisory boards of the 130 corporations by the 1st of July 2004. A network centrality measure is computed from this network, where we weigh the interlocks by the compliance rate. Thus, in the models where we explain firms' overall compliance, we include the network centrality variable in which the number of interlocks is weighed by the

relevant compliance rate of the firms in the network. We measure board power as the number of directors serving on the management board over the total number of directors. In the Dutch two-tier system, management and supervision are separated into two distinct bodies. We argue – in line with previous studies – that if one board outnumbers the other strongly, the former's views on compliance will be more prominently represented in the firms' strategic choices. The variable board independence is based on information from the compliance study as well (Akkermans et al., 2007). Board independence is a composite measure of various statements referring to this concept (see the Appendix).

Next to industry dummies, three control variables are included, all of which are derived from Thomson Financial's database Datastream. First, in line with many findings that larger firms comply more, we include firm size in the regressions. Second, we add performance (in terms of profitability), as low performance may be an indicator of firms being scrutinized more by investors. Third, we introduce leverage, as this may proxy for the extent to which managers adhere to the best practices, which are usually designed with the investor's perspective in mind. Firm size is operationalized as the natural logarithm of the total value of the assets, performance as return on assets in the year prior to our compliance study, and leverage as the debt-to-equity ratio, taking the market value of equity and the book value of debt. Finally, we control for industry effects in compliance by distinguishing between three broad sectors: financial, service, and industrial corporations. The industry classification is the Dutch so-called BIK system, which is based upon the United Nations' ISIC classification, and which was developed by the Dutch chambers of commerce. We considered controlling for the index in which the corporation is listed as well, but this categorization turned out to be highly correlated with the size measure.

4.2.4   Method

Because the compliance rates are bounded to the unit interval by definition, we not only entered the rates as the dependent variable, but we also ran analyses with the log odds of the rates as the dependent. After all, applying OLS to range-limited dependent variables may result in predictions that lie outside the unit interval. However, we found that the results do not change substantively, indicating that predictions larger than one or smaller than zero do not occur. Because the coefficient estimates in the models with untransformed compliance rates can be interpreted as the marginal effect of a focal exogenous variable on compliance at any level of the other exogenous variables, and because using the log odds solves for a potential statistical problem we consider not being present, we use the untransformed compliance rates in our regression models below. We have computed predicted compliance

scores and report upon the number of predictions that fall outside the unit interval. We do acknowledge, though, that the variance of an exogenous variable does not need to be constant at all values of the endogenous variables by calculating White's heteroskedasticity-consistent standard errors.

4.3   Results

We first test Hypothesis 4.1 by comparing the level of compliance for best practices relating to executive compensation to compliance with other best practice provisions. Subsequently, a test of the other hypotheses is conducted through regression analyses. A difficulty in testing Hypothesis 4.1 is that it presumes a clear division of best practice provisions over the three categories – managerially accepted, debated, and contested provisions, as distinguished in Table 4.1. Such a distinction does not yet exist, and we have chosen to compare the compliance level of one set of provisions – i.e., those concerning executive remuneration – to all other provisions. Since compliance with one provision may depend on compliance with other provisions, future research could verify our approach, and develop more rigid tests of the empirical validity of the classification of provisions our theory suggests. For the purpose of our study, it is sufficient to assume that the dependent variable that has been selected – compliance with executive remuneration provisions – directly affects the utility of the executive. The approach that we take here is in a sense more strict than one that compares the three classes of provisions directly: the other provisions to which we compare the executive compensation best practices contain contested provisions as well, and thus it will be more difficult to find a difference between compliance rates of remuneration vis-à-vis other recommendations.

The Tabaksblat code contains five chapters, which are subdivided into a total of 17 sections. The study by Akkermans et al. (2007) demonstrated four stylized facts: (i) taking all firms into account, section II.2 (on executive remuneration) was complied to by 59 per cent of the companies, which is the lowest percentage for all sections (the second-lowest is 69 per cent); (ii) focusing on the largest firms (those contained in the large-cap AEX index), the compliance rate for executive remuneration provisions is 75 per cent, while most other scores are above 90 per cent; (iii) although provisions relating to director independence were also not-complied to by AEX-listed firms, non-compliance was frequently explained here, whereas this was not the case for remuneration provisions; and (iv), finally, even the smallest companies, where complex compensation packages are usually not in place and directors are paid based on a fixed fee and a cash bonus, compliance with remuneration provisions was at a low 50 per cent, whereas compliance rates for other best practices are mostly between 65 and

85 per cent for these firms. The above percentages clearly show that compliance with this selected set of managerially contested corporate governance provisions is lower than compliance with other provisions. This evidence thus provides tentative support for Hypothesis 4.1.

Having provided some anecdotal evidence for the first hypothesis, we proceed by testing the effects of opposing forces. Table 4.2 presents summary statistics and correlation coefficients for all the variables in this study. Note that since network centrality is weighed by compliance, there actually are two centrality measures.

The results in Table 4.2 show, first, that it is meaningful to calculate different compliance rates for compensation versus disclosure practices. The correlation coefficient among the two dependent variables in this study is a mere 0.47. This distinction is not apparent in the networks in which firms are embedded: if a network of firms that disclose pay practices would exist relatively unattached to a network of firms that account for pay practices, the two network variables should be empirically distinct, which they are not. Since both variables are not entered into the same regression models, this observation does not warrant statistical concern. We do observe that larger firms tend to have larger networks, although the correlation coefficient is only larger relative to other coefficients, and not so much in absolute terms.

TABLE 4.2

Descriptive Statistics and Correlation Coefficients

		Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11
1	Disclosure compliance	0.60	0.15	1.00										
2	Accountability compliance	0.60	0.31	0.47	1.00									
3	Firm size (log of assets)	5.68	1.11	0.36	0.39	1.00								
4	Leverage	0.60	1.20	-0.15	-0.01	0.34	1.00							
5	Performance	-0.01	0.14	0.24	0.10	0.29	0.02	1.00						
6	Board power	0.37	0.16	-0.18	0.07	-0.13	-0.02	-0.28	1.00					
7	Board independence	0.75	0.27	0.29	0.19	0.17	0.09	0.15	0.01	1.00				
8	Network centrality (disclosure)	0.84	0.33	0.74	0.47	0.48	-0.08	0.26	-0.19	0.20	1.00			
9	Network centrality (accountability)	0.84	0.33	0.74	0.47	0.48	-0.08	0.26	-0.19	0.20	1.00	1.00		
10	Industrials (industry dummy)	0.45		0.04	0.08	0.03	-0.19	-0.02	-0.09	-0.17	0.06	0.06	1.00	
11	Financials (industry dummy)	0.35		-0.05	-0.02	-0.08	0.21	0.02	0.08	0.13	-0.12	-0.12	-0.66	1.00
12	Services (industry dummy)	0.20		0.02	-0.08	0.06	-0.02	-0.00	0.03	0.07	0.07	0.07	-0.46	-0.36

Table 4.3 displays the results of the regression analyses. In the first and the third columns of this table, the benchmark models are depicted, whereas the second and fourth columns show the results of the full models. Note, first, that the application of OLS to this dataset indeed turns out to be unproblematic since only one predicted value of the dependent variable in one of the models lies (somewhat) outside the unit interval.

TABLE 4.3

Regression Analyses

	Disclosure of pay				Accountability of pay			
Constant	0.27	**	0.24	**	-0.17		-0.47	**
Network centrality			0.32	**			0.37	**
Board power			-0.07				0.29	
Board independence			0.09	*			0.16	+
Firm size	0.06	**	0.01		0.13	**	0.08	**
Leverage	-0.04	**	-0.02	+	-0.04		-0.02	
Performance	0.13	+	0.01		0.02		-0.05	
Financials	0.01		0.02		0.06		0.07	
Industrials	-0.00		0.01		0.06		0.10	+
N	129		127		119		117	
F-test	7.34	**	22.27	**	5.04	**	7.39	**
Incremental F-test			38.71	**			9.53	**
Adjusted R^2	0.20		0.58		0.15		0.31	
# predictions outside unit interval	0		0		0		1	

White heteroskedasticity-consistent standard errors and covariance; Incremental F is the F-test for the explanatory power of the model *vis-à-vis* a model with the control variables only; ** $p < 0.01$; * $p < 0.05$; and + $p < 0.10$.

All models reach statistical significance. The two benchmark cases show that, indeed, larger firms tend to comply more, even to managerially contested corporate governance provisions. This is in line with previous findings in compliance studies (e.g., Alves and Mendez, 2004; Fernández-Rodríguez et al., 2004; Von Werder et al., 2005). For best practices that refer to the disclosure of executive compensation, we also find that leverage contributes negatively to compliance and that past performance exerts a positive influence on compliance. The first is in line with our expectation that firms which are heavily indebted tend to comply more with creditor's best practices that may not necessarily be reflected in shareholder-oriented governance codes. The effect of performance runs counter to our expectations, though. One explanation may be that the effects of firm size, leverage, and performance

together somehow proxy for a firm's reputation. Large firms, with no financing needs (i.e., potentially large free cash flows) and good past performance may be the stars in our sample, which are seen as examples in the press for good governance. In this case, the reputation argument would predict that these firms wish to maintain their status, and consequently comply more to even those provisions to which managers oppose the most.

The independent variables are added in the second and fourth columns of Table 4.3. We clearly find support for both Hypotheses 4.2 and 4.3. The incremental F-test shows that adding board independence, board power and network centrality variables adds significantly to the explanatory power of the models. Previous studies thus omit relevant variables in predicting compliance. Specifically, the effect of firm size that is found in almost all compliance studies may actually proxy for other salient characteristics on which large firms are different from their smaller counterparts. Thus, not only are relevant variables excluded, but also other variables that are included in earlier work may suggest an effect that is in fact due to the covariation of these variables with the omitted measures.

Hypothesis 4.2 suggests that embeddedness of a firm in a network of director interlocks creates normative pressure on managers to comply, which would be an indication of self-regulating director networks. After all, at the country level, compliance is desirable to avoid stricter regulations, and since managers wish not to comply themselves, they may use influencing tactics to convince others in related firms to adopt the provision. The results in Table 4.3 clearly show that network embeddedness has an important effect on compliance. Substantively, if a firm has one link with another firm, and this other firm complies fully with all best practice provisions relating to disclosing of or accounting for executive compensation, the focal firm has a compliance rate that is 32 to 37 per cent higher than when such a link would not exist. We thus find clear support for Hypothesis 4.2.

Hypothesis 4.3 predicts that independent boards are less inclined to allow managers not to comply with contested governance provisions. Our results also provide support for this hypothesis. Although the effects are less significant than those found for network centrality, still compliance rates are 9 up to 16 per cent higher for firms with fully independent boards, as compared to firms with fully dependent boards. We thus find clear support for Hypothesis 4.3.

4.4   Conclusion and discussion

In this chapter, we developed what is, to our best knowledge, the first theory of compliance with corporate governance codes. In contrast to previous studies, in which no distinction among provisions was made, we introduce a classification of best practices according to the extent to which they influence the private interests of executives. At one extreme, we argue that if private interests are not affected by the practice on which a recommendation is developed, managers are more likely to engage in pro-organizational behavior. Managerially accepted best practice provisions refer to such cases. At the other extreme, managers are likely to resist implementation of those best practices that directly target their private interest. In our theory, such provisions, of which executive remuneration is a prominent example, are managerially contested corporate governance provisions. Managerially debated corporate governance provisions are between these extremes, and refer to practices that indirectly affect managerial well-being – for example, through an increased probability of job loss in case of the dismantling of anti-investor constructions. We study the extent to which executive remuneration practices are lived up to, and indeed find that this managerially contested corporate governance provision is significantly less complied with than other provisions. Thus, we find tentative evidence in support of our classification. Human choices are thus incorporated, as we show that abstract firm contingencies actually proxy for social relationships.

We proceed by theorizing that non-compliance with provisions does not take place is a vacuum. We argue that good governance codes become a societal norm upon their introduction, and interested parties will either push for compliance or for additional regulations in case non-compliance is frequently observed. Thus, in order to avoid stricter regulation, managers who wish to resist compliance with contested governance provisions, would also strive for compliance with these provisions at other firms. We thus contend that embeddedness of a firm in a network of interlocking directorships will place the managers of this firm under institutional pressure to comply. We indeed find that for our selected contested governance provision, executive remuneration, centrality in such a network positively impacts upon the compliance score. Additionally, we argue that board independence will also imply a counterforce against managerial motives not to comply, and find evidence for this claim. Thus, context matters to explain compliance, albeit not necessarily the local context.

This chapter thus adds to the governance literature by showing that conformity to corporate norms and relational perspectives may well add to the understanding of compliance with specific best practice provisions. Several areas of future research remain. First, a full test of the distinction between accepted, debated and contested governance provisions would

allow to assess the extent to which the theoretical classification has empirical validity. We are not able to test directly whether compliance levels for either of the categories is significantly different from any of the other categories. Such an endeavor would require an understanding of what constitutes managerial interests and which practices directly or indirectly affect these interests, or leave them unaffected. Second, a full test of the model would show whether the opposing forces we have identified – centrality in a network of director interlocks and board independence – are only important for contested provisions, or whether they also help to strike a balance in deciding whether or not to comply to debated provisions. More broadly, the forces that lead to the acceptance of managerially debated governance practices deserve further attention, where the application of a relational lens is probably useful since a bargaining situation exists almost by definition for these provisions. Third, our study deserves to be replicated in environments where investors have a stronger say in corporate practice, and in environments where a one-tier governance structure is in place. Particularly, the role of other outsiders – such as consultants or accountants – on the decision whether or not to comply to a best-practice provision seems a fruitful follow-up to our reasoning.

Appendix: Best practice provisions used for variable construction

This appendix provides an overview of the best practice recommendations in the code that are considered in each of the topical areas. We briefly summarize the content of a provision. The full text is available in Committee Corporate Governance (2003). The variables on executive compensation include a selection of provisions from section II.2 of the code, leaving out questions referring to non-compensation issues. It is clear from the wording of the provisions, which best practices refer to disclosing pay arrangements, and which refer to accounting for (motivating) these policies. Specifically, the following sub-provisions are included: II.2.1 (conditional stock options), II.2.2 (unconditional stock options), II.2.3 (shares), II.2.4 (exercise price of stock options), II.2.5 (terms of stock options contract), II.2.9 (remuneration report), II.2.10 (content of remuneration report), II.2.12 (special remuneration), and II.2.14 (value of stock options). The independent variable 'board independence' draws on the sections III.2 and III.5 of the code. It includes the sub-provisions III.2.1 (supervisory board members shall be independent), III.2.3 (declaration of independence), III.5.1 (drawing of regulations of board committees), III.5.2 (composition of board committees), III.5.3 (report from board committees), III.5.6 (chair of the audit committee), III.5.7 (financial expert in the audit committee), III.5.11 (chair of the remuneration committee), and III.5.12 (no managers in the remuneration committee).

5. CEO Compensation as a Reflection of Power or Performance: An Empirical Test for the Netherlands, 2002-2006[9]

The academic debate over executive compensation in publicly listed corporations has grown substantially over the past few decades. Since Jensen and Meckling (1976), scholars hold that executive compensation is best tied to corporate performance. Many papers have been devoted to documenting such a relationship, yet Yermack (1995) discarded most executive compensation theories, and reviews questioned the importance of corporate performance in establishing CEO pay (Dalton, Hitt, Certo and Dalton, 2008; Tosi, Werner, Katz and Gomez-Mejia, 2000). Bebchuk and Fried argued that pay is not related to performance since managers have substantial bargaining power over their boards (Bebchuk and Fried, 2004; Bebchuk, Fried and Walker, 2002). They thereby question the assumption that bargaining with the CEO takes place at arms' length. Instead, they contend that non-executive directors depend on the CEO for a re-appointment. CEOs may thus have the ability to influence the structure, level, and performance-sensitivity of their compensation contracts.

Empirically, the battle of these theories takes place through interpretation of findings in pay-for-performance studies. Consequently, for some phenomena, several explanations exist. For example, option re-pricing is interpreted as re-establishing incentives by optimal contracting theorists, and as evidence of how managers secure high pay even when performance declines by managerial power theorists (see volume 69 of the *University of Chicago Law Review* for such a confrontation of the two approaches). The joint existence of multiple explanations for the same phenomenon is unsatisfactory, particularly since the predictions from the two theories are derived from different assumptions with respect to the bargaining process. Under optimal contracting, the board of directors sets the CEO's pay, in an effort to maximize shareholder returns. Managerial power theory, on the contrary, assumes that the CEO has the ability to manipulate the pay-setting to her own benefit. To gain further insight into executive compensation theories, the core assumptions of both theories may be tested and yield conclusions that allow research to develop the theory further. This study aims

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[9] This chapter grew out of a research project commissioned by the Dutch government to Hans van Ees, Eric Engesaeth, Camiel Selker, and myself (Van Ees, Van der Laan, Engesaeth and Selker, 2008). The chapter not only uses the data, which was collected for this research, but also benefits from the many discussions we had over executive compensation. I am further indebted to Dirk Akkermans and Dennis Veltrop for assistance in data collection for this project, and to Colin Ellis, whose firm ownership database was also used for this study.

to contribute to this theory building by directly estimating a relationship between CEO power and compensation contract design, compensation level, and compensation sensitivity to firm performance, respectively. In terms of Figure 1.1, this chapter is mainly about the relationship between executives and non-executives (relationship 3), although aspects of the relationship between shareholders and (non-)executives are also referred to.

We develop hypotheses on the association between CEO power and the design, level and performance sensitivity of CEO compensation. A pooled time series cross-section dataset comprising most listed firms in The Netherlands for the period 2002-2006 allows us to explore two alternative narratives. First, we assess whether CEO power is related to the choice of compensation contracts. Specifically, we hypothesize that when CEOs have substantial power over their board, the compensation contract is more likely to contain long-term incentive plans (LTIP; either stock options or shares). Second, we test whether CEO power is associated with higher compensation levels. After all, CEOs with substantial power may be able to obtain higher salaries or cash bonuses regardless of company performance. Also, due to risk-averse CEOs, the expected value of compensation contracts containing long-term incentives is likely to include a risk premium, and therefore CEO power may lead to higher compensation levels. As this partly reflects the selection of the compensation contract, and not so much CEO power, we proceed by estimating the effect of power on compensation, controlling for the effect of power on the design of the compensation contract. After all, an effect of power on compensation levels may actually reflect the CEO's ability to select such a compensation contract. Finally, we hypothesize that CEO power is likely to lead to a lower pay for performance sensitivity (PPS), as CEOs are risk averse. The measures of CEO power are based on a multidimensional scale developed by Finkelstein (1992), and capture structural, ownership, expertise and status sources of CEO power.

The results of this chapter show that power does not contribute strongly to the explanation of the design of the compensation contract. An effect of power on pay levels is found, yet this effect does not stand the robustness test in which we control for the effect of power on contract design. Moreover, corporate performance is a predictor of the level of equity-based compensation. Finally, there are some relationships among CEO power and PPS, but these are not all in line with the predictions, nor are they consistent across compensation elements. The latter may suggest that several contingencies, not included in this chapter, may affect which compensation element is susceptible to managerial power. The former, however, is discomforting, as in some instances it is shown that CEO power actually makes the relationship between performance and pay stronger.

The next section proceeds with the two theories, and offers a brief overview of the empirical evidence. Subsequently, we provide a detailed description of our fine-grained compensation and power measures in Section 5.2. Results Section 5.3 discusses the effect of

power on contract design and the effect on compensation levels. Finally, Section 5.4 concludes the chapter, offering reflections on the findings.

5.1   Theory development

Among law and economics scholars, the following two theories of CEO compensation are most prominent. First, optimal contracting, relates to neo-classical economics and holds that CEO pay should be structured such that she is motivated to maximize shareholder interests. Second, the managerial power approach, is closely related to behavioral law theory, and contends that solving for the agency problem through designing a compensation contract is not the solution to the problem. The CEO may have bargaining power over the board and is likely to try to influence the contract to her own benefit. According to the managerial power thesis, when CEOs have such bargaining power, the efficient compensation contract will not be feasible.

In this section, we first develop the optimal contracting thesis and the managerial power approach. Subsequently, we discuss empirical evidence regarding both approaches. This leads us to conclude that a direct assessment of the assumption in managerial power theory, that CEO power affects the compensation contract design, pay level and performance sensitivity, is necessary to further generate progress in the CEO performance pay literature.

5.1.1   Optimal contracting versus managerial power

The optimal contracting approach can be traced back to Jensen and Meckling's (1976) formalization of the agency problem that may occur when a company is not owned by the managers (Berle and Means, 1932). The starting point is that rational, self-serving behavior may create conflicts of interest exist between shareholders and the CEO. Risk-neutral shareholders are assumed to be interested in a return on their investment, whereas the risk-averse CEO may also value other benefits such as growing a large company, or using company assets to satisfy her private needs. After all, with a separation of ownership and control, the marginal benefit to the CEO of her labor does not reflect the marginal contribution of such labor to corporate performance. Consequently, a CEO may decide to shirk her duties by delivering effort which is deemed sub-optimal by the owners. Even with strong incentives to maximize corporate performance, the CEO will not perceive the full costs of perks she may consume, as these costs are borne by all shareholders. Therefore, her efforts may be misdirected towards generous perks consumption, or strategies that benefit the CEO's utility more than company performance. Such a deviation from shareholder interests is

possible due to information asymmetries. Shareholders will never have the inside information which CEOs have, which hampers corrective action. A solution to the agency problem thus asks for measures that counter the motivation to both undersupplied and misdirected effort.

Various mechanisms that mitigate this agency problem have been identified (Dalton et al., 2008), including the design of compensation contracts. A compensation contract which specifies that the CEO receives the highest pay when corporate performance is at its top, makes the CEO strive for corporate objectives instead of private motivations to deviate from these objectives (Jensen and Murphy, 1990). It is recognized, however, that several factors make the enforcement of a compensation contract difficult (Grabke-Rundell and Gomez-Meija, 2002). For example, if the compensation contract is not perfect, monitoring by shareholders is still required because of imperfect interest alignment. If ownership is dispersed, single shareholders will not find it in their best interest to monitor the CEO as the costs of monitoring will not be offset by substantial gains in their wealth due to improved corporate leadership. It has been suggested that the analysis of such moral hazard problems is best analyzed in a bargaining framework where power imbalances cause rent extraction (Grabke-Rundell and Gomez-Meija, 2002).

Managerial power scholars take this message even further, and argue that not only the enforcement of the compensation contract is a bargaining game, subject to power relationships, but that also the design of the contract is affected by CEO, director, and shareholder power (Bebchuk and Fried, 2004; Bebchuk et al., 2002). The managerial power scholars argue that directors, in practice, do not have the bargaining power to reach the equilibrium which optimal contracting prescribes (Bebchuk and Fried, 2003). The argument builds on insights from the board member selection process. When new directors are appointed, the company submits one slate to the shareholder meeting, which is usually approved. The CEO has a substantial influence over who gets onto the company's slate (Westphal and Zajac, 1996), particularly in cases where she is also the chairperson of the board and/or a member of the nomination committee (see also Demb and Neubauer, 1992; Lorsch and MacIver, 1989). A director who opposes against a generous compensation package for the CEO may not be slated (Westphal and Khanna, 2003), and thus such a director may feel that his personal interests are best served when he does not oppose to the pay package. In principle, in the US and other countries, shareholders also have the right to submit a slate to the shareholder meeting, yet this rarely happens since selecting and drawing up a list of candidates is costly (Bebchuk and Fried, 2004). Various protection mechanisms also complicate shareholder intervention, to such an extent that some law scholars have argued that shareholders cannot be legally considered the principals of the managers (Blair and Stout, 1999). Therefore, executives and directors alike have been insulated from the influence of shareholders, which renders the compensation issue essentially a boardroom

topic. Inside the boardroom, exerting the power which formally accrues to the directors is compromised by the CEO's influence over director nomination. Therefore, the arms' length bargaining assumption is not met in practice.

What, besides the CEO's norms as to what is reasonable, then limits executive compensation? Bebchuk et al. (2002: 786-788) introduced the concept of outrage costs, which serve as a constraint on CEO pay. If pay is set excessively high, public outrage may cause social and reputational damage to the directors. Both the CEO and the other directors may experience difficulties in securing positions in other companies, when they have been associated with excess managerial rent extraction. Also, investor groups may try to generate profits by placing a tender offer, obtaining control over the firm's assets, removing the CEO, and selling off the company at a higher price. Thus, outrage costs are associated with reputational concerns and career prospects for the CEO, and place a limit on her compensation level.

To prevent public outrage, CEOs are argued to engage in camouflage, which is the second key concept in the managerial power theory, next to outrage costs. Camouflage involves the practice of reducing pay transparency through the establishment of seemingly complex pay arrangements, which only formally suggest a strong pay-performance relationship (Bebchuk and Fried, 2004). An example is to set a variety of complex targets, which suggest incentive compensation but may function otherwise, as performance measures need not be positively correlated. Sales increases and profit levels may be negatively related if price cuts are necessary to generate additional sales. If compensation is dependent on both sales and profitability, the compensation level may not be affected by the increase in sales. Thus, while such a contract suggests performance sensitive compensation, in practice pay would not be very responsive to changes in performance.

Overall, the two approaches mentioned above result in fundamentally different perspectives on the compensation contract. Under optimal contracting, directors maximize shareholder return by designing a contract that motivates the CEO to work in line with what is best for the shareholders, while satisfying the managerial participation constraint. Thus incentive contracts are considered a solution to the agency problem, although it is likely that the problem will never be solved completely due to the costs of incentive contracts. This contract is a feasible solution, because bilateral bargaining takes place at arms' length, which implies that directors are independent from the CEO and negotiate a contract with only the shareholders' interest in mind. Under managerial power theory, the assumption of arms' length bargaining is not met in practice. As the negotiations over the compensation contract do not take place in a relational vacuum but rather in a bargaining framework, directors are likely to value the preservation of the relationship with the CEO. Next to the direct utility derived from this, directors may also experience indirect utility as CEOs are more likely to

support directors in securing re-appointment on the board. Thus, the compensation contract, instead of being a partial solution to the agency problem, is a reflection of the agency problem under this approach.

5.1.2 Empirical evidence and challenges

Both the managerial power and the optimal contracting theorists have argued that empirical studies support their predictions. As extensive reviews are available elsewhere (Bebchuk and Fried, 2004; Core, Guay and Larcker, 2003; Devers, Cannella, Reilly and Yoder, 2007), we do not aspire to provide broad coverage here.

Several authors have documented a statistically and substantively significant pay-performance relationship for US samples (e.g., Aggarwal and Samwick, 1999; Baber, Kang and Kumar, 1998; Conyon and Peck, 1998; Hall and Liebman, 1998). Where others found no strong pay for performance sensitivity (Jensen and Murphy, 1990; Yermack, 1995), it was argued that these findings may have been due to, either, a lack of understanding on the workings of incentive contracts by (non-)executive directors (Murphy, 2002), or by the claim that society would place restrictions on optimal incentives and would disprove of contracts that allow for large sums to be distributed to CEOs (Jensen and Murphy, 1990), even if such payments would be optimal. Thus, in terms of Bebchuk and Fried, it might be optimal for shareholders to cause outrage. It has also been shown that trends in performance are related to performance levels, thus suggesting that firms with higher performance pay more (Kaplan, 2008), although these results have also been questioned (Bogle, 2008).

For The Netherlands, the country for which data has been collected for the present study, research into this topic is only recently possible due to new legislation demanding disclosure of compensation. It is therefore not surprising that there is only one study testing Dutch pay-performance sensitivity (Duffhues and Kabir, 2008). In this study, long-term incentive plans cannot completely be covered (due to the study being conducted before the above-mentioned legislation became effective). Duffhues and Kabir (2008) find a negative relationship between performance and cash compensation. Their review of the compensation literature outside the United States and the United Kingdom further indicates that pay-performance relations have been substantively and/or statistically insignificant there.

Managerial power scholars have built on these inconclusive findings, and focused on elements of compensation practices which are not in line with optimal contracting predictions. They argued that these elements – together with the inconclusiveness of the pay-performance literature – are more in line with managerial power theory than with arms' length bargaining. Exemplary practices are the re-pricing of stock options and generous severance payments.

Although Weisbach states that the interpretations offered by managerial power theorists are persuasive (Weisbach, 2007), it is nevertheless problematic that there is usually an optimal contracting explanation to these practices alongside the managerial power interpretation. For example, option re-pricing takes place when the likelihood that the share price will exceed the exercise price approaches zero. The exercise price is sometimes adjusted in such a situation. Since the downward adjustment of the exercise price is seen as an *ex post* relaxation of the performance targets, managerial power theorists interpret option re-pricing as adjusting the parameters of the contract such that the CEO's wage is substantial also when corporate performance declines (Bebchuk and Fried, 2004). Optimal contracting scholars, on the contrary, argue that when the exercise price is likely not to be exceeded by the share price, re-pricing allows the principals to restore the CEO's incentives. Regarding severance payments, managerial power theorists hold that directors pay outrageously high goodbye fees to CEOs to compensate for the perceived disutility of firing the CEO. Others, however, argue that the discussion over severance payments is influenced by outliers, which are broadly covered in the media, whereas median severance pay is rather unsubstantial (Kaplan, 2008). In order to be able to discriminate market forces from power arguments, a direct test of the relationship between CEO power and CEO compensation may clear up some of the confusion.

One interesting test of this relationship is offered in Dorff's (2005) experimental setup. Through experiments, two challenges, common in the empirical literature, are less salient. First, optimal contracting holds the promise that one can determine to what extent a specific remuneration package differs from one with optimal incentives, yet it is at least tedious to find the empirical counterpart of this optimal contract (Dorff, 2005). Second, even when managerial power theory holds, a moderate pay-performance relationship is expected due to the outrage constraint: selecting a performance-insensitive compensation contract would cause public concern (Grabke-Rundell and Gomez-Meija, 2002). Moreover, the laboratory conditions in experiments are much more under control than those situations observed in business practice. Dorff assigned students one out of three roles in a game in which, first, directors were supposed to select a CEO and reach an agreement over the CEO's pay. In subsequent rounds, directors could either keep the CEO – possibly renegotiating the wage – or fire the CEO and hire another one. Directors also set their own fee. In a second phase, CEOs were given power over the board. Specifically, after the CEO had been contracted, she was allowed to both set the director's fee and fire directors. Obviously, these powers do not formally accrue to the CEO in practice. The findings show that when CEOs are given these instruments, CEO pay increases dramatically and CEO turnover decreases. Of course, the characteristics of the actors (law students) and the fact that there was no uncertainty with respect to firm performance may, among other reasons, limit the external validity of the experiment, yet it is informative to see that managerial power theory is strongly

supported in this study (Dorff, 2005). Other supportive evidence is found in the study of director selection processes. Studies by Westphal and colleagues have shown that interpersonal influencing tactics are applied in the context of CEO-board relations (Westphal and Stern, 2007), that individuals stand a larger chance of being appointed to the board when they are demographically similar to the CEO (Westphal and Zajac, 1996), and that directors who are associated with the implementation of anti-CEO provisions loose influence over future decision-making (Westphal and Khanna, 2003).

5.1.3   Hypotheses

We adopt a different methodology to test whether CEO power is related to compensation. We test the basic assumption that CEO power affects the structure of the compensation contract, the level of compensation, and pay for performance sensitivity. This is, after all, the central hypothesis in from managerial power theory. In doing so, we allow for a double agency problem in line with managerial power assumptions. It might be argued that optimal contracting theory also predicts a positive relationship between power and compensation, as more powerful CEOs would have to be incentivized more to keep them in line. We discuss the consequences of this notion below, but mention here that a relationship between power and compensation need not be against contracting prescriptions.

The key argument of the managerial power approach is that CEO power not only affects post-contractual moral hazard, but that the CEO is also likely to influence the parameters of the compensation contract. Assuming that the compensation can be paid through salary, bonus and long-term incentives, the first two are arguably less subjected to camouflage and more likely to elicit outrage. Of course, if a CEO has the power to affect the composition of the peer group, this may positively impact on the level of the salary. Also, through the selection of performance targets, the bonus may be subjected to managerial power. Yet the costs of stock option and share plans can both be diluted and camouflaged. Costs are diluted because shareholders also bear part of the cost of stock options and shares – after all, their claim concerns a smaller part of the profit pie. Costs can also more easily be camouflaged, as particularly conditional options – those for which the number that is granted depends on performance targets – can be subjected to various kinds of complex calculations. Shareholders will find it difficult to estimate the value of the option when faced with the decision to approve the compensation package. This does not hold for salary and bonus levels, where the value of the compensation elements is immediately obvious. Therefore, we argue that long-term incentive plans are more susceptible to camouflage, and hence more

appropriate as a vehicle to compensate a relatively powerful CEO in a more generous way for running performance risks. This gives

> *Hypothesis 5.1:*   *CEO power is positively associated with the adoption of long-term incentive plans.*

If a relationship between CEO power and the use of long-term incentive plans (LTIPs) is found, this needs not necessarily invalidate optimal contracting theory. Indeed, even if the compensation contract is negotiated at arms' length, but the CEO has superior abilities to behave opportunistically, it may be optimal for the shareholders to provide the CEO with more incentives. Following this logic, a positive relationship between LTIP adoption and power would also be expected.

Because LTIPs introduce uncertainty into the expected compensation of the risk-averse CEO, a risk premium may be added to the compensation contract as CEOs may otherwise not accept the contract. However, following this logic, higher compensation would be due to the risk-aversion of the CEO, not to her power. Managerial power theory has not placed a strong emphasis on pay levels, although it seems that public outrage over compensation is more about the level of compensation than about its structure, and maybe even about performance sensitivity. The rationale which is applied to the sensitivity of pay to performance and the structure of compensation contracts, however, directly extends to the level of compensation: CEOs having substantial bargaining power may succeed to obtain larger (performance-insensitive) sums as compensation for their efforts. Furthermore, under optimal contracting theory, a CEO who has substantial powers to behave opportunistically, may be offered a premium to make the downside of opportunistic behavior (i.e., the income loss resulting from being fired) larger. This logic suggests

> *Hypothesis 5.2:*   *CEO power is positively associated with the level of CEO salary and bonus.*

Finally, the CEOs' utility function is not only increasing in the level of pay, but also in the performance invariability thereof. It holds by definition for risk-averse agents that a certain grant of one dollar is preferred over a grant with an expected value of one dollar. It has been argued that CEO power is likely to lead to the adoption of long-term incentive plans. This is because these plans are more susceptible to camouflage and less likely to cause outrage than cash compensation. Absent outrage costs, CEOs would prefer to receive pay increases in cash, yet as this is much more likely to cause outrage than pay through LTIPs, CEOs are argued to strive for the adoption of LTIPs and subsequently strive for a low sensitivity of pay to performance for these plans. In this way, the uncertainty over expected earnings is reduced. Therefore, we have

> *Hypothesis 5.3:*   *CEO power is negatively moderates the relationship between performance and compensation*

Extending the contracting argument to performance sensitivity, a CEO who has substantial power may be able to serve her private interests better. She would thus (Hypothesis 5.1) be offered a compensation contract containing more incentives than would otherwise be the case. Consequently, for this CEO, it would actually be expected that the relationship between power and pay sensitivity is positive. We note, finally, that our operationalization of power reflect a broader notion than is found in managerial power theory. We do not explicitly capture the power of a CEO to influence the re-appointment process of non-executive directors, yet we use a multidimensional conceptualization of power based on Finkelstein's (1992) framework. We now turn to such issues of sampling and measurement.

5.2   Data and Method

5.2.1   Sample

A dataset of all CEOs in 107 stock-listed Dutch companies in 2002-2006 was hand-collected. Information on fixed pay, cash bonuses, stock options share grants and portfolios, and other compensation types was derived from the annual reports of these companies. Firm performance data was taken from Thompson Financial's Datastream database. CEO power was derived from annual reports and company websites. We recorded compensation information from 2002, when the reporting of individual executive compensation levels for all statutory members of the management board was required for the first time.

The Dutch stock market is characterized by relatively few listings and a large variety in firm size and industry membership. We therefore aimed to include all listed firms in our sample. An initial count of all listed companies resulted in 177 listings. Several companies were not included in the sample because their primary listing was elsewhere, and there was no material business activity in The Netherlands. Executives in these corporations would probably not conform to Dutch pay practices. Also, it was required that corporations were listed for at least three years in the sampling period, because of information availability, of which at least two of these listings should be in or after 2004. Thus, companies that delisted in 2004 but were listed throughout 2002-2004, as well as companies that were listed as of 2005 or later, would not be included in the sample. For the former, information would be difficult to obtain, whereas the observation window for the latter is too short to draw meaningful conclusions. Finally, 117 corporations remained in the sample. Annual reports for all these companies were analyzed. Whenever annual reports were not found, the company was contacted and the reports were requested. The final sample consists of 107 corporations.

The deletion of 30 non-Dutch companies furthers a clear definition of the sampling frame, and is likely to make our results more generalizable for the Dutch context. For informational purposes, however, 40 additional companies were removed, which may imply a sampling bias. The main reasons for a delisting may after all be either bankruptcy or merger. Both exit modes are likely to emerge in situations of performance extremity. Therefore, this potential bias has to be taken into account when interpreting the results. Before removal of cases due to missing information for the independent variables, 576 observations remained. Some companies are entered twice in one year, due to a CEO change, and 100 firms are included for all years. For 43 companies, there is only one CEO during the observation window, while the medium number of CEOs per firm is 2 (the maximum is 3). In sum, the observed units are relatively stable throughout the years, as 93 per cent of the firms have a listing in all years, and 92 per cent of the firms experienced no more than one CEO change.

5.2.2 Compensation Variables

Compensation is defined as the change in the wealth of the executive caused by grants of the company to the executive or changes in the value of grants made to the executive in the past. We thus include fixed salary, cash bonuses, stock option grants, share grants and the change in the value of the option and share portfolio in our study. Such an all-inclusive study goes unprecedented in The Netherlands, and is rarely seen in the international academic literature at large.

Salary. Executives in virtually all corporations obtain fixed grants in cash. If such grants were made in foreign currencies – mainly US dollars or pound sterling – the amount was converted into euros using the European Central Bank's conversion rates per July 1st. To properly account for appointments or leaves during a year, the number of months the executive worked in the focal position has been recorded, and the salary is annualized accordingly.

Bonus. Supervisory directors in European countries tend to use cash bonuses to reward executives for good performance more than their American counterparts. Also, cash bonuses may be used to reward executives for individual performance, which is not (directly) observable from corporate outcome measures. Where necessary, conversions to euros were made.

Options and shares. This variable contains a variety of underlying concepts. Option and share grants have been included, as well as the appreciation of the value of portfolios of options and shares previously granted to the CEO by the company. Obviously, LTIPs may contain other forms of compensation as well, such as deferred cash payments, and the value

of a requirement to hold a number of shares in the company, but these forms are rare in The Netherlands.

  Stock option grants. A stock option is the right to buy shares in the company at a pre-specified exercise price. In our sample, 68 companies have granted stock options in at least one year (64 per cent). Such options typically cannot be exercised for three years (the so-called vesting period), but can be exercised in the two years thereafter. Options have been valued through the binomial model and the Black Scholes formula. The resulting values correlated with a coefficient of 0.99. We therefore – arbitrarily – decided to use the binomial model valuations in the analyses. For this valuation, six inputs are required. First, the *exercise price* is taken at face value. In case options were granted on shares issued by the focal company but listed on a foreign stock exchange, the value was computed with the information for this foreign listing and the resulting valuation was converted into euros. Second, the *number of options granted* was taken at face value for unconditional options. In The Netherlands, conditional option grants are also frequently observed. These conditional grants imply that there is not only a restriction on exercising stock options, but also that certain performance targets determine the amount of options that is granted at the end of the vesting period. Thus, instead of being granted 10,000 options, which may be exercised after three years (unconditional options), a CEO knows that she will receive 7,000 options when performance is low, 10,000 when performance is at target, and 13,000 options in cases of outstanding performance, for example. We corrected for this conditionality of grants by computing the expected number of options to be granted at the end of the vesting period using the equal probabilities method. This method involves the computation of the number of options to be granted at each performance level (mentioned in the annual report), and, subsequently, the computation of the expected amount assuming that all performance levels are equally likely.

  Third, the *expected life* of the option is determined. Most options are exercised somewhere after the end of the vesting period, but before the options lapse. Computing the value of the options at the time they expire, would thus result in a biased estimate. We used two rules of thumb to determine the value of the options. The first rule implied that a CEO exercises the options halfway the period where she is allowed to do so. The second rule involves exercising the option when the stock price reaches a certain threshold, which was set at twice the price of the option. The valuations that resulted with each of these rules correlated with a coefficient of 0.96, and we therefore – arbitrarily – choose the first decision rule. Fourth, the *volatility* of the share price was determined using closing prices in the three preceding years. Fifth, the *stock price at valuation date* was taken as the average stock price in a one-month window around the end of the year of valuation. Thus, the year-end closing price was taken, which was averaged out over the period of December 15th – January 15th to

filter out possible outliers. Sixth, and finally, the *dividend yield* was computed by dividing the dividend amount in the previous year by the half-year stock price in the previous year, where this price was again the average of 30 closing prices around July 1st.

Stock option portfolio. Once options have been granted, the wealth of the CEO varies with the changes in the values of these options. Such changes, although of material importance, have rarely been taken into account in empirical work (Hall and Liebman, 1998). Therefore, the six input parameters to the binomial model mentioned above are updated every year the options have not been exercised or lapsed. Among others, this implies that when conditional grants become unconditional, the number of granted stock options is recorded instead of the expected amount. Also, when options are exercised, the associated profits and the reduced value of the stock option portfolio has been noted. Stock options may or may not lapse when an executive leaves the company, and this has been taken into account. The profit obtained by exercising options is also included.

Share grants. A large minority of 42 companies (39 per cent) have granted shares in at least one year. Since shares are usually granted at no cost to the executive, the valuation is straightforward: the amount granted is multiplied by the share price at the end of the year, averaged out over thirty closing prices. In case share grants are conditional, the equal probability method, which was also applied to stock options, has been used.

Share portfolio. Comparable to option portfolios, share grants also constitute a portfolio if the grants cannot be sold for a number of years, as is usually the case. Shares that can be traded on the stock market, including voluntarily bought shares, are not taken into account, because these have not been granted by the company. If unvested shares lapse because of termination of the executive's contract, this is taken into account.

Total compensation includes all the above-mentioned variables and also irregular cash payments (such as the value of perks).

5.2.3   Firm performance, Power, and Control Variables

Firm performance. According to Devers et al. (2007), company performance has been measured in a variety of ways, including both market-based measures, such as share price increase or total shareholder return, and accounting-based measures, such as return on equity or return on assets. Since accounting-based measures of corporate performance reflect past performance, whereas investors also factor in expected future performance in determining the stock price, the choice of performance measure is not conceptually unimportant (Devers et al., 2007). Empirically, however, there is not much guidance as to which measures are frequently used.

To measure company performance, we first made an inventory of the performance criteria used by the 54 largest companies in 2005, and the 63 largest companies in 2006, both for short-term variable compensation (i.e., cash bonus) and long-term (i.e., options and share) plans. The plethora of criteria that was found, indicates that a single measure of corporate performance is likely not to capture all aspects of corporate performance on which compensation contracts steer. The criteria were subdivided, as Table 5.1 shows, according to – first – the type of compensation to which they applied and – second – whether the criterion was related to financial targets or not.

TABLE 5.1

Performance Criteria

	2005	2006
Total number of criteria	154	244
Short-term criteria (bonus)	90 (58 per cent)	151 (62 per cent)
Financial	85 (94 per cent)	122 (81 per cent)
Non-financial	5 (6 per cent)	29 (19 per cent)
Long-term criteria (options, shares)	64 (42 per cent)	93 (38 per cent)
Financial	62 (97 per cent)	82 (88 per cent)
Non-financial	2 (3 per cent)	11 (12 per cent)

Note: The sample consists of 54 firms in 2005 and 63 firms in 2006. All AEX and most AMX funds are included. Percentages are included in brackets.

The findings in Table 5.1 show that the majority of the performance criteria is financial, although non-financial criteria have become more popular. In 2005, 6 per cent of the short-term criteria was non-financial, and 3 per cent of the long-term criteria. These percentages increased to 19 and 12, respectively, in 2006. Also, the findings indicate that a firm uses, on average, three to four performance criteria. Although a large variety of targets was set, it was possible to create groups of performance criteria at a higher level of abstraction. The conceptual difference between, for example, relative share price and relative total shareholder return will be small. Thus, four performance measures were defined and applied throughout the study. These performance measures cover 75 per cent (2006: 82 per cent) of the short-term financial performance measures in 2005. The financial performance criteria not covered by our selection refer mostly to cash flow variables or ambiguously defined criteria such as 'growth' or 'the value of new businesses'. For the long-term criteria,

the four performance measures cover 89 per cent (2006: 87 per cent) of the financial performance criteria. Consequently, for this study, four performance measures were used: revenues, profit, relative total shareholder return, and earnings per share (EPS).

Revenues are recorded in millions of euros. Profit is measured as operating income divided by total assets. Total shareholder return includes share price appreciation and dividends relative to a peer group. Total shareholder returns are measured relative to a peer group. Companies usually make use of such groups, including the performance of competitors and other similar companies (in terms of industry and size, for example) to establish the relative share performance. Peer groups were determined based on cluster analysis. Firm size, proxied for by total assets, revenue, market value, and the number of employees, and the number of years (in 2002-2006) the firm was listed in either the index of large caps (AEX 25) or midcaps (AMX 20) were used as clustering variables. Four clusters resulted, and the firms in each cluster were considered each others peers for the purpose of this study. Because of this procedure, the relative TSR measure only relates to firm size, and is not informative with respect to performance relative to, for example, industry. Total shareholder return (TSR) was computed for each company in the sample, and relative TSR was defined as the deviation of company TSR from the peer group (i.e., cluster) mean. The data were obtained from Thomsen Financial's database Datastream. Each of the firm performance variables measures a different aspect of firm performance, as the highest correlation coefficient among the performance indicators is only 0.18.

Power. In line with Finkelstein (1992) and Grabke-Rundell and Gomez-Meija (2002), we distinguish among four sources of CEO power: structural, expertise, status, and ownership power. First, ownership power is measured through the percentage of shares held by the CEO (CEO ownership). We made use of a database of ownership, constructed from filings with The Netherlands Authority for the Financial Markets and a Dutch financial newspaper. Under Dutch law, owners of at least 5 per cent of company shares are obliged to report their shareholdings, and filings made under this law have been used. Furthermore, the database REACH, based on Chambers of Commerce information, has data on shareholdings for some owners holding less than 5 per cent of company shares. Also, companies are required to report executive shareholdings in their annual report. Information from these various sources was combined to generate an overview of shareholders and their stake in the company. Shareholdings by the CEO, or investment vehicles owned by the CEO, were elicited for the CEO ownership variable. Second, structural power was measured through the CEOs tenure on the board. CEOs who have held the position longer have likely developed relationships with directors. Third, nationality and education level proxy for expertise power. Nationality is recorded as a binary variable indicating whether the CEO is Dutch (coded 0) or not (coded 1). As the Dutch economy is relatively small and open to foreign investors, a relatively large

share of (non-)executives are of foreign birth (Van Veen and Marsman, Forthcoming). In terms of education, most CEOs have a degree in either law, economics, or business, whereas a large minority holds engineering degrees. The distinguishing characteristic may be the level of the degree, rather than the degree program, and we thus included a variable education level, running from no higher education (coded 0), to lower professional education (coded 1), higher professional education (coded 2), university masters (coded 3), and PhD level education (coded 4). The data for both structural and expertise power sources were drawn from annual reports, company websites, and directories of executives. Finally, status power is measured by the number of non-executive positions held by CEOs in other firms. Although CEOs are not allowed to sit on the supervisory board of their own firm, 17 per cent held a seat on the board of another company.

Control variables. Three control variables were included in this study. As Tosi et al. (2000) demonstrate, the lion's share of compensation is explained by firm size. Thus it is imperative to include this variable, measured as the log of total assets. Ownership concentration may well impact the extent to which the agency problem is salient, as dispersed ownership is a condition for free-riding problems among shareholders with respect to their monitoring efforts. Thus, from the ownership database mentioned above, we also constructed a Herfindahl index in which the sum of the squared ownership percentages was calculated to indicate ownership concentration. When computing this variable, it was assumed that those shares which were not accounted for in the database, were held by a large number of dispersed owners. This assumption, which may cause a slight downward bias in the concentration index, appears not to be of material interest, as block holders are required to report their stake. Third, as compensation practices tend to spread through networks of interlocking directorates (Davis and Greve, 1997), and since US firms tend to pay a larger share of executive pay through stock and stock option plans, it was expected that a listing on a US stock exchange may make it more likely for a CEO of a Dutch firm to be paid through such means. We thus included a binary variable indicating whether (coded 1) or not (coded 0) a firm was also listed on the New York Stock Exchange or NASDAQ. By means of a check of current listings, it was found that a listing on another stock exchange that may exhibit similar network effects, such as the London Stock Exchange, was not of material importance to the current sample.

5.2.4   Method

All hypotheses are tested through panel OLS regression. As the dependent variable in the models of contract choice is binary, probit models were estimated to test the associated

hypothesis. In all models, a correction for heteroskedasticity was introduced, and in the models for compensation levels and pay performance sensitivity it was tested whether period fixed effects added to the explanatory power of the models. This turned out not to be the case. Instead, autoregressive schemes were generally required as the Durbin-Watson statistics deviated from the bounds developed by Bhargava, Franzini and Narendranathan (1982).

Straightforward regressions of the level of compensation on power and performance variables would fail to acknowledge that some of the factors assumed to explain pay levels may also have an effect on the adoption of pay practices. For example, if CEO power causes the adoption of variable pay, then such analyses may well suggest that power is related to the level of pay just because variable pay components are likely to generate higher payments. We developed an alternative method, and control for this through interaction effects (see also Parker and Van Witteloostuijn, 2008). Let compensation variables be included in the set Y, and performance variables in the set X. The set Z includes those variables which were also expected to explain the adoption of variable pay (indicated by the binary variable D). We demean the variables contained in Z, and estimate $Y = f(X,D,Z,D*Z)$. If there is no other effect of CEO power on pay than through the choice of compensation contract, we would expect to find insignificant coefficients for Z and significant coefficients for the interaction terms in $D*Z$. Note that another explanation for finding insignificant Z-coefficients and significant $D*Z$-coefficients may be that the adoption of variable pay is exogenous, and that pay levels are higher because variable pay grants power to the CEO. For most power variables, however, this reverse causality is logically improbable.

Testing the hypothesis that power affects the performance sensitivity of compensation while controlling for the effect of power on contract choice, involves introducing interaction terms among the four performance criteria and the five power measures. As this consumes many degrees of freedom, an alternative approach is, again, applied. We started with a model (for each dependent variable) with all four sets of interaction terms included: the interactions among the variable pay dummy (D), on the one hand, and the control and power variables (set Z), on the other hand, were included $(D*Z)$, similar to the method presented above. Additionally, interaction terms among CEO power and performance $(X*Z)$, and interactions among variable pay, CEO power and performance $(D*X*Z)$ were added. After all, the effect of performance on compensation contracts may go through power, or through power and the design of compensation contracts. If this argument holds, it would be expected that only interaction terms containing D will turn out statistically significant. Thus, powerful CEOs may be able to reduce the pay-for-performance sensitivity $(X*Z)$, for example through re-pricing of options, and be able to select compensation contracts that are associated with a pay-for-performance sensitivity $(D*X*Z)$, for example contracts containing targets which are easily met. These models, with 63 parameters, were subjected to a stepwise, backward,

regression analysis. In five subsequent rounds, interaction terms were dropped when the *p*-value was above some threshold value, which was reduced to 0.50 in subsequent rounds.

5.3   Results

The managerial power approach may be summarized in three hypotheses. First, CEOs having power over the board are able to secure compensation contracts which allow for high payments. As bonuses and salaries are less susceptible to camouflage, we thus proceed with testing whether CEO power is related to the adoption of long-term incentive plans (Hypothesis 5.1). Second, CEOs having power over the board are proposed to be paid more. We analyze the effect of CEO power on pay levels below (Hypothesis 5.2). We test this effect in two ways. First, we enter all independent and control variables simultaneously. Subsequently, we acknowledge that part of a supposedly higher pay may be due to CEOs being able to convince their boards to pay through compensation types which are more likely to generate higher pay levels. The logic is that CEO power results in higher pay both because of a direct bargaining effect, and because such CEOs have contracts that allow for higher compensation levels. Powerful CEOs will minimize downside risk, and create as much upside potential as possible. The alternative methodology, outlined in Section 5.2.4, is applied here. Third, the managerial power approach argues that CEO power allows CEOs to reduce the pay-performance sensitivity, as the expected value of a variable compensation component is valued less than the same guaranteed dollar amount in cash (Hypothesis 5.3). We test this notion in Section 5.3.3.

5.3.1   CEO power and the structure of compensation contracts

The key argument of the managerial power approach is that CEO power not only affects post-contractual moral hazard, but that the CEO is also likely to influence the parameters of the compensation contract such that the potential for rent extraction is maximized. Table 5.2 presents descriptive statistics and correlation coefficients for the independent variables and a dummy 'variable pay'. This dummy is coded 1 if a CEO received compensation in the form of stock options or shares in the year under study. The upper panel of Table 5.2 presents means and standard deviations. It appears that 58 per cent of the observations involve some kind of compensation through long-term incentive plan (i.e., stock options and/or shares). Firms granting these pay components tend to be larger, although unconditional options are also granted by smaller firms. Ownership concentration is smaller in firms granting variable pay, which may reflect that for these firms incentive alignment may substitute for shareholder

monitoring as a means of guaranteeing appropriate CEO effort. The argument that boards of firms with a listing on NYSE or NASDAQ see variable pay being used in their peer group and thus also apply it to their own firm, appears to find support in our data. As can be seen from Table 5.2, 25 to 41 per cent of the firms with such pay components have a listing on these exchanges, whereas this is only 19 per cent for all firms. CEOs who own few shares in the company appear to be compensated more through share plans than those owning substantial amounts. This also makes intuitive sense, as CEO ownership already provides incentives to the CEO. Foreign CEOs also appear to be paid more through variable pay mechanisms, whereas the other power variables (tenure, and positions on supervisory boards of other firms) do not discriminate among pay components. One should bear in mind that some of these findings may be jointly caused, as – see panel B of Table 5.2 – larger firms are more likely to have a foreign listing and CEOs tend to have a higher stake in the company when there are only a few shareholders. None of these correlation coefficients is sufficiently high to cause concern over multicolinearity, though.

TABLE 5.2

Descriptive statistics and correlations for non-compensation variables

Panel A: means and standard deviations								
Sample:	All		Firms with conditional stock options		Firms with unconditional stock options		Firms with share plans	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD
1 Variable pay*	0.58	0.49						
2 Size	13.52	2.55	15.13	2.33	13.77	2.75	15.42	2.72
3 Ownership concentration	0.10	0.14	0.07	0.09	0.09	0.13	0.06	0.07
4 Foreign listing*	0.19	0.39	0.38	0.49	0.25	0.44	0.41	0.49
5 CEO ownership	0.03	0.11	0.01	0.06	0.04	0.14	0.00	0.01
6 Education level	2.85	0.59	2.85	0.55	2.87	0.61	3.00	0.59
7 Nationality*	0.14	0.35	0.21	0.41	0.19	0.40	0.31	0.47
8 Tenure	6.84	5.71	6.10	4.47	7.03	5.76	6.95	4.75
9 Other positions	0.17	0.53	0.24	0.56	0.15	0.38	0.17	0.49
Number of observations	447		94		142		103	

Panel B: correlations (x 0.01)								
	1	2	3	4	5	6	7	8
1 Variable pay*								
2 Size	33							
3 Ownership concentration	-19	-18						
4 Foreign listing*	27	43	-11					
5 CEO ownership	-4	-14	49	8				
6 Education level	9	6	-10	1	-11			
7 Nationality*	19	22	3	17	11	1		
8 Tenure	-1	19	-6	4	0	-10	-17	
9 Other positions	2	17	-5	1	2	-2	-11	27

Variables denoted with * are dummies. Correlation coefficients r (x0.01), with $p < 0.01$ for $r > 0.12$, $p < 0.05$ for $r > 0.09$, and $p < 0.10$ for $r > 0.08$.

Table 5.3 estimates – through probit models with Huber/White robust standard errors – the effect of the above-mentioned variables on the likelihood of having variable pay components.

TABLE 5.3

Probit models of compensation structure

	Variable pay		Conditional stock options		Unconditional stock options		Share plans	
Constant	-2.31**	-2.01**	-3.43**	-2.62**	-0.96**	-0.77	-4.01**	-4.49**
Size	0.19**	0.14**	0.18**	0.17**	0.04	0.00	0.23**	0.20**
Ownership	-1.34**	-1.60**	-0.86$^+$	-0.72	-0.78$^+$	-1.15*	-1.68**	-0.86
Foreign listing	0.60**	0.59**	0.35*	0.45*	0.31$^+$	0.27	0.37*	0.51**
CEO ownership		0.60		-0.83		1.23$^+$		-4.19*
Education level		0.13		-0.11		0.07		0.28$^+$
Nationality		0.53*		0.01		0.25		0.76**
Tenure		-0.01		-0.05**		0.01		0.00
Other positions		-0.04		0.20		-0.09		-0.12
N	548	447	548	447	548	447	548	447
LR-statistic	118.78 **	84.74 **	74.47 **	69.72 **	16.65 **	14.34 $^+$	116.71 **	118.40 **
McFadden R^2	0.16	0.14	0.38	0.15	0.02	0.03	0.21	0.25
Hit rate	0.68	0.68	0.83	0.80	0.70	0.69	0.83	0.83

Huber/White robust standard errors and covariance.

** $p < 0.01$, * $p < 0.05$, and $^+ p < 0.10$.

Although the models in Table 5.3 all reach statistical significance and the hit rates are acceptable, the model for unconditional stock options is somewhat ill-explained by the selected variables. The results show that firm size, ownership concentration and a listing on a US stock exchange consistently predict the adoption of variable pay components, which is in line with expectations. Larger firms with dispersed ownership are less easily monitored than tightly held small firms. Consequently, such firms tend to adopt long-term incentive plans to align the incentives of the CEO with those of the shareholders. A listing on a US exchange also increases the likelihood of having such plans. Adding CEO power to these base models, however, does not add much explanatory power. In no model, a substantial increase in the McFadden R^2 is observed, and for conditional stock options the statistic even decreases strongly. Only for share plans, does CEO power add to the explanatory power of the model. It appears that share plans are less likely to be adopted when the CEO is a shareholder herself. This is in line with expectations, as the wealth of such a CEO already moves up and down with the stock market. More powerful CEOs in terms of their expertise power, that is their education level and nationality – or, foreign experience – , tend to have more share plans than

CEOs lacking this power source. Besides this effect of expertise power on the adoption of share plans, however, there is not much evidence for Hypothesis 5.1.

5.3.2 CEO power and the level of compensation

The second hypothesis of the managerial power approach is that CEO power leads to higher pay levels. Table 5.4 presents descriptive statistics and correlations for variables not included in Table 5.2.

TABLE 5.4

Descriptive statistics and correlations for compensation variables

Panel A: means and standard deviations (x €1,000)										
	Sample:	All		Firms with conditional stock options		Firms with unconditional stock options		Firms with share plans		
		Mean	SD	Mean	SD	Mean	SD	Mean	SD	
10	Salary	450	347	663	323	522	404	708	436	
11	Cash bonus	239	430	508	656	277	446	558	640	
12	Stock options and shares	268	1431	745	2404	383	1458	1082	2231	
13	Total compensation	1121	1763	2106	2806	1296	1772	2571	2628	
	Number of observations	569		97		178		114		
Panel B: correlations (x 0.01)										
		Salary		Bonus	Options/Shares					Total
11	Bonus	56								
12	Stock options and shares	14		26						
13	Total compensation	36		51	77					
2	Size	70		54	10					35
3	Ownership concentration	-2		-8	2					13
4	Foreign listing*	58		47	6					23
5	CEO ownership	13		-1	9					10
6	Education level	-19		-33	4					-12
7	Nationality*	32		25	6					16
8	Tenure	9		-3	-2					6
9	Other positions	11		-6	-2					8

Variables denoted with * are dummies. Correlation coefficients r (x0.01), with $p < 0.01$ for $r > 0.20$, $p < 0.05$ for $r > 0.17$, and $p < 0.10$ for $r > 0.15$.

From panel A in Table 5.4 it is observed that firms with variable pay components pay more compensation. This may partly be caused by the fact that, as Table 5.3 demonstrated, these firms tend to be larger. Also, the introduction of long-term incentive plans increases the risk that the CEO will receive compensation below her reservation wage. Such firms may have to grant even more options and shares, such that expected pay increases further, or add the risk premium to the salary or cash bonus. This may also explain why firms with variable pay components pay higher salaries and bonuses.

In Table 5.5, the hypothesis is tested that CEO power positively affects pay levels. In establishing the model, period fixed effects appeared to be redundant and the Durbin-Watson statistics, although difficult to evaluate in panels with few years, indicated that a first-order autoregressive scheme was necessary. Robust standard errors were included and up to four observations were removed as these were associated with extreme error terms. Further, based on Table 5.4, we note that option/share compensation and total compensation have a relatively strong correlation, and that it therefore may not be surprising when these models generate similar results. Model fit is reasonable to good. The models show a consistent effect of firm size and nationality. Moreover, it is worth mentioning that the existence of variable pay causes both bonuses and total compensation to be higher, and – of course – similarly so variable compensation. Pay appears to be relatively insensitive to performance, with the exception of variable pay, which is driven by market-based performance. It appears, contrary to our expectations, that high performance causes lower salaries. The reason behind this finding is unclear. It may be that CEOs of growth firms prefer to receive compensation through LTIPs, substituting for fixed payments, but this remains to be tested.

TABLE 5.5

Regression models of compensation level

	Salary		Bonus		Options/Shares		Total	
Constant	10.12	**	0.51		15.83	**	15.22	**
AR(1)	0.61	**	0.36	**	0.06		0.02	
Size	0.20	**	0.81	**	0.00		0.03	**
Ownership	0.05		5.18	*	-0.09		-0.04	
Foreign listing	0.08		-1.32		0.00		0.04	
Variable pay	0.02		1.22	+	0.06	**	0.06	*
Revenues	-9.41	**	-14.05		-0.98		-0.27	
Earning per share	-0.03	*	-0.04		0.00		-0.01	
Profits	0.05		4.75		0.05		0.10	
Relative TSR	-0.03		0.55		0.05	**	0.07	**
Power variables								
CEO ownership	0.52		-8.52		0.12		0.22	
Education level	0.02		-0.67		0.01		0.02	
Nationality	0.40	**	1.74	*	0.05		0.14	**
Tenure	0.00		-0.05		0.00		0.00	
Other positions	0.03		0.31		-0.01		-0.02	
N	281		284		281		279	
F-statistic	104.93	**	12.87	**	2.67	**	11.94	**
Adjusted R2	0.84		0.37		0.08		0.36	

Dependent variables are log-transformed. White diagonal standard errors and covariance.

$** \, p < 0.01$, $* \, p < 0.05$, and $^{+} \, p < 0.10$.

As was discussed in Section 5.2.4, the results in Table 5.5 fail to acknowledge that power may have both a direct effect on compensation levels, and an indirect effect. This indirect effect is caused by the selection of contracts. When powerful CEOs are able to select contracts which are more likely to result in higher compensation levels, this already creates an effect of power on compensation. Additionally, it may be that power has a direct effect on compensation levels, as has been argued for in Hypothesis 5.2. To accommodate for this, an alternative method, described in Section 5.2.4 is applied to the analyses in Table 5.5. The results of these estimations are contained in Table 5.6.

TABLE 5.6

Regression models of compensation level including interaction terms

	Salary		Bonus		Options/Shares		Total	
Constant	13.02	**	9.07	**	15.98	**	15.71	**
AR(1)	0.60	**	0.36	**	0.08	*	0.02	
Size	0.22	**	0.69	*	-0.01		0.02	+
Ownership	0.04		8.33	**	-0.08		-0.05	
Foreign listing	0.10		-2.59		0.07		0.08	
Variable pay (D)	-0.01		1.49	+	0.07	**	0.08	**
Revenues	-8.66	**	-17.29		-1.70	*	-1.02	
Earning per share	-0.03	*	0.03		0.00		-0.01	
Profits	0.05		4.67		0.06		0.12	
Relative TSR	-0.03		0.69		0.06	**	0.07	*
Power variables								
CEO ownership	0.77		-19.67	*	0.05		-0.02	
Education level	0.05		-1.13	*	0.03		0.04	
Nationality	0.49		3.69	*	-0.01		0.05	
Tenure	0.00		-0.09		0.00		0.00	
Other positions	0.04		1.06	*	-0.01		0.00	
Interaction terms (D*Z)								
D * Size	-0.02		0.13		0.03	**	0.03	**
D * ownership	0.03		-8.76	+	-0.04		-0.04	
D * foreign listing	-0.01		1.48		-0.08		-0.05	
D * CEO ownership	-0.32		16.82		0.18		0.40	
D * education level	-0.06		0.83		-0.04		-0.03	
D * nationality	-0.09		-2.09		0.04		0.08	
D * tenure	0.00		0.07		0.00		0.00	
D * other positions	0.00		-1.58	*	0.00		-0.04	
N	281		284		280		279	
F-statistic	65.37	**	8.69	**	2.76	**	7.99	**
Adjusted R2	0.83		0.37		0.12		0.36	

Variables included in the interaction terms have been demeaned, and dependent variables are log-transformed. White diagonal standard errors and covariance.

** $p < 0.01$, * $p < 0.05$, and $^+ p < 0.10$.

The models presented in Table 5.6 fit the data well. There are few consistent findings across the pay components. Firm size predicts pay levels well, although for variable and total pay, this is mainly through the design of the compensation contract. The control variables and firm performance are similarly related to compensation levels as in Table 5.5, yet the relationships between CEO power and pay levels are somewhat different. Whereas Table 5.5 documents a strong relationship between nationality (expertise power) and CEO pay, this relationship almost completely vanishes in Table 5.6. Combining these results with the findings from the probit analyses (Table 5.3), it is suggested that the direct relationship between nationality and pay is spurious, and rather may reflect an effect of nationality on the selection of variable pay in the compensation contract. In fact, the only effect of CEO power

which is elicited by the improved methodology is the effect on bonuses. Here, a puzzling combination of findings is present: whereas status power (number of positions in supervisory boards) and nationality positively affect the level of the bonus, the other measure of expertise (education level) and ownership power reduce the bonus. Overall, however, Hypothesis 5.2 is not supported.

5.3.3 CEO power and the sensitivity of compensation to performance

The third hypothesis of the managerial power approach is that CEO power leads to lower pay-performance sensitivity. Here, also the alternative method is applied. Because of the relatively high number of interaction terms, stepwise deletion of variables is considered (see section 5.2.4). For most of the models, no interaction terms were dropped after three or four rounds, as all p-values were below 0.50. It turned out, reinforcing the results in Table 5.6, that there was no discernible effect of CEO power and control variables through the selection of the compensation contract (D*Z). Also, inside the sets of variables, relative total shareholder return was hardly related to compensation levels either through any power measure (X*Z), or through a power measure and contract design (D*X*Z). As a measure of power, finally, education level and tenure hardly affected the pay-performance sensitivity directly, or through the selection of performance-sensitive pay contracts. We thus removed these variabels altogether, and estimated regression analyses with all control variables, three power measures, three performance criteria, the variable compensation dummy, and 18 interaction terms among power and performance (X*Z), and among variable pay, power and performance (D*X*Z). The results of these estimations are contained in Table 5.7.

The results confirm the relationships that have been found before: firm size is a strong predictor of CEO compensation, yet CEO power and performance do not contribute much directly. The interaction effects show various significant findings, yet none are consistent over the pay components. Also, some interaction effects go against the hypothesis of managerial power theory, and are intuitively odd, as they show that powerful CEOs are likely to incentivize themselves. This questions the risk-averseness assumption that is common to the optimal contracting and managerial power theories. It may be that a contingency theory can further the insights into the problem, suggesting why some power variables would be related to certain compensation components, but not to others.

TABLE 5.7

Regression models of compensation sensitivity

	Salary		Bonus		Options/Shares		Total	
Constant	12.78	**	9.04	**	15.99	**	15.72	**
AR(1)	0.38	+	0.33	**	0.09		0.03	
Size	0.19	**	1.10	**	0.01		0.04	**
Ownership	-0.05		6.22	**	-0.09		-0.03	
Foreign listing	0.07		-1.69		0.02		0.01	
Variable pay	0.15	*	0.63		0.05	**	0.05	+
Revenues	-2.87		-24.98		-0.52		-0.99	
Earning per share (EPS)	-0.02		-0.35		0.00		-0.01	
Profit	0.41	+	14.37	**	0.13		0.21	
Power variables								
CEO ownership	0.38		-9.81		-0.01		0.00	
Nationality	0.16		1.10		0.09	**	0.16	**
Tenure	0.01		-0.09		-0.01	+	0.00	
X*Z Interaction terms								
Revenue * CEO ownership	77.77		-32.20		6.40		13.35	
Revenue * nationality	0.00		-155.13		15.74	*	9.66	
Revenue * tenure	0.27		8.95		-0.63	+	-0.79	
EPS * CEO ownership	-1.30	*	0.45		0.07		0.03	
EPS * nationality	0.38		-1.10		0.03		-0.01	
EPS * tenure	0.00		0.09	*	0.00		0.00	
Profit * CEO ownership	-5.52	*	-6.85		0.32		0.94	
Profit * nationality	1.27	+	13.79	*	0.00		-0.11	
Profit * tenure	0.04		0.92		-0.01		0.00	
D*X*Z Interaction terms								
D * Rev. * CEO ownership	-72.04		411.23		8.64		1.14	
D * Rev. * nationality	-16.60		182.27		-17.00	*	-7.64	
D * Rev. * tenure	-1.32		-6.13		0.57		0.92	
D * EPS * CEO ownership	1.50	*	-3.35		-0.21		-0.12	
D * EPS * nationality	-0.59	**	0.70		0.02		0.02	
D * EPS * tenure	-0.01		-0.14	*	0.00		0.00	
D * Profit * ownership	4.24		-21.61		-0.44		-1.35	
D * Profit * nationality	2.50	+	-28.72	**	-0.11		-0.13	
D * Profit * tenure	-0.30	*	-1.13		0.03		0.02	
N	323		329		322		324	
F-statistic	73.43	**	9.15	**	2.27	**	5.07	**
Adjusted R2	0.87		0.42		0.10		0.27	

Dependent variables are log-transformed. Power and performance variables have been demeaned. White diagonal standard errors and covariance.

** $p < 0.01$, * $p < 0.05$, + $p < 0.10$.

Overall, the analyses do not show a strong effect of CEO power on executive compensation. It appears that those factors determining the salience of the agency problem (firm size and ownership concentration) are the key drivers of compensation contract structure, next to having a listing on a US stock exchange. Firm size subsequently also seems to affect the level of compensation, next to an effect of market-based performance on CEO pay. This is in line with findings from Tosi et al. (2000), whose meta-analytic review documents that forty per cent of the variance in executive compensation is attributable to firm size. Some effects of CEO power on pay-for-performance sensitivity were found, yet in about half of the cases the effects were contrary to managerial power theory's predictions (Table 5.7), and not consistent across compensation elements. A robust relationship between CEO power and pay-for-performance sensitivity could not be identified, although the various findings do call for additional theorizing in this direction.

5.4   Conclusion and discussion

In this chapter, a key assumption in the managerial power theory of executive compensation is tested. Optimal contracting theory predicts that non-executive directors select a compensation contract in which pay is at its top when expected performance is maximized. According to managerial power theory, this equilibrium will not be reached when the CEO has substantial power over the board. In this situation, the compensation contract will allow for excessive pay levels that are relatively insensitive to performance. This study tests whether CEO power affects the structure, level and performance sensitivity of compensation.

Previous empirical tests have relied on a comparison of results from different pay-performance studies, and have not directly tested the relationship between power and compensation. These comparisons result in conclusions which convince some scholars that managerial power theory has predictive validity (Weisbach, 2007), yet direct tests of whether power is related to compensation may contribute to our understanding of the compensation puzzle. After all, these comparisons often led to competing interpretations of the same phenomenon, which is undesirable as the two models are based on opposing assumptions with respect to the bargaining process. Also in our study, some findings are susceptible to such interpretations. We find that companies use a multitude of performance criteria in their bonuses and long-term incentive plans. Table 5.1 shows that the average firm uses three to four performance criteria, and managerial power theorists may argue that this is an indication of camouflage. Compensation contracts in which many performance criteria are included may complicate the evaluation of such contracts by outsiders. However, optimal contracting theorists may argue that one performance criterion will not adequately cover all dimensions of

CEO performance, and conclude that apparently three to four criteria are sufficient to do so. After all, there is a tension between criteria that capture the CEOs effort, on the one hand, and those that proxy for shareholders interests, on the other hand. CEO effort and company performance need not be perfectly correlated, and this may call for multiple performance criteria.

We set up several regression analyses in which the effect of CEO power is directly estimated. First, we estimate the effect of CEO power on the choice of compensation contracts. For stock option plans, power is found to be unrelated to the adoption of such plans, yet CEO power does predict the adoption of share plans. Here, it is observed that a multidimensional conceptualization of CEO power is useful: we find that one source of CEO power (CEO ownership) reduces the probability of adopting a share plan, whereas other sources (relating to expertise power) increase this likelihood. We thus find a moderate relationship of CEO power on the adoption of variable pay elements.

Subsequently, we estimate the relationship between CEO power and the level of pay. First, not taking the effect of CEO power on the adoption of variable pay plans into account, we find a strong relationship between only one source of power (nationality, as an indicator of expertise power) and the level of mostly the salary and the cash bonus, and total compensation. Introducing a control for the effect of power on the structure of compensation contracts, this effect vanishes when the methodology is improved. Thus, also if it comes to the relationship between CEO power and the level of compensation, no strong support for the hypothesis that power is related to compensation is found.

Third, we estimate the moderating effect of CEO power on the pay-performance nexus. We find some effects of power that make the relationship between firm performance and CEO compensation either weaker or stronger. A strong effect of performance measures on compensation levels could not be identified either. This implies a puzzle, which implies that further research is needed to further deepen our understanding of the determinants of CEO incentive schemes.

The present study suffers from several limitations, which may result in future research. First, a qualification of the results is that the managerial power theory is not supported *for this specific context*. It may well be that institutional characteristics of the Dutch corporate governance system make it difficult for powerful CEOs to affect their compensation contracts. This may be because the two-tier board structure that is present, particularly in light of the structural regime, may establish more independent boards than may be found in other countries. Also, the first two years of the period under study was one of economic downturn for The Netherlands, and executives were under scrutiny from the public to demand only moderate wage increases. Although this appears not to have taken place (Van Ees, Van der Laan, Engesaeth and Selker, 2007), the heightened attention to executive compensation might

have made the outrage constraint more restrictive. In periods of limited share price appreciation, it may be difficult to generate high returns from variable pay components anyway, and stock market trends may thus moderate the relationship between power and performance sensitivity. Moreover, long-term incentive plans have been used much more extensively in the United States as compared to European countries. Thus, outrage costs may also place a stricter constraint on the rents that can possibly be extracted through such plans than is the case in the US. Other institutional differences may, on the contrary, lead to the expectation that managerial power should be more salient in The Netherlands. Particularly, it has been documented that shareholder protection is weak (Chirinko, Van Ees, Garretsen and Sterken, 2004), although companies have abolished defense mechanisms since this was recommended by the 2004 corporate governance code. Thus, shareholders would have few options but selling their stock when they disagreed with their representatives (the directors) over the compensation policy.

Second, although we use a multidimensional conceptualization of power, all power measures are essentially based on objective proxies, available in public archives. There is, therefore, an imperfect match with the power concept in managerial power theory, which refers to the influence of the CEO on the reappointment of non-executive directors. Here, social psychological perspectives on power, using interpersonal influencing tactics, are ignored. It may well be that other aspects of power, not included in this study, are better able to capture the social dynamics in the boardroom. Westphal has extensively used such influencing tactics, such as ingratiation and persuasion (Westphal and Bednar, 2008; Westphal and Khanna, 2003; Westphal and Stern, 2006; 2007), which may also result in a separation of two interpretations of the measures of power which have been used in this study: expertise and status may also add to the human capital of the CEO, and managerial power theory would not contend that such power sources cause excess rent extraction. Tenure, on the other hand, proxies well for the type of power refered to in this theory. The effect of power on compensation in contracting theory, which runs through the increased opportunity of CEOs to behave in their own interest, is partially caused by their risk aversion. Future research may disentangle the effect of power on compensation from the effect of risk aversion on compensation levels and performance sensitivity.

Third, future research may also focus on compensation decisions at a higher level of detail and precision. For example, in conditional option plans, the extent to which changes in performance result in changes in expected payments could be a superior measure of pay sensitivity than the realized, *ex post*, share price elasticity of income which is often used in the empirical literature (Jensen and Murphy, 1990). More generally, it has been argued that stock options and share plans have different behavioral consequences as there is no downside risk to stock option plans (Certo, Daily, Cannella and Dalton, 2003). Conditional stock

options plans have not been studied often in the literature, particularly since US compensation contracts are rarely adjusted for general market trends (Bertrand and Mullainathan, 2001), yet conditional and unconditional stock option plans may also be argued to have different behavioral effects. After all, in a declining market, conditional options may still have a positive value as the firm performs better than its peers. For the purpose of this study, these types of long-term incentive compensation have been jointly analyzed, yet it may be the case that since they are argued to have different behavioral consequences, CEOs may also have different preferences over which form is included in the contract. A pecking order of incentive contracts, where the order may depend on CEO personality, may thus be established. A first suggestion may be that powerful CEOs prefer conditional option contracts over other incentive plans, as the formula which determines the number of options actually granted may be susceptible to camouflage, and as these options also have downwards potential in a declining market.

Fourth, a deeper understanding of risk-taking behavior may benefit the development of power-compensation predictions. Studies in the tradition of the behavioral theory of the firm, and particularly prospect theory, have shown that risk-taking need not be consistent (Kahneman and Tversky, 1979; March and Shapira, 1987). This implies that risk-taking is different when CEOs frame decisions in terms of potential gains as opposed to losses (a more detailed discussion of prospect theory is offered in chapter 2 of this thesis). Thus, the aspiration levels of CEOs impact on the extent to which they are risk-seeking for a given incentive structure. The determinants of CEO aspiration levels, such as the past performance of the firm, therefore enter the extent to which shareholders desire the variability of compensation and consequently the extent to which CEO power over this contract would be relevant. Wiseman and Gomez-Meija (1998) further argue that the design of the compensation contract may affect risk-taking, and develop a behavioral agency theory that aims to more accurately represent risk-taking by CEOs. For example, they argue that when CEOs have in-the-money options, they are likely to reduce the riskiness of their strategic choices, such as to avoid compensation losses. Following the arguments developed in Wiseman and Gomez-Meija (1998), CEOs need not prefer fixed salaries over variable compensation, as is assumed in agency theory and this chapter alike, but may have preferences over the competitiveness of targets, the performance measures, and other aspects of the compensation contract. Following behavioral agency theory implies conducting a more fine-grained comparison of powerful CEOs' compensation contracts with contracts of relatively less powerful CEOs.

Fifth, and finally, it is suggested that theory should move beyond contracting and power to seek explanations. Particularly since abstract variables such as firm size, ownership concentration and foreign listings – variables over which CEOs only have limited influence –

affect the lion's share of compensation, it is suggested that institutional theory has a lot to offer. Contextual differences among countries and industries may well impact upon the norms with respect to compensation in an institutional field. Since CEOs and directors have been argued, throughout many national studies, to be part of a corporate elite, and insulated from the influence of minority shareholders, it may well be that norms as to what is considered a reasonable compensation level have a stronger impact on CEO compensation than the possibility of outrage. Defection from elite norms may, in the end, have a larger bearing on the CEO's (and director's) behavior than defection from norms of individuals with whom they do not identify, or have a relationship of mutual exchange with. A behavioral perspective on compensation would thus focus on institutional norms and interpersonal influencing tactics in seeking explanations for compensation. Institutional theory, and social psychological conceptualizations of relationships, will likely bring the literature forward.

6.   Conclusion and Appraisal

This chapter summarizes the main findings reported in the empirical chapters. As each of the chapters contains a summary already, the emphasis here is on key findings, contributions and directions for future research. Section 6.1 summarizes the findings. In Section 6.2, the contribution to the behavioral perspective on corporate governance (see Section 1.2) is discussed. Section 6.3, finally, offers some directions for future research.

6.1   Summary

Chapter 2 provides a qualification of agency theory's discrete interactions assumption. It is assumed in the agency perspective on the tasks of boards that directors and managers always act as if they meet for the first time. In this context, directors are likely to perceive the least disutility of taking negative decisions about, for example, executive compensation or dismissal. We argue, on the contrary, that directors in practice value the relationship with management as such, and aspire to remain on good terms. These social contracting norms foster the development of trust, which, in turn, positively affects board tasks performance. In line with the theory, we indeed find that social norms among the board chairperson and the CEO are associated with board effort and the development of two types of trust: reliance and disclosure trust. Reliance trust refers to the willingness of directors to assume that managers will do a good job. This makes directors less vigilant in monitoring management. Disclosure trust refers to the willingness to share information and lose face in a discussion. When disclosure trust is present, directors are assumed to actively participate in board meetings with management. It is subsequently found that disclosure trust positively affects board effort, and also has a positive impact on board tasks performance. Reliance trust, on the contrary, is negatively related to board monitoring performance, and has no discernible effect on board advice task performance. Consequently, Chapter 2 offers support for the notion that a model of board behavior in which the preservation of a good relationship between the CEO and the board chairperson is emphasized, may well contribute positively to board tasks performance. We thus offer an alternative for agency theory that also encompasses board advice task performance, and is empirically validated, at least in a setting where opportunistic behavior is not expected to dominate.

In Chapter 3, the relationship between a firm and its stakeholders is studied. Two key arguments have been tested. First, it is argued that primary stakeholders, as they have frequent exchanges with the firm, do not need to rely on a reputation for the company's well-doing with respect to their demands. Through their exchanges, the company's stances will become

clear to these stakeholders much more directly. For secondary stakeholders, who do not have frequent exchanges with the company by definition, such a reputation is much more crucial. Thus we expect that a reputation for good corporate social performance (CSP) is stronger related to corporate financial performance (CFP) when secondary stakeholders are concerned. We do not find evidence for this hypothesis, however, and it appears that the strength of the relationship between stakeholder CSP and firm financial performance is primarily driven by the proximity of the stakeholder to the core business processes. Second, we use insights from prospect decision theory, and argue that in the evaluation of company's CSP, a negative reputation is given more weight than a positive reputation. As the evaluation of a company's CSP may impact the extent to which a firm has access to resources, it is argued that positive CSP scores are unrelated to financial performance, whereas negative reputations are strongly and negatively related to CFP. The implication of the findings with respect to the first set of hypotheses as discussed above is that the relationship between CSP and CFP is not expected to be significant in the short run. In the long run, however, companies may suffer from maltreating secondary stakeholders. Indeed, we do not find evidence for the hypothesis that a negative CSP reputation is related to CFP for secondary stakeholders. However, for primary stakeholders, our hypothesis is supported. It is indeed true that employees, customers and the like respond strongly to a negative reputation for CSP, yet once the company has lined up with the norms as to what is socially responsible, there are no short-term financial benefits to be gained by further improving the CSP reputation.

Chapter 4 studies compliance with corporate governance codes. These codes may be conceived of as a collection of stakeholder claims, namely those formulated by shareholders. Since compliance with these codes is voluntary, firms may resist implementation of some provisions. Moreover, as codes contain many recommendations, non-compliance with some provisions may be hidden behind compliance with many other recommendations. We argue that a proper analysis of drivers of compliance starts with a decomposition of the code itself. A classification is developed, in which recommendations are considered accepted, debated or contested by managers, based on the extent to which implementation of a provision would affect the managers' utility. Accepted best practice provisions would, in this classification, not affect the managers' utility, debated provisions have an indirect effect, and contested best practice provisions directly impact upon the managers' well-being. The first hypothesis is that managerially contested corporate governance provisions are complied with the least. A comparison of some provisions that evidently affect managerial well-being, those relating to executive compensation, to all other provisions indeed provides support for this hypothesis. We proceed by arguing, given that managers are likely to resist the implementation of these recommendations, that several counter-forces may increase the compliance rates with contested provisions. It is argued that when a firm is central in a network of directors, this

network is likely to exert normative pressure on the firm to comply. Furthermore, we hypothesize that board independence is associated with increased compliance rates. Evidence for these hypotheses is found. The chapter supports claims made in the recent stream in the corporate governance codes literature that seeks explanations of compliance, and adds to it that a more fine-grained analysis of best practice provisions is required.

Chapter 5, finally, empirically tests the existence of a relationship between CEO power and CEO compensation. We build on the managerial power theory, in which it is assumed that powerful CEOs are able to secure high and performance-insensitive compensation. Power may be relevant when the arms' length bargaining assumption, similar to the argument presented in Chapter 2, does not hold. Directors may not be able to negotiate a contract with a CEO at arms' length when CEOs have a substantial influence over who gets appointed on the board of directors. Power also is of interest to optimal contracting scholars, as powerful CEOs may have to be compensated for their ability to behave opportunistically. Our hypotheses hold that powerful CEOs manage to (1) secure compensation contracts that allow for large payments, (2) obtain higher levels of compensation than CEOs who have less bargaining power, and (3) reduce the performance sensitivity of their compensation. We find that power is unrelated to the design and the level of executive compensation, however. Performance only weakly explains some elements of compensation levels. The performance sensitivity of compensation is not strongly influenced by CEO power either. Instead, it appears that firm size, ownership concentration and having a listing on a US stock exchange have a much more substantial effect on CEO compensation.

Chapters 2, 4, and 5 all relate to bargaining over different solutions. In Chapter 5, the bargain concerns the executive compensation contract, whereas Chapter 4 involves the implementation of managerially contested corporate governance provisions. Chapter 2 directly deals with the bargaining process, and tests whether proximity and trust are likely to yield satisfactory solutions (as opposed to distance and distrust). The power that accrues to each stakeholder appears to be of importance in determining the outcome of the bargaining process, a finding which is further supported in Chapter 3. Thus, power – and its cousin, independence – are key concepts throughout this book. Therefore, the contributions section below focuses on these two concepts.

6.2 Contribution to the behavioral perspective on corporate governance

Power and independence have been treated differently in the academic literature. Conceptually, the distinction among the two concepts is clear, yet empirically the differences

turn out to be elusive. As I will argue later (Section 6.3), a lack of theoretical development of concepts is a fundamental problem in the behavioral perspective on corporate governance. Consequently, the literature develops in separate yet related streams, and it is sometimes unclear to what extent arguments relating to the same topic are actually comparable. Moreover, due to a shortage of theoretical guidance, a body of empirical papers relating to a topic tends to give a cluttered image with regards to measures and variables, as is apparent from the many meta-analyses with regards to board structure, composition and director contingencies, on the one hand, and board or firm performance, on the other hand.

Conceptually, power is the ability of an individual to exert her/his will upon somebody else (e.g., Finkelstein, 1992). Independence refers to the distinction between decision management and decision control, as introduced by Fama and Jensen (1983). Decision control refers to the ratification of decision proposals, and the control to the implementation of ratified proposals. An independent board is able to minimize the role of management in decision control (Maassen and Van den Bosch, 1999). This suggests a theoretical link between power and independence, which is yet to be explored: a powerful board would be able to ratify management's proposals and control its implementation without the management's will being exerted upon the directors. Board power would thus be a prerequisite for board independence.

Udueni (1999), however, argues that independence is a prerequisite for power. The empirical operationalization of the power and independence concepts is, to my opinion, what causes this argument to be different from the one above. Legislators see independence as an objectifiable characteristic, and define it – simply put – as the absence of financial and family ties between directors and managers (Rodrigues, 2008). Such a formal definition of independence only captures some elements of this key feature of relationships. Indeed, in some US jurisdictions (e.g., Delaware) directors who have no financial and family ties to the firm are considered outside board members, or non-executive directors, yet courts evaluate independence in specific conflicts inside a boardroom based on the problem itself, using a wider set of dependence factors (Rodrigues, 2008). Therefore, if a board is independent according to the law, this does not imply that it has the power to perform its decision control tasks outside the influence of managers. In this sense, legal independence may be conceived of as a prerequisite of power, in line with Udueni (1999). Power measures suffer from the same issues, as objectifiable indicators such as tenure and stock holdings in the company are commonly used to proxy for power (Finkelstein and Mooney, 2003). Such structural measures, again, may only be a prerequisite for directors to be able to exert their will on management. In terms of the classification in Table 1.1, current measures of power and independence are indicators of formal structures. It is exactly the assumption that setting the formal structures right does not imply that the desired outcomes will not be achieved, that is

the key distinction between behavioral and legal/economic approaches to corporate governance. In the empirical behavioral literature, it seems that the assumption that is so strongly criticized in the economic perspective has not been replaced by behavioral assumptions.

In Chapters 4 and 5 in this book, it is indeed assumed that power and independence are essentially two sides of the same coin, similar to what Pettigrew and McNulty (1998: 200) argue: "[f]or boards to exercise their vigilance role over the CEO, the board needs power." In Chapter 4, it is argued that independent boards are more likely to emphasize the interest of the firm in the boardroom, and such boards will thus achieve a higher compliance rate with managerially contested best practice provisions. In Chapter 5, it is assumed that when directors depend on the CEO for their reappointment, they will not have the power to achieve optimal contracting solutions with respect to executive compensation. The latter conceptualization of power is similar to Emerson's (1962) dependency framework, where the power of actor A over B is directly related to the dependency of B on A (see also Wenstøp, 2008). The measure of power, however, remains mostly structural, and fails to capture interpersonal dynamics inside the boardroom. In terms of results, it is striking, as the studies use almost identical samples, that board independence does affect compliance rates (Chapter 4), whereas no effect of CEO power on decision-making is found (Chapter 5). That is, whilst formal independence does affect outcomes, an effect of power measures could not be found. This offers support for the notion that both cannot be seen as highly related concepts. Obviously, the different findings may also be due to the different measures of power and independence. The independence of the board is measured by means of several criteria relating to whether the board contains no more than one (formally) dependent member, whether the board committees are composed of only (formally) independent members, et cetera. It appears to be the case that such formal independence results in decisions that are in the interest of the firm. In Chapter 5, power was measured according to Finkelstein's (1992) classification, based on a multidimensional conceptualization of power. Although these measures also refer to structural, formal, sources of power, it is not found that CEO power leads to more opportunistic behavior, as it is not observed that CEO power affects the level and performance sensitivity of compensation. However, it is not found either that, for the firms in this sample, CEO compensation is strongly tied to performance. This decoupling of pay from performance is, however, not related to CEO power. These findings support the study by Udueni (Udueni, 1999) in its call for a separation of power from independence in theory and measurement.

In Chapter 2, independence is given a completely different interpretation, namely the absence of social contracting norms. In this situation, directors would not be proximate to CEOs, and would be able to take tough decisions. Indeed, from Chapter 4 it seems that some

tough decisions – implementing managerially contested corporate governance provisions – are established in this context. Yet, the absence of social contracting norms also generates an environment in which director effort is reduced and distrust is emphasized. On the contrary, for some tough decisions, it may be better to develop a context in which trust and mutual problem-solving are central. In that sense, non-linearities in the relationship between trust and board tasks performance, as contained in Chapter 2, may model this initial benefit of trust, whereas too much trust may result in dependence and opportunistic CEO behavior. In the literature, this curvilinear effect of trust has been identified before (Langfred, 2004). Additionally, it suggests a relationship between trust and power (Van der Laan and Zhang, 2007), which may succinctly be summarized as "trust me, I'm your boss" (Willemyns, Gallois and Callan, 2003). All in all, the thesis documents the importance of a relational lens on corporate governance problems. Relational characteristics such as power, independence and trust are suggested to provide insights into board effectiveness.

6.3   Future research

The classification of perspectives on corporate governance (Table 1.1) points to the need to study formal and informal structures, and board processes. The economic perspective on corporate governance has, in the past few decades, developed theory as to how formal structures would affect outcomes under the rationality assumption. A behavioral perspective on corporate governance could aim to study the consequences of dropping the rationality assumption, which would lead to the consideration of micro and macro-social forces on board tasks performance (Zajac and Westphal, 1998). Several authors have identified key concepts and tried to link structures, processes and outcomes (Forbes and Milliken, 1999; Huse, 2005). Also, empirical tests of the hypotheses generated by these models have been presented.

The behavioral models, however, tend to be difficult to test empirically, as they contain many concepts and interrelations. While this could be addressed by studies of partial models, focusing on, for example, the effect of informal structures on a selected behavioral process, it is more troubling that the theoretical development of the literature appears to result in divergent instead of convergent contributions. For example, the model of Forbes and Milliken (1999) distinguishes three behavioral processes: effort norms, cognitive conflict, and use of knowledge and skills. These processes are argued to relate to board tasks performance. Huse's (2007) model, however, discusses effort norms under the heading of preparation and involvement, and use of knowledge and skills under the heading of openness and generosity. Additionally, criticality and creativity are added as characteristics of the board decision-making culture. Although the underlying relationships assumed by the authors may be the

same, empirical scholars are likely to look for different sets of measures to proxy for norms regarding board work (effort norms) than when trying to proxy for director preparation. Consequently, subtle differences among concepts may cause the development of different streams in the behavioral perspective to address similar topics, but departing from similar assumptions. This complicates the development of a behavioral perspective, as has been illustrated for the case of power and independence in Section 6.2.

Next to conceptual clarity, I feel that the behavioral perspective could benefit from two additional insights. Figure 6.1 presents a framework that does not have as its purpose to provide yet another web of relationships, but rather to show that behavior takes place at different levels of analysis, and that structures, processes and outcomes can and should be separated. These aspects have not frequently been taken into account so far. Clearly, this does point to interesting avenues for future research, of which I will briefly discuss a few issues I believe deserve priority.

FIGURE 6.1

A multil-evel input-process-output model of board task performance
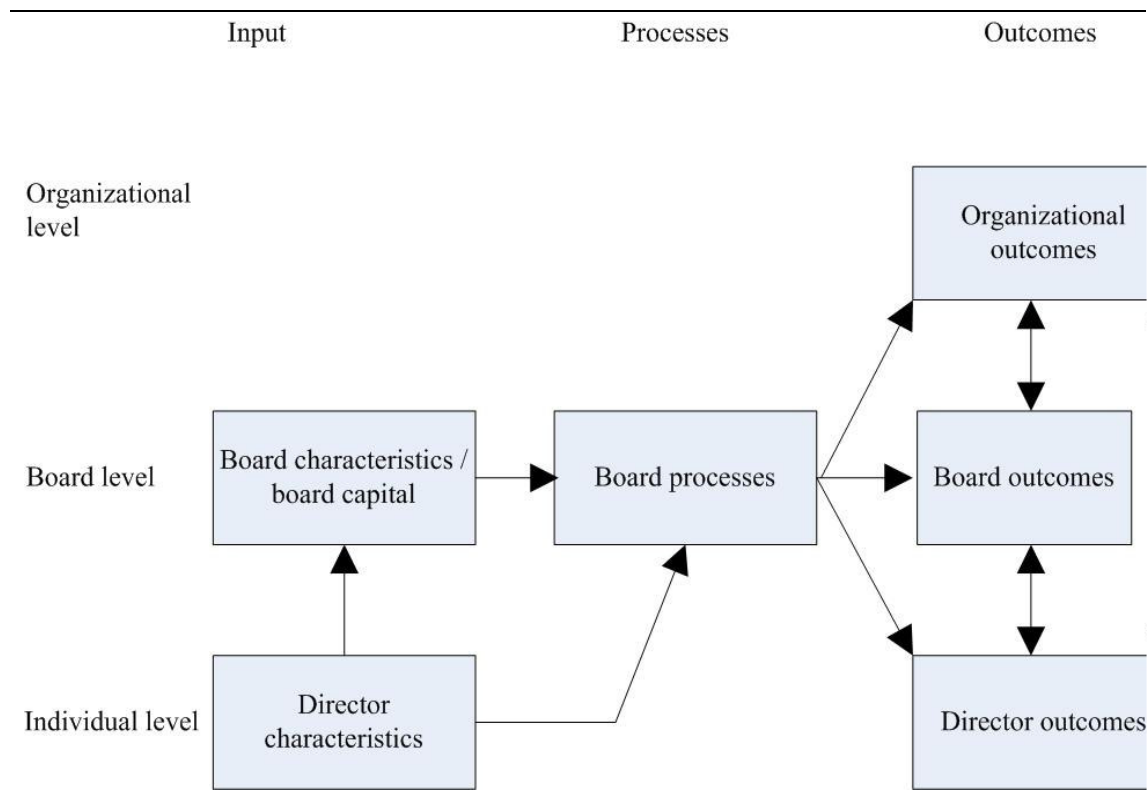
First and foremost, the behavioral corporate governance literature, to date, largely ignores multi-level issues. Although studies exist that link board-level capital to the capital of individual directors (Oh, Labianca and Chung, 2006), research would yield improved insights when board processes were explained by both director characteristics and board features. This

notion builds on the work of Hillman and Dalziel (2003), who give primary importance to board capital when seeking an explanation for board tasks performance. Relating, for example, to the earlier discussion on power and trust, it may well be that board effectiveness is greatly enhanced when a powerful director (individual characteristic) can rely on a board where trust among directors is present (board-level characteristic). Thus, next to the central tendency (mean or median) of the distribution of a single input variable, such as directors' knowledge or skills, it may be worthwhile to study the effects of the joint shape of the distribution of various input variables on board tasks performance. It has been found in the literature with regards to team diversity, for example, that gender heterogeneity affects team performance differently when men represent the dominant coalition as compared to women (Williams and O'Reilly, 1998). Also, tenure heterogeneity is argued to affect communication among directors (Williams and O'Reilly, 1998). The study of the joint distribution of gender and tenure diversity may yield additional insights into the issue of what makes a board effective.

Second, it may well be recognized that the board's working style has effects on all three levels of analysis. Board working style affects board performance, as is frequently hypothesized in the behavioral perspective on corporate governance (e.g., Zona and Zattoni, 2007), and also affects firm performance, as is frequently suggested in the economic literature, although processes tend to be treated as a black box in this literature (e.g., Barnhart, Marr and Rosenstein, 1994). Finally, board working processes affect individual-level outcomes, such as the probability that a director will be slated for board provisions in other firms (Westphal and Khanna, 2003). The decisions directors make may well be a trade-off among their tasks as stewards of the firm (organizational-level outcomes), their norms and values with respect to board work (board-level outcomes) and their personal agendas (individual-level outcomes). The intricacies implied by this bargaining over objectives has, to my knowledge, not been addressed in the corporate governance literature yet.

7   Samenvatting (summary in Dutch)

Als gevolg van technologische groei, is de schaal van productie in de loop van de 19^e en 20^e eeuw toegenomen. Ondernemers waren niet langer in staat om zelfstandig in de financieringsbehoefte te voorzien. Dat heeft een scheiding tussen het eigendom van een onderneming en de controle over de onderneming veroorzaakt: de eigenaren hadden niet langer de dagelijkse leiding in handen. In deze context kunnen zogenaamde principaal-agent problemen ontstaan: de eigenaren en de manager hebben niet noodzakelijkerwijs dezelfde belangen, en aangezien de manager superieure informatie over het bedrijf heeft, bestaat er de mogelijkheid dat hij zich opportunistisch gedraagt. Het principaal-agent probleem is uitgebreid bestudeerd in de economische en juridische corporate governance (dat wil zeggen: ondernemingsbestuur) literatuur en richt zich op contractuele oplossingen en studies van het onderhandelingsspel tussen de manager en de eigenaar. Zo is er een uitgebreide literatuur over de beloning van de manager die stelt dat het belangenconflict tussen eigenaren en managers dat de grondslag vormt voor het principaal-agent probleem verholpen kan worden door de beloning van de manager afhankelijk te maken van de prestaties van de onderneming. Tevens is er nadruk op onafhankelijk toezicht door een raad van commissarissen gelegd.

Enkele meta-analyses van de relatie tussen indicatoren voor onafhankelijkheid en andere gesuggereerde oplossingen voor het principaal-agent probleem aan de ene kant en bedrijfsprestaties aan de andere kant, laten echter zien dat een eenduidig verband tussen deze klassen van variabelen niet bestaat. Het is niet zondermeer te stellen dat de contractuele oplossingen uit de economische en juridische theorie het praktische principaal-agent probleem oplossen. Derhalve zijn recent alternatieve, meer gedragsmatige, benaderingen van ondernemingsbestuur populair geworden. Hambrick en collega's (2008) geven aan dat deze studies zich kenmerken door een focus op informele structuren en gedragsprocessen binnen de raad van bestuur en/of de raad van commissarissen, die in de Angelsaksische literatuur gezamenlijk *board* genoemd worden. De alternatieve benaderingen nemen expliciet micro- en macro-sociale krachten die de *governance* uitkomsten beïnvloeden mee. Micro-sociale krachten zijn afkomstig uit de scoiale psychologie, en betreffen inter-persoonlijke processen zoals affectie en conflict. Macro-sociale krachten zijn afgeleid van de sociologie en beschouwen de onderneming als een onderdeel van een groter geheel waarin concurrentie om bronnen en legitimering tussen ondernemingen plaatsvindt. In dit kader zijn netwerken van bestuurders en commissarissen bijvoorbeeld onderwerp van studie geweest. In dit proefschrift wordt aansluiting gezocht bij deze stromingen, door expliciet te veronderstellen dat aan de contractuele oplossingen tussen diverse partijen die voor de studie van ondernemingsbestuur relevant zijn, individueel gedrag ten grondslag ligt.

Voor dit proefschrift wordt onderscheid gemaakt tussen verschillende belanghebbenden bij goed ondernemingsbestuur. In de eerste plaats zijn dit de bestuurders en commissarissen. In de tweede plaats zijn kapitaalverschaffers, of meer specifiek aandeelhouders relevant. In de derde plaats worden algemene belanghebbenden (*stakeholders*) opgevoerd. De interacties binnen en tussen deze vier groepen hebben uitkomsten op het niveau van de organisatie tot gevolg. Dit is schematisch weergegeven in Figuur 1.1 in de inleiding van het proefschrift.

In de hoofdstukken 2 tot en met 5 van het proefschrift wordt telkens een ander onderwerp bestudeerd vanuit de hierboven omschreven achtergrond. De centrale aanname in de agentschaptheorie dat efficiënte controle op bestuurders wordt bereikt door een raad van commissarissen die onafhankelijk is van de raad van bestuur is het onderwerp van hoofdstuk 2. Onafhankelijkheid leidt tot een gepercipieerde afstand tussen de bestuurder en de commissaris, en in deze context is het nemen van negatieve beslissingen over de prestaties van de bestuurder door de commissaris het minst belastend voor de commissaris. In het hoofdstuk wordt beargumenteerd dat commissarissen naast controletaken ook tot taak hebben om de raad van bestuur bij te staan met strategisch advies, en dat voor deze rol nabijheid juist de informatievoorziening ten goede kan komen. Deze hypothese is in lijn met eerder onderzoek. We gaan echter verder met te argumenteren dat ook voor de controletaken nabijheid voordelig kan zijn. Voor het uitvoeren van controle op de prestaties van de bestuurder heeft de commissaris immers informatie nodig, die hij voornamelijk van de bestuurder en andere topfunctionarissen binnen de onderneming krijgt. Het argument is dat nabijheid positief gerelateerd is aan de ontwikkeling van twee typen vertrouwen: één type (*reliance trust*) betreft het er vertrouwen in hebben dat de andere partij goed zal handelen. We argumenteren dat dit type vertrouwen negatieve effecten heeft op de prestaties van controletaken, maar ook van adviestaken. Het andere type vertrouwen heeft betrekking op de bereidwilligheid om in een open discussie te treden, vertrouwende dat de andere partij geen misbruik zal maken van deze openheid. Als gevolg van dit type vertrouwen (*disclosure trust*) is meer informatie beschikbaar voor de commissaris en, zo luidt ons argument, dit heeft een positief effect op zowel de strategische adviezen die de commissarissen uitbrengen als de kwaliteit van controle.

De argumenten worden getoetst op een Noorse dataset, die door middel van vragenlijstenonderzoek is samengesteld. Deze set bevat 378 middelgrote ondernemingen, waarvan de bestuursvoorzitter vragenlijsten ingevuld heeft met betrekking tot zijn of haar relatie met de voorzitter van de raad van commissarissen. Het model – gepresenteerd in Figuur 2.1 – wordt getoetst middels lineaire structurele vergelijkingen (LISREL), wat een combinatie is van factoranalyse en regressieanalyse. De analyses tonen aan dat voor de door

ons onderscheiden constructen onderling covariërende maatstaven gevonden kunnen worden en dat de constructen afdoende discriminerend zijn vanuit een statistisch oogpunt. De resultaten ondersteunen het model en suggereren dus dat naast de onderscheiden voordelen van afstandelijkheid tussen de bestuursvoorzitter en de raad van commissarissen er ook voordelen zijn aan nabijheid tussen beiden. Een toets op het mediërende effect van vertrouwen toont aan dat het statistisch nauwelijks overtuigend is dat deze voordelen door de vertrouwensconcepten wordt veroorzaakt. Dit neemt echter niet weg dat gepercipieerde nabijheid tussen de bestuursvoorzitter en de voorzitter van de raad van commissarissen zowel de strategische adviezen als de controle van de raad van commissarissen ten goede kan komen.

In hoofdstuk 3 worden argumenten gebruikt uit de prospecttheorie en de belanghebbendentheorie (*stakeholder theory*) om de relatie tussen maatschappelijk verantwoord ondernemen en de financiële prestaties van de onderneming nader te beschouwen. Het argument luidt, op basis van prospecttheorie, dat de mate waarin financiële prestaties afhankelijk zijn van maatschappelijk verantwoord ondernemen beïnvloed wordt door de verwachtingen van de belanghebbenden. Meer specifiek wordt beargumenteerd dat wanneer ondernemingen beneden de verwachtingen van de belanghebbenden presteren, hier een negatief effect van uitgaat op de financiële prestaties, terwijl het overtreffen van deze verwachtingen niet gepaard gaat met een vergelijkbare positief effect. Bovendien luidt de hypothese, op basis van de belanghebbendentheorie, dat de invloed van een reputatie voor het nakomen van de wensen van een belanghebbende op de financiële prestaties van de onderneming groter is naarmate de belanghebbende verder van de onderneming afstaat. Dit laatste argument stelt dat, hoewel primaire belanghebbende (zoals werknemers of investeerders) van groter belang zijn voor de onderneming, zij minder gebruik hoeven te maken van een reputatiemaatstaf om de mate waarin hun wensen worden nagekomen te evalueren. Primaire belanghebbenden hebben immers een meer directe relatie met de onderneming, en kunnen uit deze relatie de mate waarin aan hun wensen wordt tegemoetgekomen afleiden. Secundaire belanghebbenden hebben per definitie geen directe relatie met de onderneming en voor hen is een reputatiemaatstaf meer relevant in het evalueren van de maatschappelijke verantwoordelijkheid die de onderneming tentoonspreidt.

De twee kernhypothesen uit hoofdstuk 3 worden getoetst op een dataset van grote Amerikaanse ondernemingen in de periode 1997-2002, meer specifiek die ondernemingen die in de Standard & Poors 500 index zijn opgenomen. Data van Kinder, Lydenberg & Domini (KLD) over maatschappelijk verantwoord ondernemen wordt gekoppeld aan financiële gegevens van Thomson Financial's database Datastream. De resultaten ondersteunen de hypothese dat een reputatie voor maatschappelijk verantwoord ondernemen die de verwachtingen van belanghebbenden niet overschrijd negatief gerelateerd is aan de

winstgevendheid van de onderneming, maar dat een reputatie die de verwachtingen wel te boven gaat niet gerelateerd is aan superieure winstgevendheid. De hypothese waarin gesteld wordt dat een reputatie vooral voor secundaire belanghebbenden gerelateerd is aan de winstgevendheid, aangezien deze hem als instrument voor het beoordelen van de maatschappelijke positie van de onderneming aanwenden, wordt echter niet ondersteund.

In hoofdstuk 4 bestuderen we naleving met bepalingen uit een code voor goed ondernemingsbestuur. Deze codes zijn aanvullingen op de wetgeving, waar verondersteld wordt dat uniforme toepassing van de wet op alle vennootschappen niet tegemoet komt aan de specifieke eigenschappen van groepen vennootschappen. Bij het toepassen van de bepalingen uit een code, volgen de ondernemingen het leef-na-of-leg-uit principe. Volgens dit principe is het vennootschappen toegestaan om af te wijken van wat in de bepaling uit de code is gesteld, indien deze afwijking gemotiveerd wordt. Er is een uitgebreide literatuur ontstaan die de fractie van de bepalingen die door een vennootschap wordt nageleefd verklaard uit, bijvoorbeeld, de omvang van de onderneming. Het beginpunt voor hoofdstuk 4 is dat deze studies voorbijgaan aan het feit dat een code uit een groot aantal en qua inhoud diverse bepalingen bestaat, waardoor het aggregeren van naleving op het niveau van de code slechts beperkt inzichten verschaft. Bovendien is een beginpunt dat de variabelen die worden aangewend voor het verklaren van de naleving voorbijgaan aan het besluitvormingsproces dat in de raad van bestuur en de raad van commissarissen plaatsheeft. Er wordt immers voornamelijk gebruik gemaakt van variabelen zoals de omvang van de onderneming, die buiten de directe invloedssfeer van de besluitvormers ligt. In het hoofdstuk wordt allereerst een indeling gemaakt van bepalingen naar gelang de mate waarin deze het privébelang van bestuurders beïnvloeden (zie Tabel 4.1). De achterliggende gedachte is dat bestuurders – als de ultieme besluitvormers binnen de beursvennootschap – in de keuze van naleven of uitleggen van een bepaling een afweging maken tussen het belang van de vennootschap en hun privébelang. Voor sommige bepalingen, die de privébelangen van de bestuurders niet schaden, zal naleving vrijwel automatisch ontstaan omdat geen van de bestuurders bezwaar heeft tegen invoering. Hierbij valt te denken aan het voorschrift om procedures op te stellen voor evaluatie van het functioneren van de raad van commissarissen door de raad van commissarissen zelf. Daartegenover staan bepalingen die rechtstreeks het privébelang van de bestuurder schaden, zoals bepalingen die de beloning van bestuurders betreft. De eerste hypothese luidt dan ook dat voor bepalingen die het privébelang van de bestuurders betreffen, aanmerkelijk lagere naleving zal worden geconstateerd. Vervolgens worden, uit de agentschaptheorie en de netwerktheorie, argumenten geleend die verklaren waarom voor deze bepalingen toch naleving kan ontstaan. In de eerste plaats wordt een hypothese ontwikkeld omtrent de onafhankelijkheid van commissarissen. Hier wordt opgeworpen dat een onafhankelijke raad van commissarissen beter in staat is om naleving te bereiken van

bepalingen die het privébelang van bestuurders schaden dan een minder onafhankelijke raad van commissarissen. Tevens wordt een hypothese ontwikkeld waarin gesteld wordt dat de naleving van deze bepalingen hoger is naarmate de vennootschap een centrale positie inneemt in een elitenetwerk van bestuurders en commissarissen waarin naleving veelvuldig plaatsheeft. In een dergelijk netwerk staat de onderneming onder druk van commissarissen bij andere ondernemingen om ook na te leven, omdat massale niet-naleving op populatieniveau aanleiding zou kunnen zijn om striktere regels te ontwikkelen.

De hypothesen worden getoetst middels een gedetailleerde analyse van de naleving met de Nederlandse corporate governance code (de 'code Tabaksblat') door 130 beursgenoteerde vennootschappen in 2004. De studie richt zich specifiek op bepalingen die gerelateerd zijn aan bestuurdersbeloning, aangezien hiervan a priori aannemelijk te maken is dat deze het privébelang van de bestuurder schaden. Het blijkt inderdaad, zij het dat hiervoor geen statistische toets is opgenomen, dat nalevingspercentages voor de bepalingen die in de Tabaksblat code de bestuurdersbeloning betreffen substantieel lager zijn dan wat gemiddeld over alle percentages wordt aangetroffen. Dit ondersteunt de aanname dat bestuurdersbeloning een onderwerp is dat na aan het hart van de bestuurder ligt en waar de mechanismen uit onze theorie bij uitstek op van toepassing zouden kunnen zijn. Er wordt vervolgens ook bewijs gevonden voor de stelling dat naleving van de bepalingen inzake bestuurdersbeloning hoger is naarmate de raad van commissarissen onafhankelijk is van de raad van bestuur, en dat een centrale positie in een netwerk van beursvennootschappen die de bepalingen naleven tevens voor naleving in de betreffende onderneming zorgt. Al met al suggereren de resultaten van dit hoofdstuk dat een analyse van naleving van codes van goed ondernemingsbestuur op het niveau van best practice bepalingen toegevoegde waarde heeft, vooral als daarbij geanalyseerd wordt welke factoren het besluit al dan niet na te leven kunnen beïnvloeden.

In hoofdstuk 5 wordt een studie gemaakt van een centrale aanname in de machtsbenadering van bestuurdersbeloning (*managerial power approach*). Deze benadering trekt de stelling in twijfel dat beloningscontracten worden ontworpen door de raad van commissarissen van een onderneming met het belang van de aandeelhouder in gedachten. Deze stroming stelt daarentegen dat bestuurders een machtspositie binnen de onderneming hebben, die hen in staat stelt om de parameters van het beloningscontract ten faveure van zichzelf te beïnvloeden. Zo zou een bestuurder prestatieonafhankelijke beloning prefereren of pogingen kunnen ondernemen om bij tegenvallende resultaten de doelstellingen van het beloningscontract te laten versoepelen. Er is in de economisch-juridische literatuur een uitgebreide discussie ontstaan over de mate waarin beloningscontracten efficiënt zijn. De basale aanname dat macht aan beloning is gerelateerd is echter minder uitgebreid bestudeerd, en is het onderwerp van dit hoofdstuk. In het hoofdstuk worden drie hypothesen uitgewerkt.

In de eerste plaats wordt het concept camouflage uit de machtsbenadering benut om te beargumenteren dat het bij vaste beloning moeilijker is een invloed van macht te maskeren dan bij variabele beloning. Dit is omdat de waarde van de variabele beloning moeilijker te bepalen is voor een buitenstaander; deze hangt immers af van doelstellingen die vaak niet transparant zijn. De eerste hypothese luidt dan ook dat indien bestuursvoorzitters machtig zijn, een groter deel van de beloning variabel zal zijn. In de tweede plaats wordt de hoogte van de beloning bestudeerd. Het is immers zo dat indien een groter deel van de beloning variabel is, het risico op uitkeringen beneden de verwachtingen van de bestuursvoorzitter groter wordt. Ter compensatie van dit risico wordt een premie in de beloning ingebouwd. De hypothese luidt dat bestuursvoorzitters die bovenproportionele macht hebben in staat zijn om de verwachte waarde van de variabele beloning hoger vast te laten stellen, zodat in feite gecompenseerd wordt voor een risico dat de bestuurder niet in die mate loopt. In de derde plaats wordt de prestatieafhankelijkheid van de beloning bestudeerd. Het is immers zo dat het nut van de bestuurder niet alleen positief afhangt van de (verwachte) hoogte van de beloning, maar ook van de invariabiliteit ervan. Een bestuurder die buitenproportioneel machtig is, zal volgens de hypothese proberen om de marginale reactie van de beloning in respons op een eenheid verandering van de bedrijfsprestatie te minimaliseren. Er worden dus hypothesen ontwikkeld die stellen dat machtige bestuurders beloningscontracten afdwingen die (1) variabele beloningsvormen bevatten, (2) een hoge verwachte waarde kennen en (3) prestatieonafhankelijk zijn.

De argumenten worden getoetst met behulp van een dataset van 107 bestuursvoorzitters in Nederlandse beursgenoteerde vennootschappen in de periode 2002-2006. Middels regressieanalyses wordt bekeken of macht een invloed heeft op de mate waarin aandelen- en optieregelingen een element zijn van het beloningscontract. Er wordt geen robuust verband gevonden. Het blijkt dat het hebben van een (tweede) beursnotering in de Verenigde Staten, de grootte van de onderneming en de mate waarin het aandelenkapitaal gespreid is over meerdere aandeelhouders een sterkere indicator is voor het opnemen van opties en aandelen als onderdeel van de beloning. Vervolgens wordt gekeken of de macht van de bestuursvoorzitter gerelateerd is aan het niveau van zijn of haar beloning. Ook hier blijven robuuste bevindingen die de hypothese ondersteunen uit. Tenslotte wordt bezien of de macht van de bestuursvoorzitter de relatie tussen de prestaties van de onderneming en de beloning van de bestuurder negatief modereert – wat bewijs zou zijn van een effect van macht op de prestatieafhankelijkheid van de beloning. Voor deze stelling wordt echter ook geen overtuigend bewijs gevonden. Al met al wordt dus geen robuust bewijs aangedragen dat de aanname van de machtsbenadering van bestuurdersbeloning staaft.

In het besluit van het proefschrift wordt nader ingegaan op twee concepten die in de verschillende hoofdstukken centraal staan: macht en onafhankelijkheid. In de literatuur op het gebied van goed ondernemingsbestuur zijn verschillende visies betreffende de relatie tussen deze twee concepten te vinden. Waar sommigen beweren dat macht een voorwaarde is voor onafhankelijkheid, beweren anderen dat onafhankelijkheid een voorwaarde is voor macht. Weer anderen laten het onderscheid links liggen en behandelen de concepten alsof zij in essentie op hetzelfde neerkomen. In dit proefschrift zijn enkele – deels tegenstrijdige – conclusies over macht en onafhankelijkheid te vinden. In hoofdstuk 4 wordt aangenomen dat onafhankelijkheid een voorwaarde is voor de onderhandelingsmacht van commissarissen in de context van best practice bepalingen die niet de instemming van bestuurders hebben. Er wordt inderdaad aangetoond dat onafhankelijkheid eerder tot naleving van deze bepalingen leidt. Deze relatie houdt echter niet stand in hoofdstuk 5 waar de andere kant van de medaille wordt bestudeerd: de macht van de bestuurder blijkt niet gerelateerd te zijn aan de mate waarin de raad van commissarissen beloningscontracten kan ontwerpen die tegen het privébelang van de bestuurder ingaan. Dit roept vragen op over de relatie tussen macht en onafhankelijkheid: wat verklaart dat de macht van de bestuurder niet de armslag van de raad van commissarissen beperkt, terwijl onafhankelijkheid van de commissarissen deze armslag wel vergroot? Uiteraard kan een deel van de verklaring liggen in het verschil tussen feitelijke beloning (hoofdstuk 5) en transparantie van het beloningsbeleid (hoofdstuk 4). In hoofdstuk 2 wordt tenslotte nog aangegeven dat onafhankelijkheid nadelig kan uitpakken voor het functioneren van de raad van commissarissen indien deze leidt tot gepercipieerde afstand tussen bestuurders en commissarissen.

Deze overwegingen met betrekking tot onafhankelijkheid en macht zijn breder toepasbaar op de literatuur die poogt inzicht te krijgen in feitelijke gedragingen van bestuurders en commissarissen (in navolging van Forbes en Milliken, 1999). Door conceptuele onduidelijkheid ontstaan meerdere empirische maatstaven voor concepten die in hoge mate vergelijkbaar zijn. Zo is in de praktijk zowel macht als onafhankelijkheid gemeten door de demografische gelijkenis tussen bestuurders en commissarissen. Voor het ontstaan van begrip in de werking van de raden, is een verdere verdieping van concepten noodzakelijk en vooral een duidelijke afbakening van de verschillen tussen de concepten. Hieraan worden in paragraaf 6.3 nog twee aanbevelingen voor toekomstig onderzoek toegevoegd. In de eerste plaats is onderzoek gebaat bij een onderscheid tussen structuurkenmerken, proceskenmerken en uitkomsten van het gedrag van bestuurders en commissarissen. Al te vaak worden structuurkenmerken (zoals de omvang van een raad) genomen als benadering van een proceskenmerk (zoals de beslisvaardigheid van deze raad), hetgeen slechts indirecte inzichten kan verschaffen. In de tweede plaats is er een behoefte aan analyses die de meerdere niveaus van analyses beschouwen. Zo bestaan de structuurkenmerken, proceskenmerken en

uitkomsten op het niveau van het individu, de raad, en de onderneming. Waar baanbehoud bijvoorbeeld een uitkomst op het niveau van het individu is, is de onderneming eerder gebaat bij een optimale afweging tussen risico en rendement.

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