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Co-opted Directors and Board Effectiveness: The Impact of Director Gender

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Abstract

Independent directors are viewed as critical to effective corporate governance. However Coles et al. (2014) introduce the concept of a "co-opted" director, one appointed after the firm's CEO took office. They argue that, although technically independent, co-opted directors' interests are more aligned with the CEO who was instrumental in their selection than with shareholders. However, research has shown that woman directors are more conscientious about their board duties than are men. This study investigates whether director gender mitigates the impact of co-option on board effectiveness, as measured by the frequency of board meetings. The results indicate that an increase in the proportion of co-opted male directors on a board is associated with a less effective board. However, no such relation is found for co-opted female directors. Despite incentives to act otherwise, boards with higher percentages of co-opted women directors appear to continue to fulfill their duties to shareholders.

Introduction

The importance of independent directors to effective corporate governance has long been widely accepted. However, Coles et al. (2014) argue that not all directors classified as independent are, in fact, committed to serving shareholder interests. They introduce the concept of a "co-opted" or "captured" director, one appointed to the board after the firm's CEO took office. Because of the CEO's influence in securing their position on the board, co-opted directors' interests may more closely align with management than with shareholders. Coles et al. (2014, p. 1752) note "that such co-opted directors, regardless of whether they are classified as independent using traditional definitions, are more likely to assign their allegiance to the CEO because the CEO was involved in their initial appointment."

In their analysis, Coles et al. (2014) do not distinguish between male and female co-opted directors. However prior research indicates that there are gender-based differences in director approaches to corporate governance. For example, Post and Byron (2015) cite studies indicating that value differences may lead female directors to be more committed to their fiduciary duties than are men, and also that higher aversion to risk may increase the motivation of women directors to oversee management.

This study contributes to the literature by investigating the impact of co-option on board effectiveness through the perspective of director gender. If women directors are more committed to their fiduciary duties than are men, they should be less influenced by incentives to transfer loyalty to management. A difference should thus be observable between the impact of co-opted male directors and co-opted female directors on board effectiveness.

Effectiveness is measured by the frequency with boards meet to carry out their duties. Meetings are a critical component of a board's monitoring function. Vafeas (1999, p. 114) summarized the relevant literature and concluded that "(a) clear implication of these articles is that directors of boards that meet more frequently are more likely to perform their duties in accordance with shareholders' interests." Brick and Chidambaran (2010, p. 533) echo this point, noting that "shareholder services groups . . . make the argument that board activity is very important and material in valuing the firm."

The remainder of this paper is divided into four sections. The first section summarizes selected literature regarding co-option, women directors and corporate governance, as well of the value of board meetings as a proxy for board effectiveness. The research model is developed in the second section, followed by presentation of the results. The paper closes with a summary and discussion of the findings.

Literature Review

Co-opted Boards

The idea that all directors classified as independent are not equally committed to shareholder interests is not recent. Vicknair et al. (1993) discuss the prevalence of "grey" area directors who, though legally independent, may have had their objectivity compromised through receiving consulting fees, board interlocks, or other business relationships. More recently, Cohen et al. (2012) note that many directors, while technically independent, are actually overly sympathetic to management interests. The failure of legal and regulatory definitions of independence to capture true independence may explain the inconsistent results of research investigating the relation between firm performance and board independence noted by both Cohen et al. (2012) and Coles et al. (2014).

Coles et al. (2014) argue that the choice of new directors to a firm's board is strongly influenced by the firm's CEO. Because of this influence in director appointments, new directors owe their loyalty to the CEO instead of to the shareholders. This loyalty results in directors allowing the CEO more discretion or latitude than they would otherwise grant. In other words, as Coles et al. (2014, pp. 1753-1754) note, "co-opted independent directors, though independent of the CEO in the conventional and legal sense, behave as though they are not independent in the function of monitoring management." Their findings indicate that, as a result of this weaker monitoring, CEOs of firms with co-opted boards are paid more and have greater job security in time of poor performance than other CEOs

Women Directors and Corporate Governance

Research into the effects of women directors on firm financial performance and board activities has been extensive. Two of the more notable recent studies are by Post and Byron (2015) and Chen et al. (2016). Post and Byron (2015) conduct a meta-analysis of 140 of these prior studies. They argue that female directors are likely to have a positive impact on board monitoring of management, and provide three rationales for this view. The first comes from prior research suggesting that women apply stricter ethical standards than men and are more likely to judge suspect business activities as unethical. Post and Byron (2015) argue that this enhanced ethical commitment will lead female directors to be more diligent in carrying out their fiduciary duties to monitor management.

Post and Byron's (2015) second rationale is drawn from research indicating that women are more risk averse than men. In the context of the boardroom, this may result in women being more motivated to monitor management behavior, so as to avoid the legal and reputational risks that come with not doing so.

Finally, Post and Byron (2015) note that women historically have faced greater difficulty being taken seriously in a professional setting. To establish credibility in their role as directors, women are likely to take the position more seriously, approach meetings better prepared, and be more effective monitors of management.

Taken together, Post and Byron's (2015) rationales provide a basis for expecting women to be more committed to shareholder interests and less likely to allow management the opportunity for self-serving behavior. Their meta-analysis reported results consistent with this expectation, as female representation on boards was positively and significantly associated with board monitoring activities.

Subsequent to Post and Byron (2015) and not included in their meta-analysis is research by Chen et al. (2016). Noting studies showing women to be less tolerant of opportunistic behavior in general than are men, they argue that women directors will be less tolerant of internal control weaknesses, since these weaknesses provide management with the ability to act opportunistically. Their findings confirm this expectation as female directors were associated with lower rates of internal control issues. In fact, they found evidence that the presence of even one female director on the board reduced the likelihood of internal control weaknesses.

Both Post and Bryon (2015) and Chen et al. (2016) provide evidence that women directors are likely to be more committed to limiting management discretion and protecting shareholder interests than are men. This provides reason to believe that women appointed to the board after the firm's CEO takes office will be more effective in their duties and less likely to be co-opted than will male directors.

Board Meeting Frequency

Boards of directors are supposed to protect the interests of shareholders by monitoring the actions of their firm's management. The quality of such monitoring is not directly observable, so researchers have often employed the number of board meetings as a proxy for board effectiveness. Conger et al. (1998, p. 143) state that "(t)o make effective decisions, directors need sufficient, well-organized periods of time together as a group." Vafeas (1999) examined the association between board meetings and firm value. He found that poor performance by a firm would lead to more frequent meetings by the board. These additional board meetings would then result in improved firm performance in later years.

Brick et al. (2010) also used meetings as a proxy for the effectiveness of the board's monitoring of management. Their findings were consistent with those of Vafeas (1999) and further documented that increases in firm value arose from additional board meetings. Al-Najjar (2010) documented an association between the frequency of board meetings and the quality of the firm's internal monitoring mechanisms.

Other studies have examined the number of meetings held by the audit committee, as opposed to the board as a whole. Abbott et al. (2004) and Raghunandan & Rama (2007) both note that meeting frequency has been often used as a proxy for the diligence with which the audit committee carries out its oversight of the financial reporting function. DeZoort et al. (2002, p. 65) reviewed prior research and concluded that it shows that "greater meeting frequency is associated with a reduced incidence of financial reporting problems and greater external audit quality."

If the proportion of co-opted directors on boards influences the effectiveness of those boards, and meeting frequency is a proxy for effectiveness, then there should be an association between co-option and the number of meetings held. If men and women do differ in the strength of their commitment to shareholder interests, differences in the impact of male and female co-opted directors should also be observable.

Model Development

Al-Najjar (2010) developed a model to predict board meeting frequency that incorporates variables based on both firm characteristics and internal governance mechanisms. This study employs a slightly modified version of that model. The model's internal governance variables are discussed first.

The frequency with which a board meets may be affected by the size of the board itself. A larger group may need more time to discuss issues and reach a consensus; more meetings are one means of affording that additional time. Al-Najjar (2010, p. 7) states "the larger the board size, the more demand on board meetings."

The importance to effective governance of truly independent directors has long been recognized. Boone et al. (2007) argue that independent boards reduce opportunities for management to subordinate shareholder interests to their own private benefit. To achieve this oversight and constraint of management, boards must meet. If legal and regulatory definitions of "independent" capture true independence to some extent, increases in board independence should be associated with increases in the number of board meetings.

Vafeas (1999) notes that boards delegate some of their responsibilities to committees, such as the compensation or audit committee. If committees perform duties that were formerly the responsibility of the board as a whole, the lessened workload of the board might lead to fewer meetings. However, boards must supervise and coordinate their committees, a task that increases with the amount of delegation and may require more meetings to accomplish. Al-Najjar (2010) used the number of audit committee meetings as a proxy for board delegation and found more audit committee meetings were associated with fewer meetings of the board as a whole.

Al-Najjar's (2010) model also incorporates several firm characteristics, the first of which is firm size. The activities of larger firms are normally held to be more numerous and complex than for smaller firms. In turn, this volume and complexity may lead to an increased need for effective monitoring by the board (Boone et al., 2007). An increased demand for monitoring would be expected to lead to more frequent meetings.

The next group of variables arise from a firm's exposure to the risk of fraud. High levels of debt and leverage have been shown to be associated with an increased risk of fraud (Dechow et al., 1996). Al-Najjar (2010) posits highly leveraged firms will respond to this increased risk by intensifying their monitoring efforts, resulting in more meetings of the board.

Another indicator of potential fraud is rapid growth (Loebbecke et al., 1989). Also, Raghunandan and Rama (2007) note that future growth opportunities (as measured by the ratio of market value to book value) are associated with an increased risk of fraud. Boards of high-growth firms are expected to respond to the increased risk of fraud by increasing their monitoring efforts and meeting more often.

Firms with high amounts of free cash flows (FCF) may also face issues that require increased monitoring by the board. Jensen (1986) notes that managers have incentives to use FCF for their private benefit, rather than for the benefit of shareholders. The resulting agency conflicts may force firms to increase their oversight of management and lead to more board meetings.

The final firm characteristic from Al-Najjar's (2010) model is firm value. As noted earlier, both Vafeas (1999) and Brick and Chidambaran (2010) find that boards meet more frequently in response to poor firm performance and that performance subsequently improves, increasing the value of the firm. The measure of firm value employed in these analyses has often been Tobin's Q (Al-Najjar, 2010 and Brick and Chidambaran, 2010).

In addition to the variables developed by Al-Najjar (2010), this study employs one additional firm characteristic to predict meeting frequency. Raghunandan and Rama (2007) argue that there should be a negative association between the amount of company stock owned by corporate insiders and the frequency of audit committee meetings. They note that agency costs should decrease as insider ownership of the company increases, reducing the need for committee meetings and other monitoring mechanisms. To the extent this relation holds, one would expect fewer meetings of the board as a whole as insider ownership rises.

The variables of chief interest in the model are the proportion of the board's directors who have been co-opted by the firm's CEO, classified by director gender. If co-opted directors do, in fact, allow the CEO greater discretion, then monitoring by the board should be reduced. One potential consequence of lower effort expended in monitoring management would be fewer meetings of the board. Following Coles et al. (2014) a director is classified as co-opted if he or she is elected after the firm's CEO takes office. Co-opted proportions are computed separately for male and female directors.

These variables are incorporated into the following regression model based on that developed by Al-Najjar (2010):

BODMEET = *f*(BSIZE, IND, AMEET, SIZE, LEV, MB, FCF, TOBQ, INSIDER, COOPTMALE, COOPTFEMALE)

where:

BODMEET	= natural log of the number of board meetings;
BSIZE	= natural log of the number of directors on the board;
IND	= proportion of independent directors on the board;
AMEET	= natural log of the number of audit committee meetings;
SIZE	= natural log of firm's market value;
LEV	= debt scaled by total assets;
MB	= market value to book value ratio;
FCF	= free cash flows scaled by total assets;
TOBQ	= Tobin's Q (measured as book value of assets plus market value of equity less book value of equity divided by book value of assets;
INSIDER	= percentage of common shares owned by officers and directors;
COOPTMALE	= the proportion of directors appointed to the board after the CEO assumed office who are male;
COOPTFEMALE	= the proportion of directors appointed to the board after the CEO assumed office who are female.

Sample and Data

The sample for this study consists of 100 companies randomly selected from the S&P 500 Index. Director and firm governance information were hand collected from firm proxy statements filed in 2015. Information was collected for 1,088 individual directors. Financial data were obtained through firm 10-K's and the S&P Research Insight database.

TABLE 1
Descriptive Statistics

Variable	Mean	Median	SD
# of Directors on Board	10.860	11.00	1.83
% Independent Directors	85.54%	90.00%	.082
Audit Committee Meetings	8.71	8.00	3.07
Assets ($MM)	40,256.36	16,124.36	73,259.57
Leverage	.29	.26	.17
Market-Book Ratio	24.57	3.30	139.52
Free Cash Flows/Assets	0.05	.04	.05
Tobin's Q	2.47	2.17	1.43

Insider %	2.56%	.94%	5.37
% of Co-opted Directors	37.13%	33.33%	.27

Table 1 provides selected descriptive data for the sample. As would be expected from a sample of S&P 500 firms, the average company is very large, with over $40 billion in assets. The overwhelming majority of directors are classified as independent (85.54%). However over 37% of directors are classified as co-opted.

More information regarding the gender distribution of co-opted directors is presented in Table 2. As expected, boards are overwhelmingly male. The percentage of female co-opted directors is slightly higher than for the sample as a whole, perhaps reflecting recent increases in the numbers of women appointed to corporate boards.

Table 2
Co-opted Directors and Gender

	All Directors			Co-opted Directors	
	#	%		#	%
Male	877	80.61%		316	78.22%
Female	211	19.39%		88	21.78%
Total	1,088	100.00%		404	100.00%

Table 3 provides information about the frequency of board meetings of sample firms. The average number of meetings was slightly over 8 for the year. Meetings appear to be roughly evenly distributed, except for the higher percentage of firms meeting 10 or more times during the year.

TABLE 3
Frequency of Board Meetings

Number of Meetings	%
4 or fewer	13.0%
5	13.5%
6	13.5%
7	12.5%
8	11.5%
9	8.5%
10 or more	27.5%
Mean # of Meetings	8.15

Results

Table 4 provides results for the regression model. The model's F-statistic is 2.963 ($p = .002$). The highest variance inflation factor (VIF) is 2.152, reducing concerns about multicollinearity. As the Table indicates, statistically significant coefficients are observed for several independent variables. The number of audit committee meetings (AMEET) is higher for firms whose boards meet more frequently. Consistent with expectations, the percentage of common shares owned by officers and directors (INSIDER) is negatively and significantly associated with board meeting frequency.

The independent variables of chief interest are COOPTMALE and COOPTFEMALE. As Table 4 shows, the coefficient of COOPTFEMALE, is positive and not significantly associated with board meeting frequency. However COOPTMALE is significantly and negatively associated with the number of board meetings. An increase in the proportion of co-opted male directors is associated with a decline in meeting frequency. No such relation is found for co-opted female directors.

Table 4
Regression Results

BODMEET = *f*(BSIZE, IND, AMEET, SIZE, LEV, MB, FCF, TOBQ, INSIDER, COOPTMALE, COOPTFEMALE)

Variable	Coefficient	t-stat	p-value
Intercept	1.611	***2.418***	***.018***
BSIZE	0.031	0.133	.895
IND	-0.360	-0.645	.520
AMEET	0.387	***3.529***	***.001***
SIZE	0.000	-0.010	.992
LEV	-0.158	-0.753	.454
MB	0.000	0.701	.485
FCF	-1.279	-1.506	.136
TOBQ	0.013	0.388	.699
INSIDER	-0.018	***-2.132***	***.036***
COOPTMALE	-0.437	***-2.492***	***.015***
COOPTFEMALE	0.380	0.759	.450
Adj R-square	.179		
F-statistic	2.963		
Pr > F	***.002***		
Highest VIF	2.152		

Conclusion

This study is the first to examine whether gender affects the impact of director co-option on board effectiveness, as measured by board meeting frequency. Co-option is a concept developed by Coles et al. (2014) which holds that directors owe their loyalty to the CEO who was instrumental in their selection to the board, rather than to the firm’s shareholders. Thus, even directors legally classified as independent may not always act in the best interests of shareholders. This lack of true independence results in less monitoring of management by the board, and to the extent that activity reflects effectiveness, fewer board meetings.

However, research has shown (Post and Byron, 2015; Chen et al., 2016) that woman directors fulfill board functions more conscientiously than do men, raising the possibility that co-option may not equally affect the effectiveness of male and female directors. To investigate this issue, a sample of 100 S&P 500 firms was selected and the percentage of the board made up of male co-opted directors and female co-opted directors was calculated. A regression model, based on one developed by Al-Najjar (2010), was employed to predict the frequency of board meetings during the year.

Regression results revealed a significant and negative association between co-option and meeting frequency, but only for male directors. The greater the proportion of male co-opted directors on the board, the less frequently the board met. However, no association was found for co-opted female directors. Coles et al. (2014, p. 1781) argued that "independent directors that are co-opted behave as though they are not independent." The findings of this study indicate that this statement only holds for boards with higher percentages of co-opted male directors. Whether due to their ethical commitment, risk aversion, or intolerance of opportunistic behavior, boards with higher percentages of co-opted women directors appear to continue to fulfill their duties to shareholders, despite the incentives to act otherwise.

These findings are subject to several limitations. First is this study's use of board meeting frequency as a proxy for effectively representing shareholder interests. Although prior research has employed the number of meetings as an indicator of board effectiveness, Vafeas (1999) notes that the number or quantity of meetings may not fully capture the quality of those meetings. Shareholders are better served by fewer meetings substantively addressing their interests than by a larger number of unproductive board sessions. Also, this study's dichotomous measure of co-option implicitly assumes that all CEO's have equal power and influence on firm boards.

Further research is clearly called for. In their discussion of independence, Cohen et al. (2012, p. 1057) argued that "(b)efore the question of whether independent boards benefit shareholders can be adequately addressed, more research is needed to determine the true nature of "independence" within corporate boards, which begins with an understanding of the true independence of directors." The results reported here make clear that director gender should be considered in any analysis of "true independence."

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