Why do Boards Exist? Governance Design in the Absence of Corporate Law

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Motivation

Why do corporate boards exist and when do they add value for shareholders?

- What are their costs and benefits to shareholders?
- Corporate law makes it difficult to answer
  - Mandate boards’ existence
  - Lays down the powers of the board
- We offer a setting where corporate law does not exist
Setting

Norway didn’t have corporate law until 1911

- Person could freely establish corporations
- Limited liability firms had legal personhood
  - Well-functioning institutions and courts

Contractual freedom

- Owners could freely write articles of association (*statutes*)
- Free to decide authority-structure within the firm
  - Governance is based on authority
  - E.g. are mergers decided in general meeting (GM) or elsewhere?

- Today, much authority is laid down in corporate law
Most firms operate without a board

- But some complicate their organizational structure by installing a board
  - Formally distinct from management and GM
  - Elected by shareholders

- Board are often given authority over major corporate decisions

We study boards’ raison d’être and role in the organization of the corporation

- What characterizes firms that install boards?
- What role(s) do boards perform?
Contributions

1. When do boards add value for owners?
   - Trade off costs and benefits of boards
   - Boards are “optimal” when observed
     ▶ What owners believe to be best governance design
   - Can directly test common perception that boards exist to monitor managers bc collective action problems

2. Heterogeneity in authority reveal boards’ roles
   - Different roles require different powers
     ▶ Monitoring necessitates authority
     ▶ Advise might require relinquishing power to overrule (Adams Ferreira 2007)
   - Can answer whether particular role adds value simply by observation
Data

- Statutes of 85 public Norwegian corporations around 1900
  - Brokers handbook

- Study authority over 5 major corporate decisions
  - Sales/acquisition of major assets
  - Secured borrowing
  - Equity issuance
  - Liquidation
  - Dividends

- Provisions also about voting, conduct of M and B, conduct of GM, extraordinary GMs, disclosure of info, ...

- 22 firms with board (26%)
- Everything endogenous
Allocation of authority over 5 major decisions

General Meeting

- Acquisitions/sales
- Borrowing
- Equity issues
- Liquidation
- Dividend

Fraction of firms

Board

- Acquisitions/sales
- Borrowing
- Equity issues
- Liquidation
- Dividend

Fraction of firms

Management

- Acquisitions/sales
- Borrowing
- Equity issues
- Liquidation
- Dividend

Fraction of firms

Shared with Management

- Acquisitions/sales
- Borrowing
- Equity issues
- Liquidation
- Dividend

Fraction of firms
Are firms with collective action problems more prone to delegate authority?
• Need proxy for collective action costs (little ownership data)
  ▶ Share denomination (nominal value)
  ▶ Varies from 100 to 10,000 (687–68,750 USD)
  ▶ (compare to 5,000)

• 3 groups: small-denomination, large-denomination, intermediate

• Small-denomination firm more plagued by collective action problems
  ▶ More and smaller shareholders
  ▶ Fewer blockholders

• Large-denomination firms have larger and informed owners

• Subsample of ownership structure in 15 firms confirms
Authority of the General Meeting

Small-denomination firms

Average number of decisions

DEL GM

Large-denomination firms

Average number of decisions

DEL GM
When do boards emerge?
## Determinants of board existence

<table>
<thead>
<tr>
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<td>Share Denomination ('000)</td>
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<td>Small Denomination Dummy</td>
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<td>Size (log)</td>
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<td>Firm age in 1900</td>
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<td>-0.06+</td>
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<td>Fixed Assets Ratio</td>
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<tr>
<td>Constant</td>
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<td>2.58**</td>
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<td>p-value</td>
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<tr>
<td>Pseudo R-squared</td>
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- Only 1 large-denomination firm installs a board!
Other characteristics of large-denomination firms

- Larger (paid-in equity)
- Fewer outstanding shares
- Equally likely to be family owner or have founder in M
What happens with authority allocation in firms with boards?
Authority in firms with and without a board

Asset decisions

Dividend decision

Average number of decisions

Board | GM | Mgmt

No Board | Board

Board | GM | Mgmt

No Board | Board
Boards given authority over assets decisions

- Authority not given to GM
  - Collective action problems
- Authority not given to management
  - Monitoring!

Boards given authority over dividends

- Authority not given to GM
  - Mediation between shareholders
How do boards’ other duties relate to authority?
Indices of other board tasks

**Information index**
(B approves, M reports to B, B inspects)

**Advice index**
(B decides when asked, M sit on B, M vote in B)

**Career index**
(B selects M, B sets salary of M)
Other board tasks and authority

<table>
<thead>
<tr>
<th>Info Index</th>
<th>Advise Index</th>
<th>Career Index</th>
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<tbody>
<tr>
<td>B approve</td>
<td>B advices</td>
<td>B sets M salary</td>
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<tr>
<td>M reports to B</td>
<td>M sit on B</td>
<td>B elects M</td>
</tr>
<tr>
<td>B inspects</td>
<td>M vote in B</td>
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<td>(0.18)</td>
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<td>Obs.</td>
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<td>p-value</td>
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<tr>
<td>R-squared</td>
<td>0.35</td>
<td>0.18</td>
<td>0.21</td>
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</table>
Boards with more authority over asset decisions...

- ...are also given more information-related tasks
  - ⇒ Make board informed to act independently from M
- Doesn’t hold when boards have only dividend authority

When management has asset authority...

- ... boards have more advise-related tasks
- ... board don’t have to acquire information
  - Strong commitment not to overrule
Other results

Boards arise to balance small shareholder protection against managerial discretion

- Firms that impose strong voting caps are more likely to set up boards (holding denomination fixed)

Founders impact choice between delegation to board or management

- When founders are managers, firms that delegate are more likely to delegate to management, and less likely to set up board
Unallocated authority

- When M and shareholders aligned, firms more likely to avoid costly contracting
  - Requirement that managers be shareholders
Conclusions

- Under free-contracting, firms allocate authority heterogeneously

- Not all firms set up a board
  - But presence of boards affect the balance of power

- Owners install boards to perform multiple roles
  - Monitor, mediate, advise
  - Different roles in different firms
  - Mediation-role unexplored

- Boards and informed shareholders are substitutes

Policy takeaway

- Firms need flexibility in design of board
Nominal value of shares
(Norwegian kroner)

- Passive owners
- Many (dispersed) owners
- Active owners