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

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EU-Asia Corporate Governance Dialogue Series
NUS July 7th, 2017

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

Boards arise endogenously

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

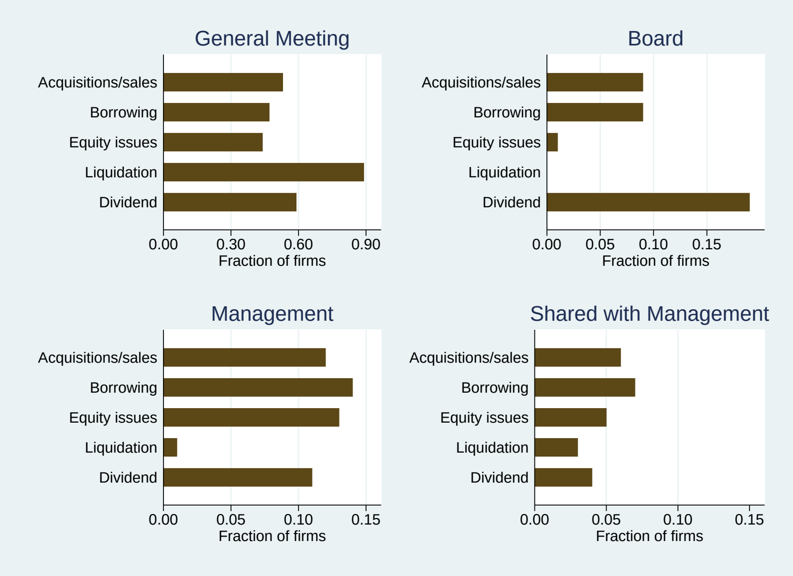
1. **When do boards add value for owners?**
   - Trade off costs and benefits of boards
   - Boards are "optimal" when observed
     - What owners believe to be best governance design
   - Can **directly test** common perception that boards exist to monitor managers bc collective action problems
2. **Heterogeneity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

  asset decisions
- Provisions also about voting, conduct of M and B, conduct of GM, extraordinary GMs, disclosure of info, ...
- 22 firms with board (26%)
- Everything endogenous

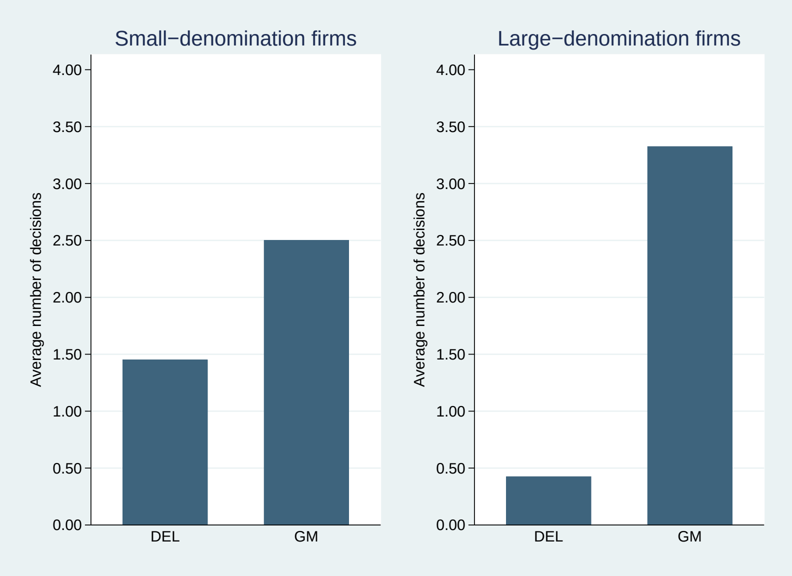
Allocation of authority over 5 major decisions



Are firms w 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



When do boards emerge?

Determinants of board existence

	(1)	(2)
Share Denomination ('000)	-0.40***	
	(0.00)	
Small Denomination Dummy		0.33***
		(0.00)
Size (log)	0.16***	0.13***
	(0.00)	(0.00)
Firm age in 1900	-0.05+	-0.06+
	(0.15)	(0.15)
Fixed Assets Ratio	0.02	0.04
	(0.67)	(0.29)
Constant	-4.88***	2.58**
	(0.01)	(0.02)
Obs.	85	85
p-value	0.00	0.00
Pseudo R-squared	0.42	0.27

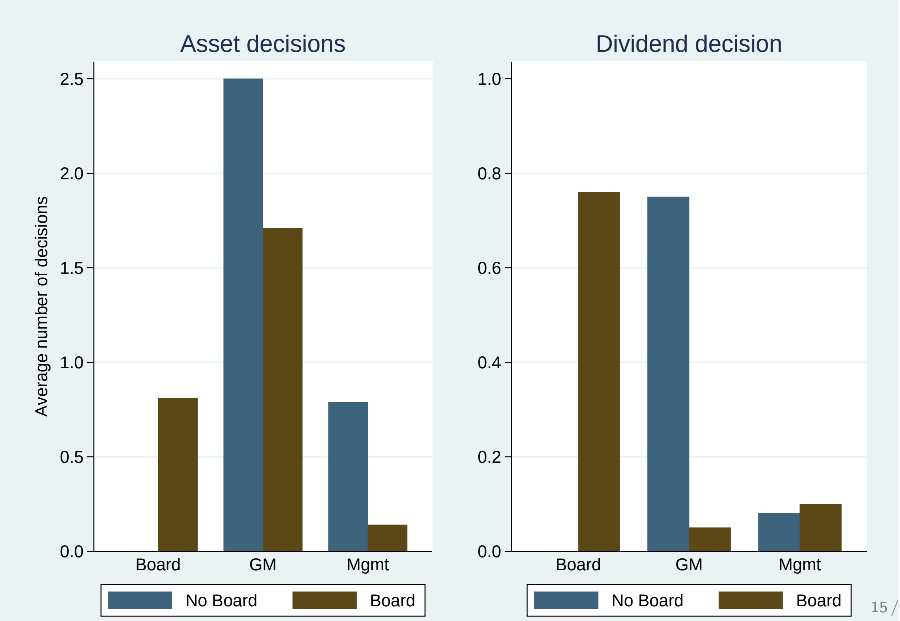
- Only 1 large-denomination firm installs a board!

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



Boards given authority over assets decisions

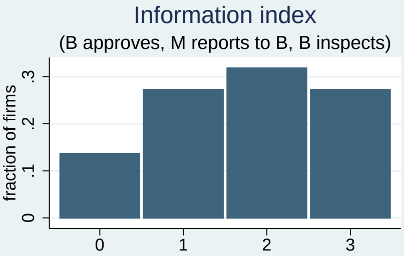
- Authority not given to GM
  - Collective action problems
- Authority not given to management
  - Monitoring!

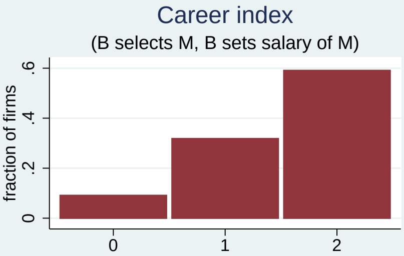
Boards given authority over dividends

- Authority not given to GM
  - Mediation btwn shareholders

How do boards' other duties relate to authority?

Indices of other board tasks





Other board tasks and authority

	Info Index	Advise Index	Career Index
	B approve	B advices	B sets M salary
	M reports to B	M sit on B	B elects M
	B inspects	M vote in B	
	(1)	(2)	(3)
B authority of assets and possibly dividends (index)	0.49**	0.20	0.29
	(0.02)	(0.49)	(0.18)
B authority of dividends only (dummy)	-0.32	-0.07	0.08
	(0.50)	(0.90)	(0.83)
M authority index	-0.16	0.78**	-0.01
	(0.55)	(0.01)	(0.94)
Constant	1.16**	1.19*	1.13**
	(0.04)	(0.08)	(0.03)
Obs.	22	22	22
p-value	0.01	0.09	0.18
R-squared	0.35	0.18	0.21

Boards with more authority over asset decisions...

- ...are also given more information-related tasks
  - $\Rightarrow$ 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

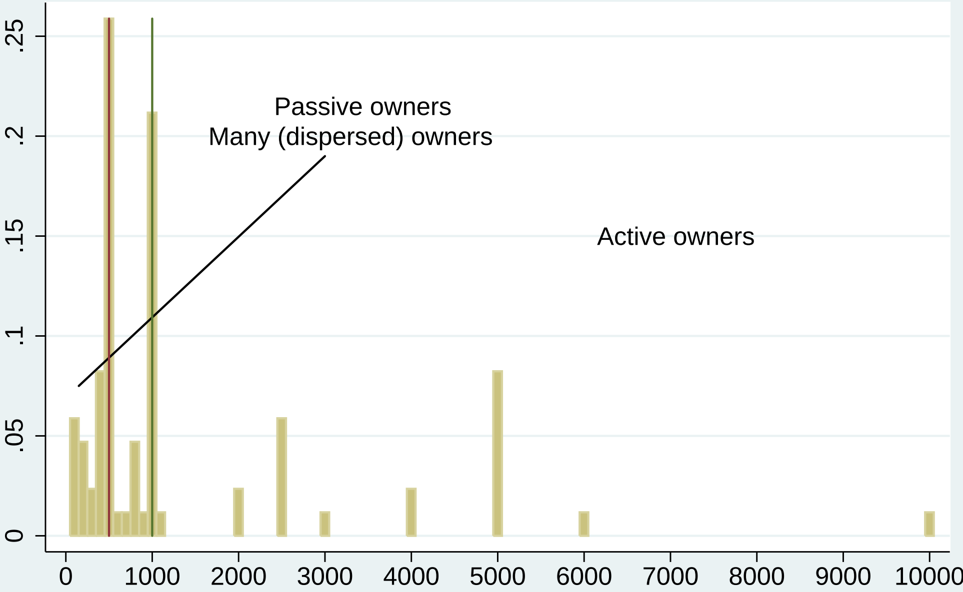
- Under free-contracting, firms allocate authority heterogeneously
- Not all firms set up a board
  - But presence of boards affect the balance of power
- Owners install boards to perform multiple roles
  - Monitor, mediate, advise
  - Different roles in different firms
  - Mediation-role unexplored
- Boards and and informed shareholders are substitutes

Policy takeaway

- Firms need flexibility in design of board

Nominal value of shares

(Norwegian kroner)



Industry composition