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Outside Directors on Corporate Boards: Background and Behavior

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Outside Directors on Corporate Boards: Background and Behavior

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The substantial influence of CEOs diminishes the oversight function of the board of directors. Many outside directors have social ties with CEOs and their behavioral patterns are inconsistent with those of vigilant monitors. Dissents are rare, and those who do dissent are highly likely to be replaced. Further, the director ratio tends to be lower when more supervisory items are on the board agenda. In order for the outside director system to operate properly, the voting rights of minority shareholders should be respected, outside directors and agenda selection must remain independent from CEOs, and objective evaluation and disclosure of outside directors' board activities must ensue.

I. Introduction

Since the 1998 Asia currency crisis, regulations on outside directors have been strengthened to improve their independence on corporate boards of directors with the goal of containing irrational management practices. Still, the effectiveness of outside directors remains in question. This is probably due to the fact that the oversight function of external directors cannot work properly under the current regulations, which only address the percentage of outsiders on boards.

The primary concern is whether outside directors with personal connections with CEOs can fulfill their role as independent supervisors. Behavioral economist Dan Ariely showed that people are more likely to commit fraud when the interests of their friends and relatives are at stake. This is because it is easier for them to rationalize wrongdoings that are committed to benefit personal connections. If this argument is applied to corporate boards, it means that outside directors with social ties with CEOs would likely defer to them.

Analysis on corporate data shows that, under the current outside director system, CEOs can immobilize oversight by outside directors.

Moreover, CEOs' substantial influence on outside directors' tenure and board agenda can severely undermine the effectiveness of outside directors' supervision. CEOs can steer the composition of outside directors by appointing and retaining only those with whom he/she has personal connections. Considering that the outside director ratio changes over time even in the same year, CEOs may put sensitive items on the agenda when the outside director ratio is low.

This paper examined data on the boards of directors of 100 firms to identify board composition and the behavior of outside directors of Korean companies and offers policy suggestions.¹⁾ Analysis on corporate data shows that, under the current outside director system, CEOs can immobilize oversight by outside directors.

II . Attendance and Voting at Board Meetings

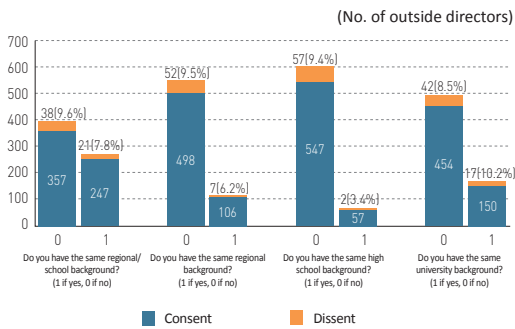
Outside directors are expected to actively oversee CEOs and dismiss or stop them if their ability is in doubt or if they act against shareholder interests. However, records of board meetings reveal that outside directors rarely vote against management proposals. There were only 33 items or 0.4% from a total of 9,101 items on which at least one outside director casted a dissenting vote (including all types of disapproval such as suspension, call for revision, or conditional consent). 59 (9%) outside directors from 15 companies dissented at least once during the three-year sample period; casting a dissenting vote on 2.5 items on average with 53% saying no on only one item.²⁾³⁾ The items which received more than one dissenting vote were associated with overseas investment in resources,

1) Sample firms encompass Korea's top 100 non-financial private listed companies in terms of average annual sales that disclosed respective outside directors' attendance and voting records by item in 2010-2012. We gathered data on the companies' financial information, board composition and activities, and tenure, demographic features, and work experience of CEOs and outside directors. The data covered 4,253 board meetings; 9,101 agenda items; 612 outside directors; and 37,248 cases of attendance and voting by outside directors at board meetings.

2) If the largest two companies, in terms of dissenting votes, are excluded from those that recorded opposition by outside directors at board meetings, 32 outside directors (5%) opposed 18 items (0.2%) at least once with most of them opposing on only one item.

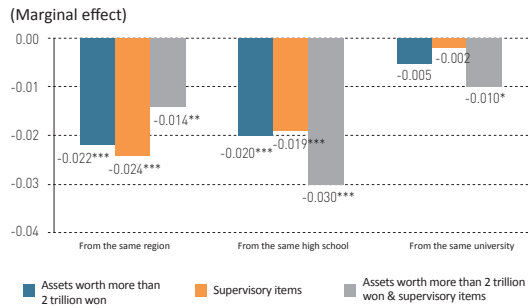
3) According to Ma and Khanna (2013), about 0.7% of outside directors of listed companies in China opposed an item at board meetings at least once in 2011. According to Jiang et al. (2014), 5.8% of outside directors of Chinese public corporations opposed at least once in 2004-2011. These figures are generally lower than those of comparable firms in Korea. It seems that Korea and China are the only countries where individual outside directors' voting records are disclosed by item. It is difficult to gather relevant statistics on other countries.

[Figure 1] Voting by Outside Directors



Note: 1. Data cover observations of 663 outside directors in total.
 2. "Dissent" includes those who have cast a dissenting vote at least once between 2010 and 2012.
 3. Regional/school background means having the same regional/high school/university background with CEOs.
 4. Region means area governed by an autonomous metropolitan government.

[Figure2] Influence of Social Ties with CEOs on Outside Directors' Attendance - Results of Logit Analysis (Marginal Effect)



Note: 1. *** p<0.01, ** p<0.05, * p<0.1.
 2. Marginal effect represents change in probability to attend by an additional unit of change of each explanatory variable.
 3. "More than 2 trillion won" includes firms with over 2 trillion won in assets as of the previous year only. "Supervisory items" include supervisory items only. "Assets worth more than 2 trillion won & supervisory items" show the sample analysis results using supervisory items only from companies with more than 2 trillion won in assets.
 4. Some variables considered in the analysis are not included in this report. They include outside directors' gender, age, educational level, and regional background as well as work experience in such areas as academia, industry, government, legal and other professional services, and banking. Features of CEOs and firms, size and frequency of board meetings, and yearly and monthly dummies are also absent from this report.

personnel management, corporate governance, stocks, and others. Most of these issues were covered by the press and appear to generate conflict of interests.

Outside directors with social ties to CEOs including alumni and those from the same region cast far fewer dissenting votes than those without such connections. Figure 1 shows the correlation between social ties and voting of outside directors. Among those from the same region, only seven (6%) cast at least one dissenting vote; and among those who graduated from the same high school, only two (3%) did so. Among outside directors without such ties, 52 (10%) and 57 (9%) cast a nay vote at least once, respectively. The comparison shows that those "friendly" outside directors with social ties with CEOs cast significantly fewer dissenting votes. However, the tendency was not evident among outside directors who graduated from the same university with the CEOs.

Furthermore, dissenting votes are rarer on boards with a high percentage of friendly outside directors. On average, friendly outside directors occupied 28% of the outside director seats on boards that had at least one dissenting vote in a one year period, while 41% were on boards that had no dissenting votes. The difference is statistically significant. This implies that the possibility of dissent is lower on boards that lack independence from management.

Outside directors must, of course, attend board meetings to fulfill their supervisory role. Although the average attendance of outside directors on board meetings is as high as 91%, it differs between outside directors with social ties with CEOs and those without. Figure 2 shows the results of a logit analysis on how outside directors' demographic features and

There is a low possibility of dissent on boards that lack independence from management.

The attendance pattern of friendly outside directors is consistent with delegating decision making to inside directors.

social ties with CEOs influence their attendance at board meetings.

Companies with more than 2 trillion won in assets in the previous year are required to place outside directors on the majority of their board seats. In such companies, outside directors with the same regional or high school background as the CEO had a tendency to be absent at board meetings. We found the same tendency using a sample of supervisory items.⁴⁾ Specifically, attendance of outside directors with the same regional or high school background marked about 2 percentage points lower than that of outside directors with no such ties. This is a significant gap given that the average absence is a mere 9%. When limiting our attention to companies with assets worth over 2 trillion won and supervisory items, we find that attendance of outside directors who graduated from the same university as the CEO also fell significantly. Attendance of outside directors who graduated from the same high school fell even further.⁵⁾

So, what are the reasons for the discrepancies in attendance rates based on social ties with CEOs? Friendly outside directors will probably attend a meeting if their “yes” vote raises the possibility for passage. Furthermore, with inside directors tending to agree with all agenda items, the attendance rate of outside directors will rise if their attendance and agreement helps inside directors obtain executive power. Even if this is not the case, outside directors will indirectly help CEOs by remaining absent from board meetings to again give inside directors decision making rights. Needless to say, however, actively supporting CEOs in this way may damage the reputation and careers of outside directors.

Assume a seven-member corporate board with four outside directors. The need is high for a friendly outside director to attend meetings to vote in support of the CEO’s wishes if the remaining three outside directors are “independent,” with no social ties to the CEO. However, the need is low if there are two or three friendly outside directors.

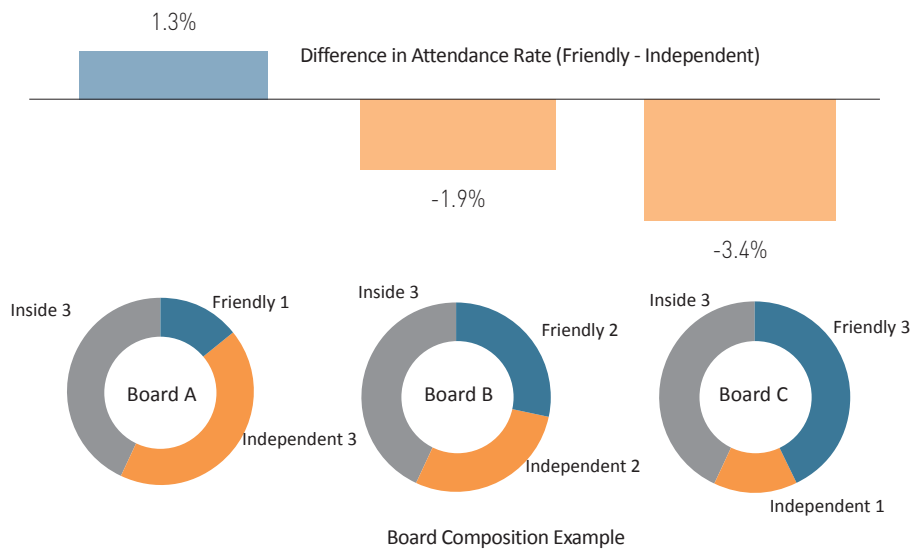
Figure 3 presents board composition with a varying number of friendly outside directors and the gap in average attendance rates between friendly and independent outside directors.

On Board A, independent directors take up most of the seats dedicated to outside directors whereas on Board C, friendly directors do so. On Board B, friendly and independent outside directors have the same number of seats. The need for friendly

4) For this study, we broadly classified agenda items into managerial, supervisory, and report. We classified items with a high probability of disagreement between CEOs and shareholders as “supervisory.” For example, items on mergers and acquisitions were classified as supervisory items since they tend to incur the conflict of interests between CEOs and shareholders. The rest of the items to be voted on were classified as “managerial.” For further discussion, see Kim and Lee(2014).

5) In terms of attendance, outside directors who were public officials or lawmakers, were at the bottom and those from academia were second from the bottom. The two groups’ attendance was only 74% and 84% of that of outside directors who are professionals, respectively. Attendance of outside directors who were in banking was as much as 1.6 times higher than that of those from other professional services. The probability of foreign outside directors attending board meetings was 32 percentage points lower than that of local outside directors; and that of male outside directors, 4 percentage points higher than that of female outside directors. This shows that, although foreign and female outside directors are generally believed to be independent from management in Korea’s corporate environments mainly led by male and local CEOs, they do not actively fulfill their role as vigilant monitors. Their low attendance may be due to the fact that most board meetings are conducted in Korean or in a dominantly masculine culture.

[Figure 3] Average Attendance Rate by Board Composition and Social Ties



Note: 1. 'Friendly' refers to friendly outside directors; 'Independent' refers to independent outside directors; 'Inside' refers to inside directors
 2. The difference in attendance rate equals the average attendance rate of friendly outside directors – average attendance rate of independent outside directors.
 3. [Board A] Independent outsider directors occupy the majority of seats reserved for outside directors
 [Board B] Independent and friendly outside directors each occupy half of the seats reserved for outside directors
 [Board C] Friendly outside directors occupy the majority of seats reserved for outside directors
 The percentage of outside directors exceeds the majority on all boards. Among the boards with outside directors occupying the majority of seats, Boards A, B and C had 59%, 9% and 32%, respectively.

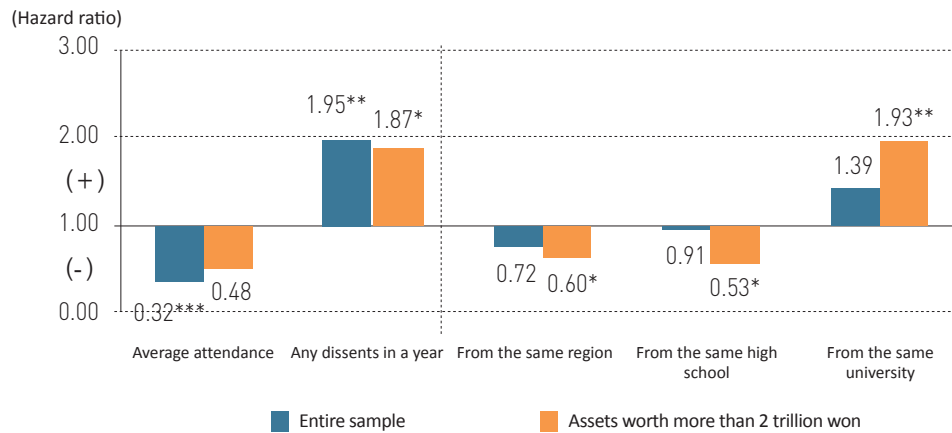
outside directors to be at meetings to vote for an item declines from Board A to Board C. Attendance of friendly outside directors is higher than that of independent outside directors on Board A but lower on Board B. The attendance gap between the two types of outside directors is even wider on Board C.

In sum, attendance of outside directors is generally high, but that of those with social ties with CEOs is lower than that of independent outside directors. Assuming that inside directors attend every board meeting, absence of outside directors leaves decision making up to the inside directors, thereby allowing CEOs to dominate the board indirectly. In particular, outside directors' absence from board meetings of companies that have more than 2 trillion won in assets and grant voting power to outside directors, or from board meetings with items that are aimed at controlling management is tantamount to ignoring their fiduciary responsibility.

III. Replacement of Outside Directors

As shown in the previous section's analysis, even if the number of outside directors is the same, their composition can sway the efficiency of the board of director's oversight function. CEOs may want to re-appoint personally connected outside directors and replace those who are proactive. Hazard (dismissal or resignation risk) analysis was used to

[Figure 4] Outside Directors' Probability of being Replaced for Voting Behavior & Social Ties with CEOs - Results of Cox PH Model Analysis (hazard ratio)



Note: 1. *** p<0.01, ** p<0.05, * p<0.1.

2. "Hazard" refers to the conditional probability of someone resigning or being dismissed in the next term if he/she has not yet resigned or been dismissed. "Hazard ratio" refers to the ratio of hazard by variable. A hazard ratio above 1 means positive influence of a certain variable and a hazard ratio below 1 indicates negative influence of a certain variable.

3. "Entire sample" is the estimation result using the entire sample and "Assets worth more than 2 trillion won" is the result using only firms with more than 2 trillion won in assets.

4. Among variables considered in the analysis, outside directors' demographic features and work experience, features of CEOs and firms, size and frequency of board meetings, and yearly and monthly dummies are absent.

examine the factors affecting the replacement probability of outside directors.

Outside directors rarely cast a dissenting vote, but once they do, they face a higher risk of being replaced.

In Figure 4, analysis of the entire sample shows that outside directors who regularly attend board meetings have less chance of being replaced. However, if they cast at least one dissenting vote during the year, their chances of being on the board the following year diminish significantly. Analysis on a sample of firms with more than 2 trillion won in assets shows attendance has no meaningful influence on deciding tenure but any recorded opposition significantly raises the probability of termination. Specifically, the probability of a dissenting outside director being replaced is two times higher than outsider cohorts who never oppose agenda items. This implies that outside directors are forced off the board or voluntarily leave once they oppose, even though their opposition is a rare case.

Regional ties with CEOs also influence the probability of being replaced in the next term. Among companies with more than 2 trillion won in assets, the probability of replacement for outside directors from the same region as the CEO is about 60% of that of those from other regions. Outside directors from the same high school as the CEO have half as much chance of being replaced as those from other high schools. Meanwhile, the probability of those from the same university as the CEO is 1.9 times higher than that of those from other universities.⁶⁾

6) Outside directors from academia and professional services have the lowest and second-lowest probability of being replaced, respectively. Public officials, lawmakers and corporate executives were twice as likely to be replaced compared to those from academia. Banker outside directors had the highest probability of being replaced. Academicians tend to have low attendance at board meetings while bankers have a high attendance. This seems to suggest that outside directors who actively participate in board activities are not preferred.

Comparison between outside directors with social ties with CEOs and those without such ties reveals that friendly outside directors tend to avoid displacement in the next year even if both groups opposed items at board meetings. Of the 62 outside directors who are from different regions as the CEO and opposed an item at least once in a certain year, 18 (29%) were replaced in the next year. But, the 12 outside directors, who were from the same region and opposed an item at least once in a certain year, were replaced. Additionally, none of the three outside directors who had attended the same high school as the CEO and opposed an item at least once in a certain year was replaced the next year. However, of the 71 outside directors who had attended different high schools as the CEO and opposed an item at least once in a certain year, 18 (25%) were replaced in the next year. This tendency did not appear in the case of outside directors who graduated from the same university. Of the 17 outside directors who graduated from the same university as the CEO and opposed an item at least once in a certain year, 5 (29%) were replaced in the next year whereas, of the 57 outside directors who did not have such ties and opposed an item at least once in a certain year, 13 (23%) were replaced in the next year. The outcomes combined with the analysis of outside directors' attendance at board meetings, suggest that outside directors with the same regional or high school background as the CEO are more sympathetic to the CEO and also preferred by them. Social ties based on same university do not play a significant role, relatively.

In sum, dissenting in board meetings raises outside directors' chances of being replaced during the following year while those from the same region or high schools have a low chance of being replaced. Under the circumstances, those who want to retain their positions do not dissent and as such, CEOs can use reappointment as a 'training tool' to control outside directors. Furthermore, analysis results suggest that CEOs may be keeping outside directors with whom they have social ties. Consequently, as long as CEOs can influence the tenure of outside directors it is difficult to expect the board of directors to keep CEOs in check.

IV . Monthly Changes in Board Composition and Agenda Items

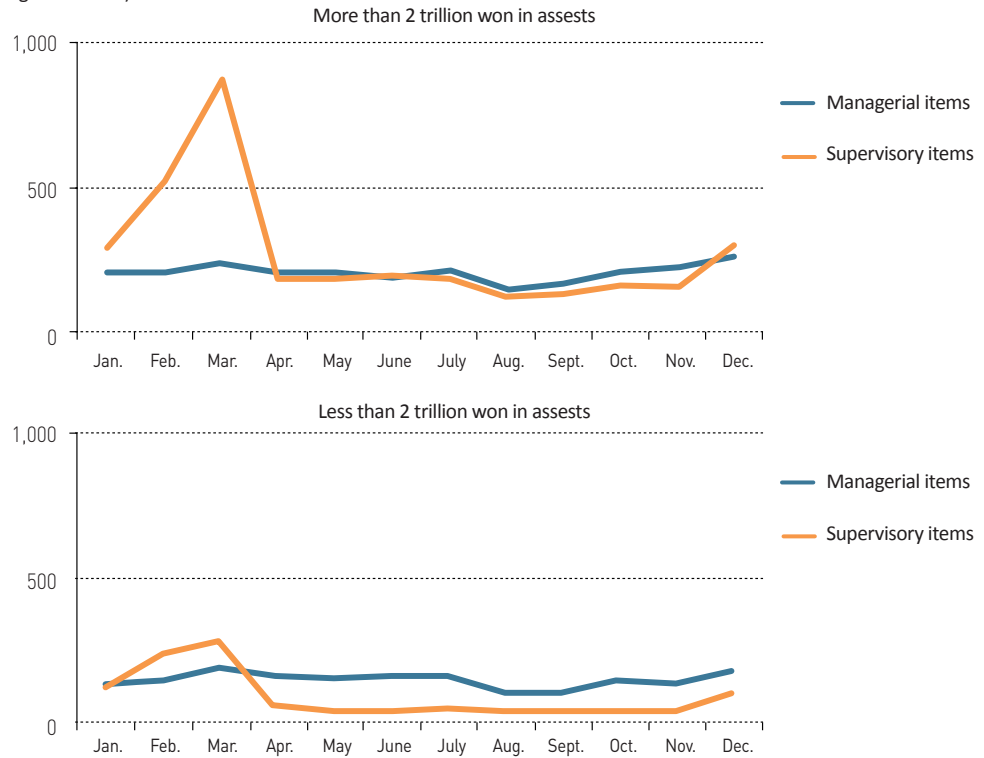
CEOs can still undermine boards of directors even if outside directors are independent. A closer look at board meeting items reveals that the outside director ratio tends to be low when the most supervisory items are discussed. Considering that CEOs are also the board chair in most Korean firms, this may imply that CEOs put sensitive items on the agenda when inside directors have the decision making power as the outside director ratio is low.

Figure 5 shows the monthly number of agenda items at companies with more/less than 2 trillion won in assets. In the case of companies with less than 2 trillion won in assets, the number of supervisory items was half the number of managerial items during the year, except in February and March. At companies with more than 2 trillion won in assets, the

Outside directors with the same regional or high school background as the CEO face lower replacement risks than those without such connections.

[Figure 5] Number of Agenda Items by Month

(No. of agenda items)



Note: "More than 2 trillion won in assets" includes firms with over 2 trillion won in assets as of the previous year. "Less than 2 trillion won in assets" includes the remainder.

It seems that practical influence of outside directors on boards is low during times when their supervisory role is critical. The situation also implies that CEOs have the windows of opportunity to obtain approval on sensitive issues at board meetings.

number of supervisory items was about the same as that of managerial items throughout the year, excluding the first quarter.

It is notable that the number of managerial items is steady throughout the year, but that of supervisory items is high in the first quarter. The number of supervisory items passed in the first quarter is apparently higher at large companies. This is probably due to the fact that items related to personnel management and stockholders are major issues at general shareholders' meetings, which are mostly held in February and March. The tendency still remains even if such items are excluded from the analysis.

It is noteworthy that the percentage of outside directors on boards also falls in the first quarter. The percentage of outside directors bottoms out in February and March and peaks in April and May. One possible cause is a rule that allows firms to delay the appointment of outside directors until the next general shareholders' meeting when the director vacates his/her position before the meeting, unless board composition rules are violated. An interesting difference exists between outside directors with social ties with CEOs and those without. The percentage of independent outside directors with no social ties on boards is lower in the first quarter and higher in April and May⁷⁾, which is in accordance

with the results of the overall analysis mentioned above. Meanwhile, the percentage of friendly outside directors is higher in the first quarter, but lower in April and May. These contradicting patterns suggest that there is an opportunity for CEOs to pass items during times of weakened supervision by outside directors in the first quarter.

V . Policy Implications

Outside directors are expected to be actively involved in efforts to monitor CEOs or provide consultation, playing the role of a defensive stopper when the CEO acts against the interests of minority shareholders. The role is of utmost importance in cases where minority shareholders have more than 50% board voting rights but their opinions are too extensive to be reconciled into a consensual settlement.

However, the analysis of board meeting records found that CEOs have wielded certain influence on the appointment of outside directors and decisions over agenda items, effectively undermining the control function of the board. CEOs tend to retain friendly outside directors in board meetings even when they raise objections, but independent and active outside directors with opposing opinions are replaced. CEOs may deal with sensitive agenda items during times when the control of outside directors is weakened.

Acknowledging the reality presented above should serve as the basis of efforts to formulate measures to improve the outside director system. Above all, this paper suggests establishing an outside director candidate recommendation committee that consists of only outside directors so that intervention by CEOs can be limited. In this case, the board may have a few friendly outside directors at the beginning, allowing certain room for the CEO to wield influence; but once the CEO, who appoints those friendly outside directors is replaced, the board will become much freer from the influence.⁷⁾

Another suggestion is to increase the number of nominees recommended as outside directors, which is currently limited to a single candidate recommendation. The current Commercial Act sees no wrong with the recommendation of a single nominee by the candidate recommendation committee. The general shareholders' meeting cannot refuse to vote on the single nominee; the committee recommending a single nominee is no different from coercing shareholders to accept the given recommendation as failing to meet the conditions for the outside director system would make it impossible to run the board of directors as well as the company. In this sense, the general shareholders' meeting should

In order to restrict CEOs from intervening in the process of outside director recommendation, it is necessary to strengthen the role of outside directors in the composition of the candidate recommendation committee and to mandate the committee to recommend more than one candidate.

The general shareholders' meeting should be provided with information on objective indices regarding how the board of directors has operated on essential issues.

7) Possibly because independent outside directors might retire earlier than friendly outside directors. Or because in the case of vacancies, the position of friendly outside directors could've been filled promptly while there could've been a delay in the substitution of independently outside directors.

8) The Commercial Act was revised in April 2011 to mandate the outside director candidate recommendation committee to be composed of the majority of outside directors, starting in April 2012.

have the right to refuse the single nominee recommendation itself.

Even if the system of multiple candidate recommendation is implemented, its effectiveness would not be guaranteed unless the following preconditions are satisfied. First, shareholders should be provided with sufficient information on nominees. Second, systemic instruments need to be improved to secure the exercise of minority shareholders' voting rights. For instance, systems such as electronic voting or proxy voting should be considered as mandatory. Once these systems are adopted, cumulative voting and voting restrictions imposed on large shareholders are expected to witness smaller profits and large losses due to decision-making distortions, and hence they need to be reconsidered.

In this regard, to encourage outside directors to act as appropriate supervisors, it is important that the general shareholders' meeting be offered with objective information and indices regarding outside directors, such as their social ties with the CEO, their roles in critical issues, attendance rate, the number of inquiries, and speech time.⁹⁾

In addition, further consideration is needed on limiting the tenure of outside directors, based on the premise that it is the CEO who decides the extension of the tenure of outside directors. If the candidate recommendation committee consisting of outside directors only recommends more than one, including incumbent outside directors, it would be no longer necessary to keep the tenure limit imposed on outside directors as a deterrent to CEOs' influence.

Lastly, prohibiting CEOs from concurrently holding the position of board chairman must be examined. As seen in the analysis of agenda items by month and the ratio of outside directors, it is possible that the CEO might deal with sensitive issues while eluding the attentions of outside directors. Such behavior of CEOs as an agenda setter and their influence could be discouraged. ■

The CEO should not be allowed to hold the position of board chairman.

9) The key point of the Sarbanes-Oxley Act (SOX) lies in enhancing the independent nature of the board of directors; therefore providing a comprehensive understanding of the independence of outside directors with consideration of their social ties or conflict of interest with the CEO. For instance, the US court ruled against the appointment of Stanford University professors as outside directors at Oracle whose president has been and will likely to continue to donate large sums in contributions to the university. See Brundage and Brahmst (2004) for further details about the Oracle case.

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