
MULTIPLE DIRECTORSHIPS AND CORPORATE MISCONDUCT: THE MODERATING INFLUENCES OF BOARD SIZE AND OUTSIDE DIRECTORS

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Abstract

This study examined the possible impact of both board size and the proportion of outside directors on the link between directors holding multiple directorships and firm misconduct. The study utilized a sample of 181 firms drawn from the financial services sector during the 1999-2003 time period. The results suggest that among those firms whose directors hold multiple directorships, the incidence of 10K investigations initiated against those firms is significantly less in those firms having smaller boards. The results offer further evidence that smaller boards might be better monitors of their firms' behavior than larger boards. Further, contrary to theory, no significant relationship was observed between proportion of outside directors, multiple directorships and the incidence of 10K investigations. The implications of the findings and areas for future research are discussed.

Background

There is an on-going debate within the area of corporate governance regarding the membership of directors on multiple boards and its potential impact on effective firm monitoring. In light of the recent scandals involving firms such as Enron, Worldcom, and Tyco, effective corporate governance is seen by institutional investors and shareholder activists to be extremely important. While researchers have examined various governance issues, the potential consequence of multiple board membership by directors on monitoring their firms remains largely unexplored (Ferris, Jagannathan & Pritchard, 2003).

Multiple Directorships and Director Distraction

There is some debate as to whether the service of directors on multiple boards will serve to either bolster or hinder proper firm monitoring, and serve to prevent firm misbehavior. Some favor multiple directorships, arguing that firms can obtain valuable resources and vital information through board interlocks (Business Roundtable, 1997; Schnake, Fredenberger & Williams, 2005; Zahra & Pearce, 1989).

There is some evidence that board interlocks may be linked with effective capital acquisition (Mizruchi & Stearns, 1988; Stearns & Mizruchi, 1993). A board whose members serve on several other boards may enable the firm to gain access to needed resources and critical information through these multiple directorships (Bhagat & Black, 1999; Zahra & Pearce, 1989). Interlocked directors may be able to observe investigations and legal proceedings brought against other firms on whose boards they serve. Directors can then bring that vital information back to the other boards on which they serve, enabling these firms to take action to avoid similar legal pitfalls and litigation (Schnake et al., 2005).

On the other hand, there appears to be a dominant belief among institutional investors and governance activists that, given their limited time and cognitive abilities, service on multiple boards may result in board members becoming distracted, and may reduce their abilities to effectively monitor their firms (Ferris et al., 2003; Lipton & Lorsch, 1992). Through their service on several boards, directors may serve on fewer board committees and, therefore, may simply be too busy to properly monitor their firms (Ferris et al., 2003). Thus, any informational advantages gained through service on other boards may be lost due to director distraction caused by being too busy and being spread too thinly.

Further, it is likely that directors who serve on multiple boards may serve on firms in different industry settings. Having to face different industrial scenarios, the result is a greater demand on the director's cognitive abilities and more distraction for the director (Schnake et al., 2005). This notion of director distraction is often termed the "busyness hypothesis," and is linked by some to improper board oversight and its consequences.

The Council of Institutional Investors takes a position in line with the busyness hypothesis. The Council is an association of approximately 130 public and private pension funds whose members collectively manage more than \$3 trillion in pension assets. The Council has argued that directors holding full-time positions should limit the number of boards on which they serve, and has argued strongly in favor of restricting multiple directorships due to director distraction.

10-K Investigations

Those firms that are not properly monitored by their boards are far more likely to engage in illegal activity, and are often the target of investigations conducted by various state and federal agencies (Schnake et al., 2005). In many cases these investigations result in a prosecution of the firm as a means to sanction the firm, or to impose remedies resulting from certain illegal acts committed by the firm.

A broad measure of possible firm misbehavior is reflected in the number of investigations reported in each firm's 10-K Reports. The term "investigations" is used in the present study because not all of these actions result in legal proceedings. The fact that a firm is being investigated for possible illegal activity, however, does indicate that the potential for wrongdoing is highly possible, and some party or parties feel(s) the need for litigation to remedy an actual or perceived illegal act on the firm's part.

Specifically, 10-K investigations involve those investigations and legal proceedings instituted by the U. S. Department of Justice, the Securities and Exchange Commission, the Environmental Protection Agency, the Federal Trade Commission, the Equal Employment Opportunity Commission, or similar agencies at the state level. If brought to fruition with sanctions levied against the firm, these proceedings could significantly impact the firm's long term financial position.

These types of serious violations are the responsibility of the board to monitor and prevent, and may include investigations involving accounting fraud, product liability, environmental degradation, workplace discrimination, antitrust activity, and employee safety. While not all investigations culminate in legal sanctions against the firm, we feel that the sheer number of investigations does reflect the extent to which the firm's board is either properly performing or shirking its oversight duties.

If directors become too busy or distracted to adequately monitor their firms, there will be a greater likelihood that illegal activity will increase within the firm. A firm led by directors who are distracted to some degree may well provide fertile ground for misbehavior and for the instigation of government investigations to uncover either actual or alleged wrongdoing.

It can be argued that the link between director distraction resulting from multiple directorships and inadequate firm oversight should be moderated, to some extent, by both board size and the proportion of outside directors that serve on the firm's board. With respect to board size, however, there is no consensus among researchers as to whether larger or smaller boards are better equipped to provide effective firm oversight (Dalton, Daily, Johnson & Ellstrand, 1999; Johnson, Daily & Ellstrand, 1996).

Board Size and Firm Monitoring

Research on the possible influence of board size on firm behavior has been somewhat limited. Nevertheless, some theoretical arguments favoring both larger and smaller boards have been established. Those favoring large boards argue that larger boards are more diverse and less cohesive than smaller boards. This diversity may be beneficial, as it may encourage conflict and debate among directors and result in the formulation of a variety of decision alternatives (Dalton et al., 1999; Johnson et al., 1996). A larger board possesses a more diverse set of skills and opinions among its members, and may be better equipped to acquire and evaluate information about the firm and its environment (Amason & Sapienza, 1997).

There is evidence that firms with larger boards experience lower variability in both accounting and stock market returns (Cheng, 2008). This may result from the fact that larger boards require more compromise among members in order to reach consensus, thus, decisions made by larger boards may be less extreme, resulting in lower variability in firm performance (Cheng, 2008).

Some researchers take the opposite view on board size, and argue that smaller boards may be better equipped to monitor their firms than larger boards. Smaller boards tend to encourage greater focus, more member participation, and cohesiveness, less social loafing, and more lively debate among board members than

larger boards (Firstenberg & Malkiel, 1994; Garg, 2007; Hermalin & Weisbach, 2003; Lipton & Lorsch, 1992; Yermack, 1996).

Disagreements and fragmentation among board members tends to be more common in larger boards. When this occurs, the firm's top management team might gain relative advantage in power and influence through a number of political strategies, including coalition-building, selective channeling of information, and "dividing and conquering" (Alexander, Fennel & Halpern, 1993). Smaller boards, therefore, may be less subject to manipulation by the firm's top managers (Alexander et al., 1993; Lipton & Lorsch, 1992; Yermack, 1996).

Using a sample of 452 large industrial firms from the 1984-1991 time period, Yermack (1996) observed a link between firm value and small board size. Yermack concluded that as boards increase in size they become less effective as a result of the problems of coordinating a large board. Thus, the problems that arise with coordinating a larger board overwhelm the advantages from having more board members to draw on.

While there is some anecdotal evidence linking board size with firm performance, there are only a few studies that have examined the possible link between board size and firm misbehavior. In one of the few studies that has examined this issue, Williams, Fadil & Armstrong (2005) found an inverse relationship between board size and both OSHA and EPA violations in 221 retailing and manufacturing firms from the 1998-2002 time period. This study was insightful, and its results support the notion that larger boards might provide better firm oversight than smaller boards.

Nevertheless, it is arguable as to whether the nature of firm misbehavior used in the Williams et al. (2005) study, namely OSHA and EPA violations, would actually rise to the level of board oversight. This type of illegal activity might fall, more realistically, under the auspices of the top management team. The measure of firm misbehavior used by Williams et al. (2005) may be more symptomatic of a sloppy management style, rather than inadequate firm monitoring by the board.

In another study, Schnake, Fredenberger & Williams (2005) found no direct link between board size and firm misconduct among sample firms in the financial services sector. Schnake et al. (2005) did include the number of 10K investigations as their measure of firm misconduct, the first time such a measure has been used to measure firm misconduct.

Given the limited empirical research in this area, the authors' were swayed by the theoretical arguments involving the diminished effectiveness of larger boards in monitoring their firms. Further, given that Schnake et al. (2005) found no direct link between board size and firm misconduct, perhaps board size might better be viewed as a moderator between the number of boards served on and firm misconduct.

Theoretically, a larger board coupled with a higher level of multiple board membership by a firm's directors should promote both member distraction and diminished board focus, and should reduce a board's capacity for adequate oversight. This interaction may offset any advantages of board size in increased information flow and access to resources. In addition, by modeling board size

as having more of a moderating effect, rather than a direct effect, on the number of boards served on and firm misconduct relationship, and by using a unique measure of firm misconduct (10K investigations), this study should build upon and extend the findings of both Williams et al. (2005) and Schnake et al. (2005). Thus, the following hypothesis is offered.

Hypothesis 1: Board size moderates the relationship between the number of total boards served on by a firm's directors and the number of 10K investigations initiated against their firms, such that the number of 10-K investigations will increase among those firms having larger boards and whose directors serve on multiple boards.

Outside Directors and Firm Monitoring

Outside directors on a firm's board may increase the breadth of experience and knowledge of the board allowing it to make more informed decisions. Further, outsiders may be more independent from the CEO and/or top management team and, therefore, better able to protect shareholder interests.

The trend in corporate governance has resulted in an increase in the proportion of outsiders on many firms' boards (Wheelen & Hunger, 2004). This trend toward more outsiders has resulted from the growing influence of institutional investors such as CalPERS, TIAA-CREF, various pension funds, mutual funds, and insurance companies who are putting pressure on firms to improve performance (Wheelen & Hunger, 2004).

Wang & Dewhirst (1992) found that outside directors are very committed to representing various stakeholders beyond just the stockholders. As a result, outsiders tend to be sensitive to environmental issues, women and minority issues, employee welfare, and firm behavior. Outsiders are more likely to be knowledgeable about issues facing the firm and comply with legal requirements in order to avoid penalties and negative public relations (Johnson & Greening, 1999).

Beginning in November, 2003, the Securities and Exchange Commission approved new listing standards that apply to firms listed on the New York Stock Exchange and NASDAQ. These standards require that a majority of a listed firm's board be composed of outside (independent) directors. In addition, section 301 of the Sarbanes-Oxley (SOX) legislation of 2002 calls for an increased role for outside directors on a firm's board (Lee & Carlson, 2007). SOX has mandated that at least one member of the board will be an outsider with financial expertise, and all members of the firm's audit committee will be outsiders.

There has been significantly more research on the influence of outside directors on firm performance than has been conducted with board size and firm performance. Further, the authors are aware of no studies that have examined the nature of the interaction of board size with the percentage of outsiders on the board, and how this interaction, if any, might affect firm monitoring. While of interest, the possible presence of this interactive effect was beyond the scope of the present study.

Given these arguments regarding the role played by outside directors, it is our contention that the percentage of outside directors on a firm's board should moderate the link between multiple board membership and firm monitoring. Therefore, the following hypothesis is offered.

Hypothesis 2: The percentage of outside directors moderates the relationship between the number of total boards served on by a firm's directors and the number of 10-K investigations initiated against their firms, such that the number of 10K investigations will decrease in those firms having a higher percentage of outsiders on their boards and whose directors serve on fewer multiple boards.

Methods

Sample

Firms in the financial services sector were selected for study. We confined our sample to all financial services firms that were continuously listed on the New York Stock Exchange during the 1999-2003 time period for which adequate information regarding both 10-K investigations and board data were available. The sample consisted of 181 firms drawn from the following industries within the financial services sector: (1) consumer financial services, (2) accident and health insurance, (3) life insurance, (4) property and casualty insurance, (5) investment services, (6) money center banks, (7) regional banks, (8) savings banks, and (9) miscellaneous financial services.

This study was limited to firms within a single sector to reduce any possible industry effects that might influence the results. Given that financial services firms are highly regulated by various federal and state agencies, the potential impact of various board characteristics on these firms should be of particular interest.

Measures

Board Data. Board composition data were gathered from the Edgar database available from the Securities and Exchange Commission. The sample firms' 10-K Reports and Def 14-A Reports for the years 1999-2003 were the sources of the data. We were able to determine average board size (total number of directors), board composition (insiders versus outsiders), and the average number of total boards that each director served on during the study period.

In addition, the logarithm of average firm sales during the five year period served as a measure of firm size, and was obtained from *Hoover's Company Profiles*. All of the variables represent averages over the five year study period.

In determining whether a director was an insider or an outsider, we were aware of the lack of independence and potential inadequacies in firm monitoring posed by, so called, "gray" directors (Helland & Sykuta, 2005; Ryan & Wiggins, 2004). Gray directors may be retired former directors or employees of the firm,

or they may be family directors with family ties to the firm's founder and may hold large blocks of the firm's stock. In addition, gray directors may work for other affiliated firms that are large suppliers of the firm, or other firms that may handle the insurance, legal, or consulting work for the firm.

While it is often difficult to identify gray directors, we did make a diligent effort to do so. In compiling the data, we opted to classify family directors, retired former directors and employees, and affiliated directors as insiders. While these directors were not technically insiders, their influence would, in all likelihood, exert the same level of independence as an insider.

10-K Investigations. The number of investigations initiated against each firm was obtained from the SEC database. Detailed descriptions of these investigations, if any, are presented in Item 3 of each firm's 10-K Reports. The number of 10-K investigations reflect possible misbehavior, and reflect how well these firms are being monitored by their boards. Only those investigations conducted between 1999-2003 were included. The possible types of misbehavior for which firms are investigated are frequently very serious in nature, and involve legal proceedings beyond the firm's ordinary business activity.

In analyzing the 10-K Reports, two raters were used to categorize the types and timing of the various investigations. In the vast majority of cases, the raters were in agreement as to the nature and time period in which the investigations were undertaken. In the few cases where agreement could not be reached, a third rater was used to settle the issue. It was observed that 94 of the 181 sample firms (52%) had encountered at least one investigation during the study period.

Analytical Procedures

Table 1 shows the means, standard deviations and a correlation matrix of all variables included in the analysis.

Table 1
Means, Standard Deviations and a Correlation Matrix

	Mean	Std. Dev.	1	2	3	4	5
1. 10K Investigations	.93	2.94	1.00	.17*	.31**	.39**	.08
2. Board Size	11.64	3.97		1.00	.07	.36**	.30**
3. Total Number of Boards Served On	1.65	1.00			1.00	.48**	.24**
4. Log Average Revenue	7.12	1.61				1.00	.16*
5. Percent of Outsiders on Board	.73	.13					1.00

*p < .05 **p < .01 n = 181

A stepwise regression analysis was used to test the interaction hypotheses. The logarithm of firm size (average revenue) was entered on step one as a control variable. Then, for Hypothesis 1, board size and total number of boards served on was entered on step two. On step 3, the 2-way interaction term (board size X total number of boards served on) was entered. For Hypothesis 2, percentage of outside board members and total number of boards served on was entered on step two, followed by the 2-way interaction term (percentage of outside board members X total number of boards) on step three. A possible 3-way interaction (board size x percentage of outsiders x total number of boards served on) was similarly tested, with the 2-way interactions entered on step 3 and the 3-way interaction term entered on step 4.

The results of the stepwise regression analysis appear in Table 2. It should be noted that the 3-way interaction results were not significant (F change = .993, $p < .32$), and therefore, did not add to explained variance beyond the 2-way interaction effects. Given the lack of significance in the 3-way interaction term, the result was not included in Table 2. Thus, it is appropriate to interpret any 2-way interactions.

Table 2
Results of the Regression Analysis

	Change in R2
Step 1: log average revenue	.151**
Step 2: Bdsiz,TotalBds,%Outsiders	.024
Step 3: Two-way interactions	.05**
Model R2 = .23**	
Beta Coefficients of Two-way Interactions	
TotalBds x Bdsiz	.83**
TotalBds x %Outsiders	.40
Bdsiz x %Outsiders	.24

* $p < .05$ ** $p < .01$ $n = 181$

Bdsiz = Board Size

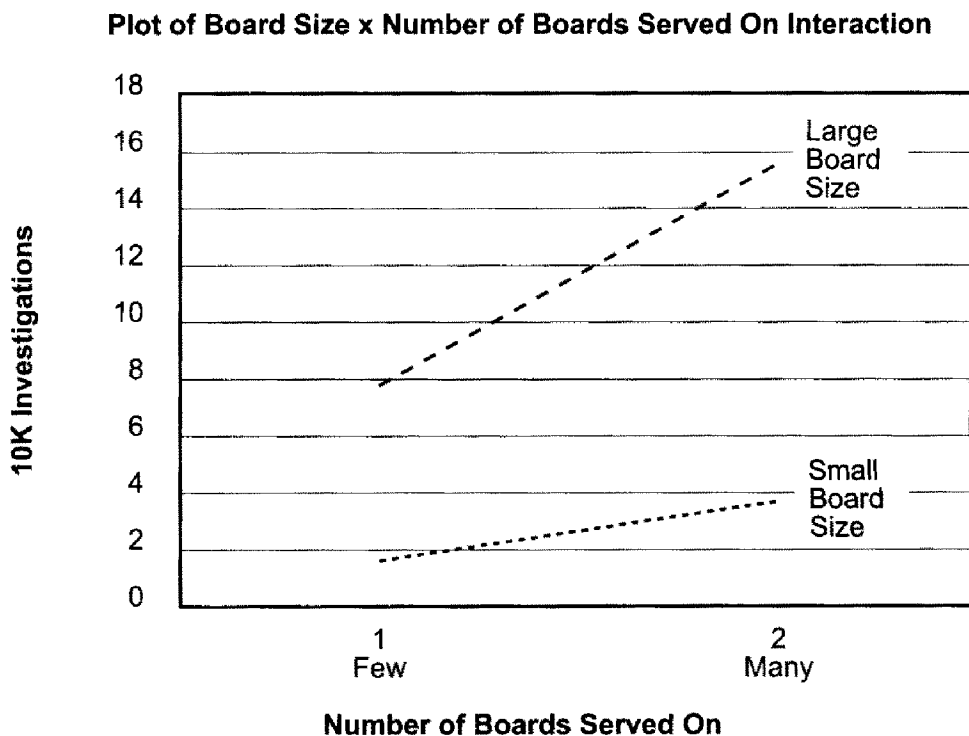
TotalBds = Total number of boards on which directors serve

%Outsiders = Percentage of outsiders on the board

A stepwise regression analysis entering the 2-way interactions at step 3 revealed the 2-way interactions to be statistically significant. A review of the beta coefficients revealed that the total boards served on x board size 2-way interaction contributed a significant amount of explained variance in the number of 10K investigations (beta = .83, $p < .01$). The beta coefficients of the other 2-way interactions were not statistically significant.

Hypothesis 1 was supported. The control variable (log of average revenue) was statistically significant on step one ($\Delta R^2 = .15, p < .01$). The 2-way interaction term was also statistically significant ($\Delta R^2 = .05, p < .01$). A plot of the 2-way interaction of board size and total number of boards served on appears in Figure 1.

Figure 1
Plot of Two-Way Interaction Effect of Board Size and Total Number of Boards Served On and Number of 10K Investigations



To interpret the 2-way interaction, a group (categorical) variable was created by splitting the board size and total boards served on variables at the mean. The Bonferroni multiple comparison procedure was used to examine which groups were significantly different. This analysis revealed that larger boards with directors serving on a larger number of other boards had significantly greater numbers of 10K investigations than smaller boards with directors serving on fewer other boards, and larger boards with directors serving on fewer other boards. There was no significant difference between smaller boards with directors serving on many other boards and larger boards with directors serving on many other boards. Thus, the total number of boards served on appears to dominate board size in its effect on the number of 10K investigations.

Hypothesis 2 was not supported. Again, the control variable (log of average revenue) was significant ($\Delta R^2 = .15, p < .01$), however, there was no significant 2-way interaction effect nor any significant main effects observed. In the process

of conducting the analyses, we also examined a possible board size x percentage of outsiders on the board which was found to be non-significant.

Discussion

There remains considerable debate as to the role that board size plays in influencing various firm outcomes. Further, the extent to which directors might become too busy and distracted to properly discharge their board oversight duties as a result of multiple board memberships also remains speculative. The results of the present study, however, shed some light on a possible linkage between these two constructs.

Our findings suggest that if the busyness hypothesis is present in firms whose directors hold multiple directorships, the distraction and diminished focus of these directors might be greatly magnified if they serve on larger boards. A large board may become fragmented and its activities more difficult to coordinate. This might allow an opening for the firm's top management team to gain relative advantage in power and influence in relation to the board. This factor, coupled with directors who are simultaneously holding multiple directorships, should result in further fragmentation of the board and hamper its ability to discharge its oversight function.

The results do provide additional evidence in support of those who advocate the virtues of smaller boards. Smaller boards may be better focused, more easily coordinated, and less susceptible to member fragmentation than larger boards. With respect to proper firm oversight, the results suggest that smaller boards would seem preferable among firms whose directors are serving on the boards of other firms.

The proposed benefits resulting from the inclusion of outside directors on the board were not observed, at least with respect to the abilities of outsiders to reduce the number of investigations. Outsiders do bring objectivity, diverse ideas, and external knowledge to a firm, and these might provide the firm with distinct performance advantages. Nevertheless, our results suggest that with respect to firm oversight, the proposed benefits associated with outsiders may be overstated, at least for firms in the financial services sector.

Outside directors generally possess a higher level of independence than insiders. Nevertheless, outsiders also possess less day-to-day knowledge of their firms' activities and, therefore, may not be in a position to sufficiently detect firm misconduct. There is a growing trend among institutional investors to prompt boards to appoint more outsiders. While the presence of outsiders did not reduce investigations among the financial services firms examined in this study, perhaps firms in other industries might experience fewer investigations as more outsiders are added to their boards.

Several limitations were evident in this study. First, by using the total number of investigations as reported by firms in their 10K Reports, differences in the magnitude of the investigations was not considered. Obviously, more minor

violations might be committed more often than more serious violations. In fact, a firm having several minor investigations might be more a victim of sloppy management, rather than a gross violator of the law. Still, sloppy management must be addressed and corrected by the board since the board is ultimately responsible for firm outcomes. In addition to the number of 10K investigations, it is recommended that other measures of firm behavior also be considered for use in this area of research.

A second limitation involves the use of sample firms drawn exclusively from the financial services sector. There might be an industry effect present here, as firms in certain industries and sectors face more stringent government oversight. Does this increased oversight that commonly occurs with financial services firms result in better behavior and/or the greater likelihood for the detection of misbehavior by government regulators? Future studies might examine these same variables in firms drawn from other industries where government oversight might not be as stringent.

Another limitation involves the use of average data over the study period. Averaging data reduces the influence of possible fluctuations in the variables over time. Perhaps there is some delay between the time the board takes some action to reduce some actual or potential misconduct, and the action taken has the desired effect on influencing firm behavior. Future studies might consider means to control for the lag effect of time.

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