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Costs and benefits of friendly boards during mergers and acquisitions ☆

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ABSTRACT

Finance theory predicts that board independence is not always in the shareholders' interest. in situations in which board advice is more important than monitoring, independence can decrease firm value. I test this prediction by examining the connection between takeover returns and board friendliness, using social ties between the CEO and board members as a proxy for less independent boards. I find that social ties are associated with higher bidder announcement returns when the potential value of board advice is high, but with lower returns when monitoring needs are high. The evidence suggests that friendly boards can have both costs and benefits, depending on the company's specific needs.

1. Introduction

Recent regulations such as the Sarbanes-Oxley Act of 2002 and the NYSE new listing requirements of 2003 call for greater participation of outside directors in corporate governance. The new regulations are motivated at least in part by the view that independent directors are better able to discipline the chief executive officer (CEO), an idea with a long pedigree in corporate finance (e.g., Berle and Means, 1932; Fama and Jensen, 1983); and Jensen, 1993). Despite the widespread belief among regulators and scholars that independent directors are good for corporations, surprising little evidence supports the notion that outside board members increase corporate value or efficiency.[1] In addition, theory suggests that in some circumstances less independent boards can benefit shareholders (e.g., Adams and Ferreira, 2007; Harris and Raviv, 2008).

This paper tests the largely unexplored hypothesis that less independent, more friendly boards can benefit the

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[1] See, e.g., Bhagat and Black (2002) and Hermalin and Weisbach (2003). Evidence exists, however, that outside directors can influence certain corporate tasks, such as CEO turnover (Weisbach, 1988). See Duchin, Matsusaka, and Ozbas (2010) and references therein for more details on regulatory changes affecting outside representation on boards of directors.

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shareholders.[2] Of course, naively connecting any board characteristic to measures of firm performance is fraught with problems. Because board composition and firm value are both endogenous variables, interpreting contemporaneous relations between these two quantities is difficult, a point well emphasized by Hermalin and Weisbach (2003). In addition, board monitoring and advising do not necessarily have a direct impact on all corporate policies.

To overcome these difficulties, this paper focuses on a corporate decision in which both the monitoring and the advisory roles of the board are likely to affect the firm's value and current board composition is not necessarily optimally determined to deal with that particular policy. I argue that one policy that meets these requirements is the decision to acquire another company. Mergers are major and complex corporate events that require the board's approval and have potentially large effects on shareholders' wealth. In addition, shareholders are likely to take into consideration all corporate policies, not only the decision to merge, when choosing the board structure. Boards thus might not adjust instantaneously to changes in the economic environment that prompt a merger opportunity. Therefore, value effects of board independence could be observed following economic shocks that give rise to merger opportunities. I discuss the validity of these assumptions in Section 3 and show that the effects I find are stronger when board composition is less likely to reflect future merger plans.

The main contribution of this paper is twofold. First, I use mergers and acquisitions (M&A) as an experimental ground to study the interplay between the dual role of the board and how board independence affects firm value. My main proxy for less independent boards is based on observable social connections between the CEO and outside board members. Using this measure, I find that when board directors are more likely to possess valuable information about a merger, higher announcement returns are observed for bidders with more friendly boards. Conversely, when the need to discipline the manager is a greater concern, social ties have a negative impact on the acquiring firm's performance. Similar effects are not observed when outside representation is used to proxy for board independence. Second, this paper shows that CEO-director social ties have explanatory power beyond the regulatory definition of inside-outside directors, at least in the context of M&A. This last result is of particular relevance, as it highlights the potential discrepancy between actual board independence and its regulatory definition.

An important contribution of this study is to test a class of equilibrium models of board composition that specify the circumstances under which board independence increases the value of the firm. To that extent, it is useful to situate this paper in the context of the board structure literature. Adams and Ferreira (2007) provide a theoretical analysis of the advisory role of boards. In their model, the board can affect the firm's value through both disciplining and advising the CEO. How well it performs each function depends on how much information executives and board members exchange. When directors are independent, the CEO is reluctant to reveal private information. Revealing what underlies some proposed policy could prompt the board to intervene in favor of shareholders. The manager thus protects himself or herself from monitoring, though at the cost of not receiving proper advice. Conversely, when board members do not take actions against the CEO, no incentive exists for the manager to conceal information from the board.[3] More informed directors in turn improve the overall quality of board counsel. Friendly boards therefore provide better advice but cannot supervise managers efficiently. From the shareholders' perspective, independent boards are desirable when monitoring is more important than advice. When supervising the CEO is less crucial than the need for feedback from board members, however, shareholders prefer a less independent, more friendly board.[4]

In Adams and Ferreira's model, the concept of friendly boards is therefore broader than outside representation. In particular, the model does not preclude outside board members from being friendly. For instance, friendship ties between CEOs and outside board members can impair board members' willingness to discipline the CEO, reducing their true independence. This in turn increases the information flow between the parties and improves the quality of board advice. As indicated above, this distinction is important because the proportion of outside members on the board of directors has been traditionally used to measure board independence.

Although I do consider employment connections in some of the tests, my primary gauge for friendly boards relies on social connections between chief executives and board members outside the boardroom. This choice is motivated by recent work in the management literature suggesting that social ties foster friendship (e.g., Westphal, 1999; Westphal, Boivie, and Chng, 2006; Kroll, Walters, and Wright, 2008).[5]

If social ties do capture part of the actual level of board independence, Adams and Ferreira's hypothesis can be restated in the following terms: Social ties between CEOs

[2] The term “friendly boards,” which I use throughout, is borrowed from Adams and Ferreira (2007). It is meant to capture the degree to which the board is reluctant to take actions against the CEO.

[3] In the stylized model of Adams and Ferreira (2007), distinction is made between hard and soft information. Although it is unlikely that the CEO conceals hard information from the board (in the sense she can be held liable for witholding it), the CEO could be reluctant to share soft (albeit pertinent) information with a more independent board.

[4] Harris and Raviv (2008) and Raheja (2005) make similar arguments. Although the exact channels through which board composition affects firm value differ in their models, they all share this insight: Because independent directors are less informed, they can impair the board's ability to serve as valuable advisers to the CEO. The immediate implication is that less dependent directors can increase firm value when the advice they provide is sufficiently important for the success of the merger. Testing this joint prediction is the central theme of my paper.

[5] An alternative interpretation is that social ties promote shared values, which enhances corporate culture. These shared values could improve the alignment of actions (e.g., Kreps, 1990; Cremer, 1993) of CEOs and board members. Shared beliefs about the prospects of the acquisition benefit shareholders of acquiring companies if, and only if, agency problems are not a main concern.