Journal of Business Research 65 (2012) 1139–1143

Contents lists available at SciVerse ScienceDirect

Journal of Business Research

Corporate board attributes and bankruptcy ☆

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ARTICLE INFO

Article history:
Accepted in revised form 6 August 2011
Available online 6 September 2011

Keywords:
Boards of directors
Bankruptcy
Stock ownership
Board composition
Board characteristics

ABSTRACT

This paper examines how the composition and characteristics of corporate boards relates to firms' success and solvency; the study here focuses on the question of insolvency. This study finds that both board composition and member characteristics relate to whether or not firms can avoid bankruptcy. Boards have a major role to play in whether or not the company can remain solvent. A more versus less independent board, one which is larger and comprised of older members, has more members currently serving as CEOs of other companies, and whose independent/outside directors own less stock is best positioned to help a firm remain out of bankruptcy. Firms may use the results to custom tailor boards as older members retire and new members are inducted.

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1. Introduction

Corporate boards of directors are responsible for a variety of tasks and responsibilities. Among these, and possibly the most critical is the obligation to maintain the firm's solvency. The importance of this role of a board of directors becomes clear following the 2008 and counting financial crisis which left so many companies either petitioning bankruptcy courts for protection or forcing the selloff of significant assets to repay creditors. This paper addresses the question of how boards of directors and their audit and compensation committees should be configured to reduce the risk of bankruptcy.

The study here includes a compilation of statistics enabling the comparison of director attributes of bankrupt and non-bankrupt companies. A future paper addresses the question of whether these board attributes are important antecedents of corporate bankruptcy that adds to the explanatory power of traditional financial ratios. The current paper is important because it provides a detailed assessment of the factors related to corporate governance that distinguish between companies that fail and those that survive. The study may provide benefit to companies in the process of reconfiguring their boards and may assist sitting directors to take steps that would improve the likelihood of corporate survival.

The primary findings of this study suggest that many board composition and board characteristics do differentiate between healthy, stable on-going firms (non-bankrupt) and firms that have filed for Chapter 11 protection from creditors (bankrupt). Most notably, non-bankrupt (vs. bankrupt) firms have larger, more independent board members and fewer gray directors. The CEO of non-bankrupt boards is older, as is the average director on the board. Along with greater age, the board members of non-bankrupt boards bring greater expertise, as they sit on more corporate boards than their counterparts on bankrupt boards. Further, independent board members of non-bankrupt boards own less stock in total and on average than do analogous board members of bankrupt firms. This same pattern holds for all outside directors; that is, both independent directors and gray directors. Finally, a higher percentage of non-bankrupt firms' boards are staggered, ensuring predictable turnover of board members which may lead to a longer-term view of corporate policy.

The remaining portion of the paper includes three sections. The first section discusses issues relating to board composition. These include questions about the impact on solvency of board size, director independence, and experience. Section two examines how board characteristics such as age, number of boards that directors serve on, and their stock ownership influence corporate solvency. Section three provides conclusions and suggestions about corporate governance to improve the health and solvency of corporations.

1.1. Literature review

Most corporate governance literature focuses on healthy, growing firms (Daily, Dalton & Cannella, 2003). Agency theory is the prevailing theoretical foundation for much of the research predicting corporate failure or bankruptcy based on financial and corporate governance factors (Daily, et al., 2003). Most researchers find the simple notion

☆ The authors thank Olubunmi Faleye and Emery Trahan Northeastern University, and JBR reviewers and editors for reading and commenting on an early version of this article.

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doi:10.1016/j.jbusres.2011.08.003

that the two main parties involved with corporate activity – managers and owners – often behave in their own self-interest which may often be in conflict. Corporate governance mechanisms are conceived as devices to mitigate or restrain managerial self-interest to enable the firm to optimally create wealth for shareholders. Other theories have also been used to explain directors' behavior, such as resource dependence theory (Pfeffer & Salancik, 1978) and stewardship theory (Davis, Schoorman & Donaldson, 1997).

The evidence from studies on the relationship of corporate governance factors to corporate bankruptcy has been mixed (Daily & Dalton, 1994a, b; Darrat, Gray & Wu, 2010; Fich & Slezak, 2008; Lajili & Zéghal, 2010). Some studies find that bankrupt companies are more likely to have small boards of directors or lose directors as bankruptcy approaches (Darrat, et al., 2010; Gales & Kesner, 1994), while others find just the opposite (Fich & Slezak, 2008). These differences may be due to either difference in sample periods or in statistical techniques.

Some studies find that the combination of the CEO and the board chairmanship is an important predictor of bankruptcy. Several studies report that this duality is more prevalent in bankrupt firms (Daily & Dalton, 1994a, b; Darrat, et al., 2010), while others do not find this relationship to be predictive (Lajili & Zéghal, 2010). By contrast, the percentage of independent directors relates positively to corporate health (Daily & Dalton, 1994a, b; Darrat, et al., 2010; Fich & Slezak, 2008; Lajili & Zéghal, 2010). Gales and Kesner (1994) go further and observe that companies which fail have different board structures than companies which survive.

Mueller and Barker (1997) observe similar phenomena regarding board structure and in particular note the significant differences between bankrupt and non-bankrupt companies in compositional issues such as whether the CEO is also the chairman and in board size. Despite the consistency of results with respect to the existence of independent board member effect on corporate health, the mixed results regarding other factors such as board size and CEO/board chair duality suggest that further study is necessary.

2. Method

The study here examines a unique data set which combines data from two separate sources. The first is a compilation of corporate board of director characteristics and responsibilities from Riskmetrics. This data set contains information on 695 companies, both publicly traded and private, and their boards for which there are 10 years of data spanning 1998–2007. The second data source documents companies which have filed for bankruptcy protection is the WebBRD LoPucki bankruptcy database. There are 552 companies, both publicly traded and private, in this data set that filed for bankruptcy protection from 1998–2009. From these companies, the study identifies 114 publicly traded companies filing for bankruptcy protection from 1998–2009.

Each of these 114 companies was matched with at least one solvent company from the board dataset based on size (measured by total assets) and year before the bankruptcy filing, using the one-to-many matching design advocated by Zmijewski (1984). Financial characteristics of the companies, obtained from COMPUSTAT, were incorporated to create the final dataset which includes 87 bankrupt and 205 non-bankrupt companies. Table 1 displays the composition of the sample dataset over the sample period. The results discussed in the following section highlight the differences between bankrupt and non-bankrupt companies in their overall board composition and characteristics as well as other important governance committees.

Table 1

		Status	
		Non-bankrupt	Bankrupt
A. Sample Composition: Bankruptcy Status by Year			
Year	1998	5	2
	1999	18	9
	2000	25	12
	2001	35	13
	2002	18	9
	2003	39	11
	2004	6	6
	2005	17	9
	2006	8	3
	2007	4	3
	2008	19	4
	2009	11	6
Total		205	87
B. Sample Composition: bankruptcy status by industry (2-digit SIC Code)			
SIC	1300	11	2
	2000	8	4
	2100	1	0
	2211	4	5
	2300	5	3
	2600	7	4
	2700	2	1
	2800	6	5
	3000	1	1
	3300	6	4
	3400	5	1
	3500	5	2
	3600	6	3
	3700	10	6
	3900	3	1
	4200	4	1
	4500	5	4
	4800	11	10
	4900	41	6
	5000	3	1
	5300	7	2
	5400	5	1
	5600	8	3
	5700	3	2
	5800	16	1
	5900	4	2
	7300	11	6
	7800	2	2
	8000	2	2
	8700	1	1
Total		205	87

3. Results and discussion

3.1. Impact of board composition

Historically corporate boards were less of a melting pot and more of a country club. This urge to uniformity is breaking down in the past few decades as a potential board member's skills and strengths assume greater importance over their gender, age, club membership, university attendance, or religion. Factors emanating from a variety of sources including governmental oversight, shifts in the American population, and most importantly the attention given by investors to value creation and the belief that an effective board contributes to this creation are among the forces pressuring corporations to adopt a meritocracy-based selection methodology for new directors.

3.2. Director affiliation to the firm

Independence of the board of directors is an issue that has assumed greater public scrutiny following public scandals and the financial meltdown. Directors are categorized into one of two groups: inside or outside directors. Inside directors are employees of the firm, including the CEO, President, CFO, Vice-Presidents, etc. Outside directors are not employed by the firm; however, all outsider directors are not alike. Researchers and regulators tend to distinguish between gray directors and independent directors. While the firm

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