

## Co-opted directors and board effectiveness: an analysis of meeting frequency

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### ABSTRACT

Independent directors are viewed as critical to effective corporate governance. However research into the relation between firm performance and board independence has yielded mixed results. Coles et al. (2014) suggest this may be because not all directors classified as independent are, in fact, committed to serving shareholder interests. They introduce the concept of a “co-opted” or “captured” director, one appointed after the firm’s CEO took office. They argue that co-opted directors’ interests are more closely aligned with the CEO who was instrumental in their selection to the board. This study investigates the relation between director co-option and board effectiveness, as measured by the frequency of board meetings. Board meetings are an indicator of how effectively the board is carrying out its responsibility to monitor management (Vafeas, 1999, Brick and Chidambaran, 2010). Analysis reveals a significant and negative association between the proportion of the board made up of co-opted directors and the number of board meetings held. The results support the view that co-opted directors do not function as truly independent directors and that a better understanding of director independence is needed.

Keywords: directors, independence, boards, co-option

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## INTRODUCTION

The importance of independent directors to good corporate governance has become a truism. Cohen et al. (2012, p. 1041) summarize the prevailing wisdom as “independent directors are custodians of shareholder interests, whose presence on the board helps reduce agency problems and improve firm performance.” However, as Coles et al. (2014, p. 1751) note, “evidence on the connection between board independence and firm performance . . . is mixed and weak.”

One reason for the mixed empirical results is suggested by Coles et al. (2014), who suggest that not all directors classified as independent are, in fact, committed to serving shareholder interests. In particular, they introduce the concept of a “co-opted” or “captured” director, one appointed to the board after the firm’s CEO took office. Because of the influence of the CEO in securing their position on the board, co-opted directors’ interests more closely align with management. They argue “that such co-opted directors, regardless of whether they are classified as independent using traditional definitions, are more likely to assign their allegiance to the CEO because the CEO was involved in their initial appointment” (p. 1752).

This study investigates the relation between board co-option and board effectiveness, as measured by the frequency with which corporate boards meet to carry out their duties. Meetings are a critical component of a board’s monitoring function. Vafeas (1999, p. 114) summarized the relevant literature and concluded that “(a) clear implication of these articles is that directors of boards that meet more frequently are more likely to perform their duties in accordance with shareholders’ interests.” Brick and Chidambaran (2010, p. 533) echo this point, noting that “shareholder services groups . . . make the argument that board activity is very important and material in valuing the firm.” This study is the first to examine whether this indicator of effective corporate governance is affected by the extent to which a board has been co-opted.

The remainder of this paper is divided into four sections. The first section summarizes the relevant literature regarding director co-option and of the value of board meetings as a proxy for board effectiveness. The research model is developed in the second section, followed by presentation of the results. The paper closes with a summary and discussion of the findings.

## LITERATURE REVIEW

### Co-option

The concept that all directors classified as independent are not equally committed to shareholder interests is not new. Vicknair et al. (1993) document the prevalence of “grey” area directors who, though technically independent, may have had their objectivity compromised through board interlocks, consulting fees, or other relationships. More recently, Cohen et al. (2012) argued that the technically independent directors appointed by many firms were overly sympathetic to management. This distinction between technical independence and practical independence may explain the mixed results of research investigating the relation between firm performance and board independence noted by both Cohen et al. (2012) and Coles et al. (2014).

Coles et al. (2014) argue that a firm's CEO is able to strongly influence the selection of new directors to the board. Because of the CEO's influence in director appointments, these directors owe their loyalty to the CEO instead of the interests of shareholders. This loyalty manifests itself in allowing the CEO more discretion or latitude than would otherwise be granted. In other words, as Coles et al. (2014, pp. 1753-1754) note, "co-opted independent directors, though independent of the CEO in the conventional and legal sense, behave as though they are not independent in the function of monitoring management." This weaker monitoring by co-opted boards has a variety of practical consequences. Their findings indicate that CEOs of firms with co-opted boards receive higher pay and are less likely to be fired for poor performance than are other CEOs

This study extends the results reported by Coles et al. (2014) by examining the relationship between co-opted boards and another measure of board effectiveness – how often the board meets to perform its monitoring function.

### **Board Meeting Frequency**

The primary responsibility of a board of directors is to protect shareholder interests by monitoring firm management. The number of meetings held has often been used as a proxy for this monitoring activity. Conger et al. (1998, p. 143) note that "(t)o make effective decisions, directors need sufficient, well-organized periods of time together as a group." Vafeas (1999) found a relation between firm value and board meetings. He concluded that more frequent board meetings came in response to poor firm performance. His findings indicated that poor firm performance triggered additional board meetings, which in turn would improve the firm's operating results in later years.

Brick et al. (2010) also used board meetings as a proxy for board monitoring. Their results were consistent with those of Vafeas (1999) and further documented that increases in firm value arise from additional meetings by the board. Al-Najjar (2010) found a link between better internal monitoring by the board and the number of meetings it held during the year.

Other research has focused on the frequency with which the board's audit committee meets. Both Abbott et al. (2004) and Raghunandan & Rama (2007) note that meeting frequency has been commonly used as a proxy for audit committee diligence. DeZoort et al. (2002, p. 65), survey the relevant literature and conclude that prior research demonstrates that "greater meeting frequency is associated with a reduced incidence of financial reporting problems and greater external audit quality."

If co-option affects director effectiveness and meeting frequency is a proxy for effectiveness, then there should be an association between director co-option and the number of board meetings held. To the extent that co-opted directors do not act like independent directors, co-opted boards should perform less monitoring of management, resulting in fewer meetings.

### **MODEL DEVELOPMENT**

This study employs a model of board meeting frequency based on that developed by Al-Najjar (2010). The model incorporates variables based on both firm characteristics and internal governance mechanisms. Internal governance factors are discussed first.

The size of the board itself may play a role in meeting frequency. Larger groups may need more time to make decisions and more meetings are one means of affording that additional

time. Al-Najjar (2010, p. 7) argues that “the larger the board size, the more demand on board meetings.”

Theoretically at least, the importance of truly independent directors to effective governance has long been recognized. Boone et al. (2007) hypothesize that a more independent board reduces opportunities for management to act for their private benefit at the expense of shareholder interests. However the board must meet to achieve this more effective oversight. To the extent that regulatory and legal definitions of “independent” capture true independence, the frequency of board meetings should increase as the independence of the board increases.

Vafeas (1999) notes that committees often assume certain board responsibilities. Such delegation reduces the workload of the board as a whole, potentially leading to fewer meetings. A possible offsetting factor is that the board must coordinate and supervise its committees, a task that increases with the amount of delegation and requiring more meetings to accomplish. Al-Najjar (2010) used the number of audit committee meetings as a proxy for board delegation and found more audit committee meetings were associated with fewer meetings of the board as a whole.

Al-Najjar’s (2010) model also incorporates several firm characteristics, beginning with firm size. Larger firms are normally held to have more complex activities. In turn, this complexity has been associated with an increased need for effective monitoring of management (Boone et al., 2007). This increased demand for monitoring would be expected to lead to more frequent meetings. However, Raghunandan and Rama (2007) argue that larger firms may have alternate monitoring mechanisms in place that reduce the need for meetings to occur. Evidence on this point is mixed. Al-Najjar (2010) found board meetings decreased with firm size, while Raghunandan and Rama (2007) found a significant and positive relationship between firm size and audit committee meeting frequency.

A firm’s exposure to the risk of fraud drives the next set of firm variables in the model. Elevated amounts of debt and leverage have been shown to be positively associated with fraud (Dechow et al., 1996). Al-Najjar (2010) posits highly leveraged firms will intensify their internal monitoring efforts in response to this increased risk, resulting in more board meetings.

Rapid firm growth is often considered a “red flag” of potential fraud (Loebbecke et al., 1989). Raghunandan and Rama (2007) note that future growth opportunities, as measured by the ratio of market value to book value, are indicators of fraud. To address the concerns raised by these conditions, boards of high-growth firms are likely to meet more often.

A firm’s free cash flows (FCF) may also affect the frequency of board meetings. Jensen (1986) notes that managers have incentives to use FCF for their private benefit, rather than for the benefit of shareholders. The resulting agency conflicts can result in increased monitoring by the board and thus in more board meetings.

Brick and Chidambaran (2010) note that prior research suggests a positive association between firm value and the demand for board oversight. Both Al-Najjar (2010) and Brick and Chidambaran (2010) employ Tobin’s Q as a measure of firm value in their analysis of meeting frequency.

In addition to the variables used in the model developed by Al-Najjar (2010), this study employs one additional firm characteristic to predict meeting frequency. Raghunandan and Rama (2007) argue that there should be a negative association between the amount of company stock owned by corporate insiders and the frequency of audit committee meetings. They note that agency costs should decrease as managerial ownership of the firm increases, reducing the

need for other monitoring mechanisms such as committee meetings. To the extent this relation holds, one would expect fewer meetings of the board as a whole as insider ownership rises.

The variable of chief interest in the model is the proportion of the board which has been co-opted by the firm's CEO. If co-opted directors do, in fact, allow the CEO greater discretion, that should correspond to reduced monitoring by the board. One potential consequence of lower effort expended in monitoring management would be fewer meetings of the board. Following Coles et al. (2014) a director is classified as co-opted if he or she is elected after the firm's CEO takes office.

The characteristics discussed in the previous section are incorporated into the following regression model based on that developed by Al-Najjar (2010):

$$\text{BODMEET} = f(\text{BSIZE}, \text{IND}, \text{AMEET}, \text{SIZE}, \text{LEV}, \text{MB}, \text{FCF}, \text{TOBQ}, \text{INSIDE}, \text{COOPT})$$

where:

BODMEET	= natural log of the number of board meetings;
BSIZE	= natural log of the number of directors on the board;
IND	= proportion of independent directors on the board;
AMEET	= natural log of the number of audit committee meetings;
SIZE	= natural log of firm's market value;
LEV	= debt scaled by total assets;
MB	= market value to book value ratio;
FCF	= free cash flows scaled by total assets;
TOBQ	= Tobin's Q (measured as book value of assets plus market value of equity less book value of equity divided by book value of assets);
INSIDE	= percentage of common shares owned by officers and directors;
COOPT	= the proportion of directors appointed to the board after the CEO assumed office.

## Sample and Data

The sample for this study consists of 100 companies randomly selected from the S&P 500 Index. Firm proxy statements filed in 2015 were obtained from the SEC's EDGAR database. Financial data were obtained through firm 10-K's and the S&P Research Insight database. Information was hand collected for 1,088 individual directors.

Table 1 (Appendix) provides selected descriptive data for the sample. As would be expected from a sample drawn from the S&P 500, the average firm size is very large, over \$40 billion in assets. The overwhelming majority of directors are classified as independent (85.54%). However over 37% of directors are classified as co-opted.

Table 2 (Appendix) provides information about the number of board meetings held by sample firms. On average, boards met slightly over 8 times during the year. The distribution of meeting frequency was roughly even, with the percentage of firms meeting four or fewer times approximately the same as those meeting 12 or more times.

## RESULTS

Table 3 (Appendix) provides results for the regression model. The model's F-statistic is 3.045 ( $p = .002$ ). The highest variance inflation factor (VIF) is 2.075, reducing concerns about multicollinearity. As the Table indicates, statistically significant coefficients are observed for only a few independent variables. The number of audit committee meetings (ACMEET) is higher for firms whose boards meet more frequently. Also, as expected, higher levels of insider ownership (INSIDE) is associated with fewer board meetings.

The independent variable of chief interest is COOPT. As Table 3 indicates, COOPT is negatively and significantly associated with board meeting frequency. The results indicate that, as the percentage of co-opted directors on the board increases, the number of board meetings decreases.

## CONCLUSION

This study is the first to examine whether director co-option affects how frequently boards of directors meet. The concept of co-option, advanced by Coles et al. (2014), is that directors owe their allegiance to the CEO who was instrumental in their selection, rather than to the shareholders they theoretically represent. This lack of true independence results in less monitoring of management by the board, and thus fewer board meetings.

A sample comprised of 100 S&P 500 firms was analyzed. For each sample firm the percentage of the board made up of co-opted directors (COOPT) was calculated. A regression model, based on that developed by Al-Najjar (2010), was developed to predict the frequency of board meetings during the year.

Regression results revealed a significant and negative association between COOPT and meeting frequency. The greater the proportion of co-opted directors on the board, the less frequently the board met. Coles et al. (2014, p. 1781) argued that "independent directors that are co-opted behave as though they are not independent." To the extent that the number of meetings reflects the board's ability and willingness to monitor management behavior, the results of this study support that conclusion.

At a minimum, this study reinforces the contention of Coles et al. (2014) that the traditional dichotomous designation of directors as independent or not independent does not adequately capture the role they play in management oversight. Further research is clearly called for. Future studies might provide a better understanding of the concept of director co-option. For example, does the extent of co-option change over time? Whether focused on co-option or on other issues involving director effectiveness, the findings of this study reinforce the conclusion of Cohen et al. (2012, p. 1057) that "(b)efore the question of whether independent boards benefit shareholders can be adequately addressed, more research is needed to determine the true nature of "independence" within corporate boards, which begins with an understanding of the true independence of directors."

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## APPENDIX

<u>Variable</u>	<u>Mean</u>	<u>Median</u>	<u>SD</u>
# of Directors on Board	10.860	11.00	1.83
% Independent Directors	85.54%	90.00%	.082
Audit Committee Meetings	8.71	8.00	3.07
Assets (\$MM)	40,256.36	16,124.36	73,259.57
Leverage	.29	.26	.17
Market-Book Ratio	24.57	3.30	139.52
Free Cash Flows/Assets	0.05	.04	.05
Tobin's Q	2.47	2.17	1.43
Insider %	2.56%	.94	5.37
% of Co-opted Directors	37.05	33.33	.27



Number of Meetings	Full Sample
4 or fewer	13.0%
5	13.5%
6	13.5%
7	12.5%
8	11.5%
9	8.5%
10	9.0%
11	4.0%
12 or more	14.5%
Mean # of Meetings	8.15

<b>Table 3</b>			
<b>Regression Results</b>			
BODMEET = $f$ (BSIZE, IND, AMEET, SIZE, LEV, MB, FCF, TOBQ, INSIDE, COOPT)			
<u>Variable</u>	<u>Coefficient</u>	<u>t-stat</u>	<u>p-value</u>
Intercept	1.576	<b>2.356</b>	<b>.021</b>
BSIZE	0.076	0.327	.745
IND	-0.294	-0.528	.599
AMEET	0.375	<b>3.418</b>	<b>.001</b>
SIZE	-0.008	-0.179	.859
LEV	-0.208	-0.997	.321
MB	0.000	0.861	.392
FCF	-1.101	-1.306	.195
TOBQ	0.004	0.132	.895
INSIDE	-0.018	<b>-2.066</b>	<b>.042</b>
COOPT	-0.278	<b>-2.118</b>	<b>.037</b>
Adj R-square	0.171		
F-statistic	3.045		
Pr > F	<b>0.002</b>		
Highest VIF	2.075		