Corporate Governance as it Relates to Private Company Boards – A History of Transparency, Balance, and Trust

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Abstract

The extant literature illustrates that board governance originated largely through leadership reputation, legal measures, and large ownership concentration, migrating to identifying governance provisions which lead to enterprise value accretion. As a result, the scholarly research is predominantly positive and conclusive on the need for a robust, independent board of directors to create enhanced firm value. Moreover, a movement to providing transparency to both internal (employees) and external (industry analysts) parties has been found to be just as important, if not more so, as firms try to balance the needs of fiscal and corporate social responsibility. In fact, those firms operating through the flexibility of private ownership, or other respected elites,have an opportunity to set the stage for future corporate governance actions and policy. Regardless of the ownership structure, company governance is coming back to reputational-based and human condition-oriented means by employing the essential principles of transparency, balance, and trust.

Key Words:corporate governance, corporate social responsibility (CSR), managerial overconfidence, shareholder value, stakeholder management

1. Motivation and Purpose

Much academic research has been applied to appropriate governance routines for public companies. Equivalently, a common conjecture among practitioners is that the tenets of good corporate governance for public institutions should also serve the interests of private companies and the boards that oversee their operations. As summarized by Hammack (2019), providing a private company board of directors usually occurs when the company is diffused among a number of owners (e.g., employee stock ownership program,private/angel investors) or when ultimate ownership cannot spend the time necessary to oversee management activities, including when a founding owner or family has transitioned daily operations to professional management.

Besides providing transparency to operations and monitoring management activities,company boards often are responsible for guiding overall firm strategy and the associated company-wide policies for implementation, including establishing an ethos of ethical and social responsibility. Beyond the oversight of firm leadership, *company-level* succession planning also is an important charge of a private company board, in addition to providing other advice or guidance to the executive management team, as necessary, not unlike public corporation boards. Even though private company boards can differ significantly from public companies in that there likely is some level of enmeshmentamong ownership, management, and board oversight functions,private company governance should be acted on by boards that are operating in the best interest of the enterprise and shareholders by providing duties of care, loyalty, good faith, and confidentiality (Hammack, 2019).

While the guiding principles as explained by Hammack are clear, what are oftentimes less well known to individual private company board members are the critical,oressential,principles of good corporate governance that have transcended history. In particular, what are the foundational elements of corporate governance that have withstood the test of time? The purpose of this paper is to provide a high-level summary of how the views relating to corporate governance have changed over time, as viewed through the academic literature. And, more important, what does the research from a sampling of these seminal studies foretell about the strategy behind the structure and operationalization of private company boards?

The attention to the essential tenets of operational transparency, balance between competing priorities and paradigms, and ultimately, the establishment of trust between the firm and its shareholders, and even its broader set of stakeholders, has never been more important as the global economy recovers from one of the most detrimental exogenous events over the past 100 years as a result of the coronavirus (COVID-19) pandemic.

2. Introduction and Background

Corporate governance is founded on agency theory (or managing the differences in behavior or decisions within a group), specifically the separation of ownership and management control so financial returns are appropriately repatriated to investors. As explained in the summary review of public company boards (Shleifer &Vishny, 1997), good governance has rested on the relentless focus of organizational performance and fiscal responsibility to *shareholders* whileattracting corporate capital to the firm without granting full control or power to investors. Beyond board oversight and the individual incentive agreements with the leaders of public companies, value for *shareholders*was found to be governed through four general mechanisms: (1) management reputation building (e.g., with banks and investors through track record, dividend payments, etc.); (2) excessive investor optimism– however, it is generally felt that these two items, combined, could not fully explain the rationale for continued outside investment; (3) legal protection needed to prevent expropriation by management – this is probably the most significant instrument of corporate governance in the U.S.; and (4) the financial incentives of large investor ownership tend to drive management to distribute profits through control mechanisms, including decision and cash flow rights as well as through debt and equity governance.

The overarching theme in the academic literature from the late 1990s and through the corporate scandals that took place in the early 2000s was one of corporate governance controlling management self-interest as,“left to their own devices, managers will waste company resources” (Dittmar & Mahrt-Smith, 2007; p. 600).And, while company boards were in place to manage corporate governance, these leading scholars summarized that boards tend to be “captured by management” (Shleifer &Vishny, 1997; p. 751). Shleifer and Vishny also highlight that much of current corporate law was put in place as a result of managerial theft dating back to the eighteenth century. Their work was prophetic given the corporate scandals and other events of the late 1990s and early 2000s (e.g., Enron, Tyco, and WorldCom) that led to significant government reform through the implementation of the Sarbanes-OxleyAct of 2002,by which corporate governance is now largely regulated in the U.S. The authors conclude that *legal protection* and *ownership concentration* (the corporation is essentially governed by its largest shareholders) as the two, primary means by which corporate governance takes place, beyond what can be provided through reputational drivers and investor optimism to allow for continued corporate investment and sustainability (Shleifer &Vishny, 1997).

3. Discussion – What Is Good Governance?

Much of the academic research in the early part of the 2000s moved to identifying a large set of common corporate governance provisions that positively correlated with, or predicted, firm performance and enterprise value. In particular, two key measures for entrenchment and corporate governance were formulated (Bebchuk, Cohen,& Ferrell, 2009; Gompers, Ishii,&Metrick, 2003). These indiceswere based on the *legal restrictions* related to a company’s charter and anti-takeover provisions[1] as well as the impact from *large shareholder monitoring* (e.g., pension funds).

At the same time, in response to significant public firm takeover activity in the 1980s, an industry-wide movement to adopt governance provisions to prevent suchfuture actions, essentially reducing shareholder rights, began to take shape.The long-term nature of these defenses allowed for the study of follow-on company returns compared to the generallyacceptedgovernance provisions at the time (securities regulation at the federal level, corporate law at the state level, and charters and bylaws at the firm level). In conjunction with the movement against takeovers and after the corporate scandals of the late 1990s and early 2000s, the study of wealth effects from governance actions showed little or mixed effects. In response,Gompers, Ishii, and Metrick (2003)created what would become a highly used “governance index”based on 24 well-establishedgoverning provisions, largely those tracked by the Investor Responsibility Research Center (IRRC), assuming one point granted for each of the entrenchment provisions used by a firm.Then, the authorsstudied the eventual investor returns measured against this index, establishing it as the first comprehensive proxy to measure the balance of power between managers and investors in public companies.

In sum, the authors found the index was significant and negatively related to firm value, highlighting that higher management entrenchment, and thus lower shareholder rights,could result in a significant drop in firm value.

[1]A high governance index results in lesser shareholder rights and thus is perceived as poor governance.

More so, they concluded theperceived reduction in shareholder rights was correlated with lower sales growth, higher levels of capital expenditures, lower profitability, and a greater level of corporate acquisitions, which also had led to value degradation for acquiring firm shareholders. While it provided an initial and comprehensive view of the value of various governance or managerial entrenchment activities on shareholder value, the study was not able to establish any true causal inferences,nor did it give guidance on which specific provisions seemed to be the highest correlated with eventual firm and shareholder value degradation. In fact, as opposed to each provision leading to value degradation, one could argue that some additive provisions may lead to enhanced firm value.Forexample, board director indemnification was used as one of the 24 provisions measured. In this case, board memberprotection from potentiallegal action against the corporation is commonplace in practice to attract qualified executives who would expect such insurance coverage. Using this example, if the provision was not provided for board members (decreasing the governance index and conceivably providing greater shareholder rights and increasing firm value) itcould, in fact, lead to lower quality board members, likely negatively impacting firm performance.

In the follow-on to the Gompers, et al.study, Bebchuk, Cohen, and Ferrell (2009) forged new progress in the identification of the critical governance provisions that led to enhanced or degraded firm value, based on the establishment of a companion index (the entrenchment, or E-index). In this instance, the study was focused on what the authors found to be the most significant governance provisions related to negative firm and abnormal shareholder value returns, a noted weakness of the previous study. Their motivation and driving research question was simple: *Of the 24 provisions tracked by the IRRC and used in the Gompers, et al., index (or GIM), which provisions are critical in establishing the link between corporate governance and firm value?*Essentially, they found 18 of the provisions from the previous work were uncorrelated with negative abnormal returns or degradation in firm value (such as the board indemnification example provided earlier). In particular, they found that control of the board of directors through staggered boards, golden parachutes to company executives in the event of a change of control, poison pills that render the target company financially unattractive, limitations to shareholder bylaw amendments, supermajority clauses for charter amendments,and supermajority requirements for merger and acquisition approvals were the six key governance provisions that limited shareholder pressure on managerial performance, thereby reducing takeover opportunities and follow-on prospects for increasing shareholder wealth.

Moreover, anothersignificant contribution of the work by Bebchuk, et al. (2009), beyond beginning to close the gap in the cause-and-effect relationship between corporate governance and firm performance, is the recommendation of parsimony, as opposed to developing larger, more complicated governance indices which may, in fact, have little relative value in establishing firm performance; rather, future research should focus on the relative weights of the six critical variables, according to the authors. Bebchuk and colleagues make strong recommendations that even larger-sized indices developed and used by shareholder advisory firms (some that include as many as 600 governance provisions) are seriously misguided. While the authors admittedly highlighted that additional research was needed to better establish stronger cause-and-effect relationships, a clear critique from a practitioner perspective would question the totality of firm performance predictions from the stated six critical governance provisions; if 600 are too many, are six too few? Thus, the debate continues.

3.1 Managing Leadership Overconfidence – *the Importance of Board Independence*

While the criticality of the individual governance provisions continues to be open to additional dialogue and refinement, corporate governance priorities for public company or private company boards will always relate to providing the appropriate managerial oversight to balance shareholder interests with management decision-making. Consistent with Dittmar and Mahrt-Smith (2007) who point to good corporate governance leading to the appropriate use of cash reserves to enhance shareholder value, Malmendier and Tate (2005) provide similar conclusions regarding CEOs who overestimate their ability to efficiently invest cash flows asa means to enhance firm value. As such, managerial overconfidencereceives muchattention throughout academia relative to corporate governance needs.In a unique contribution to the extant literature, by reviewing a CEO’s management ofhis or her own personal, company stock and stock options in terms of buying and holding periods (investing in increasing levels of stock and holding options with the mindset that stock values will, essentially, always continue to grow), the authors’ motivation was to successfully argue that the personal decisions of leadership can lead to corporate investment distortions; in particular, the study focuses on the relationship between overconfidence and corporate decision-making,which can lead to poor decisions on the use of internal funds (cash) as well as the tendency that these managers will view external sources as overly costly, and thus curtail investments when outside funding sources are required.

Malmendier and Tate (2005) indeed found a significant, positive relationship in the regression model interaction between overconfidence measures and the use of cash flow for corporate investment. Moreover, they found thatoverconfident CEOs tend to overestimate the returns from their internal investments while underestimating the potential risks involved. At the same time, there is a tendency towardfocusing on entrenchment activities and the "perks" of the role, including "empire building"because the use of cash and other internal funding means are much closer to the control of the CEO. Outside equity sources, on the other hand,were viewed as expensive, or a recognition that the company is undervalued by the market. These CEOs tend to view their relative skill as "better than average," a phenomenon studied extensively in the literature (Wasserman, 2008, for example[2])relative to CEO overconfidence.

CEO overconfidence is often the driving factor behind other recommended best practices for company board governance,such as separating the CEO and board chair role, although even this best practice has shown mixed results (Daily & Dalton, 1997),suggesting the resulting firm performance results based on joining or separating the CEO/chair role can vary significantly based on idiosyncratic context. In fact, as emphatically pointed out by Rhoades and colleagues, the appropriate research question is probably not related to "if" the role should be separated, but "when" (Rhoades, Rechner,&Sundramurthy, 2001), wherein CEO overconfidence is a substantive factor in such a decision.

While the Malmendier and Tate article (2005) tends to shadow overconfidence in a negative light, after reviewing CEO stock/option behaviors and firm performance across 477 large companies from 1980 to 1994, these "overconfident CEOs" do not encounter significant abnormal returns in comparison to the Standard and Poor's 500 (S&P 500). Detailed recommendations from the study suggest boards must exercise caution with respect to the value of standard stock and option-based incentivesfor company leadership, which were not shown to significantly curb overconfident behavior, and instead,the needs for alternative governance strategies were recommended. Namely, the use of debt overhang techniqueswas suggested to better manage internal cash. More important, the study concludes, that *vigilant and independent directors* are even more critical in the face of overconfident CEOs. In fact, while there seems to be long-standing debate surrounding critical governance provisions to firm value accretion, whether considering the initial 24 items within the initial GIM index or through other corporate structural designs, such as separating the CEO and board chair role, the literature is predominantly positive and conclusive on the need for a robust, independent board of directors as a means to create enhanced firm value(Brickley, Coles,& Terry, 1994; Byrd & Hickman, 1992a, 1992b; Rosenstein & Wyatt, 1990; and Weisbach, 1988; c.f. Fernando, Sharfman,&Uysal, 2017).

3.2 Returning to Reputational Motivation

While legacy attempts to yield appropriate governance systems were focused on legal and large shareholder ownership drivers, moving toward the management of CEO overconfidence, research within the last decade has been moving toward two dominant motivational themes: (1) going back tothe initial beliefs that reputation and non-financial factors can appropriately,and additively, drive good corporate governance outcomes, and (2) following on the importance of independent board structures, how can a boardmeld relation-oriented diversity (gender, race, and age) to improve ethical and social norms while maintaining fiscal standard of care?Specifically, in line with the movement to enhanced corporate social responsibility (CSR), internal (employee-based) and external (industry analysts) pressures are driving for the necessary increase in transparency and the need to manage outcomes to all *stakeholders* of the company, not just *shareholders*. In fact, the importance of *building social capital and trust between a company and its shareholders, as well as the firm's societal and community-basedstakeholders*, was never found to be more paramount thanduring the last global financial crisis of 2008. As an example, Lins and colleagues found that building financial capital *in addition to creating social capital through enhanced CSR activities*, not unlike an umbrella insurance policy, resulted in superior firm performance as compared to lower-level CSR peers during periods of financial crisis (Lins, Servaes, & Tamayo, 2017).

Reputation-related matters are receiving much attention in the current academic literature related to corporate governance. As an example, to determine what motivates board directors to carefully monitor senior management, Masulis and Mobbs (2014) contribute to the extant literature by providing evidence that indeed reputation-based factors play a substantive role, even by comparison to individual financial incentives. Prior studies had limited the assessment of directors holding multiple positions as an indicator of reduced effectiveness.

[2]CEOs will tend to rate themselves and their company's opportunities as better than average, realizing firms have a somewhat equal chance of being above or below the average in many instances.

Alternatively, this study focuses on the authors' motivation to determine what makes individual directors focus their attention on competing board responsibilities and find that independent directors who hold multiple company board seats will focus their attention on assignments for firms with the greatest level of "prestige," in this case, measured by firm size (market capitalization). More so, these reputation-based incentives go beyond pecuniary-based incentives that had shown limited effects in the literature, according to the authors(Masulis&Mobbs, 2014).

The article's contribution to the literature includes groundbreaking evidence as to how individual-director actions are affected by reputation-based incentives, and in fact, they find that multi-board directors are more attentive to their directorship requirements with themore substantive and prestigious firms, with improved firm performance as a result. In fact, directors who hold multiple director positions are more reluctant to give up visible positions even if firm performance is weak.Interestingly, *the study also gives warning to conditionsof suboptimal board monitoring on behalf of independent directors, such as outside directors having strong social connections to the CEO (compromising independence), the independent director simply has too many board commitments, and the numbers of directors on the boardare too large*, based on a summary of previous research(Masulis& Mobbs, 2014).

3.3 Protecting *Stakeholder* Interests and Diversity

Following on the paradigm of broadening shareholder attention to stakeholder concerns as a part of recommended corporate governance and on the back of the economic recession of 2008, Jo and Harjoto (2011) highlight the significant heterogeneity of corporate governance approaches in place throughout corporate America. They summarize that information transparency and managerial incentives have limited the effect of corporate performance in public organizations, and while governance structures are put in place to protect shareholder interests by curtailing managerial self-interest, the authors posit that good governance goes beyond this limitation in scope to balance the interests of shareholders and non-investing stakeholders as well. The study's contribution sought to fill a void in the empirical analysis of how reputational-based factors such as CSR can enhance these aspects of firm governance, and indeed, generate greater returns for shareholders.

Specifically, the authors reviewed the impact of CSR on firm value, serving as one of the first empirical studies coveringthe topic. Results indicated that emphasis on CSR is positively associated with board leadership, institutional ownership,and anti-takeover provisions, leading to a positive influence in firm value, after controlling for endogeneity and various firm characteristics.*Most interestingly, it was found that external analyst engagement with firms that implement CSR mechanisms had the strongest impact on firm value, largely because of the transparency and additional monitoring oversight they provide, again highlighting the impact of reputational and non-financial factors on firm financial outcomes*. The authors cite evidence that corporations must follow corporate governance regulations embodied in legal regulations; yet, these organizations need to go beyond regulatory means to enact appropriate ethical customs within the corporation. Findings also suggest that the greatest value from CSR enrichment activities is generated from those interactions associated with *social enhancement, diversity, and employee relations* more so than activities associated with community and environmental issues.*Correlations between CSR and firm performance were greatest for firms among the S&P500, those firms with the greatest number of industry analysts following the firm, and the age of the firm, with the two typical governance and entrenchment indices (referenced previously) showing smaller effect sizes*.

Besides the recognition that public companies needed to broaden the span of attention to stakeholder interests, new attention to board diversity measures aligned with balancing the needs of stakeholders were taking on greater importance in the literature as well. By December 2009, the U.S. Securities and Exchange Commission mandated new regulations for public companies to disclose their processes behind selecting director nominees. In particular, (Harjoto, Laksmana,&Lee, 2015) were interested in determining the impact of board diversity on management decisions regarding social responsibility, beyond overseeing the financial processes and firm performance often associated with diversity studies at the time. This environmental shift was the motivation for the study, and the paper serves as additional support for evidence of needed improvement in this area, largely through the enhancement of CSR approaches through board diversity. Of note, the paper's literature review clearly cites that the extant literature has proven to be mixed regarding the desired makeup for the most effective boards. In particular, they state, "while the importance of board diversity is widely recognized, empirical evidence on the benefits of board diversity is inconclusive" (Harjoto, Laksmana, & Lee, 2015; p. 643), which is consistent with other scholarly reviews (Rhode &Packel, 2014).

Using stakeholder theory (what benefits one group has a translational benefit to others), the authors studied 1,489 firms from 1999 to 2011 and found that *board diversity better satisfies a wide range of stakeholders and is positively related to CSR performance*.

In particular, in alignment with the extant literature, gender, tenure, and expertise-related diversities are the driving factors in overall CSR performance, largely through the reduction of CSR concerns, with tenure and expertise only associated with abating CSR concerns, whereas gender increases CSR strengths and reduces CSR concerns.

Thus, collectively, the literature summarizes that a balance between task-oriented dimensions (such as financial oversight) and relation-oriented dimensions through board diversityis required to enhance a firm's CSR values.

4. Summary andConclusions

The span of academic literature relative to corporate governance has followed a circuitous path regarding the relevant and important tenets for adequate company governance. Early studies highlighted the importance of leadership reputation as well as legal provisions and large institutional ownership as driving factors for good governance, but eventually a movement to simply providing transparency to firm operations to both internal (employees) and external (industry analysts) parties may be just as important, if not more so, as firms try to balance the needs of fiscal responsibility and CSR. And, while the most important provisions of the various governance indices will be debated, having an uncompromised and independent board structure to appropriately balance the risk/reward decisions of management, guarding against overconfidence, is vitally important. A good company board is one that is socially diverse and fiscally responsible,which is critical to balance a broader range of company stakeholders (beyond shareholders). This balance should take place in the form of enhanced company financial performance while, at the same time, responding to increased attention to reputational factors, such as CSR, as these outcomes should not be considered mutually exclusive.

The drivers behind these changes are interestingly coming from those who take a greater stand on the need for balanced CSR, which include a large base of the S&P500 companies because these firms receive much of the reputational spotlight in North America.This change is not altogether different from what has been witnessed in other countries, in somewhat of a reverse fashion. For example, in Japan, a transformational change has taken place from too much emphasis on stakeholder concerns to the need for economic improvements to shareholders, again using reputational and motivational factors established through a new market index (Chattopadhyay, Shaffer,& Wang, 2020). In the U.S., it seems as if reputational drivers are leading to the opposite effect, moving from shareholder concerns to more intensified stakeholder considerations, based on the research summary herein.Based on the recent study in Japan, the authors clearly highlight that *incentive-based changes, such as those proliferated to alter social, environmental, and corporate governance norms,could be considered through similar "prestige" incentives as changes in cultural norms tend to be incubated by the "behavior of a small group of respected elites"* (Chattopadhyay, Shaffer,& Wang, 2020; p. 721).

In the case of the U.S., it appears as if the S&P500, and perhaps those firms operating through the flexibility of private ownership, have the opportunity to set the stage for future corporate governance actions and policy. Regardless of the ownership structure, company governance will be enhanced through reputational-based and human condition-oriented means and methods and the development of both financial and social capital by employing the essential principles of transparency, balance, and trust.

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