

MANAGING REPUTATION IN THE BOARDROOM

by

MICHAEL WILLIAM HILL

(Under the Direction of Allen Amason)

ABSTRACT

The reputational perspective on boards of directors lends a number of insights to the corporate governance literature which clarifies and explains outcomes which are counter to those using an agency based perspective. The theoretical perspective developed in this work suggests that recent heightened scrutiny on boards has increased the likelihood that outside directors will act to in ways to protect their reputations. Reputation management actions by outside directors reveal that they may not be risk neutral but, in actuality, risk-averse executives seeking to protect their own reputations from potential damage arising as a result of their directorship duties. As a means of protecting their reputation, outside directors may therefore have a vested interest in creating celebrity CEOs.

INDEX WORDS: reputation, corporate governance, celebrity CEOs, outside directors, agency theory, executive reputation

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B.B.A., The University of Georgia, 1998

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A Thesis Submitted to the Graduate Faculty of The University of Georgia in Partial
Fulfillment of the Requirements for the Degree

MASTER OF ARTS

ATHENS, GEORGIA

2012

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December 2012

DEDICATION

To my ever understanding wife.

ACKNOWLEDGEMENTS

To all who have helped.

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CHAPTER 1

INTRODUCTION AND LITERATURE REVIEW

The purpose of this study is to examine the implications of incorporation of the reputational perspective on the behavior of outside directors of public firms when performing their corporate governance duties. In this work research is presented that demonstrates the potential importance to individual outside directors of their personal reputation as executives. By examining the behavioral implications for these outside directors emanating from their concern for their reputation as executives certain insights are developed which enhance strategy scholars understanding of the cloistered world of the corporate boardroom. Integrating the insights of the reputational perspective with the dominant agency theory based corporate governance perspective provides a framework for understanding outcomes dissonant with agency theory based predictions about the rapidly evolving area of corporate governance. In particular, it also provides a framework for understanding the implications of the heightened scrutiny upon corporate boards and their directors.

In this chapter a review of the literature concerning recent changes in the level of attention paid to corporate boards will be presented. The reputational concerns which are enhanced by this heightened attention are examined using the extant literature. Finally agency theory based perspectives of corporate governance are also reviewed. In the following chapter a manuscript examining board behavior and reputational concerns is presented. This manuscript uses primary sources in the agency theory based corporate

governance literature and the growing reputation literature to develop propositions pertaining to outside directors, their reputation management activities, and potential moderators of these activities. Finally, a final chapter concludes this work with a discussion of the contributions and implications posed by these insights.

SCRUTINY, REPUTATION, AND THE OUTSIDE DIRECTOR

Scrutiny of corporate boards has intensified in recent years after the heavily publicized corporate scandals at WorldCom, Enron, Tyco, and elsewhere. The increased attention on boards has led to regulatory changes, including the passage of the Sarbanes-Oxley Act by the United States Congress. One result of Sarbanes-Oxley was the imposition of new laws for corporate board composition and governance (Dey, 2010). At the same time, the popular business press has also increasingly scrutinized the practices of corporate boards. For example, *Business Week* publishes an annual list of the best and worst boards in America, and the book, *Money for Nothing: How the Failure of Corporate Boards is Ruining American Business and Costing Us Trillions* (Gillespie & Zweig, 2010), proclaims that corporate boards have failed in their oversight duties and allowed management to reap large financial rewards even when the firm has performed poorly. Additionally, investors are paying closer attention to the actions of corporate boards in making investment decisions. Indeed, a recent study suggests that investors may value the effectiveness of boardroom control as much as they do the firm's financial performance when making investment decisions (Westphal & Graebner, 2010). Finally, investor groups, such as the Council for Institutional Investors (CII), publish annual lists that link poor firm performance to suboptimal board governance practices (Ward, Brown, & Graffin, 2009).

One important implication of this increased scrutiny may be that legislators, investors, and the media have become more critical of the performance of the board of directors. This increased attention on boards of directors may have particular implications for outside directors. Outside directors comprise a substantial majority of the members of corporate boards. Recent research indicates that approximately 82% of all directors at publicly traded firms were classified as outside directors (Finklestein & Mooney, 2003; Linck, Netter, & Yang, 2009), and most are often executives of other corporations or other large organizations (Fama & Jensen, 1983). Thus, outside directors may be justifiably concerned that any potential negative assessments of their performance may also negatively impact their reputations as high quality executives in their “home” organizations. Indeed, an executive’s reputation is particularly important due to the high level of evaluative uncertainty regarding his or her actual managerial ability (Graffin, Pfarrer, & Hill, 2012; Milbourn, 2003; Wade, Porac, Pollock, & Graffin, 2006). Consistent with this idea, agency theorists have long recognized the importance of an outside director’s reputation, and recent studies have suggested that being associated with a poorly performing board may have negative consequences for outside directors (Arthaud-Day, Certo, Dalton, & Dalton, 2006; Srinivasan, 2005). In this regard, Fama and Jensen (1983) stated that “outside directors have incentives to develop reputations as experts in decision control” (315). Regarding these same individuals, the authors went on to note that “[t]he value of their human capital depends primarily on their performance as internal decision managers in other organizations. They use their directorships to signal to internal and external markets for decision agents...” (315).

This work suggests that such reputational considerations may not be properly amplified in light of the high level of scrutiny outside directors currently face. Indeed, outside directors likely recognize the additional risks posed to their reputation from the increased attention aimed at corporate boards. Recent studies provide support for this concern as executives who have lost their reputation as expert decision makers have faced significant career consequences, including job loss, reduced future income, and reduced employment opportunities (Graffin et al., 2012; Semadeni, Cannella, Fraser, & Lee, 2008; Wiesenfeld, Wurthmann, & Hambrick, 2008). Thus, due to the high level of importance of their reputation, outside board members may take actions to protect this asset (Wiesenfeld et al., 2008) in ways that are currently not predicted by agency theory.

This work suggests that outside directors, in light of this increased scrutiny, will actively seek to minimize any potential reputational damage that may result from their directorships. We define reputation as the collective judgment of observers regarding the quality or capabilities of a focal organization or individual that is earned over time (Fombrun, 1996; Podolny, 2005; Rindova, Williamson, Petkova, & Sever, 2005). At the organizational level reputation has been shown to be related to a number of outcomes such as profitability, attractiveness to employees, and attractiveness to investors (Fombrun & Shanley, 1990; Hall 1992; Hall, 1993). At the individual level reputation has been associated with the amount and type of compensation an executive receives (Milbourn, 2003; Wade et al., 2006). Together, these findings suggest that executives who serve as outside directors may be justified in actively attempting to manage their reputations. In the remainder of this chapter, a review of agency theory based literatures as it relates to board behavior is presented.

Agency Theory and Outside Directors

Most prior studies of boards of directors are rooted in agency theory (e.g., Davis, 2005; Zajac & Westphal, 1995). Agency theory is generally concerned with the problems that arise with the division of ownership and control within a modern corporation (Eisenhardt, 1989; Jensen & Meckling, 1976). Agency theory tries to offer a framework for understanding the problems that develop from the conflicting wishes of the manager, or agent, and the shareowner, or principal; the difficulty for the principal to monitor the agent; and the potential conflict of risk preferences for the principal and the agent (Eisenhardt, 1989). The corporate board is thought to be an effective tool to deal with the “agency problem” by reducing agency costs, monitoring managers’ behavior, and aligning managers’ and owners’ interests through compensation incentives (Kosnik, 1987).

From an agency perspective, the primary responsibility of the board of directors is to monitor and control top management to protect the interests of the shareholders (Fama 1980; Fama & Jensen, 1983). The board of directors has the ability to hire and fire the CEO, set executive compensation, and limit managerial discretion (Fama & Jensen, 1983). Board members are often classified as either inside board members or outside board members; inside board members are often top-level managers of the firm while outside board members are typically executives from other companies and are not employed on a full-time basis at the focal firm (Fama & Jensen, 1983). Due to their close ties with the firm, inside directors are not normally viewed as capable of fulfilling the monitoring role of the board (Baysinger & Hoskisson, 1990; Kosnik, 1987). In contrast, outside directors are believed to be more capable of performing the monitoring function

due to their presumed objectivity and independence from management (Baysinger & Hoskisson, 1990; Kosnik, 1987).

The idea that outside directors are the most effective monitors of management has become institutionalized or taken-for-granted in the eyes of both academics and practitioners (Davis, 2005; Zajac & Westphal, 1995). For instance, recent corporate governance reforms adopted by the United States Congress and regulatory bodies require that audit committees be comprised entirely of outside directors and require that the majority of the board of directors be comprised of outsiders (Dey, 2010). Commensurate with these regulatory changes, the ratio of outside directors to inside directors increased by approximately 15% from 1999 to 2005, with 82.3% of directors being outsiders by the end of the period (Linck et al., 2009).

Board composition is also thought to be important due to the differing risk preferences for principals and agents. Shareholders are viewed as being risk neutral while managers are viewed as being risk averse (Eisenhardt, 1989; Fama 1980). For example, shareholders want managers to undertake activities that have a positive net present value for the firm, which will lead to increased profits, increase future dividends, and increase the value of their shares (Jensen & Murphy, 1990). In other words, shareholders can mitigate their risk through diverse investments, but executives are unable to “diversify away” their primary employment and thus will be more averse in their actions (Eisenhardt, 1989). Thus, agency theory suggests that at their home firms, executives risk negative career consequences with fewer future employment opportunities and lower wages when compared to the risk faced by outside directors from sitting on the boards of other firms (Fama, 1980; Semadeni et al., 2008).

However, one of the potential consequences of the recent heightened scrutiny on board actions is that it may alter the risk preferences of outside directors. As mentioned above, the responsibility for reducing the agency costs that result from the separation of ownership and control typically falls on outside directors, since insiders are also employed by the firm (Davis, 2005; Zajac & Westphal, 1995). For outside directors to mitigate the agency problems arising from differing risk preferences and for them to best represent the preferences of shareholders, agency theory postulates that they to be risk-neutral. However, the heightened scrutiny focused on board actions may make it more unlikely that outside board members will maintain a risk-neutral perspective similar to the firm's shareholders. For example, recent empirical evidence suggests that firms that increased the number of outside directors as a result Sarbanes-Oxley have actually engaged in less risk taking (Bargeron, Lehn, & Zutter, 2010). Decreased risk taking after the addition of outside directors may indicate that the outside directors do not have the same risk preferences as principals and are more risk averse than agency theory would predict. As postulated in the next section, a primary reason for this increase in risk aversion is the impact of heightened scrutiny on board actions, resulting in outsiders' increased concerns for their reputations.

Outside Directors and Reputational Concerns

A good reputation is critical for executives to maintain in order to keep their management positions (Graffin et al., 2012; Milbourn, 2003). Reputation is thought to be particularly important for executives due to the evaluative uncertainty associated with assessing an executive's individual performance (Wade et al., 2006). Indeed, Holmstrom (1982) argued that attributions of managerial ability are uncertain because firm

performance is influenced not only by the internal decisions of executives, but also by external factors operating at the industry and organizational level. The difficulty in assessing executives' performance means that executives' reputations can serve as proxies for their abilities as managers (Milbourn, 2003). As difficult as it is for outside observers to determine an executive's individual performance, assessing the quality of individual directors is an even more uncertain and noisy task (Cai, Garner, & Walkling, 2009; Kosnik, 1987). Indeed, a meta-analysis that examined the link between observable governance characteristics and firm performance resulted in mixed findings (e.g., Dalton et al., 1998). While others have attempted to use indirect assessments such as management entrenchment or outside director attendance, most research illustrates the difficulty in assessing whether outside board members are performing their duties effectively (e.g. Cai et al., 2009; Kosnik, 1987). Contributing to this high level of uncertainty is that outside directors' actions are often not transparent to external observers (McCafferty, 2008), and outside directors are often very reluctant to reveal how they arrived at particular governance decisions even after such decisions are announced (Lorsch & Khurana, 1999). In this regard, Gillespie and Zweig (2010) note that, "directors rarely talk in public, maintaining a code of silence and confidentiality....boards work behind closed doors, [and] leave few footprints" (4).

The following chapter is a manuscript developing these concepts further and provides a reputational based perspective of the impact of reputational concerns on outside director behavior.

CHAPTER 2
REPUTATION MANAGEMENT IN THE BOARDROOM¹

¹ Hill, M.W., Pfarrer, M.D. and Graffin, S.D. To be submitted to *Academy of Management Review*

ABSTRACT

The reputational perspective on boards of directors lends a number of insights to the corporate governance literature. Our theoretical perspective suggests that recent heightened scrutiny on boards has increased the likelihood that outside directors will act to in ways to protect their reputations. Reputation management actions by outside directors reveal that they may not be risk neutral but, in actuality, risk-averse executives seeking to protect their own reputations from potential damage arising as a result of their directorship duties. As a means of protecting their reputation, outside directors may therefore have a vested interest in creating celebrity CEOs.

INTRODUCTION

Scrutiny of corporate boards has intensified in recent years after the heavily publicized corporate scandals at WorldCom, Enron, Tyco, and elsewhere. The increased attention on boards has led to regulatory changes, including the passage of the Sarbanes-Oxley Act by the United States Congress. One result of Sarbanes-Oxley was the imposition of new laws for corporate board composition and governance (Dey, 2010). At the same time, the popular business press has also increasingly scrutinized the practices of corporate boards. For example, *Business Week* publishes an annual list of the best and worst boards in America, and the book, *Money for Nothing: How the Failure of Corporate Boards is Ruining American Business and Costing Us Trillions* (Gillespie & Zweig, 2010), proclaims that corporate boards have failed in their oversight duties and allowed management to reap large financial rewards even when the firm has performed poorly. Additionally, investors are paying closer attention to the actions of corporate boards in making investment decisions. Indeed, a recent study suggests that investors may value the effectiveness of boardroom control as much as they do the firm's financial performance when making investment decisions (Westphal & Graebner, 2010). Finally, investor groups, such as the Council for Institutional Investors (CII), publish annual lists that link poor firm performance to suboptimal board governance practices (Ward, Brown, & Graffin, 2009).

One important implication of this increased scrutiny may be that legislators, investors, and the media have become more critical of the performance of the board of directors. This increased attention on boards of directors may have particular implications for outside directors. Outside directors comprise a substantial majority of

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We suggest that such reputational considerations may not be properly amplified in light of the high level of scrutiny outside directors currently face. Indeed, outside directors likely recognize the additional risks posed to their reputation from the increased attention aimed at corporate boards. Recent studies provide support for this concern as executives who have lost their reputation as expert decision makers have faced significant

career consequences, including job loss, reduced future income, and reduced employment opportunities (Semadeni, Cannella, Fraser, & Lee, 2008; Wiesenfeld, Wurthmann, & Hambrick, 2008). Thus, due to the high level of importance of their reputation, outside board members may take actions to protect this asset (Wiesenfeld et al., 2008) in ways that are currently not predicted by agency theory.

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AGENCY THEORY AND BOARD BEHAVIOR

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However, we suggest that one of the potential consequences of the recent heightened scrutiny on board actions is that it may alter the risk preferences of outside directors. As we mentioned above, the responsibility for reducing the agency costs that result from the separation of ownership and control typically falls on outside directors, since insiders are also employed by the firm (Davis, 2005; Zajac & Westphal, 1995). For outside directors to mitigate the agency problems arising from differing risk preferences and for them to best represent the preferences of shareholders, agency theory postulates that they to be risk-neutral. However, the heightened scrutiny focused on board actions may make it more unlikely that outside board members will maintain a risk-neutral perspective similar to the firm's shareholders. For example, recent empirical evidence suggests that firms that increased the number of outside directors as a result Sarbanes-Oxley have actually engaged in less risk taking (Bargeron, Lehn, & Zutter, 2010). Decreased risk taking after the addition of outside directors may indicate that the outside directors do not have the same risk preferences as principals and are more risk averse than agency theory would predict. As we postulate in the next section, a primary reason for this increase in risk aversion is the impact of heightened scrutiny on board actions, resulting in outsiders' increased concerns for their reputations.

OUTSIDE DIRECTORS, RISK AVERSION, AND INCREASED SCRUTINY

A good reputation is critical for executives to maintain in order to keep their management positions (Milbourn, 2003). Reputation is thought to be particularly important for executives due to the evaluative uncertainty associated with assessing an executive's individual performance (Wade et al., 2006). Indeed, Holmstrom (1982) argued that attributions of managerial ability are uncertain because firm performance is

influenced not only by the internal decisions of executives, but also by external factors operating at the industry and organizational level. The difficulty in assessing executives' performance means that executives' reputations can serve as proxies for their abilities as managers (Milbourn, 2003). As difficult as it is for outside observers to determine an executive's individual performance, assessing the quality of individual directors is an even more uncertain and noisy task (Cai, Garner, & Walkling, 2009; Kosnik, 1987). Indeed, a meta-analysis that examined the link between observable governance characteristics and firm performance resulted in mixed findings (e.g., Dalton et al., 1998). While others have attempted to use indirect assessments such as management entrenchment or outside director attendance, most research illustrates the difficulty in assessing whether outside board members are performing their duties effectively (e.g. Cai et al., 2009; Kosnik, 1987). Contributing to this high level of uncertainty is that outside directors' actions are often not transparent to external observers (McCafferty, 2008), and outside directors are often very reluctant to reveal how they arrived at particular governance decisions even after such decisions are announced (Lorsch & Khurana, 1999). In this regard, Gillespie and Zweig (2010) note that, "directors rarely talk in public, maintaining a code of silence and confidentiality....boards work behind closed doors, [and] leave few footprints" (4).

Due to this evaluative uncertainty, outside director reputation can serve as an important link between director and firm performance. We suggest that the confidentiality associated with board meetings when combined with the lack of consistent findings associated with observable governance characteristics leads to the following proposition:

Proposition 1: Assessments of outside director performance are noisy and uncertain.

Asymmetric Attributions of Performance

Even though there is a high level of evaluative uncertainty associated with assessing directors' performance, outside directors still face potential damage to their reputations as skilled managers as a result of their directorships (Fama, 1980).

Holmstrom (1979) recognized that even when the performance of an individual agent is difficult to assess, observers will seek information to inform their assessments. One particularly salient metric that may be used to assess directors' performance is the performance of the focal firm. However, the link between firm performance and assessments of directors' quality may be asymmetric.

On the one hand, if the firm is performing well, previous studies suggest that the vast majority of the credit will be given to the sitting CEO (Meindl, Ehrlich, & Dukerich, 1985). This bias, known as the "romance of leadership," suggests that observers tend to attribute firm successes almost entirely to the CEO and not to the board (Meindl et al., 1985; Wade et al., 2006). In contrast, poor performance, while still attributed to the CEO, also appears to be attributed to directors, more so than positive performance. For example, poor performance at the focal firm has been shown to "spill over" to other firms with which an outside director has an affiliation (Srinivasan, 2005). Thus, there appears to be an asymmetric impact upon outside directors' reputation for positive or negative firm outcomes.

Proposition 2: Attributions of firm performance on directors are asymmetric such that they receive little or no credit for positive firm outcomes but receive blame for negative outcomes.

Risk Aversion

Agency theory has long recognized that there are reputational considerations associated with outside directors (e.g. Fama & Jensen, 1983: 315). However, the impact of such reputational considerations on the risk preference of directors has not been explicitly examined. We suggest that once outside directors factor in the potential for their reputations to become damaged, and recognize the subsequent impact a lower reputation will have on their job prospects and earning power (Arthaud-Day et al., 2006; Srinivasan, 2005); they will become more risk averse than would otherwise be expected.

As the majority of outside directors are executives, and very often CEOs, at their home firms² (Linck et al., 2009), significant reputational damage from a directorship may far outweigh any benefits associated with board membership. Previous studies have suggested that negative outcomes or associations do significantly more damage and are much more salient in the eyes of observers than positive outcomes and associations (see Rozin & Royzman, 2001 for a review). Additionally, sociocognitive research has presented a number of findings that show human beings have a strong “negativity bias” which leads to negative events being more determinative in assessments than do positive events (e.g. Hastie & Dawes, 2001; Pfarrer, Pollock, & Rindova, 2010). This “negativity bias” can lead to negative events posing a danger to one’s reputation. For example, Fombrun noted the asymmetric nature of the effects of positive event on an individual’s

² Linck et al. (2009) report that in 2005 approximately 59.3 % of outside directors are non-banking or non-attorney executives at other firms, or employed in banking and finance. We assert that these individuals are executive level employees at their home firms and have similar reputational concerns.

reputation in noting that, “the reputations they earn from doing some things particularly well sit on the slippery ground of their constituents’ fickle interpretation” (Fombrun, 1996: 388). Thus, given that the penalties for failures will outweigh the benefits of success, outside directors will seek to minimize negative outcomes in order to protect their reputations.

Proposition 3: Due to reputational concerns, outside directors are more risk averse than would be predicted by agency theory.

Moderating Effects of Scrutiny

Reputational risks are enhanced when additional scrutiny is placed upon one’s actions (Fombrun, 1996). It is readily apparent that increased legal changes, investor demands, and media attention have had an effect on the actions of corporate boards (Bargeron et al., 2010). Indeed, failures in corporate governance are now front-page news and the subject of books that excoriate directors (e.g. Gillespie & Zweig, 2010). Outside directors recognize this heightened scrutiny, and are well aware that negative corporate outcomes will damage their reputations as expert decision makers (Arthaud-Day et al., 2006; Fombrun, 1996; Srinivasan, 2005). Furthermore, outside directors gain their appointments as directors due to their attainment of high positions at other firms; for these appointments one’s reputation is often the primary decision factor (Fombrun, 1996). As the risks to outsiders’ reputations from negative firm outcomes are enhanced by increased scrutiny, the presence of asymmetric credit and blame and the risk aversion of outside directors will be amplified.

We thus propose:

Proposition 4: The asymmetric relationship between credit and blame will vary with external scrutiny such that an increase in external scrutiny will further reduce the credit and further increase the blame attributed to outside directors from firm performance.

Proposition 5: The relationship between outside directors' perceptions of reputational risk and their level of risk aversion will vary with external scrutiny such that an increase in external scrutiny will further increase their perception of reputational risk and further increase their level of risk aversion.

MANAGING OUTSIDERS' REPUTATION: CREATING THE CELEBRITY CEO

We have argued thus far that increased scrutiny of outside directors has intensified their concerns with their reputations. Coupled with the asymmetric impact of negative events on outsiders' reputations, this heightened attention has generated more risk-averse behavior from outside directors than would otherwise be predicted by agency theory. With this increase in risk-averse behavior has come an increased need for outside directors to manage their reputations. One way that they can do so is to facilitate the creation of celebrity CEOs.

The utility of a celebrity CEO for mitigating the risks to an outside director's reputation from negative firm outcomes is based on reinforcing the "romance of leadership" bias whereby observers tend to over-attribute firm-level successes and failures to the CEO (Meindl et al., 1985; Wiesenfeld et al., 2008). Outside directors may take advantage of this bias so that an external observer of the firm ascribes organizational outcomes to the CEO, regardless of valence. We suggest that outside directors take a

series of actions to magnify the effects of the biases associated with the romance of leadership and to minimize the risk to their reputations from poor firm performance.

Successfully creating a celebrity CEO results in CEOs who have firm's actions and performance attributed to them, usually by the external monitors such as the media and investor groups (Hayward, Rindova, & Pollock, 2004). The attribution of successful firm performance to a CEO creates a "star" CEO who has been anointed by experts as a top performer (Wade et al., 2006). The principal advantage to outside directors from creating a celebrity CEO is the increased attention paid to the CEO and to tighten the perceived coupling between the CEO and organizational outcomes.

The result of this tightened coupling is the added protection of outsiders' reputations from negative firm outcomes. As CEOs become celebrities, their pay becomes more tightly coupled with firm performance (Graffin, Wade, Porac, & McNamee, 2008; Malmendier & Tate, 2005; Wade et al., 2006), but this coupling can have positive or negative consequences. For example, prior research has shown that while being a celebrity can be lucrative for a CEO, it can also lead to dismissal (Fombrun, 1996; Wade et al., 2006). Therefore, by placing the CEO on a pedestal which places the credit or blame for firm actions squarely on the CEO's shoulders, the board can separate itself from the firm's performance. We thus propose:

Proposition 6: Firms with outside directors who are actively engaged in reputational management activities are more likely to create celebrity CEOs.

We envision three specific actions that outside directors can take to create celebrity CEOs. First, by making the CEO the chair of the board of directors, outside

directors can raise the profile of the CEO and tighten the linkage to firm performance for the CEO. Second, outside directors can increase CEO compensation as a justification of outstanding CEO performance. Increasing CEO compensation while praising the CEO's performance will raise the profile of the CEO with external observers and tighten the linkage with performance (Graffin et al., 2008; Milbourn, 2003). A third action that outside directors can use to aid in the creation of celebrity CEOs is to grant CEOs freer rein in setting firm strategies. By allowing the CEO greater freedom to set strategy, outside directors portray the CEO as an expert manager who does not require close guidance in leading the firm. Each of these actions—granting duality, increasing compensation, and permitting “free rein”—serve as reputation management tactics that not only create a celebrity CEO but also tighten the linkage of the CEO to firm performance.

Proposition 7: Firms with outside directors who are actively engaged in reputational management activities are 1) more likely to grant the CEO duality; 2) more likely to pay CEOs higher salaries and to justify these salaries with claims of superior CEO quality; and 3) more likely to allow greater freedom in setting the strategies of the firm.

Scapegoating

The process of creating a celebrity CEO is aided by the CEO who wishes to gain the rewards from this newfound fame. A number of positive personal outcomes for celebrity CEOs have been found: CEOs gain additional rents from the firm, higher compensation, and their evaluative uncertainty is lessened in a positive manner (Graffin et al., 2008; Malmendier & Tate, 2005; Wade et al., 2006). In short, when positive firm

performance is occurring, celebrity CEOs enjoy rewards in excess of non-celebrity CEOs (Wade et al., 2006). Thus, just as boards may actively work to elevate the CEO to celebrity status, the CEO will also likely embrace this attention in order to reap the associated rewards.

After a celebrity CEO has been created and the linkage with the performance of the firm has been tightened, future interpretations of firm outcomes are simplified. In the case of negative firm outcomes, directors, by elevating the CEO, can separate themselves from possible reputational damage (Wiesenfeld et al., 2008). Separation from a negative event is a well known tactic presented in the stigma management literature (Semadeni et al., 2004). Successful separation requires the reduction of the link between that person and a negative event in order to avoid receiving the attribution for the event (Semadeni et al., 2004; Wiesenfeld et al., 2008). Having already created a tight linkage between firm performance and the CEO, outside directors can use this linkage so that the attribution for poor firm performance is attributed more fully to the CEO.

Directing the attribution for poor firm performance onto the CEO is what Gamson and Scotch (1964) referred to as “ritual scapegoating.” Successful scapegoating requires that the CEO is perceived as effective in determining the performance outcomes of the firm; that is, both positive outcomes and negative outcomes must be seen as coming from the actions of the CEO (Gamson & Scotch, 1964). Thus, when the CEO is tightly linked to firm outcomes, effective scapegoating can occur when negative events arise. The members of the board can then disavow the actions of the CEO, claim to have been “left in the dark,” or make claims of CEO misrepresentations to the board to protect their

reputations. Once again by placing the CEO on a pedestal, it is easier to link firm outcomes to the performance of the CEO.

In order to successfully accomplish scapegoating, the CEO must be eventually exiled from the firm. Thus, in order to achieve reputation protection for outside directors during declining firm performance, CEOs are more likely to be dismissed during periods of poor performance.

Proposition 8: Firms with outside directors who are actively engaged in reputational management activities are more likely to have CEO turnover during periods of poor firm performance.

Interestingly there appears to be little downside for outside directors who engage in these reputational management activities. First, outside directors most likely have little vested financial interest in a company's success. As the largest proportion of outside directors are high-level executives at other firms (Linck et al., 2009), their director compensation may represent a very small portion of their overall income. Second, there is little actual downside for outside directors to attribute the firm's success solely to the CEO because the board may take credit for hiring a successful CEO when there are positive firm outcomes (Wade et al., 2006). Outside directors can represent themselves as expert directors for their oversight responsibilities of such a successful CEO and might enhance their reputation as expert managers (Fama & Jensen, 1983; Graffin et al., 2008). The effects of having these countervailing forces of CEO celebrity is that when outside directors are engaged in reputational management activities, a CEO is likely to be paid more but to also have a higher rate of departure if company performance turns negative. Thus, it appears that by creating a celebrity CEO, an outside director's reputation may be

able to realize a small gain from good firm performance, but protect it from the significant negative effects from poor firm performance.

Proposition 9: A celebrity CEO will enhance outside directors' reputations when the firm has good performance and will disproportionately reduce the harm to outside directors' reputation with poor performance.

MODERATORS OF OUTSIDERS' REPUTATION MANAGEMENT

As directors work to preserve their board reputation, it is important to consider what circumstances may affect the likelihood of the above processes occurring. First, the higher the firm's visibility, the more likely that outside directors will act to protect their reputation, given that the scrutiny they face is amplified for the most highly visible firms (cf. Pfarrer, DeCelles, Smith, & Taylor, 2008). More specifically, the higher the visibility of the firm, the more likely that negative outcomes will be exposed by the media and other "infomediaries." Thus we expect that the increased visibility of a particular firm will amplify the scrutiny of its board members.

Second, longer-tenured directors will be more tightly linked to the firm. Thus, the longer their service as a board member, the more likely they will desire to engage in activities to protect their reputation and distance themselves from negative outcomes.

Third, we also suggest that the more concentrated the stock ownership in the firm, the less likely board members will actively work to manage their reputations. Board members have less incentive in a situation where a large shareholder controls the majority of firm ownership because the performance of the firm will be linked primarily to this large shareholder.

Finally, institutional investor ownership of a large portion of the firm may also lead to more reputation management by board members. To the extent that such concentrated ownership increases the amount of external monitoring, this will increase the likelihood that directors will actively attempt to preserve their own reputations.

Proposition 10: Firms with 1) greater visibility; 2) longer-tenured outside directors; 3) lower concentrated ownership; and 4) larger levels of institutional ownership will have outside directors who will be more likely to be engaged in reputational management activities.

CONCLUSION

The reputational perspective on boards of directors offered in this study lends a number of insights into the corporate governance literature. First, our theoretical perspective suggests that in light of recent increased scrutiny, outside directors may be more likely to act in ways to protect their reputations. Reputation management actions practiced by outside directors reveal that outside directors, rather than being risk-neutral monitors who actively seek to oversee managers on behalf of shareholders may, in actuality, be risk-averse executives who are seeking to protect their own reputations from the damage that may result from their directorship duties. Indeed, as the majority of outside directors are executives elsewhere (Fama & Jensen, 1983; Linck et al., 2009), many have a vested interest in protecting their reputations as competent executives. We suggest that these individuals will actively work to protect their reputations from damage that may occur as a result of serving on boards of directors.

Second, this perspective highlights that outside directors may have a vested interest in generating and perpetuating CEO celebrity so that any negative performance

outcomes that may occur are attributed to the celebrity CEO rather than to their failure as directors. Third, the increasing scrutiny on board actions may lead to increased reputational management activities which result in higher CEO compensation and higher CEO turnover. Indeed, the reputational perspective suggests that filling the board with an increasing percentage of outsiders, as recent regulations have urged, may actually amplify the processes outlined here. Fourth, our theoretical framework suggests that the burden of celebrity may not only include a tighter coupling of CEO pay and firm performance for celebrity CEOs, but also that this burden may extend to these individuals being more likely to be dismissed if firm performance becomes negative. Additionally a number of variables, such as firm visibility, outside director tenure, and stock ownership, may influence this process. These insights suggest that the reputation-based view of corporate governance offers many theoretical contributions to agency theory and the role of celebrity in organizations.

Agency theory generally advocates for increasing the number of outsiders serving on corporate boards. It is thought that outsiders will provide better monitoring of management and be able to better represent the risk neutral preferences of principals (Baysinger & Hoskisson 1990; Kosnik, 1987). In response to calls for better corporate governance and regulatory change, an increasing proportion of corporate boards are comprised of outsiders (Linck et al., 2009). Additional recent empirical findings have shown a decrease in risk taking among firms in which greater numbers of outside directors serve (Bargeron et al., 2010). In this paper, we argue that the behavioral drivers for this disconnect with agency theory can be explained through a reputational perspective.

Outside directors have valuable reputations that they seek to maintain. Their reputations are put at risk when poor firm outcomes occur (Milbourn, 2003). As a result, outside directors are becoming less risk neutral and more risk averse. Additionally, as the risk to outside directors' reputations has increased due to recent heightened legislative, investor, and media scrutiny of their actions, outside directors have taken more precautions to guard their reputations (Fombrun, 1996).

One way in which outside directors may attempt to protect their reputations is to create CEO celebrities to serve as effective scapegoats. Whether firm performance rises or falls, external observers are more likely to attribute the firm's results to the actions of a celebrity CEO rather than those of outside directors. Given that outside directors receive greater blame for failure than they do praise for success (Gillespie & Zweig, 2010), increasingly risk-averse outsiders are willing to sacrifice any potentially large upside for the shield that a scapegoat CEO provides their reputations when things go bad.

Finally, a reputational perspective on corporate governance may offer more effective methods of reducing the agency problem due to differential risk preferences. In order to align risk preferences, outside directors must not be concerned with maintaining executive positions at other firms. Increased use of retired executives or tenured academics as outside directors could alleviate the problem of different risk preferences as these outside directors will have to worry less about reputational damage from poor firm performance leading to a loss of primary employment. Other potential solutions such as professional directors may also alleviate the risk preference problem.

In conclusion, as corporate governance practices evolve, solutions proposed to old problems may prove ineffective for a number of reasons. The use of a reputational

perspective on corporate governance may aid the analysis process and provide insight into future problems which would have been otherwise missed. The insights provided in this paper suggest that the reputation-based view of corporate governance represents fruitful ground for future research opportunities.

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CHAPTER 3

CONCLUSIONS

The reputational perspective on boards of directors offered in this study lends a number of insights into the corporate governance literature and provides a framework for potentially explaining outcomes which are dissonant from those predicted by agency theory. First, the theoretical perspective suggests that in light of recent increased scrutiny, outside directors may be more likely to act in ways to protect their reputations. Reputation management actions practiced by outside directors reveal that outside directors, rather than being risk-neutral monitors who actively seek to oversee managers on behalf of shareholders may, in actuality, be risk-averse executives who are seeking to protect their own reputations from the damage that may result from their directorship duties. Indeed, as the majority of outside directors are executives elsewhere (Fama & Jensen, 1983; Graffin et al., 2012; Linck et al., 2009), many have a vested interest in protecting their reputations as competent executives. Incorporating these perspectives suggests that these individuals will actively work to protect their reputations from damage that may occur as a result of serving on boards of directors.

Second, this perspective highlights that outside directors may have a vested interest in generating and perpetuating CEO celebrity so that any negative performance outcomes that may occur are attributed to the celebrity CEO rather than to their failure as directors. Third, the increasing scrutiny on board actions may lead to increased reputational management activities which result in higher CEO compensation and higher

CEO turnover. Indeed, the reputational perspective suggests that filling the board with an increasing percentage of outsiders, as recent regulations have urged, may actually amplify the processes outlined here. Fourth, this theoretical framework suggests that the burden of celebrity may not only include a tighter coupling of CEO pay and firm performance for celebrity CEOs, but also that this burden may extend to these individuals being more likely to be dismissed if firm performance becomes negative. Additionally a number of variables, such as firm visibility, outside director tenure, and stock ownership, may influence this process. These insights suggest that the reputation-based view of corporate governance offers many theoretical contributions to agency theory and the role of celebrity in organizations.

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REPUTATION PROTECTION

Outside directors have valuable reputations that they seek to maintain. Their reputations are put at risk when poor firm outcomes occur (Graffin et al., 2012; Milbourn,

2003). As a result, outside directors are actively avoiding reputation harm by becoming less risk neutral and more risk averse with their decisions. Additionally, as the risk to outside directors' reputations has increased due to recent heightened legislative, investor, and media scrutiny of their actions, outside directors have taken other precautions to guard their reputations (Fombrun, 1996; Graffin et al., 2012).

One way in which outside directors may attempt to protect their reputations is to create CEO celebrities to serve as effective scapegoats. Whether firm performance rises or falls, external observers are more likely to attribute the firm's results to the actions of a celebrity CEO rather than those of outside directors. Given that outside directors receive greater blame for failure than they do praise for success (Gillespie & Zweig, 2010), increasingly risk-averse outsiders are willing to sacrifice any potentially large upside for the shield that a scapegoat CEO provides their reputations when things go bad.

Finally, a reputational perspective on corporate governance may offer more effective methods of reducing the agency problem due to differential risk preferences. In order to align risk preferences, outside directors must not be concerned with maintaining executive positions at other firms. Increased use of retired executives or tenured academics as outside directors could alleviate the problem of different risk preferences as these outside directors will have to worry less about reputational damage from poor firm performance leading to a loss of primary employment. Other potential solutions such as professional directors may also alleviate the risk preference problem.

NEW SOLUTIONS TO EXAMINE

In conclusion, as corporate governance practices evolve, solutions proposed to old problems may prove ineffective for a number of reasons. The use of a reputational

perspective on corporate governance may aid the analysis process and provide insight into future problems which would have been otherwise missed. The insights provided in this work suggest that the reputation-based view of corporate governance represents fruitful ground for future research opportunities and provides heightened understanding of the realities of the “black box” of corporate governance.

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