

**Boards of Directors in an Era of Corporate Scandal:
An Examination of the Question of Motivation of Non-Executive Directors**

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Abstract

According to Daily and Dalton (2003), “Today, service as a corporate officer or director is more daunting a task than at any other time in business history.” With increasing potential liabilities, a greater personal commitment required because of an ever more complex business environment, and comparatively little remuneration, it is feared that qualified individuals will be less likely than ever to serve as non-executive directors (NEDs) on corporate boards. Dominant theories related to corporate governance, agency theory as well as the resource based view of the firm, provide a rationale for the role and importance of the NED, yet provide little insight into the motivation of an individual to serve as a NED. In light of the fears that qualified and experienced individuals will no longer be willing to become NEDs, this omission found in the corporate governance literature is surprising. In this paper we show how agency theory and the RBV of the firm have been deficient by not dealing with the question of director motivation. We also indicate how these theories can be enhanced by opening up new avenues of research which will lead to an integrative model of director motivation.

Introduction

On January 5th, 2005, 10 former non-executive directors (NEDs) of Worldcom agreed to pay damages to plaintiffs out of their personal funds to settle a class action lawsuit that had been brought against members of the Worldcom board in the follow-up to the debacle that had seen the collapse of the company and the loss of hundreds of millions of dollars to Worldcom shareholders. This sent a shock wave through corporate boards as directors wondered whether they, too, could be held personally liable for mistakes and lack of vigilance, which took place during their watch. Both the corporate and academic communities reacted with apprehension to this surprising development, fearing the effects it would have on potential directors' desire to serve on corporate boards. At a time when calls for increased NED representation on boards are being heeded in the United States and throughout the world, this development runs the risk of making well qualified NEDs harder to find and increasingly reluctant to serve on corporate boards. The paradox is that NEDs have been seen as those actors in corporate governance most likely to represent the interests of diverse shareholders, and most able to hold management accountable for its actions.

In light of today's fear that the increasing responsibilities and risks associated with being a NED will dissuade experienced and qualified individuals from serving as directors, it appears to us that now is the right time to address an issue which has curiously remained unaddressed in corporate governance research: the motivation to serve as a NED. What motivates an individual to become a NED? Daily and Dalton (2003) have stated "Today, service as a corporate officer or director is more daunting a task than at any other time in business history." Much recent research in the area of corporate governance has concerned the

rationale behind and the impact of the appointment of increasing numbers of NEDs to corporate boards. From the standpoint of the major theories that have informed corporate governance practice over the past decades, the anticipated benefits accruing to the firm from increased NED presence on corporate boards have been well spelled out. And yet scholars, the corporate community, and the business press are sounding an alarm over the possibility that well qualified individuals will be increasingly unlikely to seek service as a NED on a corporate board.

Our purpose in this paper is to address what we consider an issue which has not been a major focus of corporate governance research, but which recent events have shown could be an area critical to the board's success as an institution: the motivation of the non-executive director. We would like to explore how theories of corporate governance can integrate the essential question of what motivates an individual to become a NED, and move toward an integrative model of motivation. By better understanding what motivates a person to serve as a NED, we may be better able to confront the crisis of the dearth of individuals willing to serve in this important capacity.

The Paradox of the Non-Executive Director

The corporate governance literature is not lacking in research concerning NEDs. Most of the research, however, has dealt primarily with board structure. McNulty and Pettigrew (1996), identified the roles of directors in terms of three main perspectives: a governance perspective, concerned with the monitoring function of the board, a strategic perspective, concerning decisions enabling the firm to change, and the resource perspective, which is concerned with how the board links the firm to its external environment and enables it to acquire critical

resources. NEDs are seen as playing important roles in each of these areas, and board literature from each of these perspectives provides arguments for the increased presence of NEDs on boards. For the strategy perspective, see: (Pass, 2004), for the governance perspective, see: (Baysinger and Butler, 1985; Daily and Dalton, 1994b, Waldo, 1985), for the resource perspective, see: (Boussouara & Deakins, 2000; Hambrick & D'Aveni, 1992.)

The emphasis on board structure in the research led to numerous studies of the impact of NEDs on firm performance (Finkelstein and Hambrick, 1990; Zahra and Pearce, 1989). Some studies found that higher numbers of NEDs on boards were associated with higher profitability (Ezzamel and Watson, 1993; Pearce and Zahra, 1992; Rosenstein and Wyatt, 1990) or with higher ROE (Baysinger and Butler, 1985). One study (Brickley, Coles, and Terry, 1994) determined that, during takeover attempts, shareholders reacted more positively when more non-executive directors sat on a board. Despite the findings of these studies, other empirical studies demonstrated that no clear link could be established between the number of NEDs present on a board and firm performance (Daily and Dalton, 1992; Wagner, Stimpert, and Fubara, 1998; Wood and Patrick, 2003; Zahra and Stanton, 1988). Some studies even found a negative relationship between the number of NEDs on a board and firm performance (Bhagat and Black, 1999; Yermack, 1986). Results of meta-analyses have not provided a conclusive answer, either. A meta-analysis carried out in 1998 of 54 studies of the relationship between board composition and firm financial performance could not find any link (Dalton, Daily, Ellstrand, and Johnson, 1998). A meta-analysis carried out in 2000 of 59 studies of this relationship (Rhoades, Rechner, and Sundaramurthy, 2000) could find only a very small link between board composition and firm performance. Thus, after considerable research studying the effects of NEDs on firm performance, the results were summed up by

James Westphal (2002) when he stated: “Nearly two decades of research find little evidence that board independence enhances board effectiveness”.

The lack of conclusive evidence linking board structure to firm performance turned researchers’ attention back to the black box of board process, and emphasized the element of firm context in determining the role and value of the NED (Huse, 2004; Weir and Lang, 2001). This focus has enriched our theoretical insights into the major issues and problems of corporate governance (Hoskisson, Hitt, Wan, and Yiu, 1999). The perspective of board process and firm context in reference to NEDs has seen researchers concentrate on such issues as director competences and skills. A consensus has grown among researchers that NEDs must bring a variety of skills to their appointments, and NEDs must be sensitive to firm context (Kakabadse et al, 2001; Tosi and Gomez-Mejia, 1994). In terms of the strategy and resource perspective mentioned above, NEDs are seen as being able to link their firms to informal networks, provide contacts in new markets, and improve the credibility of the firm in new markets (Hambrick & D’Aveni, 1992). In an even broader context, NEDs have been called upon to provide guidance with regard to growth strategies, general problem solving, strategic planning, recruitment and staff development, and marketing (Boussouara & Deakins, 2000).

While advances in research dealing with both the impact of NEDs as well as the competences and skills which are required of them have served to underline the potential benefits to a firm of increased NED representation on the board, their limitation is the fact that each of these perspectives views the NED only from the point of view of the firm. Surprisingly little research has directly addressed what should be one of the most important issues concerning the NED: his or her motivation to become one. Some researchers have put forward rationales

which may induce an individual to serve as a NED: such appointments increase the individual's prestige, expand his or her network of influential contacts, and expose him or her to a wide range of business situations (Mizruchi, 1996). The downsides of service as a NED, however, are also apparent: service as a NED increasingly requires a significant personal commitment for comparatively little remuneration. Furthermore, the potential liabilities of service as a NED are increasing, to such an extent that one may wonder why anyone would become a NED (Hambrick and Jackson, 2000).

What corporate governance research is lacking is the incorporation of NED motivation into the corporate governance theoretical framework. We believe that research concerning boards, whether examining board structure or board process, is incomplete unless it also considers the motivation of the NED to accept this responsibility. As stated above, our purpose is to show how corporate governance theories can integrate this important issue of director motivation. We now turn our attention to the major theories of corporate governance in an effort to accomplish this task.

NEDs and the Alignment of Interests: Agency Theory in Question

The foundation of agency theory, which has been one of the dominant theories of corporate governance since the last quarter of the twentieth century, is the observation of Berle and Means (1932) concerning the separation of ownership and control in the modern corporation. Agency theory sees the firm as a nexus of contracts (Fama, 1980). Therefore, the unit of analysis of the firm under agency theory is the contract. According to agency theory, the separation of ownership and control, which as noted above, is one of the hallmarks of the modern corporation, will lead in many instances to firm managers using their firm-specific

knowledge and managerial expertise to gain an advantage over the firm's owners, who are absent from the day-to-day affairs of the firm. Since the managers are "in control" of the firm, the risk is that they will pursue actions in their own self interest, and not in the interest of the owners (Jensen and Meckling, 1976). Agency theory recognizes specific roles for the main actors in corporate governance, stipulating that it is up to top management to take strategic decisions, and that shareholders have the power to hold management accountable according to firm results obtained (Fama and Jensen 1983a). It could be said that agency theory became the main theory of corporate governance in the 1980's, and that it defined corporate governance in terms of balancing the interests of the firm's principals, the shareholders, with the responsibilities and expertise of the firm's top managers.

Agency theory's validity and coherence depend upon the existence of mechanisms by which firm owners are able to monitor the performance of managers to verify that firm managers are using their own competences, and the firm's resources, to achieve the best returns for the principals (Fama 1980). Agency theory identifies the board of directors as the primary internal control mechanism enabling firm principals to monitor management behaviour. According to the theory, one of the main tasks of the board is to specifically carry out the monitoring function on behalf of the firm's owners, acting to remove managers who misuse firm assets and participating in the formulation of strategic decisions which have a considerable impact on shareholder investments (Fleischer, Hazard and Klipper, 1988; Waldo, 1985). It is for this reason that advocates of corporate governance reform have long emphasized the independence of board members as being critical to their ability to carry out the monitoring function. Increasing the number of NEDs on a board will increase the board's independence, according to agency theory (Baysinger and Butler, 1985; Waldo, 1985).

Agency theory identifies the actors in the governance of the firm as “principals” or “agents”, and holds the view that the essential “problem” of corporate governance is the alignment of interests between the principals and agents. According to agency theory, the owners, or shareholders, are the principals, and the firm managers are their agents. But where does this leave the board of directors as the primary control mechanism? We believe that under agency theory, the board of directors in general, and NEDs in particular, are a “weak link” in the corporate governance framework. Board members may also be considered part of the nexus of contracts, which go to make up the firm, and if their primary function is one of monitoring management, then board members, particularly NEDs, are also acting as agents of the firm owners. If this is so, then one must also consider the alignment of interests between the principals (firm owners), and their agents (NEDs). This brings us back to our basic question: what is the interest of an individual to serve as a NED?

While agency theory does an adequate job of describing the alignment of interests between firm owners and managers (Baysinger and Hoskisson, 1989; Gomez-Meija, 1994; Hoskisson and Turk, 1990; Zahra and Pearce, 1989), almost no research has been done to describe the alignment of interests between firm owners and NEDs. Very few studies in the agency theory framework indicate the interest in serving as a NED from the NED’s point of view. A small number of studies has dealt with the issue of aligning the interests of NEDs with those of the firm owners, but these have largely seen increased shareholding on the part of NEDs as a solution to the problem of the alignment of interests (Hambrick and Jackson, 2000; Pass, 2004). While this addresses the issue from a mechanistic point of view, it presupposes that the NED has already agreed to serve and thus does not address the issue of an individual’s motivation to serve as a NED in the first place.

While we consider the lack of research into the motivation of an individual to serve as a NED a flaw in the agency theory framework, we do recognize the difficulty inherent in researching unobservables (Godfrey and Hill, 1995). It has already been observed that carrying out research into human motives is fraught with difficulties (Hoskisson and Hitt, 1990). Nevertheless we believe that researchers should endeavour to enhance the agency theory perspective with insights from other research perspectives to arrive at an integrated model of motivations in the area of corporate governance.

Directors or Consultants? : The Resource Based View

Recent research in the area of corporate governance has followed a more general trend in the area of strategic management to consider more closely the “black box” of the firm, and to see the firm as a bundle of unique resources, which when used effectively can provide the firm with its competitive advantage (Barney, 1991; Grant, 1996). This has come to be known as the Resource Based View of the Firm (RBV). Some corporate governance researchers have taken a view that it is an error to overemphasize the monitoring role of boards, and that more emphasis should be paid to the skills and other knowledge resources that directors, and particularly NEDs, can bring to the firm (Short, Keasey, Wright, and Hull, 1999). This has coincided with other efforts in corporate governance research to increase the focus on firm context and board process (Huse, 2004). With this increasing emphasis on issues of firm context and boardroom processes, and with certain weaknesses increasingly apparent in the agency theory view of the role of the NED, the RBV has provided supplementary rationales to support the widespread calls for increased NED presence on corporate boards. In contrast to agency theory, with its emphasis on managing conflicting goals among managers and shareholders within the firm, the resource based view underlines the role that the NED can

play in bringing unique resources to the firm. According to this theory, it is the task of management to gather and deploy the unique assets of the firm so as to achieve competitive advantage (Wernerfelt, 1984).

How does the resource based view impact the perceived role and expectations attached to the NED? Simon (1991) stated that firms can learn in only two ways: through the knowledge of its members, or, by integrating new members who possess knowledge that the firm did not previously have. By recruiting NEDs, firms use a particularly efficient method of integrating knowledge. Researchers in the RBV perspective, when identifying the skills, which are the most important availing firms of a competitive advantage, cite functionally based distinctive competencies (Hitt and Ireland, 1986), and a unique combination of business experience (Spender, 1989). Specifically, firms are increasingly seeking to recruit NEDs who will be able to provide them with knowledge assets, often coming from outside the firm itself. NEDs are also members of social networks, with access to critical knowledge, which can be put to the service of the firm (Huse, 1998). Closely related to this is the belief that the presence of NEDs facilitates the development of relationships within an organization, and that this in turn fosters improved communication and the development of knowledge (Lewicki & Bunker, 1996).

While agency theory saw the role of the NED primarily in terms of monitoring, the current view of the NED is that he or she must bring to the firm a wide variety of competences which can be contributed to the performance of the company: financial and marketing skills, business sector knowledge, links to the financial sector, experience leading change, as well as the ability to be a mentor (Kakabadse, Ward, Korac-Kakabadse, Bowman, 2001). In terms of the strategy and resource perspective, NEDs are seen as being able to link their firms to

informal networks, provide contacts in new markets, and improve the credibility of the firm in new markets (Hambrick & D'Aveni, 1992). In an even broader context, NEDs have been called upon to provide guidance with regard to growth strategies, general problem solving, strategic planning, recruitment and staff development, and marketing (Boussouara & Deakins, 2000).

While the RBV has provided important new insights with regard to corporate governance and the role of NEDs, we encounter the same situation concerning director motivation in the RBV framework as was encountered under the agency theory view: the theory has much to say with regard to the firm's motivation for seeking out a highly qualified individual who is able to provide the firm with unique knowledge assets in his or her capacity as a NED, but is silent with regard to the NED's motivation. In fact, it could be said that here we encounter a paradox, which is at the heart of NED service on behalf of a firm: Why would a non-executive director who possesses a specific asset, his or her expertise, agree to share this expertise for a relatively insignificant remuneration? What motivates such an individual to serve as a NED rather than as a well-paid consultant?

In line with our observations concerning the fact that agency theory provides little guidance concerning the motivation for an individual to monitor a firm and its managers of which he or she is by definition independent, the RBV likewise provides little insight into the motivation of an individual to provide a firm with the benefits of his or her skills, competencies, and experience as a NED, when this position is often poorly remunerated, and is increasingly exposing him or her to damaging liability claims.

As with agency theory, we recognize that the RBV is also subject to methodological weaknesses. Like motivation, corporate culture, tacit knowledge, capabilities, and intangible firm resources have proven very difficult to measure (Barney, 1986b; Hitt, Gimeno, and Hoskisson, 1998; Kogut and Zander, 1992). The inability to measure the impact of these elements is seen as an overall weakness of the RBV (Robins and Wiersema, 1995).

We believe, however, that it is important for researchers to gain insights into the motivation of these individuals who are seen as indispensable actors in corporate governance, for the very reasons cited in both the agency theory literature and the RBV literature. In the following section we shall lay out a potential framework for an integrative model of motivation for the NED.

Towards an Integrative Model of Motivation

The Agency Theory and RBV frameworks, which have been employed comprehensively to explain a firm's motivation for employing a NED, do not directly address the question of the motivation for an individual to become a NED. The literature dealing with NEDs has offered suggestions which seek to explain what may motivate an individual to serve as a NED: prestige, expansion of personal contacts, exposure to different business structures and experiences (Hambrick and Jackson, 2000), but the foundations of these viewpoints are not empirical. There is a corporate governance literature which seeks, empirically, to explain how individuals could be motivated to serve as NEDs, and the conclusion usually takes the form of a suggestion to align the interest of the NEDs with the interests of the owners by increasing the ownership stake of the NEDs themselves (Hambrick and Jackson, 2000; Pass, 2004). This emphasis on the alignment of interests is firmly embedded in the agency theory

framework, yet it is usually framed in terms of motivating NEDs after they have agreed to serve, and thus does not directly address the question of what might motivate a NED to serve in the first place.

Thus while agency theory sees the NED's value primarily in his role as a monitor of firm management, it does not explain the paradox of why a person with few, if any, significant ties to the firm would agree to monitor the management of that firm. While the resource perspective of board research, in conjunction with the wider RBV of the firm, sees the NED as a valuable source of skills and experience which could contribute to the competitive advantage of the firm, it does not venture to explain why a highly qualified individual would be willing to share his or her valuable skills and experience with a firm with he or she, admittedly, does not have close ties, and for which the remuneration is often quite low.

We believe that it is important to integrate the question of motivation into board research in light of the perceived "crisis" in the recruitment of NEDs as a result of the increased responsibilities associated with the job, as well as the potential for increased liabilities following corporate scandals which have affected NEDs' personal assets. We believe that an integrative model of non-executive director motivation must build upon both agency theory and the RBV of the firm, yet expand the boundaries of research to include other perspectives. Here we provide a number of promising theoretical perspectives and hypotheses which may be useful in constructing a model of non-executive director motivation.

One of the most interesting theoretical developments, which could have an impact on the exploration of NED motivation, is stewardship theory. Stewardship theory has emerged as an addition to agency theory in the literature, which seeks to explain management behaviour

(Davis, Schoorman, and Donaldson, 1997). We believe that it could also shed light on director motivations. Stewardship theory takes exception to agency theory's depiction of individuals as individualistic, opportunistic, and self-serving, requiring a proactive "alignment of interests" at best, and monitoring, at worst. As NEDs can be considered agents of the owners much like managers can, stewardship theory's observations concerning managers might be able to be applied to directors as well. Stewardship theory suggests that, contrary to agency theory's viewpoint, people may be motivated less by individual goals than is commonly believed. According to this framework, individuals serving as directors would be more inclined to embrace and seek to attain the goals of the organization, rather than their own personal goals. Stewardship theory is operationalised by combining the psychological attributes of the director with firm context (Davis, et al, 1997).

It is important to note, however, that while stewardship theory is seen as a promising avenue of research into manager and director motivations, it is a relatively new theory and needs to be validated by further research (Davis et al, 1997).

Based on the insights of Stewardship Theory, we propose the following hypothesis concerning motivation for service as a NED:

H1: An individual serving as a NED will be at least as motivated to serve the organization as to serve his or her own interests.

Theories concerning motivation have moved beyond a biological focus to a focus on social cognition (Pincus, 2004). Recent research into human motivation has focused upon social cognitive theories. Social cognitions are "cognitive processes and structures through which

individuals...regulate their motivation” (Cervone, 1991). While most of the literature dealing with social cognitions has dealt with subordinates (Phillips 1995), a growing body of research is addressing the social cognitions of leaders (Chemers, 2002). The social cognitions theory (SCT) framework endeavours to explain a wide range of human behaviours, including motivation (Bandura, 1997). This theoretical framework depicts the motivation of leaders as being the result of a dynamic process through which the leader’s social cognition, the firm context, and his behaviour, interact (McCormick and Martinko, 2004).

The basis of social cognitive theories of motivation is that all humans have needs for effective interactions with the environment (White, 1959). Built upon this fundamental need are other needs: the need for achievement (McClelland, 1961), the need for cognition (Cohen, Stotland, and Wolfe, 1955), the need to fit in, and the need for power (Atkinson, 1958). Each of these needs in the SCT framework could shed light upon the motivations of individuals to serve as NEDs. Indeed, they have been hinted at in the indications of researchers of boards of directors that NEDs are motivated by the prestige associated with their positions. Such motivations on the part of NEDs could help to explain the paradoxes that, as we have pointed out, are associated with service as a NED.

SCT of human motivation lead us to propose the following hypotheses with regard to NEDs:

H2a: Individuals serving as NEDs will be motivated by
a need for achievement.

H2b: Individuals serving as NEDs will be motivated by a need for cognition (i.e.- a need to exercise their faculties of thought and knowledge.)

H2c: Individuals serving as NEDs will be motivated by a need to fit in.

H2d: Individuals serving as NEDs will be motivated by a need for power

One further area of study which could lead to insights regarding NED motivation concerns corporate social responsibility (CSR). Corporate social responsibility is an increasingly important area of research in its own right, and some studies in the area of CSR have indicated that this field could provide insight into the motivations of NEDs. One study looked specifically at the level of CSR of executive vs. non-executive directors, and found that the NEDs had a significantly higher level of CSR than their executive counterparts (O'Neill, Saunders, and McCarthy, 1989). Some research has concluded that NEDs are often motivated by what they perceive to be their responsibility toward the firms, which they serve, as well as society at large (Frederick, 1983; Ibrahim and Angelidis, 1995). In light of these results, we may conclude that attitudes toward social responsibility may be an influential factor in the motivation of an individual to serve as a NED.

The CSR perspective of human motivation leads us to propose the following hypotheses:

H3: Individuals serving as NEDs will be motivated

by a sense of responsibility toward the firm and toward society as a whole.

Conclusion

In this paper we have shed light upon one of the dilemmas facing boards of directors today: how to ensure that well qualified and experienced individuals will be motivated to serve as non-executive directors on corporate boards. The academic community and business practitioners have grown increasingly concerned that the responsibilities and potential liabilities of NED service will diminish the pool of those willing to be NEDs, and that this will have a negative impact on corporate performance.

In our view, these concerns have highlighted the fact that theories dealing with corporate governance research, namely agency theory and the RBV of the firm, are incomplete when studying NEDs. Corporate governance research has emphasized the rationale for and the impact of NEDs on corporate boards, as well as the competences required of NEDs. What these theories have not adequately considered is the motivation of individuals to be NEDs. Therefore, knowledge concerning NED motivation is a “weak link” in the corporate governance research, which needs to be remedied.

In this paper we have proposed a number of avenues for further research into director motivation. These include: stewardship theory, social cognitive theory, and corporate social responsibility. Stewardship theory takes exception with the agency theory perspective and suggests that individuals are more motivated by collective goals for the good of the organization than has commonly been assumed. Social cognitive theory sees motivation as a

function of common human needs, which can be identified, such as the need for achievement, the need to fit in, and the need for power. Corporate Social Responsibility research has indicated that NEDs may be motivated by their feelings of social responsibility.

We believe that these areas provide researchers with new avenues of research, which will expand knowledge concerning the motivation of NEDs. A better understanding of motivation will permit firms to identify and encourage those individuals who are most likely to contribute their skills and experience to firms through corporate boards.

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