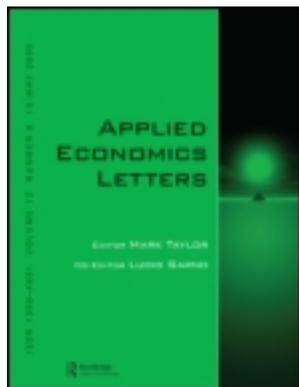


This article was downloaded by: [Wichita State University]

On: 16 April 2012, At: 10:59

Publisher: Routledge

Informa Ltd Registered in England and Wales Registered Number: 1072954 Registered office: Mortimer House, 37-41 Mortimer Street, London W1T 3JH, UK



## Applied Economics Letters

Publication details, including instructions for authors and subscription information:

<http://www.tandfonline.com/loi/rael20>

### Inter-board pay differentials for directors with multiple appointments

Kathleen Farrell<sup>a</sup> & Philip L. Hersch<sup>b</sup>

<sup>a</sup> Department of Finance, University of Nebraska-Lincoln, Lincoln 214C CBA, NE, 68588-0405, USA

<sup>b</sup> Department of Economics, Wichita State University, Campus Box 78, Wichita, KS, 67260-0078, USA

Available online: 05 Mar 2012

To cite this article: Kathleen Farrell & Philip L. Hersch (2012): Inter-board pay differentials for directors with multiple appointments, Applied Economics Letters, 19:14, 1401-1404

To link to this article: <http://dx.doi.org/10.1080/13504851.2011.631881>

PLEASE SCROLL DOWN FOR ARTICLE

Full terms and conditions of use: <http://www.tandfonline.com/page/terms-and-conditions>

This article may be used for research, teaching, and private study purposes. Any substantial or systematic reproduction, redistribution, reselling, loan, sub-licensing, systematic supply, or distribution in any form to anyone is expressly forbidden.

The publisher does not give any warranty express or implied or make any representation that the contents will be complete or accurate or up to date. The accuracy of any instructions, formulae, and drug doses should be independently verified with primary sources. The publisher shall not be liable for any loss, actions, claims, proceedings, demand, or costs or damages whatsoever or howsoever caused arising directly or indirectly in connection with or arising out of the use of this material.

---

# Inter-board pay differentials for directors with multiple appointments

Kathleen Farrell<sup>a,\*</sup> and Philip L. Hersch<sup>b</sup>

<sup>a</sup>*Department of Finance, University of Nebraska-Lincoln, Lincoln 214C CBA, NE 68588-0405, USA*

<sup>b</sup>*Department of Economics, Wichita State University, Campus Box 78, Wichita, KS 67260-0078, USA*

---

We analyse uniformity in the market's valuation of director human capital by comparing director compensation across firms with and without director overlaps. We find that although there is less variation in director compensation for connected boards, which share a common director, than for unrelated boards, there remains a high variation in director compensation for directors with multiple directorships. We also find that active Chief Executive Officers (CEOs), on average, command higher total director compensation in subsequent board appointments. This result holds for appointments where the individual already holds two or more directorships and is counter to the prediction of a busy director effect. Overall, our evidence suggests that active CEOs are high-quality directors or have a high disutility of additional board work and are able to command higher compensation when added to subsequent boards.

**Keywords:** board of directors; director compensation; connected boards; overlapping directors

**JEL Classification:** G30; G34; J33

## I. Introduction

The director labour market is one of the few labour markets where the same individual may command multiple wages for his/her expertise by simultaneously serving on multiple boards. For example, in 2004, Douglas Warner, the former Chief Executive Officer (CEO)/Chair of JP Morgan Chase served on the boards of Anheuser-Busch, Motorola and General Electric (GE). He received director compensation (annual retainer, equity awards and board meeting fees) of \$135 000, \$172 000 and \$250 000, respectively. Director compensation is unique relative to other types of managerial compensation in that outside

(nonemployee) director compensation is designed for a group of individuals and is not based on the unique characteristics of any individual director. The primary differences in compensation across individuals serving on the same board result from committee assignments, lead-director designation or attendance at meetings, not individual director qualities.<sup>1</sup>

Under the law of one price, an individual director bringing the same human capital to multiple board of director positions would be expected to earn comparable compensation on each. Alternatively, a director's compensation may vary across directorships if his/her skill set is not equally valued by all firms or adjustment constraints exist in the market. The lower valuation by

\*Corresponding author. E-mail: kfarrell2@unl.edu

<sup>1</sup>An exception is some boards provide an additional stipend to directors designated as financial experts.

firms, however, still requires the director's willingness to accept different pay across multiple directorships. In the case of Douglas Warner, the disparity in his compensation ranged from \$37 000 (Anheuser-Busch and Motorola) to \$115 000 (Anheuser-Busch and GE), illustrating the substantial variation in director compensation. The purpose of this article is to analyse to what extent individual director compensation varies across firms that share a common director.

Our analysis begins by examining outside director compensation for connected board pairs, where at least one outside director sits on both boards. Next, we analyse compensation for subsequent board appointments while considering whether the director is an active or former CEO to analyse the busy director effect.<sup>2</sup>

## II. Sample Selection and Pairwise Analysis

We draw director data from the 2004 Investor Responsibility Research Center (IRRC) database and identify all directors holding multiple directorships.<sup>3</sup> We then construct director compensation using corresponding data from ExecuComp.<sup>4</sup> We exclude committee and chair fees since they capture differences in specific board assignments.

We begin by creating connected board pairs, where at least one outside director sits on both boards. To focus exclusively on outside directors, we exclude firm pairs where an inside director also sits on both boards. If the board had two directors each sitting on the same other board, only one of the observations is used, resulting in 1999 unique board pairs.

To create a control sample or unrelated board pairs, we draw a random sample from the Cartesian product of all firms in the connected pairs set and then eliminate all pairs involving connections and duplicates ( $N = 51\ 184$ ). Our approach restricts both samples to the same universe, thereby controlling for firm characteristics.

For each board pair we calculate the absolute difference and absolute per cent difference in director compensation; the latter calculated using a midpoint formula: absolute difference divided by the midpoint of the two board incomes.<sup>5</sup> In Table 1, Panel A shows the mean absolute (%) difference in total director income is \$79 411 (53.6%) for connected boards versus \$97 133

**Table 1. Mean absolute (%) differences in outside director compensation**

	Mean absolute (%) differences	
	Connected boards (%)	Unconnected boards (%)
Panel A: All board pairs		
All income (\$)	79 411 (53.6)	97 133 (65.5)
Cash (\$)	20 279 (44.4)	21 056 (52.5)
Equity (\$)	76 006 (86.6)	92 720 (92.7)
<i>N</i>	1999	51 184
Panel B: Board pairs where the matched outside director on at least one board is in their first year of appointment.		
All income (\$)	91 676 (56.0)	109 483 (67.3)
Cash (\$)	22 607 (54.2)	24 882 (58.7)
Equity (\$)	92 474 (89.2)	104 376 (99.3)
<i>N</i>	146	28 785

(65.5%) for unconnected, which is significant at the 1% level. Equity compensation (stock and option awards) primarily accounts for the differences in director compensation across connected and unconnected pairs. These results indicate that a given director will have a smaller pay disparity across multiple board positions than will two directors drawn at random.

Since connected directors may influence pay on both boards reducing pay differentials,<sup>6</sup> we create a restricted sample to include only board pairs where the director is in his first year of appointment on at least one board. It is unlikely that directors would have any influence over director compensation in their first year of appointment. Using the restricted sample (Panel B), we find that the mean absolute (%) difference in the total director income is \$91 676 (56.0%) for connected boards versus \$109 483 (67.3%) for unconnected boards, which is significant at the 5% level. The difference across connected boards for an individual director is larger in the restricted sample (\$91 676 versus \$79 411), although the difference relative to the unconnected boards is comparable to Panel A (approximately \$18 000 lower differential in connected versus unconnected boards).

Overall, Table 1 suggests that there is less disparity in director compensation for connected boards than for unconnected, even after controlling for director ability to influence wages. What is surprising, perhaps, is that

<sup>2</sup> Ferris *et al.* (2003) described the business hypothesis as directors who are overcommitted by serving on multiple boards and as a result shirk their director responsibilities.

<sup>3</sup> We choose 2004 since it is post Sarbanes Oxley and is also the last year that IRRC collects director data.

<sup>4</sup> For details, see Farrell *et al.* (2008).

<sup>5</sup> The midpoint is used so that if we have two pairs, say (\$100 000, \$50 000) and (\$50 000, \$100 000), we get the same percentage difference.

<sup>6</sup> Bouwman (2011) found that director overlap leads to governance similarity and the results are driven by both directors being selected who serve on boards with similar governance practices and directors exerting influence over the governance practices after joining the board.

the difference between the two samples is not much larger. Based on the sample means of Panel A, holding director constant reduces the difference in means from \$97 133 to \$79 411. Although there is a smaller disparity in compensation for connected directors, the difference in compensation is still large (53.6%). Either different firms place widely different valuations on the human capital of given directors, or the governance norm of treating all directors on a board equally hinders the market from equalizing compensation across directorships for individual directors.

### III. Analysis of Pay Differentials

Given the significant pay differentials for individual directors serving on multiple boards in Table 1, we attempt to determine whether the pay differentials can be systematically explained. Using a sample of 2194 director pairs,<sup>7</sup> we regress absolute differences in director compensation on director characteristics (e.g. age, gender, occupation), with and without controls for differences in firm characteristics (e.g. size). Director characteristics have very little explanatory power.<sup>8</sup> For example, we find no greater variation for women versus men or CEOs versus non-CEOs. Next, we consider whether the ordering of appointments matters. As directors gain experience and reputation, they may obtain positions on higher paying boards.<sup>9</sup> For this result to hold for simultaneously held directorships, however, there would have to be some friction in director mobility. Otherwise, directors would resign from lower paying boards as their directorship opportunities increased. Yet, outside directors often serve on given boards for decades.

For each pair of appointments, we subtract annual compensation from the earlier acquired directorship from the latter. If both appointments occurred in the same year, the pair is dropped from the sample, leaving 1946 observations. When looking at all director pairs, evidence suggests ordering is unimportant. Only 51.6% receive more compensation in a latter appointment. (A Wilcoxon rank test, however, rejects that the difference between median *Income\_A* and *Income\_B* is 0 at the 5% level.) The average amount received is \$4234 (2.71%) greater, which while significant at the 10% level is economically small.

We also break out two subsamples: active CEOs of publicly traded firms and former CEOs of publicly traded firms (most of whom are retired). For active CEOs holding multiple directorships (where  $N = 182$ ), later appointments are likely to be more lucrative than earlier ones, with 59.3% of the sample receiving more. Additionally, on average, they receive \$19 000 (12.1%) more in the later appointment ( $p < 0.01$ ). Although, on average, former CEOs ( $N = 405$ ) also receive more (\$9196) in the later appointment (significant at the 10% level), the mean per cent difference is not significant, nor does the signs test support higher pay in later appointments.<sup>10</sup> If active and former CEOs have comparable skill sets, we conjecture that active CEOs, due to their high workloads, have a greater marginal disutility of work and, therefore, require greater compensation for taking on more board work.

A busy director effect would suggest that as directors add more directorships, they become less effective monitors. Therefore, we may expect additional directorships to be at lower compensation levels. Alternatively, if these directors become busy because they are effective directors and in high demand, we would expect them to command higher compensation. For example, Ferris *et al.* (2003) found that firm performance has a positive effect on the number of subsequent directorships held by a director suggesting that these directors are in higher demand.

We again measure the mean differences in compensation across ordered pairs where we order the directorships in time, but now restrict the sample to cases where the later appointment occurred when the director already was serving as a director on at least two other boards. Effectively the later appointment made the director a busy (or busier) director.

Overall, there is no evidence that those becoming busy directors are unable to command pay comparable to their earlier outside board appointments. For all busy appointments ( $N = 1012$ ), pay *increases* by an average \$8331, or 2.7% (only the dollar amount is significantly different from zero at conventional levels). Active CEOs, in particular, with a busy designation ( $N = 138$ ) command even higher compensation in the later paired appointment, on average, receiving a statistically significant \$27 234 (15.5%) more.<sup>11</sup>

<sup>7</sup> Note that those with more than two directorships will have an observation for each possible pairing.

<sup>8</sup> Regression results are not reported, but are available upon request.

<sup>9</sup> Conversely, if directors obtain bad reputations they might end up on lower paying boards. However, directors with bad reputations are unlikely to receive multiple directorships.

<sup>10</sup> We also performed regression analysis where the dependent variable was the ordered pair compensation difference for each director under various control sets. The results and inferences are qualitatively the same as those discussed and available upon request.

<sup>11</sup> We performed regression analysis where the dependent variable was the ordered pair compensation difference for directors serving on more than two boards. The results and inferences are qualitatively the same as those discussed.

#### IV. Conclusion

Although human capital theory predicts that individual directors bringing the same human capital to multiple board positions should earn the same compensation, we find that a substantial amount of variation continues to exist in director compensation across firms that share a common director. Our results suggest that either different firms place widely different valuations on the human capital of given directors, or the governance norm of treating all directors on a board equally hinders the market from equalizing compensation across directorships for individual

directors. Additionally, we find no evidence to suggest that busy directors fare worse in the marketplace.

#### References

- Bouwman, C. H. S. (2011) Corporate governance propagation through overlapping directors, *Review of Financial Studies*, **24**, 2358–94.
- Farrell, K. A., Friesen, G. and Hersch, P. (2008) How do firms adjust director compensation?, *Journal of Corporate Finance*, **14**, 153–62.
- Ferris, S. P., Jagannathan, M. and Pritchard, A. C. (2003) Too busy to mind the business? Monitoring by directors with multiple board appointments, *Journal of Finance*, **58**, 1087–111.