Directors' role in inter-organizational networks

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Abstract

Purpose – *This paper aims to investigate if existing theories really explain interlocking directorates in several countries. Literature on interlocking directorates is huge and fragmented. Articles in the principal management and sociological journals easily number in the hundred. However, the question that still remains is if interlocking directorates are firm's strategic choices or derivate phenomenon whose explanation comes from other drivers underestimated in literature.*

Design/methodology/approach – *At the aim to fill literature gap, the authors realize a longitudinal and cross-national analysis of existing studies on interlocking directorates.*

Findings – *The authors investigate if existing literature really explains interlocking directorates. Then, the authors offer new perspective for future researches.*

Originality/value – *The paper offers new perspectives on interlocking directorates' explanations.*

Keywords *Corporate governance, Interlocking directorates*

Paper type *Research paper*

Introduction

An interlocking directorate occurs when a director or executive of one firm is appointed on the board of another one. The shared director creates a link between the two boards that provides the channel by which organizations may potentially influence each other. A century of interlocking directorates studies has led to the accumulation of many findings. There is now a considerable literature that examines interlocks' causes and consequences (Simoni and Caiazza, 2013, 2012a, 2012b).

As the business environment has changed, so too have different paradigms as chief explanations. These theories have emerged and diminished in their explanatory power over time. Until the 70s, management control theory evidenced that interlocks have little significance in the corporate world. Since 70s, theorists have analysed interlocking directorates from class hegemony and resource dependency perspective (Pfeffer and Salancik, 1978). It could be argued that the financial control theory (Mintz and Schwartz, 1985) and the knowledge transfer perspective are simply a branch of the resource dependency model, thus like embeddedness and personal relationships perspective are branch of class hegemony theory. In the 80s, a lot of empirical paper tested these two different perspectives. Studies based on resource dependence (Burt, 1980, 1983; Galaskiewicz *et al.*, 1985), financial control (Pennings, 1980; Mintz and Schwartz, 1985) and social class perspectives (Bearden and Mintz, 1985; Johnson and Mintz, 1989) have produced conflicting results. During the 90s, there was a process of general review and systematization of previous literature (Mizruchi, 1996) that led some authors to test interlocks' effect on firms' strategic decisions (Davis, 1991; Haunschild, 1993). Current researches are focusing on the significance of interlocking directorates for political cohesion (Burris, 2005) and learning perspective (Carpenter and Westphal, 2001).

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However, the question that arises is if interlocking directorates are firm's strategic choices or derivate phenomenon whose explanation comes from other drivers underestimated in literature. This question leads us to investigate if existing theories really explains interlocking directorates in different countries (Becht and Roel, 1999; Hall and Soskice, 2001; La Porta *et al.*, 1998). At the aim to answer this question, we realized a longitudinal and cross-national analysis of existing studies.

Methodology

Literature on interlocking directorates is huge and fragmented. Articles in the principal management and sociological journals easily number in the hundred. The fragmented nature of the literature reflects the multifaceted nature of this topic, which often involves a mixture of several disciplines contributing to the field and different level of analysis. At the aim to examine and systematize the evolving literature on interlocking directorates, we reviewed main studies published on academic journals. Mapping the evolution of interlocking directorates' studies from time to time, we realize a longitudinal and a cross-national analysis of interlocking directorates.

Longitudinal analysis

After Louis Brandeis published "Other Peoples' Money" in 1914, the network of interlocking boards of directors has been a prominent piece of evidence for oligarchy. Mills (1956) published "The Power Elite" accounting how the power structure of the USA had changed in the years. The increasing dominance of national corporations, the expansion of a centralized federal government during the 1930s and the creation of a large standing military coming out of the Second World War were identified as structural elements, creating the conditions for the emergence of a single national power elite. In contrast to Brandeis (1914), Mills (1956) argued not bankers, but large owners and executives hold the keys to economic power. Through frequent contact on boards, the corporate rich come to share a worldview of appropriate action for people in their position.

Management control theory argues that a board of directors is appointed by management to act merely as passive rubberstamps, and interlocks have little significance in the corporate world. It views management as isolated and independent from external pressures and interlocks as accidental events with little importance. In the same period, however, organizational theorists began to focus on the external constraints on corporate behaviour, and this concern led to an exploration of inter-corporate relations other than stock ownership and lending (Zald, 1969). One of the first academic studies in the USA to consider the relevance of board interlocks is Dooley (1969). Dooley found that less solvent firms were likely to be interlocked with banks pointing the basis of financial control model. Dooley evidenced a direct relation between the size of a corporation and the number of interlocks and an high tendency of non-financial firms to tie with financial corporations because of industrial firms' dependency of capital to finance its activity. Levine (1972), using congressional data on interlocking between major banks and other major non-financial corporations, evidenced a network of interlocks in which industrial organizations seemed to be more strongly linked to financial institutions than with each other, confirming Dooley findings.

Given the centralization of the banking industry in the USA, even the largest firms become dependent upon a handful of banks and insurance companies, which use their leverage to dictate corporate policies that serve their own interest, or force the borrowing company to accept lender nominees as board members or top executives (Fitch and Oppenheimer, 1970; Mintz and Schwartz, 1985). This logic has led financial control theorists to argue that each important financial institution tends to dictate the activities of a group of nonfinancial firms. This control is used to maximize the profits of the group as a whole. The individual firms become integrated into a financial interest group, which acts as a coherent unified force in the economy. In this context, interlocking directorates are viewed as symptomatic of inter-corporate control and as traces of the structure of coordination in the system.

Allen (1974) replicated Dooley's study using the theory of inter-organizational elite co-optation as his conceptual foundation. Hence, he argued that firms always attempted to anticipate and reduce environmental uncertainties as well as to control their relationship with others through the practice of interlocking directorates. Allen (1978) re-examining corporate interlocking in 1978, based on the same samples used in 1974, Allen was able to identify ten principal interlocked groups and to analyse financial ties among various corporations within these interlocked groups. As a result, he could classify whether a group could be regarded as financial or family interest groups or purely a geographical grouping which shared some reciprocal interest. With the comparisons of 1935 and 1970 interest groups, Allen noticed that the 1970 interlock groups were generally smaller, less cohesive and more independent than those in 1935. In this respect, Allen suggested that the theory of management control helped to provide a more accurate description of the historical development in the corporate elite structure in the country but failed to supplant entirely the role of family and financial control model.

There was a major breakthrough when Pfeffer (1972) stated that the board of directors is an instrument for dealing with the organization's environment. In a random sample of 80 non-financial corporations, elements of board size and composition were shown to be systematically related to factors measuring the organizations' requirements for co-opting sectors of the environment. However, Pfeffer and Salancik (1978) provided the most forceful exposition of resource dependence perspective, which rests on the notion that engine of corporate interaction, is the dependence of each firm on resources that can only be obtained from outside sources. In 1980, Pennings and Burt adopted the resource dependence model as their theoretical foundation. They argued that interlocking directorates was a way to acquire scarce resources that enable firm to survive as well as preserving its integration.

Resource dependency theory accepts the managerial premise that top management dominates corporate decision-making while challenging the conclusion that this autonomy frees the company from outside constraints. As managerially directed firms control the resources required by the corporation, resource dependency leads to complex structural relationships among corporations. Firms are constrained by buyers and suppliers, depending on the extent to which they transact with only a few other industries, as well as the extent to which their industries and those with which they transact are highly concentrated (Burt, 1980, 1983). Through interlocking directorates corporations can reduce resource uncertainty and constraint by establishing linkages with firms producing in industries that generate uncertainty and constraint for them (Pfeffer and Salancik, 1978; Burt, 1980).

Behaviourists, instead, argue that companies use board-interlocks as a mechanism to improve contracting relationships (Schoorman *et al.*, 1981). Some papers in this literature focus on the reconstitution of broken or disrupted interlock ties between firms. For Koenig *et al.* (1979), Ornstein (1980a, 1980b) and Palmer (1983), the fact that accidentally broken ties were not typically reconstituted with new ties to the same firm was taken as evidence that interlocks were not primarily inter-organizational phenomena and might be better conceptualized as intra-class phenomena, that is, as social ties among corporate elites and other members of the capitalist class. This finding has led many to the conclusion that the significance of director interlocks for firms cannot be located at the level of the specific inter-firm dyad, but must be interpreted as a general resource that facilitates, through any of a number of equivalent channels, the flow of communication, monitoring of events or projection of influence across the larger corporate network (Useem, 1984; Mintz and Schwartz, 1985; Stearn and Mizruchi, 1986).

Class hegemony theory (Sonquist and Koenig, 1975) contends that interlocks emphasize upper-class participation in business. Interlocks are integrative ties whose main purpose is to support class cohesion. Belonging to the same social clubs and private schools also supports this perspective. Similar to the management control theory, interlocks are viewed as an end in themselves, a controlling mechanism rather than a means to an end. If elite individuals are always appointed to the board of directors, they will continually control corporate power. Also, Useem (1984) examined interlocking directorates as a network of corporate elites. He combined expansive archival data on the directors of the largest British and American corporations with interviews of 129 directors and executives to provide a systematic assessment of the political role of the corporate elite in each country.

Both America and UK's economies are increasingly dominated by a relatively small number of large companies linked through inclusive and diffusely structured networks formed by shared directorships. The configurations of the aggregate networks are not formed by conscious design but by the efforts of individual businesses seeking to recruit well-connected directors that enhance the firm's business scan. A relatively small number of these directors come to serve on several disparate boards and, thus, to form a cosmopolitan inner circle of the corporate elite. Through their experiences on multiple boards, members of the inner circle are able to understand and represent the interests of big business in general rather than merely the parochial interests of particular companies or regions. Moreover, these individuals end up being disproportionately represented in policy organizations, in the governance of non-profits, and in government service. They become, in a sense, the political vanguard of the corporate community.

While Useem's (1984) argument highlighted the social psychology of individual directors, Mintz and Schwartz (1985) focused less on the directors themselves and more on the network of power relations among corporations. In an updated version of the Brandeis and Dooley's theses, they found that during the 1960s, commercial banks continued to form a stable core of the interlock network. But banks did not and could not use interlocks as a means to dominate business. Rather, most bank interlocks were created not by bank executives but by the top managers of large non-financial firms that were themselves heavily interlocked. Major banks had a greater need for business scan than other corporations because they had loan capital at risk across the economy and, thus, they sought to recruit corporate diplomats from major companies to serve on their boards. Bank interlocks "give lenders access to the expertise of corporate diplomats who are knowledgeable about the viability of investment in their home sectors". In its more sophisticated form, financial control model views interlocks as the backbone of a general economic intelligence and decision-making network in which financial institutions are the key actors.

Industrial firms interlock with financial institutions to obtain information about and a voice in decisions regarding capital allocation, independent of their particular need for external supplies of capital. Financial institutions interlock with industrial firms to obtain information about and access to possible lending and investment opportunities presented by the firm, as well as those presented by other corporations to which these industrials may be connected. Mizruchi and Stearns (1994), through a longitudinal study of US firms between 1955 and 1983, confirmed that corporations with declining solvency during economic slums were more likely to form linkages with financial institutions. They evidenced that whether organizations decide to create or not to create interlocks, and with which organizations they create interlocks, are strongly determined by the economic condition of the environment at the point in time.

A number of explanations for interlocking directorates were summarized and systematized in the Mizruchi (1996) article titled "What Interlocking directorates do". Mizruchi (1996) review of previous literature evidenced that interlocks can act as a mechanism of inter-firm collusion and cooperation, personal career advancement, legitimacy, enable firms to monitor each other and exchange information about business practices. Mizruchi's (1996) article on interlocking directorates, thus, represents a milestone in interlocking directorates research also if it does not take evidence from research realized outside America.

The different perspective on interlocking directorates' explanations can be summarized into two main theories: resource dependence and the class hegemony. From resource dependence point of view, in fact interlocks are realized at the aim to achieve some resources from financial institutions, competitors, suppliers and clients. The selection of interlocked directors thus is understood as firm's strategic choice to gaining access to critical resources derived from the director's overall network position. Class hegemony perspective evidences the relevance of personal contacts and power among members of a business elite. This perspective highlights the social factors that influence the selection process of a director that sits on another board. Thus, interlocks are considerate a means to maintain cohesion among the social elite of directors (Mizruchi, 1996).

Despite of these perspectives have been widely used in explaining interlocking directorates, some critics have charged that interlocks are largely irrelevant and that research on the interlock network represents the dominance of method over substance (Stinchcombe, 1990). In contrast, we argue that researches conducted on interlocking directorates have underestimated some aspects of this phenomenon. Interlocking directorates are inter-organizational ties that have not contractual nature. Thus, differently from other inter-organizational ties, such as joint ventures, they are not intentional firms' strategic choices but derivate phenomenon depending on mechanism of directors' selection. Thus, the nature of these ties is affected by the corporate governance system of the country in which they are realized. These aspects lead us to consider that interlocking directorates' explanations have to be contextualized to that system of corporate governance. At this aim, we present a cross-national analysis of American and Asian context to evidence some specificity in the process of new director's selection that lead to interlocks' creation.

Cross-national analysis

Most articles on factors affecting interlocking directorates have been realized mainly in the American context. Thus, they are affected from its corporate governance system. American economy is a loosely connected system of autonomous large firms unconstrained by outside owners or by each other (Berle and Means, 1932). Stocks of most large companies are widely dispersed, and no single shareholder retained a block of stock large enough to impose corporate policy on the executives who made daily decisions for these firms. This diffusion of shareholders' power, coupled with the lessening dependence of large companies on outside capital, places the fundamental decision-making power in the hands of the chief executives. The canonical agency problem is between a firm's owners who are generally seen as unable to control management directly, and management, who tend to be insufficiently vigilant or trustworthy when it comes to other people's property. This conflict between owners and managers are resolved in favour of managers, leaving almost no analytic room for inter-corporate control (Berle and Means, 1932). In system of governance in which firms have dispersed ownership, board structure depends on the balance of power between the chief executive officer and the board. Boards are a market solution to an organizational design problem, an endogenously determined institution that has arisen to ameliorate the agency problems that plague any large organization. The processes of selection of new director who already sit on the board on another firm, thus, become a firm's strategic choice affected by both resource dependence and class hegemony's factors.

Outside Anglo-Saxon countries, however, widely held corporations are the exception rather than the rule. Asian listed firms exhibit a clear pattern of concentration of ownership and convergence of major shareholding and management. Unlike large shareholders, blockholders usually maintain their ownership stakes for several generations and often serve as senior executives in the firm (Mackie, 2001). The Asian system of corporate governance is the most network-oriented of all, with the company as the institutional centre for deep and enduring relationships between investors, employees, suppliers and customers. Most companies are organized as group with a holding company at the top controlling one or more subsidiaries. The holding company is often controlled by members of a powerful family that select directors to appoint on whole group's boards. A study on a sample of 1,740 listed companies (78 per cent of companies in the countries) carried out by Asia Finance evidenced that approximately 58 per cent of all Asian companies can be classified by being family-owned (Cheung and Chan, 2003). The profile of family ownership is fairly consistent throughout the various countries and economies. Malaysia and Hong Kong show the highest degree of family ownership, with 67.2 and 66.7 per cent of total market capitalization controlled by family groups. In these family-firms system of governance stocks are concentrated in the hands of a few individuals, and the process of selection of new director is realized considering the affiliation of director to the family members. Large shareholders prefer directors affiliated to family who, in seeking to protect or enhance their business relationship with the firm, are less objective and less effective monitors of the family than independent directors (Brickley *et al.*, 1994; Carcello and Neal, 2003; Perlo, 1957). These directors are more likely to facilitate the family's expropriation of the firm's resources to the family's private benefit, implying poorer firm performance (Zeitlin, 1974; Mintz and Schwartz, 1981; Mizruchi, 1982). A family that lists more than one firm appoints the same director on the base of a fiduciary relation. Thus, boards exist in name only for statutory compliance and interlocks are consequences of firms' common ownership. Interlocking directorates, thus are not independent phenomenon, but derivate phenomenon created to coordinate more firms of the same group (Lester and Cannella, 2006). Resource sharing and class cohesion are not the causes but the consequences of interlocks. Members of main powerful families belong to class that run all the economy and affiliation to the family affects the process of director's selection. Thus, personal relationship between shareholders and directors are the main causes of interlocking directorates among firms in family-owned systems.

Conclusion and implications

Research on interlocking directorates has primarily focused on a single contest. Although authors have often referred to multiple ratios in explaining interlocking directorates, the vast majority of work tends to analyse them under a single system of corporate governance. Interlocking directorate are mainly social ties and for this reason they are affected from social and cultural context of the country in which they are created. Thus they cannot be analysed without considering the corporate governance system of the country in which they are realized. Hence, the theoretical challenge, in comparative studies, remains to conceptualize interlocking directorates in terms of its embeddedness in different national contexts.

Considerations of alternative models of governance that integrate different theoretical perspectives are called in interlocking directorates' studies. Our article contributes to this literature by offering a framework of analysis for evidencing the relevance of corporate governance characteristics on interlocks. Hence, we propose a preliminary explanation of the influence of corporate governance aspects on interlocking directorates' ratio. Specifically, this article makes a contribution by integrating different theoretical perspectives on interlocking directorates and their related roles with corporate governance characteristics in companies. This integration helps us avoid the application to all types of interlocks explanations developed in a system of governance developed for organizations of a rather different nature.

Our model may also be subject to relatively empirical testing. Empirical studies that examine the comparative influence of corporate governance variables on interlocks' creation will advance the literature on boards of directorates. Empirical approaches can be used to measure the comparative effects of these various dimensions to determine those that are most influential in explaining interlocks in different economic systems. As a result, one long-term aim of empirical research in this area might be to investigate configurations of interlocks of directors associated with different dimensions of corporate governance issues.

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