CHAPTER 1

INTRODUCTION

The fundamental tenet underpinning the governance literature has been that good governance enables better decisions and improved corporate performance. For instance, decades of governance research using the lens of agency theory (Jensen & Meckling, 1976; Jensen & Murphy, 1990) suggests that affording greater equity compensation to corporate managers should lead to better decisions as there is greater alignment between the interests of corporate managers and those of the shareholders (Dalton et al., 2007). Likewise, a large volume of governance research (see Dalton et al., 2007 for a review) suggests that a greater proportion of independent directors on company boards should lead to better decisions. More independent directors enable better monitoring of the actions of corporate managers. Effectively, by enabling better alignment or better monitoring of managers, most of the prominent tools of good governance are aimed at mitigating the opportunism of corporate managers and thereby improving corporate performance (Misangyi & Acharya, 2014). In other words, extant governance research is driven by the premise that *opportunism* of corporate managers is the central governance challenge.

Empirical evidence, however, suggests that mitigating the opportunism of managers does not always improve performance (Dalton et al., 1998, 2003, 2007; Demsetz & Lehn, 1985). Indeed, most of the mechanisms for mitigating opportunism fail to improve performance (Dalton et al., 2007; Ghoshal, 2005). This limitation has prompted scholars to revisit the governance mechanisms to better understand how they can mitigate opportunism more effectively (cf. Attig et al., 2012; Dharwadkar et al., 2008; Filatotchev & Wright, 2011). Indeed, despite Hendry's (2002) insight that opportunism may *not* be the central governance problem in the first place, governance research continues to lopsidedly focus on opportunism (Bebchuk & Weisbach, 2010), agnostic to other governance problems—thus, at best searching for an incomplete solution to the challenges of governing the corporation, and at worst, searching intensively in the wrong place.

Against this backdrop, we take a different perspective—one motivated by research on judgment and decision making (cf. Camerer & Hogarth, 1999; Larrick, 2004; Soll et al., 2010)—on the central governance challenge facing organizations. We recognize that corporate insiders and corporate overseers alike may be overwhelmed by the complex nature of managerial work, and may not primarily know with confidence as to what constitutes a "better" decision. As a consequence, we focus on the *uncertainty* of the decision context—rather than *opportunism* of decision makers—as the central governance challenge.

Often, an accurate assessment of the quality of strategic decisions is not possible at the point the decisions are made due to uncertainty regarding the future states of the environment. In addition, corporate insiders' inability to predict cause-effect relationships (Priem, 1994), together with limited ability to value all possible response options (Milliken, 1987), makes most strategic decisions rife with uncertainty and leads to judgment errors *even if* managers are assumed to be honest and dutiful (Hendry, 2002). Indeed, it also makes the evaluation of managerial decisions by corporate overseers challenging. This uncertainty-laden nature of managerial decisions calls for revisiting some of the mechanisms underlying the effective governance of firms.

Chapter 2 calls for revisiting the existing mechanisms of governance, mainly focused on mitigating opportunism, and renders an alternative perspective on governing the corporation—one that treats the inherent uncertainty in decision-making, rather than the opportunistic behavior of managers, as the central governance problem to be mitigated. In other words, contrary to the focus of the extant literature on the *nature of the decision maker*, our perspective focuses on the *nature of the decision context*. Specifically, we recognize that the strategic choices by managers are laden with uncertainty, involve significant judgments, that is, "assessments or beliefs about a given situation" (Newell, Lagnado, & Shanks, 2015), and are therefore prone to errors. We focus on how two important governance mechanisms—ownership structure and board of directors—might mitigate these errors and improve the quality of strategic decisions.

In Chapter 3, we explore how *ownership structure can enable the organization to better negotiate the uncertainty inherent in strategic decisions*. We study how the corporate ownership structure may remedy judgment errors stemming from the cognitive blind spots of managers. Drawing from research on relative power (e.g. Golden & Zajac, 2001; Lynall, Golden, & Hillman, 2003; Schneper & Guillén, 2004; Zajac & Westphal, 1996) and on judgment and decision making (cf. Camerer & Hogarth, 1999; Larrick, 2004; Soll et al., 2010), we present *relative* ownership as a significant dimension of corporate ownership structure, over and above *absolute* ownership. We argue that the relative ownership of institutional investors vis-à-vis corporate insiders captures the balance of power in relative terms and influences the dynamics of interaction processes between them. Specifically, we argue that when institutional investors' relative ownership is formidable but not disproportionately higher than that of corporate insiders, the organization can take advantage of unexpected vantage points on strategic decisions and improve the quality of decisions. In addition, we juxtapose the impact of relative ownership with that of absolute ownership, and highlight how prescriptions for good governance could vary depending upon whether one focuses on negotiating the uncertainty inherent in the decision context or on mitigating opportunism of the decision makers.

In Chapter 4, we focus on internal governance and *examine how the board of directors may enable the organization to better negotiate the uncertainty inherent in strategic decisions*. Specifically, we focus on "board capital" (see Hillman and Dalziel, 2003) and examine the requisite human capital on board that enables the directors to evaluate strategic decisions. Drawing from research on boards of directors (see Hillman and Dalziel, 2003), research on group performance and productivity (e.g. de Wit et al., 2013; Karau & Williams, 1993), and research on judgment and decision making (e.g. Hammond, 1955; Newell et al., 2015), we first focus on what constitutes “board capital” in the context of strategic decisions, and then focus on the interactions between different directors that enables corporate boards to maximize board capital. By focusing on the interactions between different directors on board, we incorporate the insight from social psychology research that collective entities such as corporate boards of directors "can and should be studied as systems of interaction" (Giddens, 1993: 128). Further, we highlight how the board chair is in a unique position to increase board capital by virtue of her control over the board’s processes/discussions. Finally, we integrate these insights and provide a predictive model of board effectiveness in the context of strategic decisions.

Cumulatively, this dissertation makes several contributions to corporate governance research. Primarily, despite sustained criticisms of agency theoretic assumptions that people are opportunistic and self-seeking (Ghoshal, 2005), the codes of good practice in corporate governance continue to presume that agents are opportunistic and focus on mitigating their deliberate misdeeds (Dalton et al., 2007). That is, they are presumed to maximize their own interests at the cost of the shareholders’ interests unless appropriate governance structures are implemented (Lan & Heracleous, 2010). As a consequence, the challenges of mitigating their honest misjudgments—those that arise in agency relationships due to the complex and multifaceted nature of management work (Hendry, 2002)—have escaped scholarly attention. We redress this gap.

Further, we empirically establish that significant but not so disproportionately high relative ownership of institutional investors vis-à-vis that of insiders can enable organizations to negotiate the uncertainty inherent in strategic decisions and make better decisions. We, therefore, offer *relative ownership* as a significant dimension of ownership structure that influences relative power between corporate insiders and external shareholders. The relative power, in turn, enables or constrains a comprehensive construal of managers' strategic decisions.

As regards board of directors, we submit that the complexity of strategic decisions engenders higher demands on board capital. Specifically, we argue that improving "board incentives" alone would have minimal effect if the board doesn't have the requisite "board capital"—or possess industry-specific expertise, organization-specific expertise, and strategic task-specific expertise. We introduce the concept of expertise portfolio and model the impact of these various types of expertise and the interrelationships between them. We highlight the combinatorial gains from the distinctiveness of expertise of directors and render insights on how the paradox of expertise—the co-existence of benefits along with costs—can be negotiated through an appropriate expertise portfolio on board such that the combinatorial gains are maximized. Further, we focus on processual aspects and present guidelines on how the board chair may increase board capital. Conceptually, we present a predictive model that distinguishes effective boards from their more ordinary peers, given the uncertainty inherent in strategic decisions.

At a fundamental level, our work shows how existing governance mechanisms need critical rethinking as one moves beyond the opportunistic nature of the decision maker to focus instead on the uncertainty-laden nature of the decision context. In other words, recognizing the intrinsic challenges of decision making calls for revisiting some of the prominent tools of good governance—a research stream we hope this dissertation would stimulate.