Communication and Consensus*

Archishman Chakraborty†  Bilge Yilmaz‡

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Abstract

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†Baruch College-CUNY & York University, achakraborty@schulich.yorku.ca
‡GSB, Stanford University, Yilmaz_Bilge@GSB.Stanford.Edu
1 Extended Abstract

We consider a normative model of optimal board design from the perspective of maximizing shareholder value. In our setting effective communication between management and the board is important for making efficient decisions. Such communication may however be constrained by the fact that management has its own agency that biases it in favor of one of the decisions. For instance, the choice facing the firm may be whether or not to undertake an investment project and management may have private benefits of “empire building” that biases it in favor of recommending the investment even when the investment is against shareholder interest. Similarly, the firm may be faced with a takeover offer from a raider and management’s bias in favor of retaining control may lead it recommend the rejection of an otherwise attractive offer.

In such settings shareholders face a fundamental trade-off ex-ante. If they choose a board that shares the management’s interests then information transmission between the manager and a sympathetic board should be quite effective and the final decision of the board will be well informed. However decision-making will be distorted away ex-post from shareholder value maximization. On the other hand, if shareholders choose a board that is less sympathetic to the management, ex-post decision-making will be closer to shareholder interests. However, this will be at the cost of poor information transmission between management and the board resulting in poorly informed decision-making.

Indeed, in similar settings with a similar tradeoff, Dessein (2002) and Harris and Raviv (2008) show that the benefits of more informed decision making often outweigh the costs of more distorted decisions from the perspective of ex-ante shareholder value. In such cases, it is better for shareholders to fully delegate, i.e., to choose a board that is perfectly aligned with management over a board that is perfectly aligned with shareholders.

In this paper we wish to add to this literature in two ways. First, we consider the possibility of designing delegates (boards) that are imperfectly aligned with both the principal (shareholders) and the agent (management). We do this in settings where the principal explicitly takes into account the possibility that the delegate may later obtain private information that is relevant for the decision. We show that such imperfect alignment dominates
both of the extreme cases provided managerial agency is neither too large nor too small. Compared with the case of a fully management aligned board, with an intermediate board shareholders sacrifice some of the effectiveness of information transmission in order to gain in terms of less distorted decisions. On the other hand, compared with the case of a fully shareholder aligned board, shareholders gain with an intermediate board in terms of the effectiveness of information transmission at the cost of a greater distortion in decision making.

Our second contribution to this literature comes via an explicit consideration of the ex-post tensions that arise under full or intermediate delegation. In particular, we ask if shareholders will necessarily agree with the final decisions reached by the optimal board and to what extent this depends on details of the communication protocol between the board and management and the transparency of board deliberations. We show that shareholder value and the composition of the optimal board do not depend on details such as the communication protocol as long as private communication is allowed among board members. In particular, the optimal imperfect alignment outcome can be implemented ex-post consensus (thus without any delegation) when certain board members can communicate privately with the management prior to making a recommendation. This result is robust to the length of the communication, e.g., first management speaks and the board member makes a recommendation vs. first board member and then the manager speak and finally board member makes a recommendation.

Furthermore, we show that when the optimal board is imperfectly aligned with management, ex-post consensus may be also achieved via extended public communication as long as the conflict of interest is not too large. That is to say, shareholders will agree with the final decision of the board even if they hear all communication between the board and the manager but only if such communication is extended, i.e., involves multiple exchanges between the manager and informed board members. Extended communication achieves consensus even though (i) the communication protocol has no bearing on the final decision and (ii) without extended communication shareholders would not agree with the final decision if communication between the board and management was public. We interpret the consensus generating benefits of such extended communication in terms of the benefits of making managers per-
manent members of the board and allowing them to participate in extensive deliberations. While this cannot have any effect on shareholder value, it can allow the informed board members and management to structure communication in order to reach a final decision without creating shareholder dissent even under full transparency of board deliberations.

In contrast, when the optimal board is perfectly aligned with management or managerial agency is sufficiently large, ex-post shareholder consensus is not possible if board deliberations are transparent. In such cases shareholder consensus with the final decision of the board is still possible but only if the deliberations between the board and management occur in private.

These results on consensus building imply that final decision-making authority in an optimal board can, without loss of generality, be vested in a fully shareholder aligned member of the board. What matters is the conflict of interest between informed members of the board (such as members of the audit committee) and the management. This conflict determines both the effectiveness of information transmission and shareholder value as well as the permissible level of transparency of board deliberations from the perspective of generating ex-post consensus.

Finally, the optimality of shareholder aligned final decision-making persists in the presence of (possibly illegal) private side-communication between particular management aligned informed board members and management. In such cases fully shareholder aligned decision-making authority within the board is in fact strictly optimal ex-ante. Interestingly, allowing and anticipating such side communication is shareholder value increasing.

Beyond the specific application to corporate boards our results shed light on observed organization structures. Indeed, the principal in our setting does not need to commit to adhere to the recommendations of the delegate as long as she does not observe the interaction between the delegate and the agent and, in many cases, even if she does observe the interaction. In other words the delegate in our model may be thought of as an intermediary who merely recommends actions that the principal, in equilibrium, chooses to follow. The presence of the intermediary improves information flows in the organization without any need for the principal to give up her control rights. As such our results provide some
foundation for the observed prevalence of hierarchical structures in organizations as well as
the frequent practice of collective decision-making via delegation to specialized committees
who only have the power to recommend actions and not enforce them.

Our model of communication belongs to the growing literature on cheap talk games starting from Crawford and Sobel (1982). In contrast to the Crawford-Sobel model in our setting the decision problem is binary not continuous. The fundamental coarseness of a binary decision problem is the principal reason why shareholder consensus can be generated in our setting. We feel that a binary decision model is the appropriate choice for the application we have in mind. In practice corporate boards rarely have control over fine details of management actions such as the scale of investment or the extent of marketing and advertising expenditures. Typically the board can only provide management with approval (or not) to pursue a particular strategic plan after taking account managerial discretion (and possible agency) in implementing the details of the plan.

References

