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Behavioral Finance in Corporate Governance-  
Independent Directors and Non-Executive Chairs

by

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# **Behavioral Finance in Corporate Governance - Independent Directors and Non-Executive Chairs**

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## **Abstract**

Corporate governance disasters could often be averted had directors asked their CEOs questions, demanded answers, and blown whistles. Work in social psychology by Milgram (1974) and others shows human subjects to have an innate predisposition to obey legitimate authority. This may explain directors' eerily compliant behavior towards unrestrained CEOs. Other work reveals factors that weaken this disposition to include dissenting peers, conflicting authorities, and distant authorities. This suggests that independent directors, non-executive chairs, and committees composed of independent directors that meets without the CEO might induce greater rationality and more considered ethics in corporate governance. Empirical evidence of this is scant. This may reflect measurement problems, in that many apparently independent directors actually have financial or personal ties to their CEOs. It might also reflect other behavioral considerations that reinforce director subservience to CEOs.

*Loyalty means nothing unless it has at its heart the absolute principle of self-sacrifice.*

Woodrow T. Wilson

## **Introduction**

Misplaced loyalty lies at the heart of numerous recent scandals in corporate governance. Corporate officers and directors, who should have known better, placed loyalty to a dynamic Chief Executive Officer above duty to shareholders and obedience to the law. The officers and directors of Enron, Worldcom, Hollinger, and virtually every other allegedly misgoverned company could have asked questions, demanded answers, and blown whistles, but did not. Ultimately they sacrificed their careers and reputations for their CEO.

Loyalty is an important virtue. It makes possible the large hierarchical organizations that underpin national economies: armies, government bureaucracies, political parties and corporations. But loyalty – to political ideologues, religious zealots, ethnic purists, and other militants – also underlies the most horrific chapters in history books.<sup>1</sup> Corporate governance scandals are minor misdemeanors in this company, but the underlying problem of misplaced loyalty is the same.

Much work in empirical social psychology suggests that loyalty is hardwired into human behavior. Milgram (1974) shows that a human subject suppresses internal ethical standards surprisingly readily when they conflict with loyalty to an authority figure. This accords well with officers and directors' stalwart loyalty to misguided CEOs, even under clear signs of impending financial doom. Milgram argues that loyal behavior stimulates

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<sup>1</sup> See e.g. Lasky (1919).

feelings of well-being, and that this reflects evolutionary pressure on early human societies that favored obedience to authority as conducive to greater social organization.

Corporate governance reforms need to weaken this innate response at selective points in the corporate hierarchy. Empirical findings in social psychology suggest that introducing dissenting peers or alternative authority figures can do this. Milgram finds that dissenting peers and rival authorities undermine subjects' loyalty and revive their internal moral reasoning. Corporate governance reforms that envision independent directors (dissenting peers) and non-executive chairs (alternative authority figures) aspire to a similar effect on corporate boards – a fostering of debate to expose flawed policies before they become lethal - and thereby render corporate governance disasters rarer. Thus, the Higgs Report proposes that listed company boards in the United Kingdom have *non-executive chairs* and *senior independent directors*, and the Sarbanes Oxley reforms in the United States require that the boards contain enough independent directors to staff key board committees.

In light of these findings from social psychology, the inability of economics and finance to detect consistent linkages between board independence and corporate performance is puzzling.<sup>2</sup> There are two plausible reasons for this.

One is that insufficient time has elapsed for us to see the effects of increasingly active independent directors. Many of the directors classified as independent in corporate proxy statements may in fact be deeply beholden to the CEO. The Higgs report finds that almost half the so-called independent directors on British boards were recruited by the CEO through personal contacts or friendships. A mere four percent had a formal interview. This renders nominally independent directors beholden to CEOs. As more

stringent definitions of independence are applied, a clearer relationship with firm performance may emerge.

A second is that the behavioral constraints on board independence are much deeper. More overt means of insuring active and genuinely independent directors might be needed. More radical reforms, like letting institutional investors and public shareholders nominate candidates for elections to boards, may be necessary to permit genuinely independent directors and board chairs. Institutional investors are also only tenuously linked to firm performance, but this may reflect their inability to affect boards.

## **The Milgram Experiment**

The first empirical evidence for an innate loyalty response in human behavior is a series of social psychology experiments begun in 1961 by Stanley Milgram, then an Assistant Professor of psychology at Yale. Milgram constructed a box, depicted in Figure 1, featuring electric switches labeled “15 volts”, “30 volts”, “45 volts”, and so on up to “450 volts”. The voltages were also labeled with terms ranging from “slight” through “very strong” to “extreme intensity”, “danger severe”, and “XXX”. Wires led from this box to various parts of the body of a professional actor, the “learner” shown in Figure 1B, who was paid to feign increasingly painful electrocution as the real subject of the experiment depressed switches marked with increasing voltages. The box contained a noise maker to mimic the buzz of surging electric currents.

Each such subject was told (falsely) that the “learner” was the subject of the experiment and that they were to assist the experimenter. The purpose of the experiment

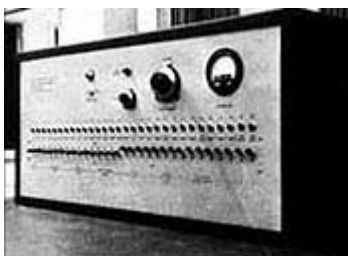
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<sup>2</sup> See e.g. Hermalin and Weisbach (2003) for a recent survey.

was explained as studying “the effects of punishment on learning and memory.” The real subjects of the experiment were ordinary citizens of New Haven, attracted by advertisements of cash for participation in psychology experiments. Thus, the subjects thus felt a financial obligation to Milgram as well as a sense of participating in important research at a leading university. Milgram wore a lab coat to impress this image.

The subject was told he or she would serve as a “teacher”, and was seated before the panel of switches. The “learner” was asked a series of questions, to which he sometimes gave incorrect answers. Each time this occurred, the “teacher” was to apply a larger electric shock to the actor, who feigned increasing pain. Milgram (p. 4) describes the actor’s script: “At 75 volts, the “learner” grunts. At 120 volts he complains verbally; at 150 he demands to be released from the experiment. His protests continue as the shocks escalate, growing increasingly vehement and emotional. At 285 volts his response can only be described as an agonized scream.”

**Figure 1. The Experimental Design**  
The setup in Stanley Milgram’s original obedience experiments at Yale University in the early 1960s.



**Panel A. The bogus shock generator contains a buzzer and has wires running to the “teacher’s” seat.**

*Source: Milgram (1974).*



**Panel B. The “teacher” (real experimental subject) helps strap in the “learner” (actor) and apply bogus electrodes**



**Panel C. The teacher is taught to operate the bogus shock generator**

Milgram initially believed most Americans would quickly break off from the experiment. He initially intended to replicate the procedure in Germany to see if there

was a cultural difference that might explain the widespread complicity of ordinary Germans in wartime atrocities.

Milgram was astonished at the results of a “test run”, in which Yale students dutifully electrocuted perfect strangers when told to do so. Milgram dismissed the results as the behavior of “Yalies”.

But the full fledged experiment, using ordinary Connecticut residents, generated qualitatively similar results. Most ordinary Americans appear perfectly willing to send high voltage electric shocks through a complete stranger if ordered to do so by an apparently legitimate authority figure.

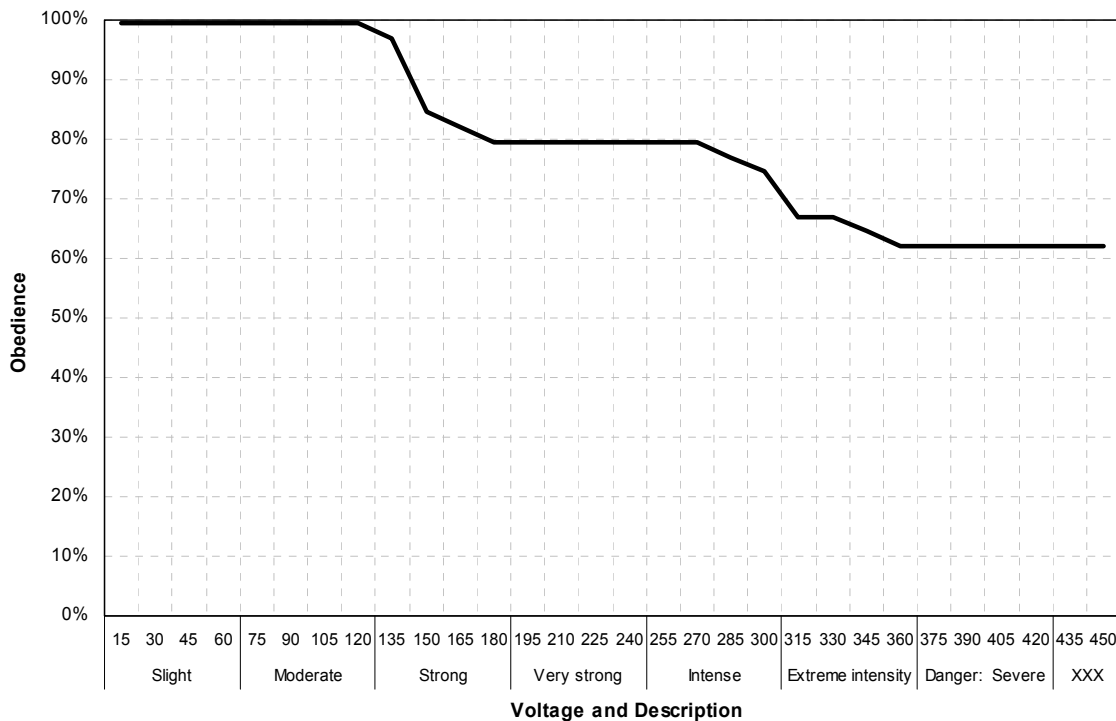
Figure 2 summarizes the results of the Milgram experiment. One hundred percent of ordinary Americans are willing to send electric shocks through an experimental subject, up through 135 volts, when the “learner” demands to be released. At that point, about twenty percent stop obeying. Eighty percent of Americans continue administering shocks labeled “very strong” and “intense”, up through two hundred and eighty-five volts, when the “learner” begins screaming in agony. A bit over sixty percent of ordinary Americans obediently administer electric shocks all the way up to four hundred and fifty volts, despite labels like “extreme intensity”, “danger severe”, and “XXX” next to the voltage figures on the control panel.

The Milgram experiment has been replicated many times - see Miller (1986) and Blass (1998, 2000) for a review of this literature and Merritt and Helmreich (1996), Tarnow (2000), and others for other related work - and has also been replicated by this author. It’s generality as a description of human nature is now beyond doubt.

Milgram repeated the experiment varying a number of the parameters. For example, he found no difference in the obedience rates of male and female subjects. Moving the experiment from Yale to Bridgeport, Connecticut, had only a minor effect. Placing the “learner” in more direct proximity to the “teacher” reduced obedience rates, but only somewhat.

Milgram was so appalled by his results that he never replicated it in Germany. He concluded instead that human have a built-in urge to obey authority.

**Figure 2. Obedience Rates, Basic Milgram Experiment**  
 Fraction of ordinary Connecticut residents who directed high voltage electric shocks through the bodies of perfect strangers when ordered to do so by a psychologist.



Source: Milgram (1974).

Milgram (1973) suggests that this urge has a genetic basis. Pre-human and early human hunters and gatherers who fell into line behind a tribal chief may well have had a significant survival advantage over otherwise biologically identical species composed of

isolated individuals. Animals that hunt in packs, like wolves, also sort themselves into hierarchies, headed by so-called alpha males. Chimpanzees and Great Apes also spontaneously form hierarchies of dominance. Milgram's hypothesis that an analogous genetic impulse affects certain aspects of human behavior seems plausible, though little is actually known of its biochemical or genetic basis. Nonetheless, that we have built-in positive feelings associated with obedience to authority goes far to explain much of the misery and atrocity overlaying human history. We feel a sense of satisfaction from self-sacrificing acts of loyalty so profound that an innate biological basis seems likely.

Milgram followed up with the subjects of his experiments to understand why they behaved as they did. Many were profoundly upset by the experience, but a common theme most subjects used in justifying their actions was that they "gave their word" to the experimenter and felt a sense of "loyalty". Many indicated that they were "doing what was expected of them". Others indicated that failing to "live up to the expectations" of the experimenter was less acceptable than administering the shocks. Self-perceptions of "duty" and "loyalty" seemed to induce positive feelings and this promoted obedience. Since similar deep emotional responses are associated with other basic instinctive drives, Milgram's postulate of a genetic basis for obedience to authority seems plausible.

## **Leadership and Corporate Governance**

In a modern liberal democracy, corporate head offices are a prominent arena for unfettered "leadership". Politicians are restrained by checks and balances and subject to the discipline of party whips. Judges are subject to reversal, bound by precedent, and restrained by rules of procedure. But corporate CEOs can exercise leadership robustly.

Short of violating the law, they can run their firms as they like. They can hire and fire lower level managers as they please, direct investment where they wish, and organize and reorganize their companies as they like.

Ideally, when a CEO proposes actions or strategies that are manifestly wrongheaded, experts in relevant fields should step forward to correct the error, or at least raise questions. But such people might be given pause by Samuel Goldwyn's famous bluster, "I don't want any yes-men around me! I want everyone to tell me the truth – even if it costs him his job!"

The board's explicit purpose is to hire, monitor, and – if necessary – fire the CEO. Corporate officers and directors in the United States have a formal *fiduciary duty* to intervene as necessary to protect public shareholders. That includes scaling back the CEO's pay when performance flags and firing seriously underperforming CEOs. But Mace (1986) shows that directors remain steadfastly loyal to misguided CEOs. The directors of Enron, WorldCom, Hollinger, Parmalat, and all the other companies currently embroiled in scandal attended regular meetings to favorably assess the performance of their CEOs. Despite increasing attention being drawn to their legal and ethical responsibilities, directors seem paralyzed in the presence of powerful CEOs.

To students of social psychology, this paralysis is not surprising. Like the ordinary Americans who felt duty-bound to administer high voltage electric shocks to perfect strangers, directors often feel an allegiance to the CEO. Criticizing a CEO, even for palpably awful decisions, smacks of "disloyalty". Such a feeling is apparently to be avoided, even at considerable cost to one's conscious. Just as the "teacher" felt a need to meet the experimenter's expectations and electrocute the "learner", directors may feel a

need to “live up to” a hubristic CEO’s expectations and condone actions that harm public shareholders.

Why do directors’ feelings of loyalty to the CEO outweigh their legal duty of loyalty to public shareholders? Public shareholders, the vulnerable widows and orphans of financial lore, are not present in the board room. Except one day each year, the annual general meeting, they are, at best, a remote abstraction. Milgram found that “teachers” were more willing to administer shocks to a more remotely located subject – seated around a corner or in an adjacent room – than to a subject sitting immediately next to them. Figure 3 depicts a “close proximity” variant of the experiment, in which the “teacher” was required to hold the “learner’s” hands against metal plates while administering the shock. In this variant of the experiment, a lower percentage of “teachers (thirty percent) administered shocks all the way up to the maximum. In other variants, where the “learner” was around a corner or in a different room, a higher proportion of “teachers” administered maximum shocks than in the baseline experiment.

### **Figure 3. Variant Experimental Designs**

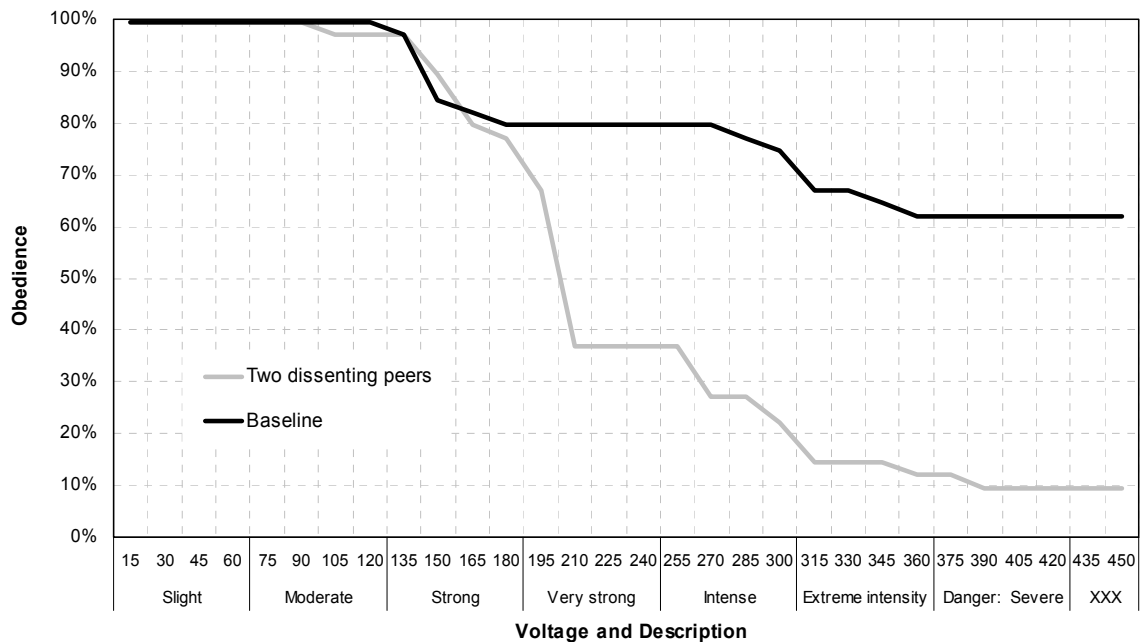
**When the “teacher” was required to hold the “learner’s” hands against metal plates to administer the shock, obedience rates declined somewhat. At higher voltages, the “learner”, a professional actor, feigns cried of agony.**



*Source: Milgram (1974).*

Jensen (1993, pp. 862-3) observes in his *Presidential Address to the American Finance Association*: “The problems with corporate internal control systems start with the board of directors. The board, at the apex of the internal control system, has the final responsibility for the functioning of the firm. Most importantly, it sets the rules of the game for the CEO. The job of the board is to hire, fire, and compensate the CEO, and to provide high-level counsel. Few boards in the past decades have done this job well in the absence of external crisis. This is particularly unfortunate given that the very purpose of the internal control mechanism is to provide an early warning system to put the organization on track before difficulties reach a crisis stage. The reasons for the failure of the board are not completely understood, ... .”

**Figure 4. Obedience Rates, Dissenting Peers Variant**  
 Fraction of ordinary Connecticut residents who directed high voltage electric shocks through the bodies of perfect strangers, despite the voiced concerns of two of their peers, when ordered to do so by a psychologist.



Source: Milgram (1974).

The Milgram results, applied to boardrooms, suggest directors obtain positive feelings from acts of loyalty to a CEO perceived as a “leader”. This reflexive obedience to authority is a plausible answer to Jensen’s (1993) puzzlement about why boards work so poorly so often. But given this, what reforms make sense to improve the functioning of boards?

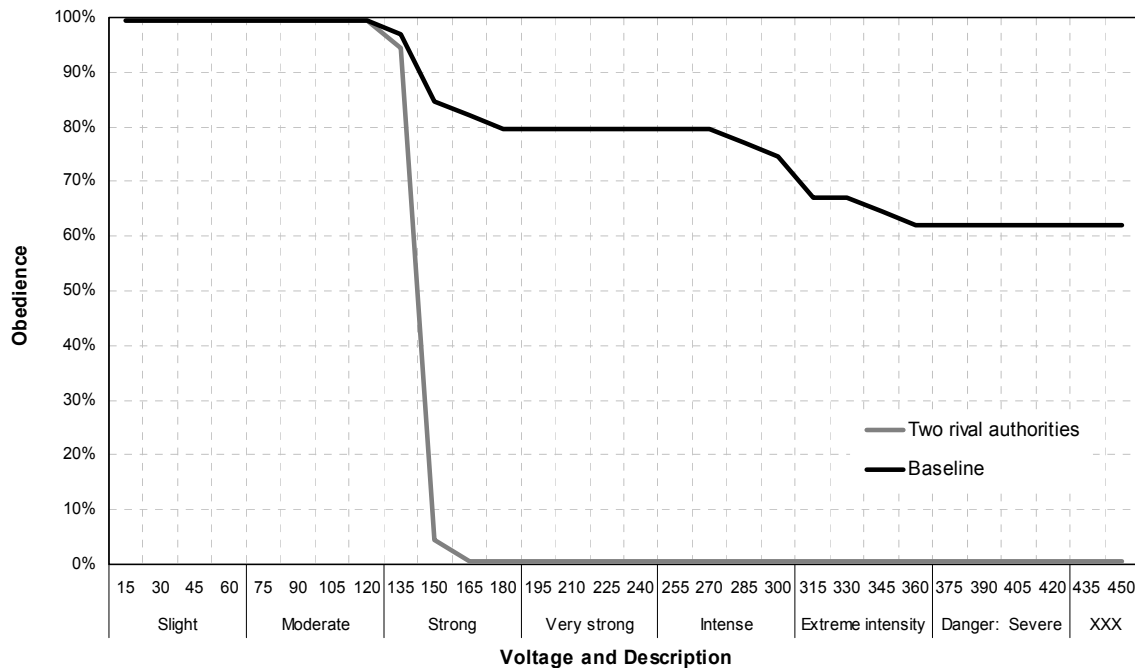
### **Dissenting Peers and Conflicting Authorities**

If the failure of the board is a consequence of fundamental aspects of human behavior revealed in the Milgram experiments, further knowledge about these aspects of human nature may hold the key to a successful board. Fortunately, Milgram performed many variations of his basic experiment. Most of the variations Milgram performed, such as using women instead of men, adjusting the proximity of the “teacher” and the “learner”, and so on, had at most only moderate effects on his results. However, two specific alternatives generated starkly different behavior on the part of the “teachers”.

One of these featured three “teachers”, one of whom was the real subject of the experiment. One reads the question aloud, the second indicates if the answer was correct, and the third (the actual subject) throws the switch to initiate the shock. At 150 volts, the first “teacher” objects and walks out. The psychologist tells the subject to ask the questions and throw the electric switches. At 210 volts, the second “teacher” also refuses to continue. The psychologist then tells the subject to go on alone. The fraction of real subjects who continued administering shocks fell off sharply when these “dissenting peers” began voicing concerns. Milgram (1974, p. 118) notes that “The effects of peer rebellion are very impressive in undercutting the experimenter’s authority.” Figure 4 illustrates.

Merely hearing someone else voice objections appears to be enough, in some cases at least, to overcome the human instinct of loyalty to legitimate authority.

**Figure 5. Obedience Rates, Disagreeing Authority Figures Variant**  
 Fraction of ordinary Connecticut residents who directed high voltage electric shocks through the bodies of perfect strangers when ordered to do so by one psychologist and ordered not to comply by another.



Source: Milgram (1974).

Another variant led to a *complete cessation of obedience* halfway through the experiment. As in the baseline experiment of Figure 2, it featured only one “teacher”. However, it now included two supervising psychologists “of approximately the same age and height”, rather than just one. At one hundred and fifty volts, one psychologist began a scripted argument that continuing to higher voltages was unnecessary, while the other argued for continuing the experiment to its end. (All p. 105) Confronted with discordant authority figures, the “teachers” sided with the psychologist who proposed ending the experiment in every case. Milgram (1974, p. 107) notes that “Not a single subject ‘took advantage’ of the opportunity to continue the shocks, and that “action was stopped dead

in its tracks.” Figure 5 illustrates the obedience rates from this version of the Milgram experiment.

Disputes between rival authority figures seem to undermine our willingness to obey authority and revitalize our own ability to weigh alternatives rationally and ethically. Authorities in conflict seem to evoke independent thought.

In further variants of this experiment, when Milgram (p. 62) removed the experimenter from the lab, and had the “teacher” and “learner” receive instructions over a telephone, obedience dropped to about one third of the baseline level. Also, several subjects who continued administering shocks surreptitiously delivered lower voltage shocks than their instructions required. Some subjects actually assured the experimenter that they were delivering the shock levels required when they in fact were not. If the experimenter reentered the lab, this behavior ended and subjects resumed compliance. Milgram concluded that “[s]ubjects seemed able to resist the experimenter far better when they did not have to confront him face to face. ... The physical presence of an authority figure was an important force.”

### **Encouraging Disobedience on Boards**

In variants of his experiments where Milgram arranged for “peers” to question the appropriateness of the experiment, obedience fell sharply. This suggests that independent directors, whose careers are not controlled by the CEO, might break the CEO’s spell and permit a degree of disobedience by all the directors. Consequently, corporate governance reforms often strive to increase the number of independent directors on listed company boards or on key board committees. For example, the Sarbanes Oxley Act requires board

to contain enough independent directors to staff key committees and the Higgs Report recommends that half of all directors be independent.

Independent directors seem to effect at least some governance pressure. Weisbach (1988) shows that CEO turnover after poor firm performance is more likely in firms with more independent directors; and Rosenstein and Wyatt (1990) find that share prices rise on the news that outsiders will join boards. These results are consistent with outside directors playing the dissenting peers in Figure 4. However, Hermalin and Weisbach (2003) show that the link between outside directors and longer term firm performance is much more tenuous.

The variants of the Milgram experiment where obedience fell to zero involved rival experimenters, one pushing for continuation of the shocks and the other demanding that the procedure stop. Consistent with this logic, the Higgs Report on corporate governance in the United Kingdom recommends that all boards have *non-executive chairs* and designate *senior independent directors*. That is, an independent director must chair the board and another must coordinate the activity of the other independent directors. Hopefully, either or both might serve as a rival authority figure to the CEO should the need arise.

Morck, Shleifer, and Vishny (1989) show that CEOs who simultaneously serve their companies as chairman of the board and president are less likely than other CEOs to be replaced following poor firm performance. This is consistent with rival authority figures in the former firms permitting directors to undertake a rational evaluation of the CEO's performance. Where all three titles are vested in the same individual, directors

appear more compliant. Nonetheless, the relationship between dual authority figures and longer term corporate performance is again unclear.

Variants of the Milgram experiment that removed the experimenter further from the “teacher’s” immediate presence generated greater disobedience. This justifies provisions like that in the Sarbanes Oxley Act that requires boards audit committees to consist solely of independent directors. By removing the CEO from these meetings, the reformers hope to induce greater disobedience to him and a more objective assessment of the company’s financial state and future.

The Milgram experiments suggest that independent directors (like dissenting peers), non-executive chairs and senior independent directors (like arguing experimenters), and committees containing only independent directors (like subjects whose experimenter left the lab) ought to help free boards of their reflexive obedience and stimulate rational debate. Yet conclusive evidence that long term performance is correlated with such governance structures remains elusive.

One possible reason is that independent directors have not been common until very recently. Many of the directors labeled independent represent the firm’s lawyers, advertising agency, suppliers, or customers. These directors, though not personally financially tied to the firm or the CEO, represent interests who have such ties.

More recent reforms stress more clearly the need for genuine independence. Thus, the Sarbanes Oxley Act of 2003 defines an independent director as “not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.” The Higgs report in the United Kingdom goes further, excluding people with “any

material business relationship” with the company. Family ties, previous employment, and ties with major shareholders also preclude independence. These definitions may still be too loose. But perhaps, as genuinely independent directors become more common, a clear performance advantage will emerge.

A second possibility is that the Milgram experiments, though clearly relevant to corporate governance problems, are an incomplete guide to policy makers. Other behavioral responses may also come into play. These responses, like those found by Milgram, probably also result from evolutionary pressure favoring early human societies that could work better in groups. However, they can become dysfunctional in corporate board rooms, where they reinforce the directors’ inclination to conform.

Corporate insiders who also serve as directors owe their careers and compensation packages to the CEO. Axelrod (1984) shows that humans reflexively repay favors.<sup>3</sup> Consequently, insider directors are unlikely to oppose the CEO, even if she is patently wrong. Festinger (1957) finds that people’s ethical standards are often swayed by their self-interest. Consequently, insider directors are likely to come to see their support for their CEO as highly ethically motivated

Many independent directors are still beholden to the firm’s CEO. Shivdasani and Yermack (1999) find that boards contain fewer independent directors where CEOs control the nominating process, and that nominally independent directors in such firms often have financial ties to the CEO or the firm. It would be surprising if such financial ties did not affect these directors’ judgment. And even directors with no such financial or other ties surely feel a sense of obligation to the CEO who appointed them, and a

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<sup>3</sup> Such reflexive behavior is appreciated by students of marketing, such as Cialdini (1998), and motivates free samples and “no obligation” gifts as sales strategies.

reflexive need to repay the favor. Even allegedly independent directors may find it hard to oppose the CEO and devise ethical justifications for their subservience.

One solution is to mandate that future independent directors be nominated by current independent directors. Another is to let institutional investors or public shareholders nominate directors. Both options have obvious drawbacks. If current independent directors are not really independent, they will appoint more of their own kind. Institutional investors may develop governance problems of their own. And public shareholders may be swayed by fads or famous names.

But even a substantial number of genuinely independent directors might not be sufficient to undermine the CEO's dominance. Asch (1951) shows that people tend to go along with a "group consensus" – even one rigged to be obviously wrong. Kahneman and Tversky (2000) summarize a large literature that shows people's decisions depend critically on how their options are "framed".<sup>4</sup> Even fully independent directors probably feel a need to conform to a group consensus. The CEO sets the agenda for board meetings, and therefore can control how issues are "framed" to direct the formation of such a consensus - even in boards nominally dominated by genuinely independent directors.

The Higgs Report requires that the CEO not chair board meetings. These reforms seek to let an alternative authority figure frame the issues. Again, such measures have costs. Entrusting too much control to an outsider deprives decision making experience and knowledge. Moreover, Adams *et al.* (2004) argue that the CEO can actually manipulate the agenda to frame issues as he likes most easily if she is the only insider on

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<sup>4</sup> This knowledge is used by, for example, professional pollsters to generate answers that lend the aura of popular support to causes advanced by their clients. See Cialdini (1998).

the board, and that boards entirely composed of independent directors actually strengthen the CEO's power. Ocasio (1994) argues that other corporate insiders on boards can emerge as alternative "leaders" if they feel they can usurp the CEO's position.

Overall, the structure of corporate boards creates strong pressures on directors to fall into line behind the CEO. Fama (1980) and Fama and Jensen (1983) argue that directors seek to build reputations as effective monitors. However, such reputations may not be the key to successful careers as directors. A reputation as a "loose canon" or a "troublemaker" may be a bigger impediment than a reputation as a "yes man".

It is tempting to argue obedient directors and dominant CEOs must be an economically efficient outcome. If more constraints on CEOs were really economically sensible, firms that found ways to impose such constraints would have flourished and grown to dominate the economy. However, such logic is fallacious. First, Adams et al. (2004) show that powerful CEOs increase the variance in firm performance. Some firms with powerful CEOs do much better than firms with constrained CEOs, others do much worse. Simply constraining the CEO probably confers no clear advantage. Good corporate governance requires constraints that fall into place when the CEO is making an obvious mistake, but not when he is enacting a visionary strategy. In practice, this distinction may often be difficult for independent observers to draw. We are now engaged in economy-wide experiments in the United States, the United Kingdom, and elsewhere to see if various regulatory reforms can induce such discriminating constraints.

## **The Ethics of Corporate Governance**

Much popular discussion of corporate governance problems has a distinct moral tone. Corporate governance scandals are “ethical failures.” Milgram (1973, p7) found that “people ... asked to render a moral judgment on what constitutes appropriate behavior in [his experiments] unfailingly see disobedience as proper.” Asked why they behaved inappropriately, his subjects advanced excuses like politeness, keeping a promise, the awkwardness of disagreement, absorption in technical details of the experiment, or a belief that a greater good, like the advancement science, must justify the learner’s pain. But the most universal response was a sense of loyalty to the experimenter. Milgram (1973, p. 8) concludes that his typical subject did not lose his moral sense; “Instead, it acquires a radically different focus. He does not respond with a moral sentiment to the actions he performs, Rather, his moral concern now shifts to a consideration of how well he is living up to the expectations that the authority has of him.”

Milgram (1974) posits an agency problem called an *agentic shift*, in which individuals forsake rational reasoning in the name of loyalty. Milgram (1974, p. 145-6) states “The most far-reaching consequence of the agentic shift is that a man feels responsibility to the authority directing him, but feels no responsibility for the content of the actions that the authority prescribes.” Directors enchanted by a powerful CEO feel a profound duty to live up to the CEO’s expectations, but none at all for how their actions affect shareholders, or other stakeholders for that matter.

Human nature changes slowly, if at all; and terms like *loyalty* and *duty* are heavily laden with moral charge. Milgram (1973, p. 188) despairs that “The virtues of loyalty, discipline, and self-sacrifice that we value so highly in the individual are the very

properties that create destructive engines of war and bind men to malevolent systems of authority.” Corporate governance scandals seem anticlimactic to this, but arise from the same weakness in human nature.

One hope whenever behavioral biases induce irrational or unethical behavior is that informing people about those biases can help them correct their errors and induce appropriate behavior. Gergen (1973, p. 313) argues in this vein that “sophistication as to psychological principles liberates one from their behavioral implications.” The Milgram experiments were highly publicized in the 1960s and 1970s, yet Schurz (1985) find no time trend in the findings of numerous subsequent studies replicating Milgram’s results. Proponents of education as liberation from behavioral influences may underestimate the difficulty of this task. Still, university ethics committees ended Milgram experiments in the 1980s, so longer trend estimates are unavailable. Corporate governance reforms and director education programs are now providing a natural experiment that holds the promise of greatly advancing our understanding of these issues.

## **Conclusions**

Behavioral issues are important in corporate governance. Milgram’s (1974) experiments in social psychology show that human nature includes a reflexive subservience to people perceived to be legitimate authorities, like corporate chief executive officers. This reflex disposes directors to fall into line behind their CEO. Because it connects to morally charged concepts like loyalty, trust, and duty, this subservience is difficult to overcome. Its moral overtone also lets people behave in overtly unethical ways, yet justify their behavior in terms of these charged concepts. This is consistent with directors justifying

their acquiescence to obviously flawed corporate strategies in terms of their loyalty to the CEO, his trust in them, and their duty to him. Other behavioral factors, such as cognitive dissonance, reciprocal favor trading, and group conformity, may significantly reinforce this subservience.

Effective corporate governance reforms must weaken this reflexive subservience. Milgram reports that dissenting peers, rival authorities, and absent authorities shook this subservience and reinitiated subjects' own reasoning. Corporate governance reforms that envision independent directors (dissenting peers), non-executive chairs (alternative authority figures), and fully independent audit committees (absent authority figures) aspire to a similar effect on corporate boards – the initiation of real debate to expose poor strategies before they become fatal. In this vein, the United Kingdom's Higgs Report suggests that boards have “non-executive” chairs, and the Sarbanes Oxley reforms in the United States mandate audit committees composed solely of “independent” directors.

Given Milgram's (1974) findings in social psychology and the large subsequent literature replicating them, the paucity of empirical evidence in the finance and economics literatures connecting such governance structures to corporate performance is puzzling.<sup>5</sup> We suggest two plausible reasons.

One reason is that genuinely independent directors have been rarer than corporate proxy statements would suggest - at least until very recently. Many directors classified as independent are actually associated with the CEO. The Higgs report notes that roughly half of the British directors classified as independent are recruited by the CEO through personal contacts or friendships. As more stringent definitions of independence are applied, a clearer relationship with firm performance may emerge.

Another reason is that overcoming Milgram's (1974) reflexive subservience may actually be quite difficult, especially if this behavior is reinforced by other innate behavioral responses. If so, genuinely independent directors and board chairs may require having institutional investors and public shareholders to nominate candidates for directorships. Such measures also entail other corporate governance risks, for they assume good governance within institutional investors and shareholder rationality.<sup>6</sup> However, continuing corporate governance scandals over the years and throughout the world suggest that serious consideration be given to such reforms as ways of infusing more open debate and overt criticism of CEOs into corporate board meetings.

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<sup>5</sup> See e.g. Hermalin and Weisbach (2003) for a recent survey.

<sup>6</sup> See e.g. Shleifer (2000).

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