



## Six Degrees of Separation: Examining Back Door Links between Directors and CEO Pay

Published : May 04, 2005 in [Knowledge@Wharton](#)

Yes, it pays to be friends of those who pay you, or even to be friends of their friends. That, roughly speaking, is the conclusion of a study analyzing the impact of director relationships on the compensation of chief executive officers.

The study examined director connections as many as a dozen steps removed from each other among 22,074 directors at 3,114 companies across a broad spectrum of economic sectors. The sample is the largest ever examined for this purpose -- to analyze the structure and influence of social networks. Wharton accounting professors [David F. Larcker](#), [Scott A. Richardson](#) and [Irem Tuna](#), and Andrew J. Seary, an expert at the School of Communication of Simon Fraser University in Burnaby, Canada, conducted the research and co-authored a paper entitled, "Back Door Links between Directors and Executive Compensation."



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The researchers call these links "the back door distance," defining that as "the minimum number of other company boards that is required to establish a connection between each pair of directors, ignoring the obvious link that occurs when directors are on the same board."

Thus the back door distance between Director Jack and Director Jill, both at Company A, would be deemed to be two in this scenario Jack is a director also at Company B and Jill is a director also at Company C, and they share a common link with Director Bob, who serves on the boards at Companies B and C. The computation resembles the game popularly known as six degrees of separation.

According to the researchers' calculations, CEOs who had any "back door" link to someone on the company's compensation committee received on average \$453,688 more than CEOs who had no such links. The average compensation for CEOs at firms where inside and outside directors were linked in any way was greater by \$612,422.

While advocates of corporate good governance for years have blamed apparently cozy director relationships for what appears to them to be runaway CEO compensation, previous studies of the issue have examined small samples -- of no more than a few hundred firms -- and have been inconclusive, the four researchers say. The vastness of their sample enables them to be more categorical. "We document that CEOs at firms where there is a relatively short back door distance between inside and outside directors or between the CEO and the members of the compensation committee earn substantially higher levels of total compensation," the researchers write.

They chose to look at the impact on CEO compensation because it is a "readily observable variable," Richardson says. "We could have looked at others, such as the quality of acquisitions, general investments, financial reporting, CEO turnover, or firm value. But CEO compensation is the linkage that the press is all over right now." Besides, he says, research that examines the economic consequences of these links is sparse.

## What Were They Thinking?

The bottom line is that the popular rhetoric is justified in connecting director linkages to the levels of CEO compensation, Richardson says. But here he parts company with those who might impugn the motives of the directors. Vast as their sample was, he notes, it was not adequate to the task of determining what the directors were thinking and feeling when they signed off on CEO pay packages.

There could be innocuous explanations for the extra compensation, he says. The network of links among directors acts as a mechanism to disseminate information, and part of the information may be that a director impressed by the work of a compensation consultant at one company simply takes the template over to another, Richardson says, adding that yet another plausible explanation for the compensation differential could be that directors who serve on multiple boards "inherently are of a higher quality," and therefore the companies where they are directors generate greater value, and that greater value is reflected in the CEO's compensation.

Of course, there could be a sinister interpretation, he suggests, namely that such links are "prima facie evidence of the compromised independence of the board." Directors who serve on multiple boards may look like outsiders but not really be outsiders and may indulge in mutual back scratching.

For now, both the innocuous and sinister interpretations will have to remain in the realm of conjecture, Richardson and his partners say. Vast as their sample was -- it represented 85% of the market capitalization of the Russell 3000 at the end of 2002 -- it won't help researchers divine the true reasons for the statistical connection between director relationships and CEO compensation.

It would take several years of observing the performance of companies to determine if the higher pay received by certain CEOs was based on the executives' merits or was undeserved, Richardson says. Their research sample was derived from board and compensation data collected by Equilar Inc. from company proxy filings for only one year, 2002-2003.

The research team would need additional analysis to determine if the higher CEO pay was the result of favors given and received among directors, Tuna says. A possible extension would be to examine future performance consequences of the back door links. "Our aim was to examine whether there was an association between director links and CEO compensation."

Director links could lead to lower CEO compensation at companies where outside board members are picked with the aim of reducing market risks to the company by aligning it with strategic partners, Tuna notes. Such strategic partners could be a supplier or a lender. In that case, a company need not add as high a risk premium to its CEO's compensation. But, "we found that the closer the links the higher the compensation."

## Navigating through the Web of Directors

The researchers say their study also reveals the limitations of commonplace measures of director interlocks. Standard & Poor's ExecuComp database, for instance, focuses on reciprocal interlocks, they say, where Directors A and B serve on each other's boards. "Such interlocks represent only a small fraction of all linkages between directors" and miss "substantial relations between directors that are more than one step removed from each other," the researchers write.

"Of the 3,114 firms in our sample, only 5.7% are reciprocally interlocked, but 24% are linked within the network. This implies that prior research has failed to capture a large part of the linkages within the corporate director network either due to looking at small samples or by focusing on solely reciprocal interlocks."

The Wharton researchers brought in Seary to help them construct and navigate through the web of directors. "My specialty is calculating things in large social networks," Seary says. Academically, the specialty is called "social network analysis" and it combines sociology and human communications studies. The analysis is based on the assumption that members of a network are interconnected or dependent on each other to different degrees.

"When you have a large number of people like this and a large number of corporations, the number of potential interactions becomes very large. Because these are indirect interactions, it is not readily obvious where they are. It's a problem of calculation and a problem of meaning," Seary notes. "I have developed a tool box of methods for handling very large networks."

It's a toolbox he has used to analyze even larger networks than the corporate directors. He is working right now on building a network of cancer patients and their families. The study is intended to unlock evidence of the roles played by factors such as genetics, lifestyle and diet in the onset of cancer. The network has 100,000 members so far, and Seary believes it will go up to a million.

The conclusions of the study of CEO compensation rest on several caveats, according to the researchers. "First, we use only one year of data in our analysis and this restricts our ability to generalize to other periods," they say. Also, while the back door distance analysis suggests director relationships do influence CEO compensation, it is "difficult to assess" whether these relationships "actually have an important impact on CEO compensation."

The time frame of the sample gives it one advantage, however, the researchers note: It coincides with the introduction of the Sarbanes-Oxley Act, and "this means that our results should reflect the current state of corporate governance."

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