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How Do Institutional Environments Affect Directors' Behaviors and Their Effectiveness?

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How Do Institutional Environments Affect Outside Directors' Behaviors and Their Effectiveness?

Abstract

We examine how institutional environments affect outside directors' behaviors and their effectiveness. Extant research on the board of directors has indicated that outside directors play a significant role in exercising independent control over management and providing resources. However, we know little about whether and how the relative importance of the two functions varies across different institutional environments characterized by distinct dominant exchange modes (contractual vs. relational). By differentiating between relationship-based and contract-based exchange regimes, we develop a conceptual model to show how the differences in transaction structures influence the relative importance of outside directors as monitors and resource providers, and consequently the effectiveness of outside directors. We also argue that the relative emphasis on the two roles is contingent on culture. Furthermore, taking a dynamic perspective of institutions, we explore how outside directors' behaviors change as institutions evolve from a relational one into a contractual one.

Key words: Outside directors, Institutions, Economic exchange, Culture

The role of outside directors is becoming increasingly important globally. In the presence of many corporate scandals in recent years (e.g., Enron Scandal, WorldCom Fraud, etc.), an increased debate on and interest in the effectiveness of outside directors has emerged in academia, industry, and regulatory institutions in both developed and developing economies (e.g., Carter & Lorsch, 2004; CSRC, 2001; Peng, et al., 2003). Research of corporate governance suggests that outside directors play two roles: monitoring management and providing resources (Hillman & Dalziel, 2003; Sundaramurthy & Lewis, 2003). Monitoring involves the assessment of managerial decision making and performance. Agency theorists argue that the formal independence of outside directors leads to more objective evaluation (Fama & Jensen, 1983). In addition to monitoring, outside directors also provide advice and counseling, information channels with external organizations, access to external resources, and legitimacy (Pfeffer & Salancik, 1978). Resource dependence theory suggests that resource-rich outside directors enhance firm performance by serving as boundary-spanners who extract resources from the environment (Pfeffer, 1972).

Although outside directors may theoretically help to improve firm performance, the empirical findings about the performance implication of outside directors are mixed. Some find that there is little relationship between outside directors and firm performance (e.g., Dalton et al., 1998; Finkelstein & Hambrick, 1996), while Westphal (1999) reports a positive effect of outside directors on U.S. firm performance resulting from the frequent advice and counsel interactions. Peng (2004) finds that outside directors of Chinese firms enhance sales growth by taking advantage of their widespread social ties, but they have little impact on financial performance such as return on equity.

We suggest that a possible explanation of these divergent findings on the efficacy of outside directors may reside in the negligence of institutional environment in which the boards operate. In this study, rather than viewing boards functioning in an institutional vacuum, we argue instead that the behavior and effectiveness of outside directors are shaped by the institutional environments. Extant literature suggests that institutional environments greatly influence the strategy and performance of firms by defining the rules of interactions between human, and organizations (North, 1990; Peng, 2003). At the individual level, institutional environments affect how individuals engage in economic and social transactions with others because people are embedded in the institutional context (Granovetter, 1985). Institutions have the power to constrain and also to enable individual behaviors by setting up rules and norms (Hodgson, 2007). Since board members are also embedded in their local institutional context, their behaviors are expected to be influenced by such rules and norms.

Prior research suggests that institutional environments can be broadly categorized into two types based on the dominant exchange regimes (North, 1990; Pearce, 2001; Peng, 2003). The first type is the contract-based environment where the transaction is characterized by impersonal exchange with third-party enforcement. The second type is the relationship-based environment where people rely on social networks to facilitate transactions with others. Focusing on these two types of institutional environments, we develop a conceptual framework to show how the different institutional environments shape the behavior of outside directors. Specifically, we argue that outside directors in the contract-based environment would emphasize both monitoring and resource provision roles, while they would place more emphasis on the resource provision role in the relationship-based environment. Such difference in the relative emphasis on the two functions determines the effectiveness of outside directors in various tasks. We also

suggest that the relative importance of outside directors as monitors and resource providers is contingent on the cultural attributes of individualism vs. collectivism. Furthermore, taking a dynamic perspective of institutions, we indicate how outside directors' behaviors change as institutions evolve from a relational one to a contractual one.

This article makes several important contributions. First, by integrating the institutional perspective with research on board of directors, we highlight the importance of institutional context when we analyze directors' behaviors and their effectiveness. We specifically advance the idea which integrates agency and resource dependence perspectives (Hillman & Dalziel, 2003) by incorporating the effects of dominant economic exchange mode in the institution to predict directors' behaviors. We also extend the resource dependence argument on board capital by presenting the argument that one type of capital (i.e., human or social capital) is more useful in one context than in the other context. Further, we advance our knowledge on board effectiveness by specifying what goals certain directors' behavior can achieve in a specific institutional context. Finally, we incorporate the dynamic aspect of directors' behaviors by incorporating the recent theoretical development on institutional change.

BEHAVIORS OF OUTSIDE DIRECTORS

Outside directors typically play two different roles: monitoring and resource provision (Hillman & Dalziel, 2003; Sundaramurthy & Lewis, 2003). Monitoring is emphasized in agency theory literature, which is based on the assumption that managers may act to maximize their own self interests (Fama, 1980; Jensen & Meckling, 1976). This activity requires the assessment of CEO's performance and strategic decision makings, based on both objective and subjective measures, and designing the CEO evaluation schemes including compensation and succession

planning. In this role, it is argued from an agency theoretic perspective that the independence of outside directors from management is a critical factor for the directors to function effectively.

A resource provision role is more consistent with a resource dependence perspective. Resource dependence research has focused on directors' expertise, knowledge, and skills as well as their ties to external organizations, and their effects on organizational performance (Pfeffer & Salancik, 1978). Hillman and Dalziel (2003) argue that such human and social capital is the antecedent of the directors' resource provision activities. In this role, the board provides advice and counseling, information channels with external organizations, access to external resources, and legitimacy. In this perspective, however, directors' incentives to provide their resources are not specified and the focus is rather on the board members' ability to provide valuable resources to the firm (Dalton et al., 1998). Researchers have recently attempted to combine the directors' resource provision and incentive issues by integrating agency and resource dependence theories (Hillman & Dalziel, 2003). In this article, we will focus on the relative importance of these two roles of outside directors in different institutional environments.

INSTITUTIONAL ENVIRONMENTS AND EXCHANGE MODES

Institutional theory has been widely adopted in research of organization and management. The core argument of institutional theory is that the behaviors of people and organizations and their consequences are influenced by the institutions which structure human interactions (North, 1990). The three pillars of institutions, namely regulative, normative, and cognitive pillars, provide the constraints and guidance on people's behaviors (Scott, 2001). People need to follow such "rules of the game" so as to reduce uncertainty, obtain legitimacy, and thus survive in the changing environment (DiMaggio & Powell, 1983; North, 1990). Since outside directors are

embedded in the local institutional context just like other economic actors, we believe that institutional theory is useful in analyzing their behaviors and effectiveness.

Although each institutional environment has unique characteristics in terms of economic exchange mode, there is a consensus that there are broadly two types; contract-based and relationship-based (Moran & Goshal, 1999; North, 1990; Peng, 2003). In an environment where contract-based transactions are prevalent, people reply on third-party contract enforcement when they enter into economic exchange with others. In such a contract-based institutional context, the formal legal and regulatory regimes govern the transaction. Hence, economic transactions are often conducted between arms-length exchange parties. Many developed economies, such as the U.S. and the U.K., belong to this category. The second type of exchange mode, relationship-based, is widespread among most developing and emerging economies (Peng, 2003) and in some developed economies (Berger & Dore, 1996). Relationship-based transaction usually relies on specific personal relationships and hence economic exchange is often personalized (North, 2000). In this relationship-based institutional environment, people need to build wide and reliable social networks to facilitate transactions with others (Peng, 2003). Many institutions have both types of transaction mode and therefore, emphasis on either relational exchange or contractual exchange is not dichotomous but rather continuum. But for simplicity of our discussion, we develop our argument by separating the institutions into these two types.

INSERT FIGURE 1 AROUND HERE

INSTITUTIONAL ENVIORNMENTS AND BEHAVIORS OF OUTSIDE DIRECTORS

We argue that the two exchange modes shape outside directors' behaviors differently by affecting two factors: the role of social ties between managers and outside directors, and the relative importance of human capital and social capital (referred as *director capital* afterwards) possessed by outside directors. Due to the distinct roles of the two factors in relational and contractual environments, outside directors differ in their incentives and capabilities to get involved in monitoring and resource provision.

Social Ties between Top Managers and Outside Directors

In the relationship-based institutional environment, economic exchange often relies on personal relationships. Managers therefore attempt to build and nurture strong social networks through which they engage in relational transactions (Peng, 2003). In such a context, since the formal sanction mechanisms are not always effective, reliable, or sometimes absent (North, 1990), managers have to depend on personal ties to reduce uncertainty and mitigate the risk of opportunism and moral hazard. This suggests that managers need to develop trust in their exchange partners through time-consuming interactions.

Mayer et al., (1995: 712) define trust as the "willingness to be vulnerable to another party when that party cannot be controlled or monitored," which entails risk because one exposes oneself to a vulnerable situation by trusting another. When trust is absent in an exchange relationship, one has to rely on monitoring to influence behaviors of one's exchange partner and thereby reducing uncertainty and protecting oneself. This also means that when managers trust their exchange partner, they can lower their safeguards and leave more autonomy to their partner (McEvily, Perrone & Zaheer, 2003). However, strong oversight and control of one's exchange partner in a low-trust relationship can create greater social distance and also lead to negative

feelings between partners (Gulati & Westphal, 1999; Sitkin & Roth, 1993), because such behavior send a negative signal to the other party. Westphal and Khanna (2003) find that outside directors who closely monitor and challenge their CEOs are often punished through social distancing in the U.S. context. Indeed, the board norms in the U.S. appear to discourage board members from challenging CEO unless they need to replace him or her (Lorsch & Maclver, 1989; Westphal & Bednar, 2005). It is expected that such mechanism is even greater in the relationship-based institutional context, because outside directors are deeply embedded in social networks where social distancing can have greater impact on their future appointments and access to other resources. Therefore, it is likely that the board norms in the relational context discourage outside directors from choosing behaviors such as objective monitoring that create greater social distance.

Another aspect that will likely affect outside directors' monitoring behaviors is the access to information. The literature on social networks suggests that strong ties tend to promote dense information flows within the social network (Granovetter, 1973). This suggests that in the relationship-based institutional environment where people heavily rely on their social networks, information is often shared among members within the same network. As a result, insiders and outsiders of the social network receive information different in quality and quantity. Therefore, in the relationship-based institutional environment, information asymmetry between those in the same social network and others tend to be large. If an outside director is not perceived and treated as an insider of the social network of management, his or her access to vital information can be constrained. Although there are usually formal rules that regulate management's information disclosure to the board members even in the relationship-based institutional environment, some key information may be passed along informally through personal ties. This

suggests that outside directors without strong ties with management are left out of the information loop, which makes their function less effective. Hence, it is likely that outside directors are not motivated to keep an independent relationship with management. This implies that monitoring is likely not a priority of outside directors.

In the contract-based institutional environment, specific personal relationships are less important, because exchange partners rely on formal rules to conduct transactions and resolve any disputes (North, 1990). Since the exchange partners follow formal rules and regulations that stipulate each partner's rights and responsibilities, they do not have to depend on personal relationships to reduce uncertainty and the risk of opportunism in economic exchange. While social networks do play a role even in such an environment, their importance in terms of access to information is expected to be lower than they are in the relationship-based environment, because appropriate information disclosure is usually enforced by formal rules. Therefore, compared to the relationship-based institutional environment, social ties are *relatively less* important in the contract-based institutional environment. Although, prior research (Westphal & Khanna, 2003) shows that outside directors who actively monitor their CEOs can be punished even in the contract-based environment such as the U.S., it is likely that they have more discretion to play a monitoring role because it is widely accepted that managerial monitoring is a part of their duties; i.e., monitoring is a contractually agreed upon responsibility for outside directors.

The board norms that are based on personal relationships have important effects on not only monitoring but also resource provision. Close personal ties lead to higher commitment to the relationship and also encourage supportive actions (McDonald, Khanna, & Westphal, 2008;

Perry-Smith & Shalley, 2003). Westphal (1999) argues that social ties between the directors and CEO encourage resource provision by the board members, because such ties make the directors feel more obligated to provide support to their CEO and also make the CEO feel more comfortable to seek advice from the directors. We expect that such norms of reciprocal commitment and support are especially strong in the relationship-based institutional environment, because people rely on specific personal ties established through long-term interactions to reduce uncertainty and protect themselves in economic exchange (North, 2000; Peng, 2003). Therefore, outside directors in the relationship-based institutional environment are likely to emphasize their resource provision role.

The discussion above suggests that institutional environments affect the board norms, which in turn influence the directors' incentives and their relative independence from management. In the relationship-based institutional environment, institutional norms are based on personal relationships in which trust with one's exchange parties plays an important role. Therefore, outside directors are discouraged from behaving in a way that creates social distance from CEO and develops negative feelings in their relationship (Gulati & Westphal, 1999). In short, strict independence of outside directors is not critical or even undesirable. In such a context, outside directors are not encouraged to monitor their CEO objectively. Further, outside directors who play an arms-length monitoring function may not be able to perform their role effectively, because monitoring may lead to greater social distance which in turn affects the information flows between the directors and the CEO. Hence, the relationship-based context does not provide strong incentives for outside directors to play a monitoring role. On the other hand, due to the importance of personal ties in economic exchange and the board norms that

reflect such values, outside directors are more likely to focus on a resource provision role to support their CEO as such a role is more consistent with the norms.

In the contract-based institutional environment, it is expected that norms of reciprocal support are weaker because economic exchange is contract-based (Peng, 2003). In this context, therefore, personal ties are less important. This suggests that whether arms-length monitoring behavior causes social distance to grow is relatively less critical, because outside directors are expected to play that role based on formal rules, responsibilities, and board norms. Therefore, outside directors are likely to be less concerned about negative implications of their formal monitoring of the CEO. Further, they are expected not only to oversee the CEO's strategic decision makings but also to provide advice and counseling if needed, as this is part of their expected responsibilities. Therefore, in this context, personal ties in the director-CEO relationship have smaller effects on directors' behaviors compared to those in the relationship-based institutional environment.

Director Capital

From a resource dependence perspective, directors contribute to improve organizational performance using their human and social capital (Pfeffer & Salancik, 1978). Human capital includes expertise, experience, knowledge, and skills that an individual has (Becker, 1964). Social capital, on the other hand, is an individual's resources that derive from his or her social networks (Nahapiet & Ghoshal, 1998). Hillman and Dalziel (2003) argue that director capital is the antecedents of the directors' resource provision role. However, director's capital is important not only for the resource provision role but also for the monitoring role. In order to assess CEO's strategic decisions and performance, outside directors need to have some knowledge and

expertise in some areas so that they can process the information competently and make appropriate judgment.

What we want to ask here is; what type of director capital is more valuable in a specific institutional environment and how does that affect outside directors' behaviors? There is an argument that human capital and social capital are difficult to separate, because they interact with each other and a director is often chosen not specifically for either his or her human or social capital (Colman, 1988; Lester et al., 2008). In our view, however, institutional difference in terms of the dominant economic exchange mode influences the relative value of each type (i.e., human and social) of director capital and consequently, behaviors of outside directors. In other words, a director may be chosen specifically for the type of capital he or she possesses.

In the relationship-based institutional environment, economic exchange relies on specific personal relationships and therefore, social capital plays an important role in promoting economic exchange and reducing transaction costs (Peng, 2003). In such an environment, outside directors are likely to provide resources by taking advantage of their social capital (Au et al., 2000). Moreover, outside directors are likely to be chosen based on their ability to leverage resources from external organizations. For example, politicians are often appointed as outside directors in the Chinese boards precisely because they have direct ties in the political networks (Peng, 2004). Therefore, while the director's social capital is an important resource in the contract-based environment as well (Hillman, 2005; Lester et al., 2008), we argue is that it is *relatively more* important in the relationship-based environment, because (1) the dominant economic exchange mode is relational and, (2) the monitoring function is less emphasized as discussed earlier and hence, human capital (i.e., professional knowledge and expertise) to assess

CEO's strategic decisions and performance is less critical. In other words, "who you know is more important than what you know" in such an environment (Peng, 2003). In our view, this relatively greater value of social capital motivates outside directors to emphasize their resource provision role in the relationship-based institutional environment.

In the contract-based institutional environment, both the director's human capital and social capital are important. However, compared to the relationship-based institutional environment, the value of the directors' social capital is likely to be lower in this environment, because the dominant mode of economic exchange is contractual and hence, there is smaller room for personal ties to play. Although personal relationships do have some role in this environment, people rely on formal rules and contracts to reduce uncertainty and moral hazard (North, 1990). Human capital of outside directors is important because their formal role includes monitoring of their CEO's strategic decisions and performance, which usually requires some professional knowledge, expertise and experience. Hence, "what you know" is as important as or sometimes more important than "who you know" in this environment.

However, although the directors' human capital and social capital are both valuable in the contract-based institutional environment, the directors' resource provision role tends to be *relatively less* emphasized in the contract-based institutional environment compared to the relationship-based institutional environment for the following reasons. First, as discussed above, the value of the directors' social capital tends to be lower in this environment and therefore, the directors have lower need and incentives to utilize their social capital compared to their counterparts in the relationship-based institutional environment. Second, the board norms are likely influenced by the formal rules and procedures rather than personal ties and hence, the

director-CEO relationship is *less* affected by the social exchange norms that emphasize reciprocity and mutual support. Therefore, it is likely that the incentives of outside directors to provide their resources to the CEO are moderated by the formal institutional rules.

From our discussions on personal ties and director capital in the different institutional environment, we draw the following propositions:

Proposition 1: In the relationship-based institutional environment, outside directors are more likely to emphasize their resource provision function.

Proposition 2: In the contract-based institutional environment, outside directors are likely to emphasize both the monitoring and resource provision functions.

Proposition 3: Comparing the relationship-based institutional environment and the contract-based institutional environment, the resource provision role is more emphasized in the former.

Contingency Exerted by Culture

We have so far discussed the impact of institutional environments on behaviors of outside directors without taking cultural differences into consideration. However, cultural values can possibly exert some effects on how business transactions are conducted (Peng, 2003). For example, even if the institutional environment has mechanisms to enforce contract-based transactions, relational exchange may still be preferred because of culture values that emphasize relationships. One cultural distinction that has been widely used in previous studies is individualism-collectivism (Hofstede, 1980; Triandis, 1995). Since people in a collectivist culture and an individualist culture tend to have difference values and orientations in their relationships with others, it is likely that the cultural differences affect how people prefer to transact with others.

One of the major differences between individualist culture and collectivist culture is the relative emphasis on personal relationships (Chen et al., 1998). Collectivists tend to value harmonious relationships with others even at the expense of task performance, while individualists are more focused on task performance rather than personal relationships (Kim et al., 1994). Also, behaviors of collectivist are more likely to be influenced by social norms and obligations and hence, they tend to emphasize conformity to such informal expectations. Individualists are, on the other hand, more likely to behave based on their personal values and beliefs (Davidson et al., 1976). These different attributes of individualists and collectivists are expected to have some impact on how people behave in economic exchange.

We have argued that people often engage in relational exchange in the relationship-based environment. In a collectivist culture, it is likely that this tendency is more emphasized regardless of the institutional environment, because the relational exchange is more consistent with their cultural values (Chen et al., 2002). In the context of the director-CEO relationship, this suggests that outside board members in the collectivist culture are more likely to emphasize their resource provision role as opposed to their monitoring role, because such activity is consistent with their cultural values. Also, in the collectivist culture where personal relationships are highly emphasized, it is likely that the directors' social capital has higher values and hence, they are more motivated to use such capital. Further, monitoring activities are likely to be avoided in such a cultural environment, because such activities create social distance and can possibly strain the relationship (Gulati & Westphal, 1999). Hence, it is likely that the collectivist culture positively affects resource provision and negatively affects monitoring activities. On the other hand, individualist culture will likely have limited effects on the directors' behaviors. Since individualist culture places less emphasis on relationships compared to collectivist culture,

directors' behaviors are more likely to be influenced only by the relative functional values of personal ties and their capital in the institution. This suggests that individualist culture will not positively nor negatively moderate the effects of institutional environments on the directors' behaviors. Therefore,

Proposition 4: Collectivist culture positively moderates the relationship between resource provision and the institutional environment, whereas it negatively moderates the relationship between monitoring and the institutional environment.

COMPLEMENTARITIES OF DIRECTORS' BEHAVIORS AND INSTITUTIONS

Recent research on comparative corporate governance suggests that it is critical to examine complementarities of corporate governance practices when we analyze the effectiveness (Aguilera et al., 2008; Khanna et al., 2006). For example, Aguilera et al. (2008) argue that independent directors, executive compensation, information disclosure, and takeover markets form a key set of complementary elements in the Anglo-American model of corporate governance. In our view, this idea also applies to the complementary relationships between the directors' two roles (i.e., monitoring and resource provision), types of director capital, and institutional environments. Different institutional environments call for different behaviors and different types of capital of outside directors for them to function effectively. It is also important to note, however, that each complementary set is beneficial for certain objectives, but it does not serve or even undermines other purposes. This implies that board effectiveness that derives from a specific complementary set can be assessed by different measures. Previous research (e.g., Aguilera et al., 2008) examines the relative effectiveness of different governance

complementarities. But here, we present both specific benefits and costs in each complementary set.

Benefits of Complementarities

While certain role of the directors and institutional characteristics are in complementary relationships, the directors' role serves different purposes in different institutional environments. In the relationship-based institutional environment, we argue that there are complementarities between the directors' resource provision role and the relational economic exchange mode. Since economic exchange is largely based on personal relationships, outside directors can bring in their social capital to the board and promote relational transactions for the firm by leveraging their social networks. By using their external ties, outside directors can also help lower transaction costs and mitigate uncertainty and risk in economic exchange (Peng, 2004). Therefore, outside directors' resource provision and their social capital are in complementary relationships with the relationship-based institutional environment.

Proposition 5: Outside directors' resource provision role and their use of social capital are in complementary relationships with the relationship-based institutional environment; this complementarity promotes relational transaction and lower risks and costs of such transaction.

In the contract-based institutional environment, outside directors' monitoring role is in a complementary relationship with the institutional environment. Formal rules and procedures require that outside directors oversee their CEO's strategic decisions and performance. Outside directors can be held liable if they do not follow the proper procedure to monitor the CEO. In order for outside directors to play a monitoring role effectively, they are also required to be independent from management. Hence, all these arrangements are in complementary relationships with their monitoring role (Aguileta et al., 2008). Further, using their human capital,

outside directors may be asked to provide their advice and counseling to their CEO. In fact, their task involves not only to monitor but also to advise the CEO by using their professional knowledge and expertise when the CEO makes strategic decisions (Hillman & Dalziel, 2003). However, due to the prevalence of the contract-based economic exchange mode, their social capital is likely to be *less* valuable in this context than in the relationship-based institutional environment as discussed earlier. Hence, outside directors' effectiveness is likely dependent upon their performance in the two roles and their use of human capital.

Proposition 6: Outside directors' monitoring and resource provision roles and their use of human capital are in complementary relationships with the contract-based institutional environment; this complementarity promotes greater managerial monitoring and provision of counseling.

Costs of Complementarities

While outside directors' behaviors that are in a complementary relationship with the institutional environment can be effective in achieving certain objectives, they are not able to fulfill other objectives or even cause problems. Outside directors serve to oversee managerial decision-makings and performance, including equitable allocation of firm resources and profits among shareholders and key stakeholders, and to provide counseling to the CEO (Hillman & Dalziel, 2003). In the relationship-based institutional environment, outside directors' focus on the resource provision role leaves their managerial control weak. This implies that outside directors are not effective in preventing management from acting opportunistically and thereby harming the interests of the firm's stakeholders including shareholders. It is likely that the more important role the personal ties play in economic exchange and in the CEO-director relationship, the more the directors emphasize their resource provision role, the weaker the managerial

monitoring by outside directors is. Hence, a strong complementarity between the directors' resource provision and the relationship-based institutional environment will likely lead to less effective managerial monitoring by outside directors.

Further, in the relationship-based institutional environment, enforcement of formal rules and regulations to ensure outside directors' accountability may be weak (North, 1990). This may lead to another kind of cost. When the directors and managers belong to the same social networks in the relationship-based context, there is no mechanism to prevent the directors from extracting firm resources. In other words, the risk of resource appropriation exists not only from management but also from outside directors in this context. For example, in China which is a relationship-based institutional context, government officials often sit on the board as outside directors. Some regard that they accept the board positions because such appointments allow them to extract firm resources for their personal benefits (Cull & Xu, 2004). Hence, the risk of resource appropriation by outside directors themselves is another cost factor in the relationship-based institutional environment.

Proposition 7: Complementarities of outside directors' resource provision, their use of social capital, and the relationship-based institutional environment increases the costs that arise from (a) risk of managerial opportunism, and (b) risk of resource appropriation by outside directors.

In the contract-based institutional environment, outside directors serve to perform a managerial monitoring function as well as a counseling role. In this environment, outside directors' social capital may not be fully leveraged, because such capital is not always useful in the contract-based and impersonal exchange context. Also, this environment emphasizes the independence of outside directors from the CEO and therefore, the directors are socially and emotionally not obligated to provide their resources to the CEO based on social exchange norms.

This suggests that outside directors' social capital tends to be under-utilized in the contract-based institutional environment, although opportunities to use such capital would be more limited in such an environment any way. This also implies that transaction costs that arise from designing formal safeguards against the risk of opportunism and moral hazard will increase (McEvily et al., 2003). Further, information needs to be disseminated following the formal procedures to outside directors who usually lack intimate firm specific and industry knowledge and often have no other ways to obtain key information due to their independence. This raises bureaucratic costs (Aguilera et al., 2008). Hence,

Proposition 8: Complementarities of outside directors' monitoring and resource provision, their use of human capital, and the contract-based institutional environment increases the costs that arise from (a) under-utilization of the directors' social capital, (b) formal safeguards against the risk of opportunism, and (c) formal bureaucratic procedures.

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INSTITUTIONAL CHANGE AND DIRECTOR BEHAVIORS

Our discussions so far have treated institutions as relatively stable as consistent with the original notion of institutional theory. North (1990) views institutions as both formal and informal rules that constrain human interaction in a society. Scott (2001: 48) similarly defines institutions as "social structures that have attained a high degree of resilience" that are "composed of cultured-cognitive, normative, and regulative elements." The common notion in these definitions is that institutions provide a framework or structure for social interaction and organizations gain legitimacy by following and accepting the both formal and informal rules within the institution in which they operate. Hence, institutions tend to reinforce the continuity of established systems and practices.

However, institutions are subject to change due to external and internal pressures (Dacin, Goodstein, & Scott, 2002; Greenwood & Hinings, 1996; Scott, 2001). Institutional change is a process that entails change in the formal and informal rules of human interaction and in the enforcement mechanisms of such rules (North, 1990), or the deinstitutionalization of existing institutional practices (Czarniawska & Sevón, 1996; Scott, 2001). Oliver (1992) distinguishes the functional, political, and social sources of institutional change. Functional pressures can arise when external market change or decline in economic performance may call into question the appropriateness or instrumental usefulness of existing systems or practices. Political pressures stem from rising performance crises and shifts in the interests and balance of power among the key players. Social pressures can arise from changing social expectations and norms or the emergence of a greater diversity of beliefs and practices within an institution. Hence, pressures to change existing practices come from multiple sources.

Many economies that are characterized by relational exchange often adopt more contract-based and impersonal transaction modes, as their institutions evolve and start implementing formal rules to regulate economic exchange (North, 1990). This type of change or transition can take place when economic transactions in the institution becomes too complex and social networks based on personal ties can no longer function effectively to reduce uncertainty and mitigate the risk of opportunism (Peng, 2003). However, regardless of the presence or absence of the gap between the existing economic exchange mode and the institutional rules, an institution sometimes faces external or internal pressures (often political or social) to adopt new rules and practices. In the area of corporate governance and the board of directors in particular, many countries and firms have been under rising pressures from global financial markets and international organizations to reform their system and practices (Aguilera & Cuervo-Cazurra,

2004; Yoshikawa & Rasheed, 2009). Such a call for governance reforms often includes the adoption of independent outside directors as a monitor of management (Ahmadjian & Song, 2004; Chizema & Kim, 2009; Peng, 2004). As a response, many countries have revised their corporate governance rules and regulations that require independent directors on the board of their domestic firms.

When the institutional environment still relies on relational exchange, however, such reform measures may have negative effects on institutional complementarities between directors' behaviors, director capital, and the economic exchange mode. The gap between the formal rules and the existing practices, which influences institutional norms, is often resolved by decoupling (Meyer & Rowan, 1977). At the organizational level, prior research shows that firms often decouple the actual practices from the officially claimed policy (Buck & Shahrim, 2005; Fiss & Zajac, 2004) when they confront pressure to adopt institutionally contested practices (Sanders & Tuschke, 2007). Hence, while the firm adopts the formal rules that require the independence of outside directors who are responsible for monitoring management, it complies with such rules only superficially and does not enforce them and consequently, the actual practices may remain the same. For example, a firm can appoint an outside director who is independent according to the official rules but has some ties with management, or it can select an individual who is likely not to challenge management. This suggests that when there is a large gap between new governance rules and the institution's economic exchange mode, symbolic compliance and decoupling will be likely to happen.

Proposition 9: The greater the gap between the formal rules on outside directors, which emphasize their independence and monitoring responsibility, and the institutional environment, the more likely the firm will symbolically comply with the rules and less likely the outside directors will change their behaviors.

As economic transactions in the institution becomes more complex and incorporates more rule-based mechanisms and gradually develops the norms of contractual exchange, then the relationship-based institutional environment may evolve (North, 1990; Peng, 2003). Such an evolution can make impersonal and arms-length exchange less risky and consequently, the importance of personal ties in economic exchange will be reduced. This change in the institution's economic exchange mode can possibly affect the directors' behaviors in two ways. First, as the institution shifts toward the contract-based environment, it will have to establish more formal rules, including those on the roles of the board of directors, which govern economic exchange (Peng, 2003). As discussed earlier, adoption of formal rules can take place without any significant shift in the economic exchange mode, which, as we have argued, leads to decoupling. However, when the dominant economic exchange mode and the formal rules are not in conflict, chances of decoupling will be reduced and outside directors' behaviors will be more likely to reflect the formal rules. As the institution moves toward the contract-based environment from the relationship-based environment, therefore, the organization may choose to adopt the new rules not symbolically but substantively and consequently, outside directors would adopt behaviors based on the formal rules that often emphasize their monitoring and control role. Hence, a narrower gap between the formal rules and the institution's economic exchange mode will enhance chances of outside directors changing their behaviors.

Proposition 10: As the gap between the formal rules on outside directors, which emphasize their independence and monitoring responsibility, and the institutional environment narrows, the more likely the firm will adopt and enforce the new practices and more likely the outside directors will change their behaviors; more emphasis on the monitoring role.

While enforcement of the formal rules or the regulative pressure would be a strong trigger of change in directors' behaviors as such pressure has coercive power (Scott, 2001), shift in the relative value of directors' capital due to the change in economic exchange mode can also affect their behaviors. When the dominant economic exchange mode becomes more contractual and impersonal, the directors' social capital becomes *relatively less* useful and therefore, they have fewer opportunities to utilize such capital. Further, as discussed earlier, personal ties in the director-CEO relationship may also become less important as the board norms would be more influenced by the formal rules and procedures. The shift in economic exchange mode also makes the directors' human capital relatively more valuable, as "what you know" becomes more important than "who you know." This suggests that when the institution's economic exchange mode changes significantly and becomes more contractual, outside board members will be more likely to change their behaviors with relatively less emphasis on resource provision role.

Proposition 11: As the institution moves from the relationship-based environment to the contract-based environment, outside directors' social capital becomes less and human capital more valuable, and consequently, they will be more likely to change their behaviors; reduce their emphasis on the resource provision role.

As discussed earlier, it is likely that collectivist culture has a positive moderating effect on the directors' resource provision and a negative moderating effect on their monitoring activities regardless of the institutional context. As it is unlikely that cultural attributes such as collectivism and individualism will change quickly during a short period of time, collectivist culture which emphasizes personal relationships is expected to moderate the relationship between the institutional environment and outside directors' behaviors even after the institution incorporates more contract-based rules and practices. Hence,

Proposition 12: Culture has a moderating effect on outside directors' behaviors even after the institution has shifted to the contract-based environment; Outside directors are more likely to emphasize their resource provision role than the monitoring role in a collectivist culture than in an individualist culture.

DISCUSSION

Contributions

We have presented a conceptual model that incorporates research on the board of directors and an institutional perspective. Our main argument is that behaviors of outside directors (monitoring and resource provision) are influenced by the dominant economic exchange mode (relational vs. contractual) of the institution. We have also discussed the moderating role of culture, especially collectivist culture on the directors' behaviors. Also, we have argued that complementarities of outside directors' behaviors, capital, and the institutional environment will be effective in achieving certain objectives but not others. In other words, each complementary set entails some benefits as well as costs, because it is not structured to pursue all the goals. Further, we have presented an argument that institutional change may lead to change in directors' behaviors. This could happen if such a change leads to new formal rules that are consistent with the economic exchange mode in the institution, and when directors are motivated to change their behaviors because the relative value of their specific types of resources also changes. Hence, our model incorporates dynamic aspects of the relationship between institutional environments and directors' behaviors.

This article makes several contributions. First, our conceptual model shows that institutional environments have important effects on what outside directors can and are expected to do in a specific institutional context and hence, contributes to the literature on the relationship

between governance and institutions (Aguilera & Jackson, 2003; Ahmadjian & Robbins, 2005; Peng, 2004). Since outside directors are embedded in the local institutional environment, their behaviors in the boardroom are expected to be influenced in the institutional rules and norms. This article has presented the argument that links the institutional environment and directors' behaviors and thereby proposing the multi-level model.

Second, we have incorporated the moderating effects of culture on the directors' behaviors. The impact of culture has not been explicitly discussed in the institutional theory literature. Previous governance research on the board does not incorporate the effects of culture either. However, it is natural to assume that social norms and the "rules of the game" in the institution are influenced by culture and therefore, the directors' cultural orientation will likely affect how they behave in the boardroom. Our argument is that institutions and culture have an interaction effect on how outside directors behave in the boardroom. In this article, we have explicitly incorporated the effects of culture, especially collectivist culture on the directors' propensity to emphasize their resource provision role as opposed to the monitoring role, even after the institution has shifted to a more relationship-based environment.

Third, we have advanced the discussion on the director effectiveness by incorporating the concept of complementarities. Complementarities of corporate governance practices are becoming an important issue in research on international corporate governance (Aguilera et al., 2008). Each institution has a set of existing practices as well as formal and informal rules that work together as a system (Schmidt & Spindler, 2004). Hence, new practices imported from another context may not function well in different environments. In this article, we have focused on complementarities between directors' behaviors, their capital, and economic exchange mode

in the institution. In the agency theory framework, outside directors are expected to play an independent monitoring role. From the resource dependence perspective, it is argued that outside directors can leverage their resources to enhance organizational performance. However, their monitoring function would not necessarily lead to expected or desired outcomes in some institutional environments, and the types of director resources or capital that are valuable may vary by institution. By incorporating the institutional perspective to corporate governance research, this article shows that it is important to consider a fit between directors' roles, capital, and the institutional environment. Further, we have advanced the complementarity argument by specifying the benefits and costs of each complementary relationship. This argument also reinforces the view that complementarities do not always lead to greater effectiveness (Aguilera et al., 2008).

Lastly, this article has addressed the impact of institutional change on directors' behaviors. While institutions are often stable, they are subject to change due to external shock or pressures from internal and external forces (Dacin et al., 2002). Our discussion has framed the change in directors' behaviors in the argument of institutional change. We have examined how changes in formal institutional rules without substantive change in the transaction mode can lead to decoupling even though the directors' formal roles have changed. We have also presented the argument that directors' behaviors would change only when there is consistency between the formal rules and the institution's economic exchange mode. The key point here is a fit between the formal institutional rules and the institution's dominant economic exchange mode. Further, the article has included the moderating role of culture. Specifically, we have argued that collectivist culture will have a positive moderating effect on the directors' resource provision role even when the institution has implemented more contract-based transaction rules.

Implications for Future Research

By incorporating the influence of institutions, we believe that researchers will be able to examine the effectiveness of outside directors more accurately. Since each institution has a unique set of formal and informal rules, it constrains what outside directors are able to do. Further, those rules also determine how the directors can contribute to certain goals but not others, as certain behavior is more consistent with the institutional rules and norms. By including the institutional factors in the analysis, we will be able to go beyond the argument that greater monitoring of CEO by independent outside directors or greater board capital is beneficial to firm performance and shareholders.

Second, there is a rising attention among researchers on complementarity of governance practices (Aguilera et al., 2008; Yoshikawa & Rasheed, 2009). However, there is still limited focus on multi-level complementarities. This article has focused on the complementary relationships between directors' behaviors (i.e., monitoring and resource provision) and the institution's economic exchange mode. Future research can pay more attention to the relationship between macro or institution level factors and micro or individual level factors. After all, individual economic actors are also embedded in the institution and a fit between the different levels can have some important performance implications.

Finally, future research on the board of directors may also benefit from incorporating the effects of culture, especially when we examine the individual-level behaviors. Most previous governance research especially on the board does not take cultural differences into consideration. However, cultural attributes such as collectivism and individualism may have important effects on how board members behave individually and also how group norms in the boardroom are

shaped. For example, as we have discussed, directors might not be encouraged to play an active monitoring role in a collectivist culture where relationship are valued and group harmony is emphasized. Even in the individualist context such as the U.S., directors who challenge their CEO can be punished through social distancing (Westphal & Khanna, 2005). Such sanction may be even stronger in the collectivist culture. Future research on the board can address such an effect.

CONCLUSION

There are a voluminous number of studies on the performance effects of outside directors and the board and yet, their conclusions are mixed. At the same time, there is a rising interest in comparative corporate governance that incorporates the institutional perspective. Our aim in this article is to advance the literature by connecting the research on the board of directors and studies on comparative corporate governance. The model we have developed here attempts to show that institutions matter when we examine the behaviors and effectiveness of outside directors and that the director's effectiveness is influenced by multi-level complementarities. We hope that the arguments we have presented will motivate further research to enrich our understanding of the functioning of the board in diverse environments.

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Figure 1: Institutional Environment, Outside Directors' Behavior, and Outcome

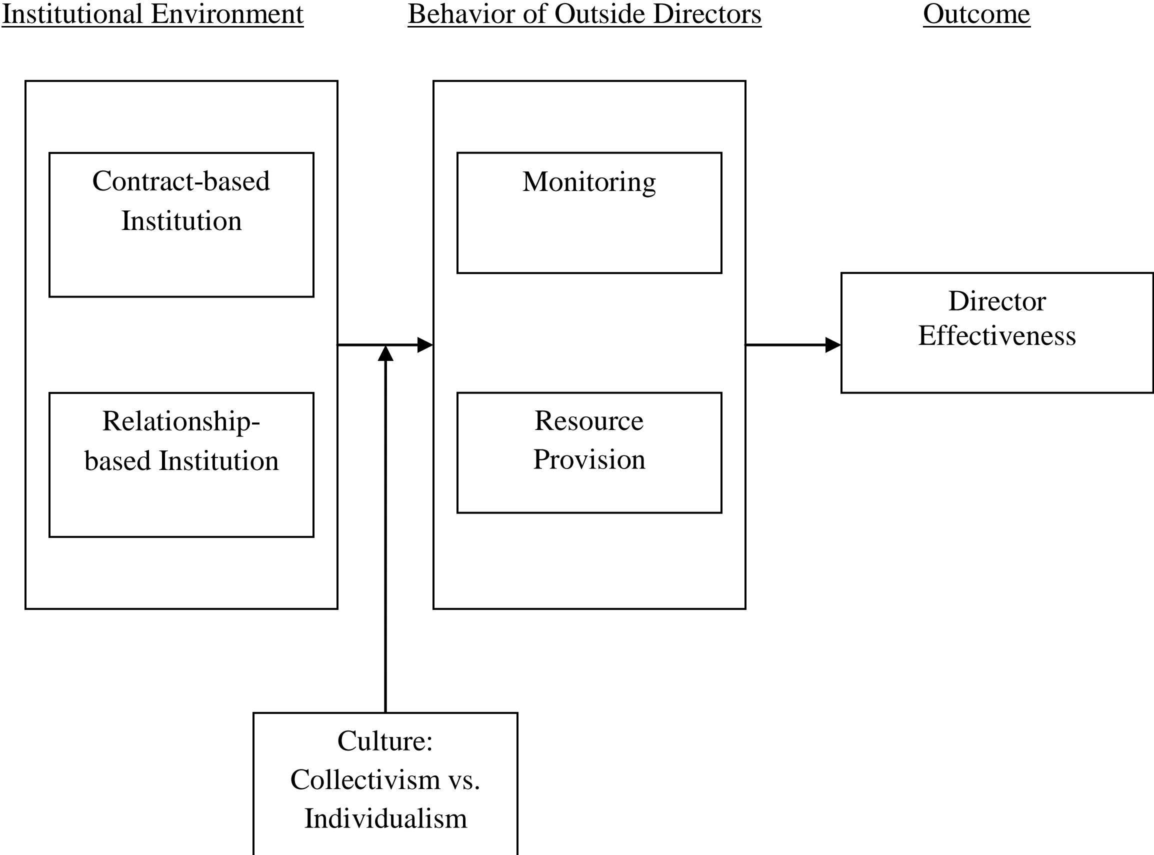

Table 1: Comparison of the Two Institutional Types

Institutional Type	Director Behaviors	Director Capital	Benefits	Costs
Relationship-based Institution	Resource Provision > Monitoring	Social Capital > Human Capital	Promotion of relational transaction; Lower transaction costs	Managerial opportunism; Risk of resource appropriation by directors
Contract-based Institution	Monitoring > Resource Provision	Human Capital > Social Capital	Prevention of managerial opportunism; Provision of counseling if required	Potential high transaction costs due to under-utilization of directors' social capital; Bureaucratic costs of information dissemination

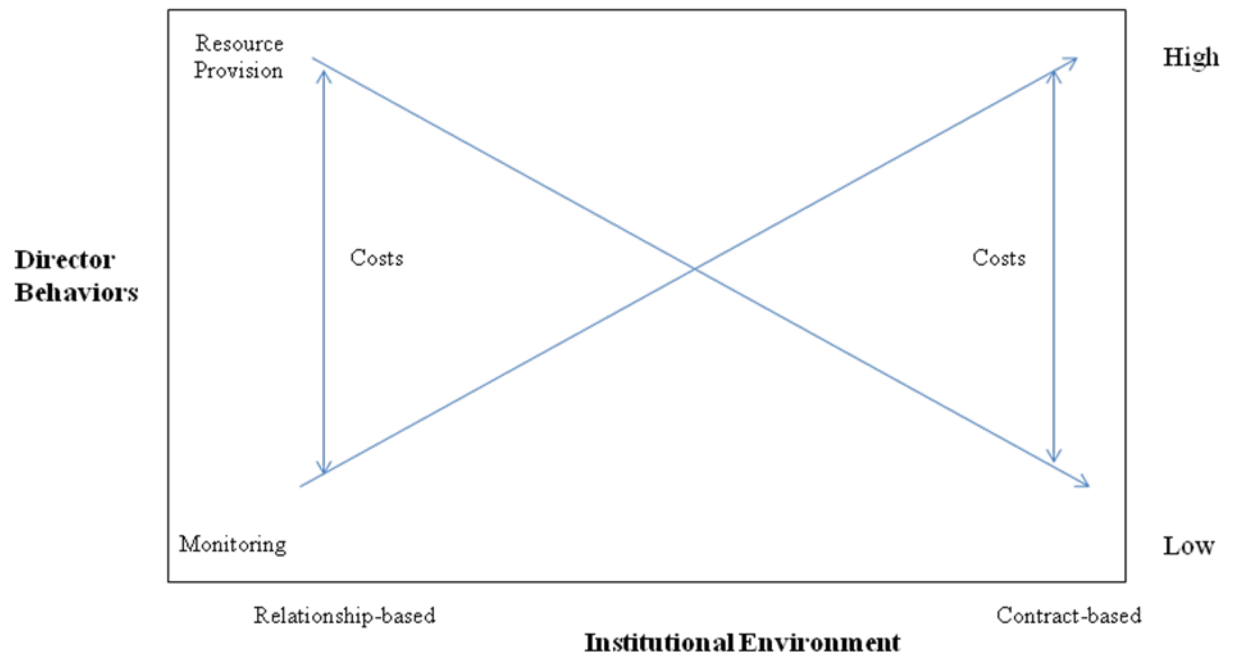
Figure 2: Effects of Institutional Environment on Director Behaviors
Resource
Provision
High
Director
Behaviors
Costs
Costs
Monitoring
Low
Relationship-based
Contract-based
Institutional Environment