



Leaving before bad times: Does the labor market penalize preemptive director resignations? ☆

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ABSTRACT

When firms experience negative events such as lawsuits or earnings restatements, their directors also suffer. But what about those who leave shortly before the events? I show that directors who leave prior to negative events experience greater declines in the number of their directorships than directors who stay through the events, but smaller declines than directors who leave after the events. These declines do not appear to be voluntary or driven by forced departures. Instead, they appear to be the results of labor market penalties. The results suggest that resigning pre-emptively does not protect directors from labor market penalties.

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1. Introduction

How effective is the director labor market? Prior studies suggest that, when firms experience negative events (e.g., class action lawsuits, and earnings restatements), their directors also suffer. Some directors are removed from the boards in the post-crisis period (e.g., Brochet and Srinivasan, 2014; Srinivasan, 2015); while some others experience a decline in their subsequent number of board seats (e.g., Fich and Shivdasani, 2007; Fos and Tsoutsoura, 2014). However, while there is ample evidence that the labor market penalizes directors who are present when the events occur, whether directors can avoid these penalties by resigning shortly before the events is less clear.

I examine the labor market consequences for independent directors who resign before the firm experiences a negative event. Pre-emptive resignations are not a new topic in the director turnover literature. Brown and Maloney (1999) find that when outside directors of acquirer firms resign prior to acquisitions, acquirers experience lower announcement returns. The

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authors' interpretation is that outside directors have an incentive to leave when they expect the firm to perform poorly. [Asthana and Balsam \(2007\)](#) find complementary evidence that anticipation of subsequent poor performance is a significant predictor of independent director departures. [Fahlenbrach et al. \(2017\)](#) show that anticipation of negative events such as lawsuits or earnings restatements leads independent directors to resign from a firm to protect their reputation and avoid an increase in their workload.

There are many reasons why independent directors might leave prior to negative events. First, directors have to invest additional time and effort when the performance of the firm declines. [Vafeas \(1999\)](#) finds an increased number of board meetings following share price declines. Since independent directors tend to hold multiple board seats and face time constraints ([Fich and Shivdasani, 2006](#)), this workload increase can be particularly problematic. Also, staying with the firm during bad events exposes directors to litigation risks ([Brochet and Srinivasan, 2014](#)). The evidence in [Agrawal and Chen \(2011\)](#) suggests that directors who remain at the firm's board are more likely to be named as defendants in subsequent class action lawsuits compared with those who have already left. Lastly, for some directors, staying also exposes them to the risk of being targeted in proxy contests, which severely damages their reputation ([Fos and Tsoutsoura, 2014](#)). Since being associated with a negative event brings several expected costs as well as damaging a director's reputation, it is reasonable that some directors find it tempting to resign pre-emptively upon anticipating a negative event.

Using class action lawsuits, earnings restatements, severe dividend reductions, and debt covenant violations as proxies for negative events, I show that the labor market does penalize pre-emptive resignations. Specifically, directors who resign prior to negative events experience significantly greater directorship declines than directors who have stayed through these events. Compared to these staying directors who have already been shown by the literature to suffer a reputation damage, resigning directors receive an additional 10.8% reduction in their number of board seats, which is economically significant.

Even though resigning pre-emptively brings stronger penalties than staying through the events, such penalties are still smaller compared to leaving a troubled firm shortly after the negative event occurs. Directors who leave in the post-event period suffer an 18.5% further board seat reduction relative to directors who stay, which is 71% greater than the penalties that directors who leave in the pre-event period receive. The stronger penalties for ex-post departures are not surprising, because these directors may have exposed themselves to lawsuits and proxy contests mentioned above, and are likely held most accountable for the negative events.

Directors may leave a board for other reasons. For example, some director departures may be forced rather than voluntary; some directors may leave a firm to voluntarily reduce their board commitments due to poor health or other time constraints; and some directors may not have anticipated the subsequent negative events when they resign, and thus their resignations should not be considered as "pre-emptive." To address these alternative explanations, I infer a director's reason for resigning by looking at whether multiple directors leave the same firm during the same year, whether the director acquires a new board seat shortly after resigning, and whether the director sold any company stock shortly before resigning. These alternative explanations do not fully explain the decline in board seats. Lastly, as a placebo test, I examine whether directors who resign from matched benchmark firms that do not experience a negative event suffer similar directorship declines. The results suggest that leaving a non-troubled firm during the same period does not have any impact on a director's subsequent number of directorships, confirming that the penalties for resigning only exist among negative-event firms.

After documenting the labor market consequences for pre-emptive resignations, I examine the channels through which these consequences occur. Cross-sectional analysis based on directors' other existing directorships shows that directors who leave a troubled firm shortly before and shortly after the negative events are more likely to also lose their other boards relative to directors who have stayed during the events. Consistent with the baseline results, such likelihood is higher for those who leave in the post-event period than for those who leave in the pre-event period. In addition, I find evidence that directors who stay subsequently acquire more directorships at firms that experience similar negative events. This can be another explanation why directors who leave a negative-event firm suffer greater directorship declines than the staying directors.

Labor market penalties extend beyond the loss of board seats. For directors that leave, there is a higher likelihood of losing committee chairmanships at their other boards compared to directors that stay through the events. Such effect is, once again, stronger for those who leave after the events occur than for those who leave before the events occur. Directors who leave (both before and after the events) also tend to subsequently hold less prestigious directorships. Upon the initial revelation of these negative events, the stock prices of the other firms where the ex-ante resigning directors are still board members react negatively, especially when the resigning directors play important roles on these boards. Relatedly, shareholders in these connected firms tend to react positively when these directors subsequently leave these boards.

This paper aims to fill a gap in the literature on the director labor market. Studies that examine firms experiencing negative events such as bankruptcy ([Gilson, 1990](#)), dividends cuts ([Kaplan and Reishus, 1990](#)), earnings restatements ([Srinivasan, 2005](#)), financial fraud ([Fich and Shivdasani, 2007](#)), option backdating ([Bereskin and Smith, 2014](#)), proxy contests ([Fos and Tsoutsoura, 2014](#)), or rejections of takeover offers ([Harford, 2003](#)) document negative consequences for the directors in these firms. Yet, it is unclear whether such penalties also extend to those who leave before the problem is revealed. Overall, the results in this study suggest that directors cannot avoid the penalties by resigning pre-emptively. Even though the penalties for resigning pre-emptively are smaller than for leaving the firm after the event occurs, they are still much stronger than staying at the firm through the event. Therefore, the labor market appears effective in providing ex-post accountability even if a director tries to abandon a firm ahead of difficult times.

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