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Busy directors and firm performance: Evidence from mergers[☆]

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ABSTRACT

This paper studies whether director appointments to multiple boards impact firm outcomes. To overcome endogeneity of board appointments, I exploit variation generated by mergers that terminate entire boards and thus shock the appointments of those terminated directors. Reductions of board appointments are associated with higher profitability, market-to-book, and likelihood of directors joining board committees. The performance gains are particularly stark when directors are geographically far from firm headquarters. I conclude that the effect of the shocks to board appointments is: (i) evidence that boards matter; and (ii) plausibly explained by a workload channel: when directors work less elsewhere, their companies benefit.

1. Introduction

The effectiveness of corporate boards as an internal mechanism of governance is questioned by skeptics. One common critique is that directors may be overcommitted and too busy to effectively fulfill their duties. A director's role of monitoring and advising management requires devoting substantial time and effort to gather information and make deliberate decisions. The criticism escalates when directors serve concurrently on boards of multiple companies and their workloads compound. The National Association of Corporate Directors recommends that directors devote at least 160 hours per year for every board appointment. Lipton and Lorsch (1992) argue that the duties of a director demand at least 100 yearly hours per board appointment, excluding travel time.[1] Yet concurrent board appointments are not uncommon: more than 20% of directors in Standard and Poor's (S&P) 1500 companies hold multiple board seats and nearly 85% of S&P1500 firms share at least one director with other S&P1500 firms. The heavy workload and prevalence of concurrent directorships spark a debate over the concern that busy board structures are inefficient.

Others, however, question if corporate boards matter at all. Although modeled as a mechanism to monitor and align manager and shareholder interests, much skepticism surrounds whether boards' impact is real and first-order (Yermack, 2006; Adams et al., 2010). Testing boards' relevance boils down to estimating causal effects of board structures. This approach hinges on natural experiments

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[1] Yet since their study, the workload of directors has increased dramatically, especially post Sarbanes-Oxley (Linck, Netter, and Yang, 2009). The issue of busy boards has flared in recent years due to these changes.

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since observed board structures are chosen endogenously by firms facing different needs. One such characteristic of board structure is the service of directors holding multiple concurrent board seats. Identifying its effect is an empirical challenge since appointments to boards are endogenously determined. Firms carefully select directors who match their needs, and those firms appointing directors who serve on multiple boards likely differ from firms appointing directors who serve on fewer boards, in aspects that confound firm outcomes.

This paper aims to identify the direct effect of concurrent board appointments on firm performance. To overcome the endogeneity issues, I exploit variation in board appointments induced by mergers. The empirical strategy uses mergers as a natural experiment that terminates directorships, in view of the fact that when two companies with two boards merge to one company, the vast majority of directorships in the acquired firm are terminated. Aside from rare cases,[2] directors of the target firm "lose" their appointments (Harford, 2003). Econometrically, the advantage of this source of variation is that it allows for examining changes in outcomes as board appointments vary, while absorbing firm and director characteristics. Following such mergers, I examine the performance of the *other* firms which continue to employ the affected directors, and find that their performance improves.

The first contribution of this paper is to provide an identification strategy to test the relevance of boards. I argue that a link between exogenous changes in directors' appointments and their firms' performance is evidence that directors matter. The finding that performance improves following mergers suggests that directors can indeed add or destroy value and hence board structures are more than just window dressing. Secondly, I ask *why* the affected firms may be performing better and turn to investigate potential mechanisms in which concurrent board appointments impact firms.

Specifically, I examine the workload aspect of concurrent board appointments. A merger which terminates directorships presumably shocks those directors with extra time to devote to their other *remaining* directorships. The underlying premise views directors as agents who optimize the time and effort they devote to their various commitments. If one commitment is to be exogenously removed, they are shocked with extra time and thus the marginal cost of exerting effort to all remaining commitments declines. As a result, they spend the extra time on all remaining directorships and in turn add value to those firms.

Given the identification challenges, the empirical evidence on the effect of director workload and busy boards is mixed and often contradictory. The endogenous selection of board appointments implies that the effect of heavy workload is entangled with the effect of director skill since most busy directors are predictably more qualified than less busy directors. Fama and Jensen (1983) and Kaplan and Reishus (1990) find that qualified directors are in high demand; they are pursued by many firms precisely for their high qualifications. Moreover, firms that select busy directors may need particular director expertise more than director time (Field et al., 2013).[3] In addition to selection, an omitted variable problem arises since complete details of a director's time-consuming activities are unobservable. While director "busyness" is typically proxied by the number of board seats (or some function of that number), directors may choose to reject board appointments due to prior commitments. Therefore, it is not obvious that directors with more board seats have less time to devote than directors with fewer board seats (Adams et al., 2010). A negative relation between board busyness and firm performance is documented by Core et al. (1999), Shivdasani and Yermack (1999), Fich and Shivdasani (2006), and Ahn et al. (2010), while positive aspects of multiple appointments are documented by Loderer and Peyer (2002), Ferris et al. (2003), Masulis and Mobbs (2011), and Field et al. (2013). In many of these studies, the relationship between board busyness and firm performance can be interpreted as a test for whether the workload effect outweighs the director quality effect (Adams et al., 2010). In this paper, I focus on the workload aspect. Instead of asking which effect is stronger, I ask a complementary question: whether director workload directly affects firm performance in a meaningful and central way.

An alternative explanation for the effect of merger-shocks is that the estimates may capture the effect of takeover procedures rather than a pure effect of workload. In particular, I consider the plausibility of a "direct takeover effect" as a potential mechanism driving the findings. Such an alternative mechanism would require that a director's role in a merger transaction directly leads to timely changes in her or his behavior. That could be the case if a director's skill set or incentives change with the takeover bid. A director's skill set might improve due to "learning by doing" and gaining managerial experience throughout the takeover process and negotiations. A director's incentives might also change due to a takeover's disciplining effect.[4] Arguably, evidence on these direct takeover effects would be equally interesting from an empirical point of view. However, I find little evidence to support direct takeover effects, while the collective evidence that I show supports the workload effect narrative.

I investigate the direct takeover effect vis-a-vis the director workload channel by exploiting geographical distances between directorships. I find a pronounced effect of a merger-shock when the merger terminates a directorship that is geographically distant from the individual's other directorships. This finding is important because of the direct link between geographical distance and a director's devotion of *time*, thus emphasizing the effect of workload. The link between distance and board monitoring has been

[2] Harford (2003) finds that acquiring firms rarely appoint directors of the acquired firm to the merged firm's board. These rare cases usually involve special circumstances such as a director who is a founder—and as such is unlikely to be a multiple director. This finding is confirmed in my data sample as well.

[3] Coles et al. (2008) and Linck et al. (2008) emphasize the heterogeneity across firms in the effect of board structures.

[4] Takeovers have been argued to have a disciplining effect on managerial behavior (e.g., Jensen and Ruback, 1983). Similar forces may apply to directors if, for example, one takeover bid increases directors' awareness of future takeover threats and that awareness affects their behavior.

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