



# Distracted directors: Does board busyness hurt shareholder value?<sup>☆</sup>

Antonio Falato<sup>a</sup>, Dalida Kadyrzhanova<sup>b</sup>, Ugur Lel<sup>c,\*</sup>

<sup>a</sup> Research and Statistics Division, Federal Reserve Board, DC 20551, USA

<sup>b</sup> Robert H. Smith School of Business, University of Maryland, MD 20742, USA

<sup>c</sup> Pamplin College of Business, Virginia Tech, VA 24061, USA

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## ABSTRACT

We use the deaths of directors and chief executive officers as a natural experiment to generate exogenous variation in the time and resources available to independent directors at interlocked firms. The loss of such key co-employees is an attention shock because it increases the board committee workload only for some interlocked directors—the ‘treatment group’. There is a negative stock market reaction to attention shocks only for treated director-interlocked firms. Interlocking directors’ busyness, the importance of their board roles, and their degree of independence magnify the treatment effect. Overall, directors’ busyness is detrimental to board monitoring quality and shareholder value.

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## 1. Introduction

A large number of publicly traded firms in the US have recently limited the number of multiple directorships held by their board members. For example, a recent survey shows that 74% of Standard & Poor’s (S&P) 500 firms

impose restrictions on the number of corporate directorships held by their independent directors, up from 27% in 2006, and the Institutional Shareholder Services recommends restrictions on the number of multiple directorships.<sup>1</sup> Although such shareholder initiatives are consistent with standard theoretical considerations (e.g., Holmstrom and Milgrom, 1991), the empirical evidence on whether director

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\* Corresponding author. Tel.: +1 540 231 7216; fax: +1 540 231 3155. E-mail address: [ulel@vt.edu](mailto:ulel@vt.edu) (U. Lel).

<sup>1</sup> The Spencer and Stuart U.S. Board Index 2012 Report shows that 286 of the S&P 500 boards impose a numerical limit for all directors, with 5% capping additional directorships at two boards, 30% at three boards, 41% at four boards, and 24% at five or more. In addition, 76 firms place tighter restrictions on directors who are executives of other publicly traded firms, mostly limiting the number of directorships to two. For 127 boards that do not specify any limits, 85% require directors to either notify the chairman in advance of accepting an invitation to join another board or encourage them to reasonably limit their other board service.

busyness has any effect on the firm is thus far mixed. While several studies find that busy directors are associated with lower firm valuations and less effective monitoring (e.g., Fich and Shivdasani, 2006; Core, Holthausen, and Larcker, 1999), others either do not, or provide mixed evidence (e.g., Ferris, Jagannathan, and Pritchard, 2003; Field, Lowry, and Mkrtchyan, 2013).<sup>2</sup>

This mixed evidence in the literature is perhaps not surprising, as Adams, Hermalin, and Weisbach (2010) point out that it is challenging to disentangle busyness costs from potentially offsetting selection effects of holding multiple directorships: busyness costs arise since individuals who hold several outside directorships will likely have relatively less time available to devote effort to each of them, while selection effects arise because more talented or reputable directors are more likely to hold multiple directorships and, hence, be considered 'busy'. In this paper, we overcome this selection issue by examining the shareholder wealth effects of an exogenous increase in the demand for outside directors' time while holding their talent constant. By doing so, we hope to provide endogeneity-free evidence that independent director busyness matters for firm value.

The main identification of the paper accounts for the selection concerns by exploiting a quasi-experiment to generate plausibly exogenous variation in independent directors' workload. The ideal natural experiment would be to generate exogenous variation in the director's workload by randomly assigning similar types of directors into different workloads. Our empirical research design is geared toward generating this random assignment. We consider directors that hold an outside board seat on at least two firms, firm A and firm B, and are subject to shocks originating from the death of either the CEO or a colleague on the board of, say, firm A. We offer evidence validating the notion that these shocks lead to an increase in board committee workload for some of firm A's independent directors, which takes away time and resources from their board activities at interlocked firms (firm B). We label this effect as the 'attention shock hypothesis'. For example, suppose that an independent director on the board of Apple Inc. passes away. Our sample would include all the other firms at which Apple's non-deceased independent directors hold an outside board seat, i.e., all director-interlocked firms.

Our experiment constructs two groups of director-interlocked firms: a group of firms whose independent directors' committee workload increased—which is our 'treatment group', and a group of firms whose independent directors' workload did not increase—our 'control group'. These two groups comprise a sample where we claim that the assignment of a firm into high versus low director workloads is random, in the sense that it is due to reasons that are plausibly unrelated to the interlocking directors' type or productivity. Under this identifying assumption, we can difference out any selection bias by comparing the changes in firm value around the increase in directors'

committee workload (the death event) for firms in the treatment group with those in the control group.

For example, in the case of director deaths, the treatment group comprises director-interlocked firms that also have a committee interlock with the deceased director, and our testable hypothesis is that the interlocking directors of firms in this group will have to take over some of their deceased colleague's committee responsibilities, which will take away time and resources from their board activities at the interlocked firms. Thus, for director-interlocked firms in the treatment group, we should see a negative stock market reaction to attention shocks, which is what our empirical tests focus on analyzing. The identification of our estimate comes from the control group of director-interlocked firms that do not have a committee interlock, which serves as a counterfactual for how the committee-interlocked firms would have performed had there not been a death.

In order to test the attention shock hypothesis, we hand-collect information on the deaths of directors and CEOs over the 1988–2007 period. We are able to find 633 independent director deaths, which result in a sample of 2,551 director-interlocked firms. Of these observations, 1,084 are due to sudden deaths and 843 are from directors who are interlocked through the same committee, i.e., the treatment group. An analysis of the likelihood of replacement of the deceased director by the next board meeting and within one or two years after it indicates that director deaths are material events and their effect on board committees is long-lasting, which validates our "attention shock" interpretation. In the second part of our analysis, we use 189 CEO deaths, yielding a sample of 592 firms that have a director-interlocked relation with the firm that loses its CEO, out of which 338 are due to sudden deaths and 323 are in the treatment group.

Our tests employ a specification which is akin to the difference-in-differences (DID) methodology. We derive estimates of the treatment effect of a plausibly exogenous increase in directors' committee workload on firm value by comparing the change in director-interlocked firm value within the treatment and control groups before and after the death event dates (first-difference) and then taking the difference across the two groups (second-difference). The latter is the key step needed to difference out potential biases arising from obvious differences between busy and non-busy directors, such as talent, reputation, and access to a wider network of corporate relations. In our large sample of director-interlocked firms, we document robust evidence that relative to the control group, firms in the treatment group experience a significant negative stock market reaction to director attention shocks. On average, for interlocked firms in the treatment group, the market reaction is as substantial as  $-1.55\%$  and statistically significant at the 1% level when the death event is sudden. By contrast, in our control group of observations that are subject to the same sudden shocks but whose interlocked relation does not involve serving in the same committee, there is no statistically significant market reaction ( $0.19\%$ ,  $t=0.354$ ). The difference in the market reaction between the treatment and control groups is  $-1.74\%$ , which is statistically significant at the 1% level and robust to a

<sup>2</sup> A director is defined as busy in these studies if she sits on the boards of at least three firms.

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