Journal of Financial Economics 111 (2014) 406–429

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Independent director incentives: Where do talented directors spend their limited time and energy? ☆

Ronald W. Masulis [a,1], Shawn Mobbs [b,*]

[a] Australian School of Business, University of New South Wales, Sydney, Australia
[b] Culverhouse College of Commerce and Business Administration, University of Alabama, Tuscaloosa, AL 35487, USA

ARTICLE INFO

Article history:
Received 17 February 2013
Received in revised form
17 June 2013
Accepted 19 July 2013
Available online 31 October 2013

JEL classification:
G30
G34

Keywords:
Director incentives
Busy directors
Labor markets
Firm reputation
Firm performance

ABSTRACT

We study reputation incentives in the director labor market and find that directors with multiple directorships distribute their effort unequally based on the directorship's relative prestige. When directors experience an exogenous increase in a directorship's relative ranking, their board attendance rate increases and subsequent firm performance improves. Also, directors are less willing to relinquish their relatively more prestigious directorships, even when firm performance declines. Finally, forced Chief Executive Officer departure sensitivity to poor performance rises when a larger fraction of independent directors view the board as relatively more prestigious. We conclude that director reputation is a powerful incentive for independent directors.

1. Introduction

What motivates corporate directors to monitor senior management carefully? Recent empirical research that examines the financial incentives of outside directors (Adams and Ferreira, 2008; Yermack, 2004) concludes that these incentives are not especially strong. In this study, we examine another important source of incentives: director reputation. Fama and Jensen (1983) argue that preserving and enhancing reputation in the labor market for directorships is a primary motivation of directors. They argue that directors want to build a reputation as a diligent monitor of management because it directly affects the value of their human capital and the likelihood of obtaining future directorships (Fama, 1980).

Firm size is a natural source of director reputation incentives given that larger firms afford a director greater visibility, prestige (Adams and Ferreira, 2008; Shivdasani, 1993), compensation (Ryan and Wiggins, 2004), and likelihood of obtaining additional directorships (Yermack, 2004; Fich, 2005). Hence, it is reasonable to expect directorships in firms of differing sizes to create differential incentives to monitor senior management closely. Specifically, the incentive to be judged as a valuable director is likely to be strongest in a director's most visible

☆ This paper has benefited from comments and suggestions of an anonymous referee, Lei Adrian, Ran Duchin, Jun Yang, David Yermack, and seminar participants at the University of Alabama, Georgetown University, the 16th New Zealand Finance Consortium, the Fifth Annual Drexel University Annual Academic Conference on Corporate Governance, the 2012 Financial Management Association (FMA) Asia conference, the 2012 FMA annual meeting, and the 2013 American Finance Association annual meeting.

* Correspondence to: 200 Alston Hall, Box 870224, 361 Stadium Drive, Tuscaloosa, AL 35487, USA. Tel.: +1 205 348 6097; fax: +1 205 348 0590.

E-mail addresses: ron.masulis@unsw.edu.au (R.W. Masulis), smobbs@cba.ua.edu (S. Mobbs).

[1] Tel.: +61 293 855 860; fax: +61 293 856 347.

0304-405X/$ - see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jfineco.2013.10.011

and prestigious directorship. This supply-side perspective on the directorship market suggests that differences in reputation incentives can be important. Consistent with this perspective, Knyazeva, Knyazeva, and Masulis (2013) find that larger firms tend to draw experienced director candidates from more distant locations. Fahlenbrach, Low, and Stulz (2010) find that independent directors are more prone to resign from poorly performing firms, which offer lower prestige and greater workloads. This body of evidence suggests that directors view board seats as varying in attractiveness and that reputation considerations can have a large effect on the supply of outside director services available to a firm. Given that most directors have heavy demands on their time, it is only natural to expect them to prioritize which boards to serve on and then how they allocate their time and energy across these boards.

The primary goal of this study is to investigate whether outside directors with multiple directorships value each directorship differently based on the relative reputation benefits a board offers. Our focus is on independent directors because they are best able to monitor and discipline management. We start by identifying all independent directors who hold multiple directorships on the boards of Standard and Poor's (S&P) 1500 firms between 1997 and 2006 using the RiskMetrics director database. Then we rank each of their directorships based on each firm's market capitalization. Given this ranking, we examine several measures of a director's expenditure of effort and commitment to board responsibilities.

Our first measure is his or her attendance at regular board meetings. We find that after controlling for firm size, directors are significantly less (more) likely to miss meetings in their relatively higher (lower) ranked directorships. Moreover, when a directorship's relative ranking increases, board attendance rises significantly. Expanding on the Fahlenbrach, Low, and Stulz (2010) finding, we show that departures are more prevalent in a director's lower ranked directorships. We find directors are quick to relinquish lower ranked directorships when performance suffers, presumably to avoid the negative reputation effects, but they are less willing to relinquish their higher ranked ones.

To capture these varying reputation incentive effects of directors at the firm level, we use either the percentage of independent directors on the board for whom this directorship is one of their highest ranked (i.e., at least 10% larger than their smallest directorship) or an indicator variable for when a majority of a firm's independent directors view this as one of their highest ranked boards. These measures capture board representation by more talented independent directors, who hold multiple outside directorships, and firms in which these talented directors have the greatest incentives to work diligently.

We find that firms with a greater proportion of independent directors who rank this directorship highly are associated with better operating performance and higher values of Tobin's *q*. We also examine board monitoring and disciplining outcomes, measured by forced Chief Executive Officer (CEO) departures, and find that these firms are also associated with a lower likelihood of forced CEO departure, but greater forced CEO turnover sensitivity to performance.

To the degree that director incentives are affected by the external market for directorships and not internal firm decisions, endogeneity is less problematic. Nonetheless, for robustness and to address the concern that some of our results could be driven by firm size, we conduct several additional tests. First, we create a matched sample based on firm size and industry and repeat our primary analysis. Second, we employ a difference-in-differences (DID) approach to the director attendance test and the firm-level performance tests using exogenous shocks that lead to a director's ranking of a directorship to increase. The robustness of our primary results to these tests decreases concerns that firm size or endogeneity is the primary cause for our findings. Finally, we explore alternative ranking measures based on market value of total assets, book value of total assets, total sales, total shareholder return and the number of employees. We find that these alternative ranking measures provide qualitatively similar, albeit weaker, results than those found when ranking directorships by a firm's equity market capitalization.

Our findings make several important contributions to the literature. First, we provide new evidence on the predicted, yet empirically elusive, positive relation between board independence and firm performance and value (Bhagat and Black, 1999; Hermalin and Weisbach, 2003). Prior research has uncovered several factors that can adversely affect a director's ability to provide reliable monitoring services such as their social connections to the CEO (Hwang and Kim, 2009), the number of directors on the board (Yermack, 1996), and their other directorships (Fich and Shivdasani, 2006). Our results deepen the understanding of the role of reputation as a strong motivating force in enhancing a director's monitoring incentives. They are also important in light of the large literature on director actions that assumes that director reputation is a strong motivator by viewing subsequent changes in directorships held as a reward or penalty for director performance.[2] Yet, to our knowledge, no studies in the literature directly examine how reputation incentives arising from current board appointments affect director actions. Our results indicate that not all directorships are equal in terms of the reputation incentives they offer, which can help to explain why some studies such as Ertimur, Ferri, and Maber (2012) find weak evidence of the directorship market rewarding or punishing directors.

Second, we provide new evidence on the influence of a board's relative prestige, which furthers the understanding of director incentives. Fama and Jensen (1983) argue that holding a directorship creates strong incentives to perform well in the boardroom because there is "substantial devaluation of human capital" (page 315) when directors neglect their monitoring duties. In contrast, Mace (1971) argues that compensation, prestige and experience are outside directors' primary motives, so that directors focus their efforts on retaining their directorships, instead of closely monitoring CEOs. Our evidence is consistent with

[2] See Brickley, Linck, and Coles (1999), Farrell and Whidbee (2000), Yermack (2004), Kaplan and Reishus (1990), Gilson (1990), Del Guercio, Seery, and Woidtke (2008), Fich and Shivdasani (2007), Srinivasan (2005), and others.