



INDEPENDENT AND OUTSIDE DIRECTORS

RESEARCH SPOTLIGHT

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KEY CONCEPTS

Outside (nonexecutive) directors

- Directors who are not employees of the firm.
- Outside directors contribute to the organization by **advising** management on strategy and operations, drawing on their professional experience.
- They also **monitor** the company to ensure that executives act in the interest of shareholders.

Independent directors

- Outside directors with no “material relationship” to the company, defined by New York Stock Exchange listing requirements.



KEY CONCEPTS

- Potential benefits:
 - (+) Represent the interests of all shareholders.
 - (+) Provide third-party advice and oversight.
 - (+) In a position to act without undue influence from management.
- Potential drawbacks
 - (-) Might be less informed about company than insiders (“information gap”).
 - (-) Might not behave with true independence (“coopted” by management).
 - (-) Not always adequately qualified or engaged.

In general, the research evidence is mixed, highlighting both positive and negative aspects of outside directorships.



SHAREHOLDERS LIKE OUTSIDE DIRECTORS

- Rosenstein and Wyatt (1990) examine the stock market reaction to the election of outside directors.
- Sample: 1,251 outside director announcements, 1981-1985.
- Find statistically significant positive stock price reaction in the 2-day trading window around the announcement.
- Results are strongest for small firms.

Conclusion: shareholders react favorably to the appointment of outside directors.



SHAREHOLDERS LIKE OUTSIDE DIRECTORS

- Nguyen and Nielsen (2010) study the stock market reaction to the sudden death of an outside director.
- Sample: 229 deaths, 1994-2007.
- Findings:
 - Shareholders react negatively to sudden death of an outside director (-0.85% abnormal returns).
 - Reaction is more negative when director serves key role: board chairman, audit committee member, or when overall representation by outsiders is low.
 - Reaction is less negative when director has been on board long time.

Conclusion: shareholders react negatively to the loss of outside directors.



IMPACT ON PERFORMANCE IS LESS CLEAR

- Bhagat and Black (2002) examine the relation between outside directors and performance.
- Sample: 928 companies, 1988-1993
- Find that companies with lower historical profitability are more likely to increase the number of independent directors on the board.
- However, they find no evidence that this increase is correlated with an improvement in long-term performance, measured by market-to-book ratio (Tobin's Q), return on assets, or abnormal returns.

Conclusion: outside directors do not improve performance.

“Firms with more independent directors
do not perform better than other firms.”



IMPACT ON PERFORMANCE IS LESS CLEAR

- Knyazeva, Knyazeva, and Masulis (2013) also examine the relation between outside directors and performance.
- Sample: ~900 small and mid-sized firms in S&P 1500 Index, 1996-2006.
- Controlling for the availability of local talent, find that independent directors are positively associated with firm value (market-to-book ratio) and operating performance (ROA).

Conclusion: outside directors improve performance.

“We find board independence positively affects firm profitability and operating performance.”



OVERCOMING THE “INFORMATION GAP” IS IMPORTANT

- Duchin, Matsusaka, and Ozbas (2010) examine whether the effectiveness of outside directors is influenced by how difficult it is for outsiders to acquire expertise about the company (i.e., close the “information gap” with insiders).
- Sample: 2,897 companies, 2000-2005.
- “Cost of acquiring information” measured by number of analysts following the firm, dispersion of estimates, and mean forecast error.
- Find that:
 - If the cost of acquiring information is low, performance increases when outside directors are added to the board (Tobin’s Q and ROA).
 - If the cost is high, performance deteriorates.

Conclusion: effectiveness of outside directors depends on “information gap”.



OUTSIDE DIRECTORS IMPROVE DEAL ACTIVITY

- Cotter, Shivdasani, and Zenner (1997) examine the relation between outside directors and takeover premiums.
- Sample: 169 tender offers, 1989-1992.
- Findings:
 - Higher takeover premiums (~20%) if the target company's board has a majority of independent directors.
 - Bid premiums are revised higher in resisted offers and target shareholders realize larger gains when the target's board is independent.

Conclusion: outside directors negotiate higher takeover premiums.

“Independent outside directors perform a statistically and economically significant value-enhancing role during tender offers.”



OUTSIDE DIRECTORS IMPROVE DEAL ACTIVITY

- Byrd and Hickman (1992) examine the relation between outside directors and deal activity among acquiring companies.
- Sample: 128 tender offers, 1980-1987.
- Measure abnormal stock price returns for the acquiring firm in the 2-day trading window around the announcement.
- Find abnormal returns are significantly less negative (-0.07% vs. -1.86%) if the acquiring company has a majority of independent outside directors.

Conclusion: outside directors encourage more rational merger activity.



OUTSIDE DIRECTORS HAVE LITTLE IMPACT ON PAY

- Boyd (1994) studies the impact of outside directors on CEO pay.
 - Sample: 193 firms, 1980.
 - Find that CEO compensation is **higher** among firms with a larger ratio of outside directors.

Conclusion: outside directors do not lead to lower CEO compensation.

- Finkelstein and Hambrick (1989) study the relation between stock ownership by outside directors and CEO compensation.
 - Sample: 110 proxy statements, 1971, 1976, 1982, and 1983.
 - Find no relation between outside director stock ownership and CEO pay.

Conclusion: outside directors do not lead to lower CEO compensation.



ARE INDEPENDENT DIRECTORS “INDEPENDENT”?

- Hwang and Kim (2009) test whether NYSE accurately measures independence.
- Sample: Fortune 100 companies, 1996-2005.
 - Distinguish between directors who are independent according to NYSE standards and those who are independent in their social relation to CEO.
- Findings:
 - 87% are NYSE independent, but only 62% are both NYSE and socially independent.
 - Social dependence is associated with higher executive pay, lower pay-for-performance sensitivity, and lower sensitivity of CEO turnover to performance.

Conclusion: NYSE standards might not measure independence.

“Our results suggest that social ties affect how directors monitor and discipline the CEO and that, consequently, a considerable percentage of the boards currently classified as independent are substantively not.”



CAN OUTSIDE DIRECTORS BE “COOPTED”?

- Coles, Daniel, and Naveen (2014) study whether outside directors appointed during the current CEO’s tenure behave independently.
- Sample: S&P 1500 companies, 1996-2010.
 - Measure the percentage of board appointed during the CEO’s tenure.
 - Assumption is that these directors have allegiance to CEO for helping to attain their board seat and therefore are “coopted.”
- Find that board cooption is positively associated with CEO pay levels, and negatively associated with pay-for-performance and CEO turnover.

Conclusion: outside directors beholden to CEO might not be independent.

“Not all independent directors are effective monitors. ... Independent directors that are coopted behave as though they are not independent.”



ARE “POWERFUL” OUTSIDE DIRECTORS MORE INDEPENDENT?

- Fogel, Ma, and Morck (2014) examine whether “powerful” directors behave independently.
- Sample: 19,223 unique directors, 1998-2010.
 - “Powerful” directors defined as having large professional networks.
 - Include directors in top quartile for 3 out of 4 measures of network centrality.
- Findings:
 - Powerful directors are associated with more valuable merger-and-acquisition activity, stricter oversight of CEO performance, and less earnings management.
 - Shareholders react negatively to sudden death of powerful directors.

Conclusion: powerful directors exhibit greater independence.



CONCLUSION

- Research evidence on the impact of outside directors is mixed.
- Outside directors can bring expertise and independence to the board, which can reduce agency costs and improve firm performance.
- However, outsiders also operate at an information disadvantage that can limit their effectiveness.
- Research results might also be confounded due to structural shortcomings in NYSE independence standards.
- So-called “independent” directors might not always behave with true independence.
- Shareholders should evaluate director talent on a company-by-company basis to determine their qualification for directorship.



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