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Upheaval in the boardroom: Outside director public resignations, motivations, and consequences ☆

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ABSTRACT

We investigate the motives and circumstances surrounding outside directors' decisions to publicly announce their board resignations. Directors who leave "quietly" are in their mid-sixties and professional directors, i.e., retirees, who are retiring entirely from professional life. Directors who announce their resignation are in their mid-fifties and active professionals. Half the time they say they are leaving because they are "busy." These directors leave from firms with some weakness in their performance, but with no overt manifestations of cronyism such as excessive compensation of either the CEO or directors. The other half of the time directors leave while publicly criticizing the firm. These directors are finance professionals who were members of the audit and compensation committees. They resign from firms with weak boards and financial performance with evidence that managers have manipulated earnings upwards. Public criticism appears to pressure these boards to make management changes associated with improved stock price performance. We conclude that while such public resignations are motivated by the reputational concerns of directors, they can act as a disciplining device for poor board performance.

1. Introduction

In this study we examine announcements of outside director resignations to provide further insight into the incentives that outside directors have in monitoring managers. In their seminal work, Fama and Jensen (1983) argue that outside directors are expert decision makers and their incentives to monitor management stem from their desire to retain their reputation as experts. Outside directors are likely to resign publicly when they are no longer able to effectively watch over management, for whatever reason, as a way to keep their reputations. An investigation into the circumstances of public resignations can provide greater understanding into how directors and boards function.

Outside directors are charged to protect shareholders' interests. Yet, their ability to do so can be limited. First, meeting only a dozen or so times of year, they are unlikely to have the time to familiarize themselves sufficiently with the firm's operating and accounting practices to uncover and prevent mismanagement before it has gone too far. Moreover, they often rely on the same management for the information that may reveal their culpability. Second, managers also tend to control who serves on the board. Every year, in most firms, managers nominate a slate of directors to be elected at the annual shareholders' meeting. The nominating process, then, also acts to compromise the independence of outside directors. Directors might be reluctant to question and thereby lose the support of management.

Given the above limitations, one of the strongest incentives that outside directors have to monitor is to preserve their reputation capital and business relationships (see Fama and Jensen, 1983). Prior researchers have argued that the value of

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directors' reputations manifests itself in additional board seats and fees, stock, and options grants that accompany those appointments (see Yermak, 2004). Similarly loss of reputation manifests itself in the loss of board appointments (see Fich and Shivdasani, 2007). However, these incentives are not wholly consistent with the incentive to maximize shareholder wealth. For one thing, outside directors may be more concerned with their reputations for cooperating with management than as "watch dogs" for shareholders, i.e., directors can be susceptible to cronyism. Specifically, cronyism can manifest itself as the exchange of board seats for awarding excessive compensation for the CEO or ignoring poor performance. Another thing is that, there are likely to be higher time costs associated with discovering mismanagement early; the longer mismanagement persists the more likely it will be revealed with a minimal amount of the director's time spent on discovery. Then, when there is clear and public evidence that managers are not acting in shareholders' interests, directors may have no choice but to act to discipline managers or they risk losing their reputation as independent monitors. However, this makes outside directors more of a mechanism of last resort rather than the proactive monitors that shareholders wish them to be. For example, boards tend to replace the CEO after a period of poor firm performance (see Weisbach, 1988) rather than remove the CEO before the damage has been done (see Jensen, 1993, for a more complete discussion of the failures of internal control systems).

Furthermore, since most board decisions are by a majority consensus, a single director relies on the support of others when questioning management (see Mace, 1971). Different directors will face different time costs and differing obligations to management which can create disagreements between directors about how to fulfill their monitoring obligation to shareholders.

Because of these tensions, board room conflicts can spill outside the confines of the board room and into the public press. Outside directors can resign when frustrated with a weak and ineffectual board, but may go further and publicly criticize management as a means of distancing themselves from a poorly performing firm. It is also likely that outside directors will publicize their reasons for resigning from the board when they are *not* leaving because of conflicts with management. Such statements can preserve their reputations for cooperating with management and reassure shareholders their leaving is not a sign of hidden trouble. Likewise, when outside directors resign publicly, but decline to provide a reason, the director may decide to let his or her silence speak for itself.

These resignations can have consequences for shareholders. Directors might offer a "busy" related reason for leaving a board when the firm is in trouble, rather than criticizing the firm, because they seek to maintain their reputations as cooperative with management. If so, such resignations could be indicative of managerial entrenchment, leading to discipline from the external control market. Alternatively, if directors, truly leave because they are busy, such resignations can improve shareholder wealth by allowing for the appointment of a director who can spend more time on board activities.

Resignations accompanied by public criticism can put pressure on the remaining directors to improve firm performance. Or public dissension in the board room may suggest that the board will be more amenable to a takeover offer. Alternatively, these might be benign events. They may be the actions of a lone disgruntled director or indicative of a personality clash between the director and the CEO or other members of the board. Then again these resignations may be viewed negatively by the market but ultimately ineffectual in bringing about positive change. Worse yet the firm may lose the monitoring benefits of a good director allowing management to become even more entrenched.[2]

In this study we investigate a sample of 52 outside director resignation announcements from 1990 to 2003. We compare our sample of public resignations to a random sample of 52 firms where outside directors leave the board "quietly," i.e., with no public announcement in the financial press. These samples allow us to investigate the circumstances around directors' decisions to publicize their resignation independent of the decision to leave the board. We find that half the time directors resign stating that they are busy and the other half of the time directors announce they are resigning because of uncooperative management or for some other problem with the firm that is likely to reflect conflict with management.

Directors who leave "quietly" are more likely to be professional directors, i.e., retirees, and significantly older-mid sixties—than directors who leave publicly. These directors are more likely to be at the end of their professional lives and less likely to feel compelled to publicly clarify their reasons for leaving the board as a means of preserving their reputation capital. Younger directors have more years left in their careers and hence more to lose from a damaged reputation. Directors who publicize their resignations are around eight to ten years younger than those who leave "quietly."

Directors who resign for "busy" related reasons are more likely to be active professionals. The firms that these directors resign from have some weakness in performance in the period prior to the resignation suggesting that changes in firm performance is putting greater demands on directors. We do not find any evidence that either the CEO or the directors are excessively compensated in these firms or that there is upward manipulation of earnings. Thus we conclude that these resignations are not attempts by directors to protect management or evidence of cronyism.

Directors are more likely to resign for "conflict" related reasons when the board is weak. These boards are less independent, smaller and dominated by a CEO who is also chairman of the board. Consistent with their desire to publicly distance themselves from poorly performing firms, we find that these directors are more likely to resign from firms with recent declines in operating performance and sales. They are more likely to be finance professionals and been a member of the audit and/or compensation committees. Not surprisingly, "conflict" firms have an increase in accounting accruals, indicating that management may be manipulating earnings to mask poor performance. Given their financial backgrounds and/or their membership on the audit committee, it is likely to be more embarrassing to have served on the board of a company with deteriorating financial performance and questionable accounting practices.

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[2] We are grateful to the referee for suggesting this alternative hypothesis.