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Does independent directors' monitoring affect reputation? Evidence from the stock and labor markets[☆]

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ABSTRACT

Using novel data on independent directors' opinions in China, we investigate the stock and labor market effects prompted by independent directors publicly saying "no" to major board decisions. We find that the market reacts negatively to modified director opinions, but positively to firms interlocked with the directors who said "no." We further find substantial turnover and decline in board seats after independent directors issue modified opinions. Overall, we identify a dilemma in China whereby the labor market does not reward vigilant directors for standing up to firm insiders, although investors add a premium to effective board monitoring.

1. Introduction

The reputation-related consequences of independent directors are an issue of considerable public and academic interest. Independent directors are widely believed to play an important role in corporate governance. Fama and Jensen (1983) suggest that independent directors can make distinct contributions in aligning managers with the interests of stockholders. The most significant incentive for independent directors to pursue

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effective board monitoring is to develop their reputations as decision experts. Although Fama and Jensen (1983) indicate that independent directors' reputations hold positive value, it is difficult to empirically evaluate such reputations, as firms rarely disclose the activities of individual directors in the boardroom. Therefore, many studies have inferred the value of independent directors' reputations by investigating the stock or director labor market responses in the wake of extraordinary events. For example, firms with insider-dominated boards are more likely to confront financial distress (Gilson, 1990; Harford, 2003), report earnings restatements (Srinivasan, 2005), face class-action lawsuits (Fich and Shivdasani, 2007) and announce director turnovers (Fahlenbrach et al., 2010; Agrawal and Chen, 2011). Most of these studies have found that on average investors react negatively to these adverse signals of weak board monitoring and that independent directors suffer reputational penalties if they do not vigilantly monitor top management. Although this line of research provides insights into the ex post settling-up mechanism of directors' labor market, it is limited in its efforts to impute these corporate failures to poor board monitoring by independent directors (Richardson, 2005). More importantly, in the vast majority of firms that do not face these crises, direct evidence of how independent directors help to oversee boards remains scant.

We exploit a unique dataset of independent directors' monitoring efforts to uncover the corresponding effect on independent directors' reputations and career prospects. China's market regulator, the China Securities Regulatory Commission (CSRC), requires independent directors to publicly disclose their opinions on important managerial decisions. Such directors are expected to say "no" in board meetings if they believe that a board proposal is not in the interests of shareholders. Furthermore, an independent director's opinion not only serves as a signal to the external market regarding his/her monitoring efforts, but also may give directors legal relief from potential lawsuits. Thus, the unique disclosure of independent directors' monitoring activities in the Chinese market sheds light on the "black box" of board function.

We use this context to investigate the consequences of the board disputes that arise when independent directors say "no." First, we study whether Chinese investors value independent directors' monitoring efforts. We expect the market to interpret independent directors standing up to firm insiders about any detected irregularities as negative news, as modified opinions disclose board disputes that may be unobservable otherwise. Our focus is the analysis of the stock market reaction to independent directors' opinions regarding director-interlocked firms. Under the reputation hypothesis, the market should respond positively to firms interlocked with directors who say "no," given that the announcement of a modified director opinion signals effective monitoring by the opinion-issuing directors. In contrast, the endogenous hypothesis predicts a negative market response to director-interlocked firms, as firms that share the same independent directors may reveal problems that are similar to those of the opinion-receiving firms. Second, to examine the wealth effects of individual independent directors, we analyze the changes in board seats for opinion-receiving firms and other director-interlocked firms. If independent directors develop a reputation for independent monitoring by saying "no" to controlling shareholders or top executives, then according to Fama and Jensen (1983) they are more likely to keep their board seats in director-interlocked firms or gain more board seats after they issue negative comments on corporate decisions.

We find that firms receiving modified director opinions sustain negative cumulative abnormal returns (CARs), whereas interlocked firms exhibit positive returns around the announcements of modified independent director opinions. There is also a significant turnover for independent directors who say "no" in opinion-receiving firms subsequent to the issuance of modified independent directors' opinions. Contrarily, the evidence shows that these directors tend to lose more directorships. Our findings are to some extent consistent with the director reputation hypothesis, which suggests that Chinese investors value effective monitoring conducted by independent directors. In the long run, however, vigilant directors are not rewarded for their reputation of effective monitoring, as Fama and Jensen (1983) suggest. One possible explanation is that Chinese firms may self-select lax monitoring for easy managerial control and manipulation.

Our study is closely related to Jiang et al. (2016), who examine the association between independent directors' propensity to issue modified opinions and their career concerns and media coverage. Our study differs from Jiang et al. (2016) in two important ways. First, our results shed light on the dilemma that although investors value effective board oversight, independent directors' monitoring efforts are not rewarded by the director labor market in China, where controlling shareholders often determine who can sit on the board. Second, our findings help differentiate the alternative hypotheses proposed by Fich and Shivdasani (2007) by