Do Independent Directors Provide a Valuable Service to Shareholders?

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What is Corporate Governance?

• “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”

• "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.“
  [OECD, 1999]
The Changing Face of Boards in India

To improve corporate governance in India, SEBI has focused on the board of directors.

- **Key changes:**
  - Require 33% (50%) independent directors if the Chairman is (not) an independent director
    - Most firms comply
  - Limiting independent director terms to two periods of five years
    - Will create lots of turnover on boards in the next few years
  - Mandatory Audit Committee, one member is required to be "financially literate"
    - Most firms comply
  - At least one women on the board
    - Firms comply, but the majority of females are wife, siblings or daughters from the family behind the firm
The Changing Face of Boards in India

![Graph showing the average size of the board over years ranging from 2006 to 2016. The graph indicates an increasing trend in the average size of the board, with a significant jump around 2014.]

- Female directors
- Independent directors
The Changing Face of Boards in India

![Graph showing the average tenure of directors in India over years from 2006 to 2016.]
The Changing Face of Boards in India

Distribution of completed term(s) for Independent Directors
The Changing Face of Boards in India
The Changing Face of Boards in India

• Significant changes to corporate boards in India

• Regulation inspired by Sarbanes-Oxley Act in United States (2002)
  • Accounting regulation
  • Audit committee
    • Financial expertise required
  • Board of directors
    • Majority of directors should be independent
    • Key sub-committees should consist entirely of independent directors: audit, compensation, and nomination committees

• Why is there so much focus on the board of directors, and independent directors in particular?
The Role of the Boards of Directors

• Directors are the representatives of shareholders to oversee the managers on their behalf
  • Shareholders cannot oversee the managers

• Key tasks:
  • Hire and replace managers
  • Evaluate performance
  • Incentivize managers
  • Insure the accuracy of financial reports
  • Oversee overall strategy and direction
  • Risk management
Motivation

– Dominant view in academic and practitioner work
  • Independent directors are *better* at monitoring

– Because of their independent stand in decision making we generally require firms to have independent directors
  • Listing in India requires 33% (50%) independent directors if the Chairman is (not) independent

– Main argument:
  • Independent directors are managers or decision makers in other organizations who care about their reputation

– Research question:
  • Are independent directors valuable to shareholders?
Motivation

• **Research question:**
  – Are independent directors valuable to shareholders?

• **Problem:**
  – How can we measure the value of independent directors?

• **Solution:**
  – A naïve approach would be to examine the relationship between the number of independent board members and corporate outcomes
    • Market value, Stock returns and Profits
Motivation

• A naïve approach would be to examine the relationship between the number of independent board members and corporate outcomes

<table>
<thead>
<tr>
<th></th>
<th>Firm A</th>
<th>Firm B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of independent directors</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Market value</td>
<td>10 M</td>
<td>15 M</td>
</tr>
<tr>
<td>Stock return</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Profits</td>
<td>1 M</td>
<td>2 M</td>
</tr>
</tbody>
</table>

• Correlations suggest that independent directors are valuable
  – Correlation is not causality!
  – Good performing firms might appoint more independent directors
Motivation

- In order to answer the research question:
  - “Are independent directors valuable to shareholders”
- We need random variation in the number of independent directors
- Example: Clinical tests of drugs

- Effect of drug is measured by comparing the differences in health outcomes between the treatment and control groups

![Diagram showing a random draw of patients into drug (Treatment) and placebo (Control) groups.](image-url)
Motivation

• (Un)fortunately, shareholders of large corporations will not allow us to run randomized experiments on their boards

• **Morbid solution:**
  – Stock price reactions to sudden deaths of independent directors

![Diagram](Director) Random draw [Sudden death (Treatment)] (Stay alive (Control))

• Value of independent directors can be measured by the stock price reactions to news about sudden deaths
Research Questions

- Our study is a first step towards measuring the contribution of independent directors to shareholder value
  
  1. We focus on the stock price reaction to sudden deaths of independent directors
     - We expect to find a negative and significant stock price reaction to the death of independent directors
  
  2. We examine the determinants of the contribution of independent directors to shareholder value
     - Does the very independence of independent directors matter?
     - What is the marginal contribution of deceased directors?
Data Sources: Sample Selection

Sample of sudden deaths

- We search news on deaths of corporate directors in United States
  - From January 1, 1994 to December 31, 2007

- Keyword search terms:
  - Directors (board member, chairman & director)
  - Death (deceased, died, passed away, etc.)

- Gross-sample of 772 deceased directors
  - Detailed follow-up search to determine cause of death

- **Final sample**: 279 suddenly terminated directorships
Definition of sudden deaths

Definition of *sudden death* in English:

**sudden death**

Line breaks: sud\'den death

**Pronunciation:** 🔊

**NOUN**

[MASS NOUN]

- *informal*

A means of deciding the winner in a tied match, especially one in which the first side or player to concede a game, goal, or point during an additional period of play is the loser:
Definition of sudden deaths

- **Medical definition**
  - Sudden death
    - An unexpected and non-traumatic death that occurs instantaneously or within a few hours of an abrupt change in the person’s previous clinical state
      » From any other cause than violence

  - Example: Sudden cardiac death (SCD)
    - SCD is defined as a non-traumatic, nonviolent, unexpected event resulting from sudden cardiac arrest within 6 hours of a previously witnessed state of normal health.

  [American Academy of Paediatrics]
Data Sources: Sample Selection

Definition of sudden deaths

– Our definition *includes*
  • Strokes where death occurs within 24 hours
  • Heart attack where death occurs within 24 hours
  • Accidents with instantaneous death
  • Deaths reported as sudden and unexpected but where the actual cause of death is unreported

– Our definition *excludes*
  • All cases with declining health prior to the death
    – Brief illness, cancer, declining health, etc.
  • All cases where the director dies from complications of a stroke or heart attack
  • Suicides
## Data Sources: Sample Selection

### Table I, Cause of Director Deaths

<table>
<thead>
<tr>
<th>Cause of sudden death</th>
<th>Count</th>
<th>Proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heart attack</td>
<td>89</td>
<td>0.389</td>
</tr>
<tr>
<td>Stroke</td>
<td>18</td>
<td>0.079</td>
</tr>
<tr>
<td>Accident or murder</td>
<td>45</td>
<td>0.197</td>
</tr>
<tr>
<td>Sudden and unexpected death</td>
<td>77</td>
<td>0.336</td>
</tr>
<tr>
<td><strong>All</strong></td>
<td><strong>229</strong></td>
<td><strong>1.000</strong></td>
</tr>
</tbody>
</table>

### Number of directorships per suddenly deceased individual

<table>
<thead>
<tr>
<th>Number of directorships</th>
<th>Count</th>
<th>Proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>194</td>
<td>0.847</td>
</tr>
<tr>
<td>2</td>
<td>26</td>
<td>0.114</td>
</tr>
<tr>
<td>3</td>
<td>5</td>
<td>0.022</td>
</tr>
<tr>
<td>4</td>
<td>3</td>
<td>0.013</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
<td>0.000</td>
</tr>
<tr>
<td>6</td>
<td>1</td>
<td>0.004</td>
</tr>
<tr>
<td><strong>All</strong></td>
<td><strong>229</strong></td>
<td><strong>1.000</strong></td>
</tr>
</tbody>
</table>
Data Sources: Director Types

Directors are classified into three types

- *Inside* directors  \( (n=114) \)
  - Current employees of the firm

- “Gray” directors  \( (n=57) \)
  - Retired employees of the firm
  - Relatives of the CEO and/or large shareholders
  - Persons with conflicts of interest or related to the firm’s business

- *Independent* directors  \( (n=108) \)
  - Not current or former employees
  - No dealings with the firm
Illustration of Methodology

Prominent examples of sudden deaths

- Jerry R. Junkins,
  - CEO & Director of Texas Instruments
  - Independent Director
    » 3M
    » Procter & Gamble
    » Caterpillar Inc.
  - Died of a heart attack during a business trip to Germany on May 29, 1996 – aged 58
Illustration of Methodology

Prominent examples of sudden deaths

- Jerry R. Junkins, Independent Director of 3M
  - Heart attack during a business trip on May 29, 1996
  - 3M stock price reaction on May 29: -2.6%
  - Market reaction on May 29 (S&P500): -0.5%
Illustration of Methodology

Prominent examples of sudden deaths

- **Jerry R. Junkins,**
  - CEO & Director of Texas Instruments
  - Stock price reactions to sudden death
    » **3M:** -2.1%
    » **Procter & Gamble:** -1.8%
    » **Caterpillar Inc.** -1.8%

- Evidence seem to suggest that independent directors provide a valuable service to shareholders
Market Reaction to Sudden Deaths

- Average stock price reaction
  - Sudden deaths of independent directors

![Graph showing the average stock price reaction to sudden deaths of independent directors. The bar graph indicates a reaction of -0.85%.](image)
The Value of Independence

– How to measure independence beyond director type?

• Measures from prior literature:
  • Tenure in years
    – Declining independence over time
  • Appointed during the tenure of current CEO
    – Directors are often hand picked from the CEO’s network

• Results confirm that the degree of independence matters
  – Stock prices are 0.16% more positive per year of tenure
  – Stock prices are 1.80% higher if the deceased director was hand picked by the CEO
Market Reaction to Sudden Deaths

- **Average stock price reaction**
  - Sudden deaths of independent directors

![Graph showing market reactions to sudden deaths of directors, chairmen, and audit committee members. The graph indicates average stock price reactions ranging from -3.00% to 0.85%.]
The Value of Independence

– What is the marginal value of an independent director?

• If the results are driven by the value of independent directors we would expect that the marginal value declines with the number of independent directors on the board

• Going from 2 to 1 independent directors should be more harmful than going from 7 to 6

• Results confirm this conjecture
  – Stock price reactions to the sudden death of an independent director are increasing in the number of independent directors on the board
Controlling for individual director skills

• Alternative explanation:
  – Directors are highly talented individuals
    • Stock price reactions might reflect individual skills rather than independence

  – How can we disentangle our story from the individual skill interpretation?

  – Solution:
    • Some directors hold multiple directorships as both independent and inside directors
      » Difference in stock price reaction will be informative about the value of independence over and above individual skills
Controlling for individual director skills

Prominent examples of sudden deaths

- Jerry R. Junkins,
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  - Stock price reactions to sudden death
    » 3M: -2.1%
    » Procter & Gamble: -1.8%
    » Caterpillar Inc. -1.8%
Controlling for individual director skills

Prominent examples of sudden deaths

– Jerry R. Junkins, CEO of Texas Instruments
  - Heart attack during a business trip on May 29, 1996
  - Texas Instr. stock price reaction on May 29:  -1.7%
  - Market reaction on May 29 (S&P500):  -0.5%

![Graph showing stock price reaction over time]
Controlling for individual director skills

Prominent examples of sudden deaths

– Jerry R. Junkins,
  – CEO & Director of Texas Instruments
    » Stock price reaction: -1.2%
  – Stock price reactions to sudden death
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– Evidence seem to suggest that independent directors provide a valuable service to shareholders
Controlling for individual director skills

– How can we disentangle our story from the individual skill interpretation?

– **Solution:**
  • Some directors hold multiple directorships as *both* independent and inside directors
    » Difference in stock price reaction will be informative about the value of independence over and above individual skills

– Results confirm that independent directors are valuable to shareholders
  • Stock prices are systematically more negative for the firms where the deceased served as an independent director
Conclusion

- Following sudden deaths stock prices drop with 0.85%.

- Stock prices react less negatively for independent directors:
  - With long board tenure
  - That are hand-picked by current CEO
  - If the board has many independent directors

- Stock prices react more negatively for independent directors serving in crucial board functions:
  - Chairman and audit committee

- Overall, we provide evidence that independent directors perform a valuable service to shareholders.
To improve corporate governance in India, SEBI has focused on the board of directors

**Key changes:**
- More independent directors
- Shorter tenure
- In particular in key positions
- At least one woman

Changes are inspired by academic studies and international corporate governance codes
- All from developed countries

**Key question is whether these regulatory changes will leave the desired impact in India …**
Thank You