

THE ROLE OF NONAFFILIATED OUTSIDE DIRECTORS IN MONITORING THE FIRM AND THE EFFECT ON SHAREHOLDER WEALTH

Stanley Block*

Abstract

The paper addresses the issue of the importance of independent, outside directors in monitoring the affairs of the firm. There is much debate about whether nonaffiliated directors are more supportive of the shareholder-interest hypothesis or the management entrenchment hypothesis. In this study of 1,026 announcements of the appointment of independent outside directors between 1990-1994, the author finds statistically significant cumulative abnormal returns during the two-day window of the announcement. However, the pattern of returns is nonmonotonic in nature in regard to the outside directors already in place. After a critical mass of outside directors is assembled, the addition of another director is likely to produce little or nothing in the way of positive abnormal returns.

INTRODUCTION

The importance of outside directors is widely debated in the literature of finance. Bhagat, Brickley, and Coles (1987); Fama (1980); Fama and Jensen (1983); Gibbs (1993) and others argue that outside directors promote the interest of shareholders. Their desire to maintain their reputational capital as well as a fear of dissident stockholder lawsuits tends to ensure that they will properly monitor the actions of management.

Others argue that the reverse is true. For example, Mace (1986), Patton and Baker (1987), and Jensen (1993) suggest that outside directors are likely to be aligned with management, not only because top management has a major say on who sits on the board, but also because outside directors tend to have a smaller equity position than other directors.

The discussion of the importance of the monitoring role of outside directors further breaks down to specific areas of activity. For example, Hermalin and Weisbach (1988) find that outside directors are more likely to be appointed to boards following poor records of stock performance. The appointment is a signal to the investment community that the board's monitoring process is being upgraded. Others suggest that outside directors reduce the probability of a firm paying greenmail (Kosnik, 1987), or being subjected to legal action (Kesner and Johnson, 1990). Furthermore, Brickley, Coles, and Terry (1994) maintain that the presence of outside directors neutralizes the anticipated negative market reaction to the adoption of poison pills, and Byrd and Hickman (1992) observe a similar neutralizing effect by outside directors to the typical negative reaction to the announcement of an acquisition of another company.

Counter arguments are made that there is empirical evidence that a proportional increase in outside directors leads to reduced R&D expenditures (Baysinger, Kosnik, and Turk, 1991). Also, Cochran, Wood, and Jones (1985) provide data indicating that the large presence of outside directors leads to an increased probability of a firm adopting golden parachutes agreements for its executives. Another interesting hypothesis is advanced by Baysinger, Kosnik, and Turk (1991). They suggest that the enhanced monitoring process provided by outside directors may actually have a perverse effect. Managers may reduce their time horizon for planning and become risk averse because of their fear of actions by outside directors.

Whatever theory one subscribes to, there is ample room for discussion and debate about whether the actions of outside directors are more supportive of the stockholder-interest hypothesis or the management entrenchment hypothesis.

*Texas Christian University

THE CURRENT STUDY

In the current study, the author examines the market reaction to the announcement of the appointment of outside directors in the financial environment of the 1990s. While the study covers some of the same issues as Rosenstein and Wyatt (1990), it introduces a data base that is a decade later in time. It also gives special attention to such issues as the “incremental value” of an outside director once a critical mass has been attained, the potential of institutional investors as an alternative monitoring device to outside directors, and the occupational and professional characteristics of nonaffiliated directors.

In the following sections, the author discusses the empirical approach taken, the composition of the data base, and the results of the tests for abnormal returns.

SAMPLE AND EMPIRICAL APPROACH

In following the model of Byrd and Hickman (1992) and Baysinger and Butler (1985), the author defines an outside director based on three categories of directors: inside directors, affiliated outside directors, and independent outside directors. Inside directors typically include the CEO, other officers of the firm, or their families. Also included in this category are retired former officers of the firm. It is not unusual for a retiring CEO to retain his or her board position so this latter delineation can be important.

The second category, affiliated outside directors, recognizes that many so-called outside directors are not truly independent. This category includes those outsiders who have a business relationship with the firm, such as investment bankers, consultants, lawyers, major suppliers, or customers.

The final category, independent outside directors, includes those directors who have no affiliation with the firm other than their role as a director. Members of this group may include academicians, retired executives from other nonaffiliated firms, private investors, public sector members (i.e., Gerald Ford, Colin Powell) and so on.

It is only members of this third category that the author considers to be true outside directors. This is important because traditional two-way classifications may fail to consider potential conflicts of interest for affiliated outside directors who are not full-time employees of the firm, but have an incentive to maintain their affiliation at the potential expense of shareholder wealth (Byrd and Hickman, 1992).

Similar to the approach of Rosenstein and Wyatt (1990), the data set is comprised of firms for which there is the announcement of only one outside director in *The Wall Street Journal* “Who’s News” section. (Unlike the above study, proxy statements were not also used as a source.) The restriction to one director is needed to eliminate the “surplus” signaling effect that multiple outside directors might produce. The message might go beyond the stockholder-interest hypothesis to indicate a major change in the direction of the corporation. Also, the coincident appointment of an inside director was disallowed as it would neutralize the effect of the appointment of an outside director.

Furthermore, firms were eliminated from the study if there were other major announcements coincident with the appointment of an outside director. Since board announcements are often made following quarterly or annual board meetings, there is the potential for significant announcements to be made at the same time as the new director’s appointment. The author was particularly sensitive to concurrent announcements of acquisitions and antitakeover provisions. The potential negative abnormal returns of the former are well documented by Byrd and Hickman (1992) and the mixed abnormal returns of the latter by Brickley, Coles and Terry (1994), Malatesta and Walking (1988) and Ryngaert (1988). Also, to the extent that the director announcement was combined with a surprise earnings announcement as defined by Kormendi and Lipe (1987) and Rendleman, Jones, and Latane (1982), the firm was eliminated from consideration.

It should be pointed out that the author considered the announcement of the director’s appointment to be tantamount to the election by stockholders. The announced appointment is affirmed by the stockholders vote over 95 percent of the time. Furthermore, the time period for testing in this event study is the announcement and not the (voting) confirmation; at that later point in time the news of the appointment of the outside director is clearly impounded in the value of the stock (to the extent the news is significant).

While Rosenstein and Wyatt (1990) also included outside director announcements that appeared in proxy statements prior to announcement in *The Wall Street Journal*, the author has deleted such announcements for consistency in the sample and ease of data collection. Preliminary testing indicated no bias introduced by omission of non-*Wall Street Journal* appointments.

Data Base

The study covered the time period of 1990-94, and all firms included in the data base met the selection criteria specified in the prior section as well as having data readily available on the Center for Research and Security Prices (CRSP) daily stock return files for the NYSE and the AMEX. One thousand and twenty-six firms are included in the study. The characteristics of the firms are shown in Table 1 following the model of Brickley, Coles, and Terry (1994).

TABLE 1
Financial Attributes of the Sample^a
(prior to announcement)

	Mean	Medium	Maximum	Minimum
Size ^b (\$ million)	\$6,376	\$2,142	\$43,182	\$322
Number of Board Members	12.246	12.000	24.000	5.00
Fraction of Inside Directors	.296	.289	.820	.011
Fraction of Affiliated Outside Directors	.308	.312	.694	.125
Fraction of Independent Outside Directors	.396	.399	.775	.000
Board Stock Ownership	.051	.016	.772	.012
CEO Stock Ownership	.021	.006	.312	.002
Inside Director Stock Ownership	.046	.010	.703	.005
Affiliated Outside Director Stock Ownership	.010	.040	.310	.006
Independent Outside Director Stock Ownership	.008	.002	.201	.004

a. All information is taken from SEC data.

b. Based on market capitalization

Abnormal Return Tests

The variable being measured is the cumulative abnormal returns (CARs) earned by shareholders around the announcement of the appointment of an independent outside director. The period for testing is the announcement date (AD) and the announcement date minus one (AD - 1). The abnormal return, employing standard event study methodology used in financial economics, is the difference between the observed return and the normal return as predicted by the CAPM.

Abnormal returns are calculated based on a market model estimated over the period of $t = -150$ to $t = -5$. Unless otherwise indicated, the statistical tests are conducted using returns for the CRSP equally weighted index including dividends. The overall results are shown in Table 2.

TABLE 2
Two Day Returns (CARs) Around the Announcement Date
of an Independent Outside Director Over the 1990-1994 Period

	Time Period	Sample Size	Mean CAR	Level of Alpha at Which t Is Significant	% > 0
Full Sample	1990-1994	1,026	.0026	.01	.480
NYSE	1990-1994	818	.0024	.01	.475
AMEX	1990-1994	208	.0033	.01	.501

The results are significant and positive at an alpha level of .01. It would appear that the announcement of the appointment of an independent outside director is viewed as a signal of confirmation for the stockholder-interest hypothesis. The results are similar to those derived by Rosenstein and Wyatt (1990) for an earlier time period.

It should be pointed out that the sample percentage showing positive abnormal returns is less than 50 percent as shown on the first line of the last column of Table 2. This is a common occurrence in event studies that show positive CARs due to the presence of strong positive CARs that have an effect on the mean CAR. It may be assumed that the distribution is skewed to the right.

Fraction of Outside Directors

While the announcement of the appointment of an independent outside director would appear to be statistically significant, there are other questions to be considered.

For example, the percent of outside directors already in place before the announcement of a new outside director has been studied by Brickley, Coles, and Terry (1994) and Byrd and Hickman (1992). They generally conclude that the appointment of an outside director should be viewed as an incremental event rather than one examined in isolation.

For a firm that has no outside directors, the appointment of an independent outside director may be viewed as a token event doing little to negate the management entrenchment hypothesis. However, for a firm that adds an independent outside director to create a critical mass of outside directors, there is the potential for a positive reaction. However, the relationship is likely to be nonmonotonic in nature as the continued addition of independent outside directors beyond a threshold level is likely to signal little in the way of new or significant information.

Note in Table 3 the effect on cumulative abnormal residuals from the appointment of a new outside director based on the current percentage of independent outside directors as expressed in deciles. The statistical returns for the CARs and significant levels of alphas clearly yield the anticipated nonmonotonicity. The impact of the new appointment is greatest in the 30–50 percent range and then begins to diminish as less important signaling is taking place.

TABLE 3
CARs as Related to Percent of Outside Directors

Fraction of Independent Outside Directors (%)	Sample Size	Mean CAR	Level of Alpha at Which t Is Significant	% > 0
0–10	12	.0012	—	.42
10–20	102	.0021	.05	.43
20–30	238	.0024	.01	.46
30–40	295	.0038	.005	.50
40–50	198	.0044	.005	.52
50–60	73	.0025	.01	.42
60–70	92	-.0018	—	.41
70–80	16	.0002	—	.44
80–90	0	—	—	—
90–100	0	—	—	—

Institutional Holdings

As indicated by Brickley, Lease, and Smith (1988), large institutional investors have a more intense interest in the firm than the average investor. This implies that optimal monitoring expenses will allow them to uncover management entrenchment strategies and to ensure that management follows strategies that are in the interest of shareholders (Allen, 1993; Kochhar and Parthiban, 1996; and Sundaramurthy, Mahoney and Mahoney, 1997).

To the extent that institutional investors own a high percentage of equity of the firm, one can hypothesize that the intended monitoring role of the independent outside director is largely redundant. The theory is tested and largely confirmed by the results in Table 4, which indicate that as the percent of institutional ownership in the firm increases, the statistical significance of adding an independent outside director is largely muted.

TABLE 4
CARs as Related to Percent of Institutional Holdings

Fraction of Institutional Holdings (%)	Sample Size	Mean CAR	Level of Alpha at Which t Is Significant	% > 0
0–10	44	.0051	.005	.54
10–20	92	.0043	.005	.51
20–30	388	.0033	.005	.52
30–40	298	.0021	.01	.48
40–50	106	.0007	—	.40
50–60	95	.0008	—	.39
60–70	3	-.0024	—	.33
70–80	0	—	—	—
80–90	0	—	—	—
90–100	0	—	—	—

ACTUAL CHARACTERISTICS OF OUTSIDE DIRECTORS

As previously indicated, outside directors may be differentiated between those that are affiliated and those that are independent. It is only the latter category that shows positive abnormal returns in event studies.

However, other delineations are also possible. For example, Rosenstein and Wyatt (1990) did additional testing in which directors were segregated between (a) neutral directors, (b) corporate outsiders, and (c) financial outsiders.

A neutral outsider is assumed to have no prior substantial knowledge of the business, and a corporate outsider, whether affiliated or independent, is assumed to be familiar with the affairs of the firm and its industry. It was hypothesized by Rosenstein and Wyatt (1990) that the fresh perspective provided by neutral outsiders may make them particularly valuable as board members, while the contributions provided by managers of other like corporations may be marginal for boards already composed primarily of professional managers.

Finally, the third category of financial outsiders was hypothesized to be particularly valuable by Rosenstein and Wyatt (1990) because they were frequently contributors of capital. The researchers rely on Easterbrook's (1984) position that contributors of capital are very good monitors of management.

While the data collected in this study could not be broken out in a similar three-way fashion because only information on nonaffiliated outside directors was collected, tests relating to the importance of financially oriented independent directors could be conducted. However, it should be made clear that the financially oriented directors in the sample are not suppliers of capital (that would violate the independence of outside directors criterion). Nevertheless, 184 out of the 1,206 independent outside directors were financially oriented. They represented investment bankers, commercial bankers, finance professors, etc., who did not have a direct affiliation with the firm.

When they were segregated from the non-financially oriented directors as shown in Table 5, the CARs related to their appointment was significant at an alpha of .01. The non-financially oriented directors alpha (for the rejection of the null hypothesis) fell to .05 from the full sample value of .01. Both analysis of variance and chi-square tests confirmed the significance of the independence of classification at a level of .01. While the methodology of testing in this study is different from Rosenstein and Wyatt (1990), the results appear to suggest a stronger emphasis on the importance of financial versus non-financial directors.

TABLE 5
CARs as Related to Financially Oriented Outside Directors

	Sample Size	Mean CAR	Level of Alpha at Which t Is Significant	% > 0
Financially Oriented Directors	214	.0035	.01	.55
Non-Financially Oriented Directors	812	.0022	.05	.47

Brinkley, Coles and Terry (1994) made a somewhat different distinction between the occupations of outside directors to provide further evidence of statistically observable data. The researchers broke down the occupations of outside directors between (1) executive directors without outside ties to the business firm, (2) private investors, (3) educators, government officials and clergy, and (4) professional directors (retired business executives and those who list their occupation as being a director).

The above mentioned researchers, in their data from 1982–1984, found the latter category, professional directors, to have the largest and most significant impact on CARs associated with the poison pill as an antitakeover defense. The main premise behind their results is that professional directors, particularly those who are CEOs from other companies, are likely to have the greatest influence on the board. They are the least likely to rubber stamp the proposals of management and the most likely to protect against management entrenchment. For these reasons, poison pill announcements in which they have a significant presence are considerably less likely to produce the normal negative abnormal returns associated with antitakeover board provisions.

Using the proxies of the 1,026 firms examined in this study, which covered a time period a decade later, similar type conclusions are shown in Table 6. Although the statistical methodology is different in this study, the results should be viewed as supportive of the Brinkley, Coles, and Terry hypothesis related to the importance of professional directors. Their presence is clearly associated with the most positive announcement effects.

TABLE 6
CARs as Related to the Occupation of Outside Directors

	Sample Size	Mean CAR	Level of Alpha at Which t Is Significant	% > 0
1) Executives without prior outside ties to the firm	187	.0023	.05	.49
2) Private Investors	289	.0017	—	.47
3) Educators, Government Officials and Clergy	51	.0002	—	.48
4) Professional Directors	499	.0034	.01	.52

The outcome is also consistent with the statements of Fama and Jensen (1983) and Ricardo-Campbell (1983), which suggest that outside board members who hold multiple directors have a greater incentive to monitor corporate performance because the professional directors have a personal investment in establishing their reputations as decision making experts. This may indicate that a professional director takes a position that jeopardizes his or her position on a given board, but protects their reputational capital as it relates to all other current and future board

positions. As a further corollary, the more boards that a person serves on, the more likely he or she is to challenge a questionable managerial decision in defense of reputational capital.

SUMMARY AND CONCLUSIONS

Most of the studies about the potential importance of outside directors were conducted with data from the 1980s when the battle for corporate control was at its peak and antitakeover amendments were being rapidly introduced.

In the present study many of the same issues about the role of the corporate outside director are addressed with a later data base (and somewhat different methodology). The results indicate that the announcement of the appointment of a nonaffiliated outside director is still viewed as supportive of stockholder interests and likely to produce positive abnormal returns. However, the pattern is nonmonotonic in nature as related to the presence of outside directors already in place. After a critical mass of outside directors is assembled, the addition of another such director is likely to produce little or nothing in the way of positive abnormal returns.

A similar pattern applies to the presence of institutional investors. To the extent that a strong contingent of institutional investors is already in place to monitor the activities of management, the appointment of independent outside directors is likely to have little impact.

In terms of the attributes and characteristics of outside directors, those that have a financial background as well as those that are professional directors (particularly with prior CEO experience) are likely to elicit the most positive response among investors.

REFERENCES

- [1] Allen, F., "Strategic Management and Financial Markets," *Strategic Management Journal* 14, 1993, pp. 11–22.
- [2] Bacon, Jeremy, "The Role of Outside Directors in Major Acquisitions and Sales," *The Conference Board Research Bulletin no. 180*.
- [3] Baysinger, B. D. and H. D. Butler, "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition," *Journal of Law, Economics and Organization* 1, 1985, pp. 101–124.
- [4] Baysinger, B. D. and R. E. Hoskisson, "The Composition of Boards and Strategic Control: Effects on Corporate Strategy," *Academy of Management Review* 15, 1990, pp. 72–87.
- [5] Baysinger, B. D., R. H. Kosnik, and T. A. Turk, "Effects of Board and Ownership Structure on Corporate R&D Strategy," *Academy of Management Journal* 34, 1991, pp. 205–214.
- [6] Bhagat, S. J., J. A. Brickley, and J. L. Coles, "Management Identification and Liability Insurance: The Effect on Stockholder Wealth," *Journal of Risk and Insurance* 54, 1987, pp. 721–736.
- [7] Brickley, J. A., J. F. Coles, and R. L. Terry, "Outside Directors and the Adoptions of Poison Pills," *Journal of Financial Economics* 35, 1994, pp. 371–390.
- [8] Brickley, J. A., R. C. Lease, and C. W. Smith, "Ownership Structure and Voting on Antitakeover Amendments," *Journal of Financial Economics* 20, 1988, pp. 267–291.
- [9] Byrd, J. J. and K. A. Hickman, "Do Outside Directors Monitor Managers?" *Journal of Financial Economics* 32, 1992, pp. 195–221.
- [10] Cochran, P. L., R. A. Wood, and T. B. Jones, "The Composition of Boards of Directors and the Incidence of Golden Parachutes," *Academy of Management Journal* 28, 1985, pp. 664–671.
- [11] Easterbrook, F. H., "Two Agency-Cost Explanation of Dividends," *American Economic Review* 74, 1984, pp. 650–659.
- [12] Fama, E. F., "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88, 1980, pp. 715–732.
- [13] Fama, E. F. and M. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 26, 1983, pp. 301–325.

- [14] Gibbs, P. A., "Determinants of Corporate Restructuring: The Relative Importance of Corporate Governance, Takeover Threat, and Free Cash Flow," *Strategic Management Journal*, Summer Special Issue 14, 1993, pp. 51–68.
- [15] Hermalin, B. and M. S. Weisbach, "The Determinants of Board Composition," *Rand Journal of Economics* 19, 1988, pp. 589–606.
- [16] Jensen, M. C., "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems," *The Journal of Finance* 48, 1993, pp. 831–880.
- [17] Jensen, M. C. and R. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics* 11, 1983, p. 5–50.
- [18] Kesner, I. F. and R. B. Johnson, "An Investigation of the Relationship Between Board Composition and Stockholder Suits," *Strategic Management Journal* 11, 1990, pp. 327–336.
- [19] Kochhar, R. and D. Parthiban, "Institutional Investors and Firm Innovation: A Test of Competing Hypotheses," *Strategic Management Journal* 17, 1996, pp. 73–84.
- [20] Kormendi, R. and R. Lipe, "Earnings Innovations, Earnings Persistence, and Stock Returns," *Journal of Business* 60, 1987, pp. 323–346.
- [21] Kosnik, R. D., "Greenmail: A Study of Board Performance in Corporate Governance," *Administrative Science Quarterly* 32, 1987, pp. 129–150.
- [22] Malatesta, P. H. and R. A. Walking, "Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure," *Journal of Financial Economics* 20, 1988, pp. 347–376.
- [23] Mace, Myles, *Directors: Myth and Reality*, Boston: Harvard Business School Press, 1986.
- [24] Patton, A. and J. Baker, "Why do Directors Not Rock the Boat?" *Harvard Business Review* 65, 1987, pp. 10–12.
- [25] Rendleman, R., C. Jones, and H. Latane, "Empirical Anomalies Based on Unexpected Earnings and the Importance of Risk Adjustments," *Journal of Financial Economics* 14, 1982, pp. 269–287.
- [26] Ricardo-Campbell, R., "Comments on the Structure of Ownership and the Theory of the Firm," *Journal of Law and Economics* 26, 1983, pp. 391–394.
- [27] Rosenstein, S. and J. G. Wyatt, "Outside Directors, Board Independence, and Shareholder Wealth," *Journal of Financial Economics* 26, 1990, pp. 175–192.
- [28] Ryngaert, M., "The Effect of Poison Pill Securities on Shareholder Wealth," *Journal of Financial Economics* 20, 1988, pp. 377–417.
- [29] Sundaramurthy, C., J. M. Mahoney, and J. T. Mahoney, "Board Structure, Antitakeover Provisions, and Stockholder Wealth," *Strategic Management Journal* 18, 1997, pp. 231–245.
- [30] Weisbach, M. S., "Outside Directors and CEO Turnover," *Journal of Financial Economics* 20, 1988, pp. 431–460.
- [31] Winter, R., "State Law Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6, 1977, pp. 251–292.
-