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Discussion of "Managing reputation: Evidence from biographies of corporate directors"

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Abstract

Gow, Wahid and Yu (2018) (henceforth GWY) examine how directors' reputation concerns influence the proxy statement disclosure of their business experience. They find that reputation concerns combine with lax disclosure requirements to cause directors' employment at troubled firms to be omitted from proxy filings. Further, the evidence suggests that these misrepresentations succeed in misleading both the labor and capital markets. In this discussion, I review the literature to highlight the importance of GWY's contribution. I also discuss the study's implications, identify some of its limitations as well as highlight several unanswered questions that provide opportunities for future research.

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Discussion of "Managing reputation: Evidence from biographies of corporate directors"

1. Introduction

Corporations are required to disclose their directors' business experience in proxy filings. This allows investors to evaluate the management of a public company and make informed investment and voting decisions. However, prior to SEC rule changes in 2010, firms were allowed considerable discretion in reporting directors' employment history. Gow, Wahid and Yu (2018) (GWY) exploit this setting to investigate two main research questions: First, do reputational concerns cause corporate directors to hide their employment at troubled firms? Second, if so, does this strategic disclosure benefit directors and the firms that employ them?

A major innovation of GWY is their ability to compare the employment history that directors choose to disclose to their actual employment history. Drawing from prior research that shows directors face labor market penalties when their employment signals they failed in their monitoring and advising duties (see, e.g. Srinivasan 2005), GWY's first hypothesis is a natural one: Reputation concerns, coupled with lax disclosure requirements, cause directors to mask their leadership at troubled firms. Consistent with their hypothesis, the evidence suggests that directors are less likely to disclose their employment at firms that experience reputation decreasing events such as a bankruptcy, securities litigation or accounting restatement. This provides a new and unique view into the specific actions directors take to influence their reputation.

To test their second hypothesis, GWY examine whether directors who strategically choose not to disclose their leadership at troubled firms escape the penalties normally imposed by the labor and capital markets. In the labor market tests, GWY find that non-disclosing

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directors lose fewer board seats than directors who disclose their leadership at troubled firms, consistent with their hypothesis. However, this effect is concentrated in the retention of current board seats as non-disclosure does not gain directors additional seats at new firms. In the capital market tests, GWY find that firms who hire non-disclosing directors experience a positive 1.7% market reaction. In contrast, firms who hire directors who disclose their employment at troubled firms experience a zero market reaction. This valuation benefit suggests that non-disclosure has real effects, though both Institutional Shareholder Services (ISS) recommendations and voting outcomes are not different for disclosing and non-disclosing directors.

Taken together, the results contained in GWY paint a picture in which reputation concerns combine with lax disclosure requirements to cause directors to hide value-relevant information from investors. Further, the evidence suggests that these misrepresentations succeed in fooling both the labor and capital markets. Overall, the authors deserve credit for addressing an important research question using a novel approach that yields intriguing results. Given the analysis is generally well executed and has improved further since the conference version, my discussion concentrates on the interpretation of the findings and their corporate governance implications. First, I review the literature to argue that in contrast to much of the prior literature, the results in GWY suggest that directors' career concerns create a *conflict* between directors and investors. Next, I discuss the implications for Fama and Jensen's (1983) hypothesis that the reputation concerns of directors can be a mechanism that aligns the interests of shareholders and directors. Finally, I discuss a number of unanswered questions raised by GWY's findings that also should be viewed as research opportunities.

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2. Prior research and Contribution

Corporate boards have long been viewed as critical to protecting shareholder's interests. However, prior research shows management has significant influence on director appointments (see, e.g., Shivdasani and Yermack 1999, Dahya et al. 2008) and directors' financial incentives are relatively modest compared to CEOs (Yermack 2004). Therefore, a long-standing question in the literature is if mechanisms exist that can motivate outside directors to monitor managers rather than collude with them. In their influential paper, Fama and Jensen (1983) argue that directors gain valuable non-monetary benefits, such as power, prestige and networks from their board seats. Therefore, directors have the incentive to enhance their reputation as experts in decision control in order to gain seats on corporate boards. In this way, the reputation concerns of directors can be a mechanism that aligns the interests of shareholders and directors even when other mechanisms are not available. Therefore, a central prediction of Fama and Jensen's (1983) hypothesis is that shareholder friendly (unfriendly) actions are rewarded (punished) in the directorial labor market, which leads to improved corporate governance.

Tests of Fama and Jensen's (1983) hypothesis face two important challenges. First, reputation is notoriously difficult to define since reputation is not a single characteristic that a director has or does not have (Noe 2012). Second, the characteristics of director reputation are generally unobservable to shareholders (Karpoff 2012). The existing literature attempts to overcome the first by focusing on the loss (or gain) in reputation defined as change in the number of outside directorships, which can proxy for the quasi-rent stream that accrues to directors based on the number of directorships they hold (Karpoff and Lott 1993). To overcome

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the second, the existing literature's approach uses observable firm-level corporate events that are plausibly under directors' control as indirect signals of directors' expertise (or lack thereof).

The empirical research to date is largely made up of applying this approach to various corporate events. Overall, these studies provide results that are generally consistent with Fama and Jensen's hypothesis that the labor market "settles up" with directors via the number of boards they subsequently are invited to serve on. For example, studies find that directors associated with corporate events that hurt shareholders are penalized with the loss of board seats. Examples include bankruptcy, dividend cuts, restating earnings, public SEC enforcement actions, private securities class action lawsuits and being a target of a proxy contest.[1] Studies also document that directors associated with corporate events that help shareholders are rewarded with an increase in the number of outside board seats. Examples include superior firm performance, opting out of state anti-takeover provisions, M&A experience, CEO experience and confronting management in the interest of shareholders.[2] Given this evidence, directors' desire for outside board seats is viewed as a mechanism that aligns directors with shareholders' interest, even though the specific actions of directors are usually unobservable to the researcher.

In contrast to these prior studies that show directors' career concerns can align the interest of managers and shareholders, I argue that the evidence in GWY suggests that directors' desire for outside board seats is a mechanism that creates a *conflict* between directors and shareholders. GWY show that by withholding their troubled employment history,

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[1] See Gilson (1990), Kaplan and Reishus (1990), Srinivasan (2005), Karpoff, Lee and Martin (2008), Fich and Shivdasani (2007), Harford (2003) and Fos and Tsoutsoura (2014), respectively.
[2] See Ferris, Jagannathan and Pritchard (2003), Coles and Hoi (2003),Harford and Schonlau (2013), Brickley, Coles and Linck (1999) and Jiang, Wan and Zhao (2013).

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directors retain valuable board seats. This provides incentives for directors to mis-represent their qualifications to shareholders and investors. To the extent that directors' biographical misrepresentations cause shareholders to appoint directors that are less qualified than they disclose, the market for director reputation is a mechanism that causes directors to behave in their own self-interest, rather than shareholders. In this way, GWY also contribute to a nascent branch of the literature showing directors' shareholder friendly actions are not always rewarded in the directorial labor market, potentially casting doubt on the Fama and Jensen (1983) hypothesis. For example, Helland (2006) finds that directors of firms charged with fraud actually see an increase in the number of outside board seats. Lel and Miller (2017) find that when country level aggregate governance is weak and boards are likely captured by managers, having a shareholder friendly reputation does not lead to additional board seats and these appointments do not increase firm value. Therefore, a particularly interesting implication of GWY is showing how the role of director reputation in shaping the governance environment of the firm is more complex than originally thought.

3. Implications for corporate governance.

A challenge researchers face when testing governance hypotheses is that it is often difficult to assess the *quality* of governance from observed *mechanisms* of governance. This is because governance mechanisms often substitute or complement one another. In addition, optimal governance mechanisms are likely to vary greatly with firm characteristics. Research to-date on director reputation generally measures how the labor market rewards or penalizes outside directors, rather than reputation's direct effect on corporate governance. Recall that one

branch of research finds that the labor market is a mechanism that aligns the interests of directors and shareholders. On the other hand, GWY document a setting in which the market for director reputation causes a conflict between directors and shareholders. Given the labor market for directors creates two opposing governance forces, it is important to emphasize that we do not yet know how these combine to influence the overall governance environment of the firm. Therefore, direct evidence on a central question raised by Fama and Jensen's (1983) hypothesis, whether directors' reputation concerns align the interests of shareholders and managers and results in better governance, remains unanswered.

The lack of direct evidence on how director reputation impacts the governance of the firm presents a research opportunity. One solution in the literature to measure firms' governance is to use a direct governance outcome: the propensity to replace poorly performing CEOs. Replacing poorly performing CEOs is argued to be a necessary condition for good corporate governance (Shleifer and Vishny (1989, 1997)) and the sensitivity of top executive turnover to performance as a measure of the quality of corporate governance has been supported by a large number of studies in the United States and abroad (see, e.g., DeFond and Hung 2004).

Using the propensity to fire poorly performing CEOs as a direct outcome of governance, a number of potential research questions arise. For example, GWY find some directors are willing to mispresent their qualifications to shareholders and potential investors in order to maintain their reputation. It would be interesting to know if having one or more of these directors on the board is associated with weaker sensitivity of CEO turnover to poor

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performance. A focus on governance outcomes can potentially answer the question if the potential conflicts documented in GWY actually impact the governance of the firm.

4. Why do mispresenting directors increase firm value?

For directors who preside over firms during an adverse event, some choose to disclose this employment while others do not. To measure the consequences of directors' non-disclosure, GWY compare the market reaction to the appointment of directors who hide their leadership in a firm during an adverse event to those that disclose it. Firms that hire non-disclosing directors experience up to a 1.7% positive market reaction while firms that hire disclosing directors experience a zero market reaction. GWY argue that these findings suggest (1) that investors view the appointment of a disclosing director negatively, and (2) that frictions such as search costs prevent investors from obtaining their true employment history elsewhere. At the same time, these findings also raise several interesting questions and suggest possible alternative interpretations.

The first question the event study results raise is why the market reaction to the appointment of a non-disclosing director appointment is so large? Recall that non-disclosing directors are not classified by a positive attribute, but only by the lack of a bad signal. Therefore, they are likely to appear to the market on average as a "normal" appointment, assuming the market cannot determine their employment at troubled firms. Despite this, their appointment is associated with a large positive market reaction. This result is relatively surprising given that prior studies find the market reaction to normal appointments of outside directors to be zero on average (see, e.g. Shivdasani and Yermack 1999, DeFond et al. 2005).

While confounding events could possibly explain these results, GWY are careful to use appointments announced on 8-Ks to minimize confounding events that normally occur during proxy filings. Therefore, why these appointments raise firm value to this extent can be viewed as both a puzzle and a potential question for future research.

The second question the event study raises is why the appointment of a disclosing director does not lower firm value? Prior research shows that the labor and capital markets penalize directors who are found to have failed in their monitoring and advising roles. For example, Fitch and Shivdasani (2007) find that following a financial fraud lawsuit, outside directors experience a significant decline in their other board seats held. Firms where these directors hold board seats also see a decline in value. In contrast, the GWY event study results suggests the appointment of a disclosing director does not lower firm value. Therefore, why appointing directors who are known to have failed in the monitoring and advising roles do not lower firm value in GWY's setting is also an interesting question.

The above two questions also motivate a third question raised by the event study results: why is the stock market fooled by non-disclosing directors? This is especially intriguing since the event study results suggest the costs to being uninformed are high while the cost to becoming informed appear to be quite low. To illustrate this, assume that the correct market reaction to the appointment of an adverse event director is zero as found by GWY. This implies that investors who are fooled by non-disclosing directors overvalue appointing firms by almost 2% of firm value. Given the employment history of directors is a relatively inexpensive internet search, it would be interesting to determine what frictions could justify the seemingly large cost

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of being uninformed. Moreover, it would be important to know why investors appear to be fooled while proxy advisors (ISS) and voters are not.

5. How strong are the incentives for directors to hide their employment history?

An innovation of this study is the ability to compare the employment history directors choose to disclose in proxy statements to their actual employment history. Unlike prior work, GWY can observe how the market for director reputation affects a specific action (biographical disclosure) that is plausibly influenced by directors' desire for outside board seats. In contrast, prior research can only observe if the labor market penalizes directors for broad firm-level events (i.e., a securities class action lawsuit), even though the director may not have contributed to the adverse event.[3] Moreover, GWY's analysis is at the individual director level. In contrast, much of the previous research employs events at the firm level and is therefore often forced to attribute the firm level signal to the entire board. Thus, the approach in GWY has potential identification benefits that can exploit within-firm variation in directors' disclosures.

While the setting in GWY has several advantages to study the effects of director reputation on disclosure choices, there are several aspects of the setting that raise interesting questions and research opportunities. The current version of the paper discusses some of these in more depth, an improvement over the conference version. To illustrate these in more detail, it is useful to note that there are two facets of the directorial job market: First is directors' desire to *gain* board seats at new firms. Second is director's desire to *retain* board seats at their

[3] Some studies are able to link board duties to the severity of penalties, such as members of the audit committee for firms restating earnings (see, e.g. Srinivasan 2005).

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existing firm(s). However, as I argue below, it is not obvious that these two labor market outcomes actually provide strong incentives for directors to engage in strategic disclosure given the way directors are appointed and evaluated.

Consider first whether hiding their employment at troubled firms is likely to increase directors' ability to gain new outside board seats. Using the example of Jan L. Murley used in GWY, we see her employment history from 2003 to 2006 included being the CEO of The Boyds Collection, which filed for bankruptcy in 2005. The firm Qwest Communications disclosed on their Form 14a that they hired a third-party search firm, Boardroom Consultants, to "assist us with the selection of Jan L. Murley as a director".[4] She was put on the ballot by Qwest Communications and voted in, consistent with previous research that finds directors proposed by management are almost always approved by shareholders (see, e.g., Iliev et al. 2015). Given the vetting by both Qwest Communications and the third-party search firm, it appears unlikely that her time as the CEO of a bankrupt firm would not be discovered by Qwest even if she did not disclose it. Therefore, the incentive for directors to engage in selective disclosure to gain new outside board seats would appear to be modest. This suggests that one drawback of the setting is that it is not particularly well suited to test the incentives of directors to gain new board seats, which unfortunately is a key prediction of Fama and Jensen's (1983) hypothesis.

If hiding their employment at troubled firms is unlikely to increase directors' ability to gain new outside board seats, then how might non-disclosure allow directors to retain their current seats? In other words, how likely is it that directors can hide their employment at a

[4] http://google.brand.edgar-online.com/displayfilinginfo.aspx?FilingID=5849500-995-329806&type=sect&TabIndex=2&companyid=9932&ppu=%252fdefault.aspx%253fsym%253dQ

troubled firm from the other firms where they currently are board members? To answer this question, it is important to note that outside directors are usually evaluated annually by the rest of the board (Larcker and Tayan 2015). Therefore, in order for a director's non-disclosure to fool the firm, it would seem necessary that members of the evaluating committee do not know their colleagues' other boards and further only use information from the 14a biographical in their discovery and evaluation. This seems unlikely to be true in most cases.

Taken together, the above arguments suggest that the forces that cause strategic disclosure to influence directors' employment outcomes may not be especially strong. However, they do not necessarily take away from GWY as it is ultimately an empirical issue to the extent of the effect. Rather, the difficulty in which directors are likely to have effectively hidden their employment history from both new and existing firms suggests that firms' managers are likely to know the directors' employment history. This leads to a number of interesting questions and potential research opportunities.

6. Who makes the decision to disclose, firm or director? Does it matter?

Despite the advantages that analyzing biographical disclosures bring to the researcher, one drawback is that we do not know who makes the decision to hide directors' troubled employment history. While it is natural to think of this as the director's decision, GWY note that the drafting process also involves the firm's managers. Therefore, in this setting it is impossible to know if the decision is made by the director, management, or a combination of both. GWY do not focus on this issue and instead argue that their predictions and interpretation of results do not depend on it being the director or the firm (or both) that drives disclosure. However,

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this leaves several opportunities to improve the analysis and better understand the real effects of strategic disclosure.

For example, a natural question is who benefits from strategic disclosure? For directors, GWY show that non-disclosing directors benefit by retaining their jobs at disclosing firms. For firms, GWY show firms enjoy a positive market reaction when adding non-disclosing directors to their board. Therefore, the results suggest that both directors and firms derive benefits from hiding adverse events. These benefits, combined with the involvement of the firm's managers in drafting of director biographies and their appointment and evaluation, leaves open the possibility that managers and directors collude to hide biographical information. On the opposite side, the evidence also suggests that investors bear the costs to the extent that the misrepresentations result in the appointment of less qualified directors and the overvaluation of equity. Viewed in this way, collusion between firms and non-disclosing directors has potentially important implications for both corporate governance and corporate reputation.

For example, to the extent that the cost of directors and managers colluding to withhold biographical information is born by shareholders and investors, it suggests strategic disclosure is likely to weaken the corporate governance environment of the firm. One important rationale why non-disclosure can signal poor governance is that management friendly firms are likely to appoint directors with a management friendly reputation, while shareholder friendly firms are likely to appoint directors with a shareholder friendly reputation (see, e.g. Levit and Malanko 2016). Thus, an interesting question is whether non-disclosure is more prevalent in poorer governed firms and if non-disclosing directors are more management friendly than disclosing directors. If so, it would further highlight that misconduct that hurts shareholders is not

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necessary penalized in the directorial labor market, again suggesting potential deviations from Fama and Jensen's (1983) hypothesis.

The likelihood that management and directors jointly decide to hide information also suggests an alternative explanation for why non-disclosing directors are more likely to retain their jobs: Retention is not because firms are fooled by director's non-disclosure but instead because management wants to retain a management friendly director who may be viewed poorly by shareholders if the director's failure in decision control was disclosed. Therefore, not knowing who makes the disclosure decision leaves also room for alternative explanations. [5]

7. Do non-disclosing directors and firms pay any price for the misrepresentations?

The results in GWY show that directors who hide their checkered employment history benefit in the labor market. Further, firms involved in the drafting/appointing process also see a positive market valuation benefit when appointing these misrepresenting directors. Yet, what is not known is if directors and firms ever pay a price for fooling shareholders and investors, making this an attractive question for future research. One way to attempt to answer this would be to examine labor market outcomes for non-disclosing directors that subsequently disclose their troubled employment. GWY note that approximately 8% of the director sample observations changes disclosure from year to year. This analysis could answer whether directors who hide their employment at troubled firms in order to boost their reputation pay a reputation penalty when they are discovered.

[5] Another possible explanation for strategic disclosure is when management vets the director and concludes she is not responsible for the adverse event. This would also provide incentives to obfuscate directors' employment experience to increase the probability of electing the director.

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Another important question raised by the possibility that managers are involved in the misrepresentation of directors' biography is if *firms* pay a reputation penalty when their disclosures are found to hide directors' troubled employment history? While GWY concentrate on the implications of director reputation, a large literature shows that corporations as a whole also have a reputation that can differ from its directors' reputation. For example, Graham, Li and Qiu (2008) find investors who discover that a firm's financial statements are incorrect lower their demand for the firm's debt and equity which raises its cost of capital. Therefore, a firm's reputation can be measured by the change in stock price surrounding the event, as it measures investors expectation of the total net costs and benefits to the firm from the news of the event (see, e.g. Karpoff 2012). Given the results in GWY suggest that firms are rewarded with higher market value upon the appointment of a non-disclosing director, one alternative interpretation is that these non-disclosing directors are viewed by the market as increasing the firm's reputation. Therefore, it is an important and interesting question whether the market ever discovers this misrepresentation and subsequently penalizes the firm for misleading it.

8. Conclusion

Disclosure of directors' business experience enables investors to evaluate management and make informed investment and voting decisions. However, prior to 2010, firms were allowed considerable discretion in reporting directors' employment history. GWY exploit this setting to compare the employment history that directors choose to include in proxy filings to their actual history. They find that directors are more likely to omit their employment at troubled firms and by doing so, are more likely to retain their current board seats. Further, the appointment of

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these non-disclosing directors is associated with a positive stock price reaction, whereas the appointment of disclosing directors is not.

In my opinion, GWY address an important question and deliver a carefully executed study. Directors' reputation concerns have long been hypothesized to influence corporate decisions. However, the existing evidence is largely indirect since the specific actions of directors are usually unobservable to the researcher. GWY identify a novel setting that allows a more direct examination of how an important directorial decision, disclosure choices, impacts their reputation. However, the setting GWY exploit is not without limitations and thus raises several unanswered questions and alternative interpretations for future research. One limitation of the setting is that we do not know whether directors or firms (or both) ultimately make the disclosure decision. Another is that while the evidence in GWY suggests directors' reputation concerns combine with lax disclosure standards to create a conflict between directors and investors, whether this materially impacts the governance of the firm remains unanswered. We also do not know if directors and firms who hide value-relevant information from investors ever pay a price for their actions. Therefore, while GWY provides several new and interesting findings, the richness of their study also leaves room for a number of promising research opportunities.

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