Exodus: The Economics of Independent Director Exit

M.D. Beneish[∇], K. Lu[+], Z. Wang*, J. Yang**

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Abstract

We examine the economics of independent directors' resignation decisions by taking advantage of a natural setting: The revised Securities Law of the People's Republic of China, which took effect on March 1, 2020 (hereafter New Securities Law or NSL), and the first successful class-action securities lawsuit on November 12, 2021. We argue that by increasing 17-fold the penalties to directors of firms that misreport, NSL reduces by the same factor the maximum probability of getting caught at which director positions remain economically viable. We predict and find that in the short run when director compensation is fixed, NSL leads to more frequent resignations, particularly in firms that have a higher ex-ante likelihood of financial misreporting, and in firms where director compensation is lower. We also find that independent director dissent that arises primarily as a result of directors' inability to establish whether their firms' financial reports are reliable is a significant antecedent to voluntary resignations post NSL. Finally, analyzing the fraction of Chinese publicly traded firms that purchase director and officer liability (D&O) insurance, we find that independent directors are less likely to resign pre NSL but more likely to resign post NSL. This finding suggests that firms with higher misreporting risk self-select pre NSL into such contracts. Given directors' valuable monitoring role, we expect to observe in the long run both increased independent director compensation and increased D&O insurance coverage.

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Keywords: independent director resignations, director dissensions, D&O insurance

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[∇] Kelley School of Business, Indiana University, [+] International Institute of Finance, School of Management, University of Science and Technology of China, *PBC School of Finance, Tsinghua University, **Corresponding Author: Kelley School of Business, Indiana University. Email: jy4@indiana.edu. We thank Isaac Hacamo, Mark Huson, Jordan Martel, Randall Morck, Alessandro Previtero, Lea Stern, Wenyu Wang, Michael Weisbach, and Frank Yu (discussant), as well as the participants at the CFRC and Frontiers in Finance Conference, as well as seminar participants at Indiana University and Hong Kong Polytechnic University for their insightful comments.