Director Incentives in the Labor Market, Corporate Governance, and Firm Performance: Evidence from Retirement

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Abstract

This paper investigates the impact of director reputational incentives in the labor market on director monitoring, corporate governance, and firm performance. Using a hand-collected sample of retired CEO directors, we first study the impact of their CEO retirement announcements on the value of the firms in which they continue to hold outside directorships. We then analyse whether post-retirement diminishing incentives in the director labor market wield real impact on the quality and intensity of retired CEO director monitoring and on governance. Finally, we discuss how our methodology addresses endogeneity of director incentives by effectively controlling for director- and firm-fixed effects.

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Abstract

This paper investigates the impact of director reputational incentives in the labor market on director monitoring, corporate governance, and firm performance. Using a hand-collected sample of retired CEO directors, we first study the impact of their CEO retirement announcements on the value of the firms in which they continue to hold outside directorships. We then analyse whether post-retirement diminishing incentives in the director labor market wield real impact on the quality and intensity of retired CEO director monitoring and on governance. Finally, we discuss how our methodology addresses endogeneity of director incentives by effectively controlling for director- and firm-fixed effects.

What induce independent directors to monitor managers, rather than collude with them to the detriment of shareholders? In their seminal paper, Fama and Jensen (1983) conjecture that "Our hypothesis is that outside directors have incentives to develop reputations as experts in decision control… The value of their human capital depends primarily on their performance as internal decision managers in other organizations. They use their directorships to signal to internal and external markets for decision agents that they are decision experts… The signals are credible when the direct payments to outside directors are small, but there is substantial devaluation of human capital when internal decision control breaks down…" (p. 315). According to this hypothesis, the directors' main incentives are their reputation in the labor market for corporate directors.

Recent evidence of relatively weak financial incentives of outside directors (Adam and Ferreira, 2008; Yermack, 2004) has further strengthened Fama and Jensen (1983)'s conjecture on the importance of director reputational incentives.[1] To date, the literature on director reputation has mainly focused on the relationship between firm performance, as a proxy for director reputation, and directors' accumulation of additional board seats, as the main reward for reputation in the labor market, finding some evidence that board members of poorly performing firms are less likely to be offered with additional directorships.[2] However, evidence on the direct impact of director reputational incentives in the labor market remains relatively scant.

This paper empirically studies the impact of director reputation in the labor market on board monitoring and corporate governance. We analyze the impact of the retirement of CEO directors from their CEO position on stock price, performance, and governance of the other firms in which they continue their independent directorships.

To fulfil their primary task of monitoring and advising the management, an outside director

[1] Yermack (2004) finds that outside directors' wealth increases 11 cents per $1,000 rise in firm value.
[2] Fich and Shivdasani (2007) report that, subsequent to a financial fraud lawsuit, outside directors on the board of the sued firm experience a significant decline in other board seats held.

needs to be independent, able, experienced, and more importantly be provided with sufficient incentives. The case of retired CEO directors is interesting for our research for several reasons.

On the one hand, directors who are recent retired CEOs appear to be among the most able and experienced directors. Moreover, following their retirement, they presumably possess a greater amount of time, at least in comparison to their pre-retirement, to devote to their directorship. Retired CEO directors should be thus ideal board members possessing ability, experience and availability.

On the other hand, however, according to Fama and Jensen's conjecture, retired-CEO directors have significantly less incentives from the director labor market. Subsequent to their retirement, they might no longer expect a lot of opportunities of having more directorships in the labor market because of the pervasive age limit in the majority of the boards nowadays. Retired-CEO directors do not even enjoy the potential financial rainfall from a higher level of reputation in the labor market after retiring from their main job. Moreover, reputation-wise, CEO directors had already reached a top job with established reputation before retirement from their CEO position. They might be less likely to seek more reputation when they retire. Finally, retired CEOs are financially wealthy enough that they are less likely to assume directorships because of pecuniary remuneration.

The retirement of CEO directors from their CEO position – a negative shock on their incentives in the director labor market – thus provides an ideal experiment to test Fama and Jensen's conjecture on director reputational incentives. Our hypothesis is that, due to the reduced incentives of CEO directors in the director labor market, their monitoring and advising activities will be less effective, leading to a reduced firm value and a worse governance quality.

[*Describe the data collection here.*] We collect information on the retirement of U.S. CEOs with outside directorships in the period between 1992 to 2015 from several data sources, including Audit Analytics, Execucomp, RiskMetrics, and the SEC's Form 8-K. We check the details of each case of retirements on Factiva to ensure that we obtain the exact chronology of the event. Personal details of directors of public firms in the U.S. are from BoardEx of Management Diagnostics Limited. Data on firm accounting and stock prices and governance metrics are obtained from CRSP and RiskMetrics, respectively.

[*Describe the empirical framework here*]. Our empirical design is based on a set of difference-in-difference regressions comparing various metrics of director monitoring and firm governance between the period pre- and the period post-CEO retirement on a sample of the same firms and directors. The only 'shock' to the sample is the retirement of CEOs who continue to hold outside director ships after retirements that presumably lower their monitoring and advising incentives. Note that focusing on the sample of firms that just start having a CEO director who retires from CEO position is more interesting for our research question than focusing on the sample of firms that just hire already retired CEOs. In the former case, we follow up with the same sample of firms so that we can control for firm- and director-fixed effects as well as director ability. In the latter case, it will be difficult to control for potential omitted variables.

Our approach and choice of experiment help overcoming the challenging endogenous relationship between director reputational incentives and director monitoring and firm value in a study on director reputation in the labor market. Our empirical framework effectively controls for director ability, director- and firm-fixed effects, and other factors as we compare the same firms and directors for the period before CEO director retirement against the period post-retirement.

We have first conducted an event study on a sample of CEO director retirement. We calculate stock price cumulated abnormal return (CAR) of each firm around the date of the retirement of its

CEO director from his CEO position.

We subsequently investigate how the reduced incentives of directors affect their monitoring and advising quality, focusing on various monitoring and governance metrics, including board meetings' attendance, CEO pay, earning management, CEO performance turnover sensitivity, payout policy, merger performance, firm performance.

[*Describe the main results here*].

We conduct our empirical investigation on a sample of 327 outside directorships hold by 495 CEOs who retired from their CEO position from 1992 to 2015. Our main results are the following.

First, the market stock prices of firms with CEO directors react negatively and significantly following the announcement of CEO director retirement from CEO position. In different event windows (-1,+1; 0,+1) following the CEO retirement announcement, the stock prices of firms in which retiring CEOs are still holding outside directorships react negatively and significantly. In the window (-1,+1), the average cumulative abnormal return is -2.4%, significant at the 1% level. Since the average firm in our sample has a market capitalization of $ XXX billion, the negative stock price reaction represents a loss of firm value of $YYY million. This result appears to confirm our hypothesis that when a CEO director retires from his CEO position, his incentives to monitor and advise are perceived to be diminished by the market. Stock prices fall accordingly. This result seems to support Fama and Jensen (1983)'s conjecture on the reputational incentives of outside directors in the labor market for directors.

We find second that retired-CEO directors are also less likely to be active and effective directors. In comparison to themselves, they are less likely to attend board meetings, less likely to fire a CEO for a poor performance after the retirement. Consequently, their firms perform worse than before, tend to overpay the CEO, fare worse in M&A decisions.

[*Describe the main contributions here*]. Our paper contributes to the literature on the board of directors and on corporate governance along several lines.

First, the paper provides a direct test to Fama and Jensen's conjecture. Reputational incentives in the labor market appreat to be crucial for directors to perform the monitoring advising roles. More importantly, the results inform us on the very important question of whether outside directors are provided with right incentives to perform.

Second, we provide an explanation to Fahlenbrach et al. (2010) result. Since retired CEOs have more time, but insufficient incentive to monitor, while active CEOs do have incentives, but no time, their monitoring is not as effective as one might expect.