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Network connections, CEO compensation and involuntary turnover: The impact of a friend of a friend☆

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ABSTRACT

We show that hard to observe, indirect connections between a CEO and "independent" board members are associated with higher CEO compensation. While we find this result for the "friend of a friend" connection, we do not find it for direct connections, i.e. friends sitting on the board. We postulate that this differential result is caused by directors with readily observable connections to the CEO being wary of provoking outrage. In contrast we find both types of connections associated with reduced involuntary CEO turnover, suggesting that outrage is not as big a concern, e.g., compensation is the foci of stakeholders.

1. Introduction

In a recent promulgation addressing the independence of compensation committees, the Securities and Exchange Commission (SEC) stated that exchanges should consider "relationships between members of the compensation committee and the listed issuer's executive officers."[1] Prior literature suggests the SEC has reason to be concerned. Larcker et al. (2005), Hoitash (2011), and Hwang and Kim (2009) find that connections between CEOs and their board of directors are associated with higher CEO compensation, while Hwang and Kim (2009) also suggest that these connections lead to lower CEO turnover. In this paper we examine whether these results are affected by whether the connection is directly between the CEO and director, i.e., a direct connection, or indirectly through a third party, i.e., an indirect connection.

Direct connections are theoretically stronger – it is simply harder to say no to a friend. As Adams et al. (2010, note 15) suggest, "one imagines that directors who have close ties to the CEO … would find monitoring him more costly than directors with fewer ties…" However, direct connections are also more easily observed, and hence, subject to closer scrutiny than indirect

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connections.[2] Thus, the cost of increasing CEO compensation or not terminating a CEO could be greater for the director with a direct observable connection to the CEO. Consistent with this premise, we find that indirect connections have a positive association with CEO compensation, while direct connections do not. However, we find that both direct and indirect connections are associated with reduced CEO involuntary turnover. This result suggests that outrage is not as big a concern when deciding whether to terminate a CEO. That is, the attention paid to executive compensation is well known, e.g., annual surveys by the media, tax code provisions and disclosure mandates by regulators, and of course, the now mandatory say-on-pay vote. In contrast, little public attention is paid to why corporations fail to terminate underperforming CEOs. An alternative non-mutually exclusive explanation for why directors are reluctant to terminate underperforming CEOs is that it increases their turnover risk as well, especially when they are seen as close to the CEO (Farrell and Whidbee, 2000). So while directors with direct connections may bear a greater cost for retaining an underperforming CEO, they weigh that against the increased likelihood they will lose their positions if they fire the CEO.[3]

Our paper contributes to the literature on CEO connections, CEO compensation, CEO turnover, and corporate governance by showing how direct and indirect connections between CEOs and their boards' impact CEO compensation and the likelihood of involuntary turnover. It also has implications for standard-setters. The SEC has expressed concern that other relationships between directors and management may hurt the independence of compensation committee members. While we find evidence consistent with this notion, our evidence is also consistent with prior regulatory actions increasing the impact of these other relationships. That is, we provide evidence consistent with regulatory actions by the SEC, NYSE and NASDAQ which mandated increased board independence, increasing the importance of connections with ostensibly "independent" directors. In particular, we show that only after these promulgations, is there an association between connections and CEO compensation.[4] In that respect, Westphal and Zajac (1994, 386) look prophetic when they wrote "increasing the number and/or proportion of outsiders on the board of directors … could be a more symbolic than substantive action, given that CEOs may simply recruit sympathetic outsiders to the board."

We organize our paper as follows. In Section 2, we develop our hypotheses; and in Section 3, we outline our research design. In Section 4, we discuss the data and descriptive statistics. Section 5 provides our empirical results, while section 6 provides additional analysis. Section 7 shows our cross-sectional tests and Section 8 discusses models utilized to mitigate endogeneity concerns. We conclude in Section 9.

2. Hypotheses development

Individuals have incentives to be appointed to corporate boards. These benefits revolve around the prestige of the appointment, which may lead to other appointments, as well as the remuneration associated with serving on the board. Remuneration for serving on boards of large companies can be substantial, e.g., Nguyen (2014) reports that mean (median) compensation was \$166,000 (\$146,000) for the period 2006–2009, while Solomon (2015) reports that median director compensation was \$233,600 in 2014.[5] Consequently, once appointed, the individual has the incentive to retain his/her position. This creates incentives to support the CEO, who may have appointed the director to the board, and who usually has some say in whether the director retains his or her position.[6]

These incentives, when combined with directors being more likely to identify with the executives they oversee, as opposed to the shareholders they represent (Lorsch and MacIver, 1989; Bainbridge, 1993), have led academics, the media, and regulators to question the independence of boards.[7] As a result, regulators have promulgated ever tightening standards on director independence and rules regarding service on essential board committees. For example, following the Sarbanes-Oxley act of 2002, which required the audit committee be comprised solely of independent directors, the NYSE changed its listing requirements to require that the compensation committee be comprised solely of independent directors, and NASDAQ required that "compensation be determined or recommended to the board for determination either by a majority of the independent directors, or by a compensation committee comprised solely of independent directors".[8] These requirements were formalized in section 952 of the Dodd-Frank Act, which required members of the compensation committee be independent. However, these rules do not proscribe directors who have personal or business relations with executive officers of the firm from serving on the compensation committee.

[2] To shed some light on this issue we merged our connections data with ISS Voting Analytics, finding, in untabulated univariate analysis, that ISS is less likely to recommend voting "for" directors who have direct connections to the CEO, when compared to directors with no or indirect connections

[3] In untabulated analyses we find that directors with connections are statistically more likely than directors without connections to leave the company in the year following the CEO's involuntary departure. We also find that directors with direct connections are slightly more likely than directors with indirect connections to leave; however that difference is not statistically significant.

[4] We are not suggesting that either these promulgations or their goals, i.e., increased director independence, are deficient, only that there may have been unintended consequences.

[5] Using an earlier time period, when compensation per director was significantly lower, Yermack (2004, note 9) estimated the cost (i.e., present value) of losing a directorship at \$618,400. In addition, there are reputation effects, as Yermack shows serving on the boards of successful companies leads to future directorships.

[6] In addition, CEO and director job security may be related. Yermack (2004) shows that when the CEO leaves, director turnover increases, especially among directors he/she appointed. Farrell and Whidbee (2000) show that this turnover is greater among directors seen as aligned with the CEO.

[7] See for example Mace (1971), Pfeffer (1972), Baker et al. (1988), Crystal (1991), Hermalin and Weisbach (1998), and Shivdasani and Yermack (1999).

[8] http://www.sec.gov/rules/sro/34-48745.htm.