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Birds of a feather: Value implications of political alignment between top management and directors ☆

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ABSTRACT

For 2,695 US corporations from 1996 to 2009, we find that alignment in political orientation between the chief executive officer (CEO) and independent directors is associated with lower firm valuations, lower operating profitability, and increased internal agency conflicts such as a reduced likelihood of dismissing poorly performing CEOs, a lower CEO pay-performance sensitivity, and a greater likelihood of accounting fraud. Importantly, we show that our results are driven neither by the effects associated with various measures of similarity and diversity within the board nor the effects of local director labor market and political conditions on board structure. We provide evidence that our measure of individual political orientation reflects the person's political beliefs rather than opportunistic attempts to seek political favor. Overall, our results suggest that diversity in political beliefs among corporate board members is valuable.

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1. Introduction

Board independence is both important and difficult to achieve.[1] Board independence can be threatened not only by overt connections between managers and directors but also by the existence of intangible networks and relationships. Such intangible ties between managers and directors are hard to identify and difficult to eliminate and, thus, have the potential to subvert regulations such as the Sarbanes-Oxley Act (SOX) that seek to enforce board independence. In this paper, we provide new evidence on the entrenchment effect of intangible ties between managers and directors. In particular, we show that alignment in political orientation between managers and directors can have an adverse effect on board independence, leading to managerial entrenchment and impairment in firm value.

Recent studies in behavioral finance show that people with different political orientations exhibit different preferences. Democratic money managers tend to invest less in companies with social responsibility concerns (Hong and Kostovetsky, 2012), whereas top executives who are Republicans tend to choose more conservative corporate financial policies (Hutton, Jiang, and Kumar, 2013). In addition, a recent marketing study featured in *Time* magazine shows that Republicans and Democrats exhibit distinctly different consumer behavior patterns, from their preferred brand of coffee to their favorite gaming console: "[w]hile Democrats prefer gaming on a Wii while sipping a Starbucks coffee, Republicans prefer afternoons of Xbox playing and chugging java from Dunkin' Donuts."[2] These findings, taken together, suggest that individual political orientations could well reflect underlying value systems and preferences.

Given the extensive evidence in the sociology literature that similarity breeds connections among people (the homophily principle; McPherson, Smith-Lovin, and Cook, 2001), we hypothesize that similarity in political orientation could also serve as a catalyst in developing connections among people (Verbrugge, 1977; Knoke, 1990; Huckfeldt and Sprague, 1995). Specifically, in the corporate board context, we posit that similarity in political beliefs between managers and directors can result in increased empathy and acceptance between them, which would affect the kind of oversight the board exerts over the chief executive officer (CEO) and top executives. While shared values and belief systems between top executives and independent directors can result in quicker and more efficient decision making and an increase in firm value (Adams and Ferreira, 2007), they can also result in greater managerial entrenchment arising from weaker monitoring by the board, if such connections impair director independence. In this paper, we empirically examine the valuation and entrenchment implications of political alignment between the top management and independent directors.

We make a number of contributions in this paper. We are the first to develop a measure of similarity in political orientation between top managers and directors. We also investigate the valuation and internal governance implications of such intangible connections. We provide evidence that our measure of political alignment is associated with lower valuations, lower operating performance, a lower probability of CEO turnover following poor performance, weaker compensation incentives, and a greater likelihood of corporate fraud. Importantly, we show that these negative outcomes associated with political alignment between the CEO and directors exist even after controlling for other measures of similarity or diversity within the board and the effects of local director labor market and political conditions on board structure. Overall, our results suggest that the intangible connections between top management and directors arising from their political orientations have a unique and distinct impact on firm valuation and managerial entrenchment.

We measure the similarity in political orientation between the CEO and independent directors by constructing a political homophily index (*PHI*) between them.[3] We follow a two-step procedure in constructing this measure. First, we measure each corporate individual's political orientation by comparing the dollar amounts of political donations made by that individual to the Republican and Democratic Parties. In particular, using the individual's full donation record over 11 election cycles since 1989, we measure the relative tilt of each person's political donations toward the Republican Party and denote it by *Rep*. Then, we calculate the group-level average of *Rep* values for the group of independent directors and compute the *PHI* for each firm by calculating the normalized inverse Euclidean distance between the CEO's *Rep* and the group-level average of *Rep* values for the independent directors. By construction, a *PHI* value of one (zero) indicates the greatest (least) similarity in political orientation between the CEO and independent directors.

For 2,695 US corporations at the intersection of the Compustat Executive Compensation (ExecuComp) and Investor Responsibility Research Center (IRRC) databases from 1996 to 2009, we find that firm values, measured by Tobin's Q (Q, hereafter), are reduced by 2.24% relative to the sample average for a one standard deviation increase in our *PHI*. This effect is statistically significant at least at the 5% level, even after controlling for various board characteristics, firm-level financial variables, and the firms'

[1] The Sarbanes-Oxley Act of 2002 emphasizes the importance of board independence. Romano (2005) argues that requiring increased board independence could be ineffective because chief executive officers could have considerable influence even over independent directors. Hermalin and Weisbach (1991) and Bhagat and Black (2002) find no evidence that board independence improves firm performance. Larcker, Richardson, Seary, and Tuna (2005) show that cross-directorships lead to higher compensation.

[2] See Time (2012).

[3] In this paper, each corporate individual's political orientation is measured using his or her political contributions. Due to the possibility that CEOs could serve as fundraisers who directly solicit contributions from their subordinates, we focus on the CEO among the top executives in each firm. In untabulated analyses, we also use the group of top five executives (based on their salary and bonus ranks) to measure the degree of political alignment between the top management group and directors and find that most of our main results hold even more strongly, both statistically and economically. These results are available in Table IA1 of the Internet Appendix.

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