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CEO identity and labor contracts: Evidence from CEO transitions☆

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ABSTRACT

This paper assesses how CEO transitions shape labor contracts within firms. We argue that family links between a new CEO and his predecessor act as a commitment device for upholding implicit contracts with the workforce. Consistent with this view, we find evidence of a wage insurance mechanism during a CEO transition. Dynastically-promoted CEOs relative to external CEOs are associated with up to 25% less job separations and 20% lower wage growth. Crucially, we show that differences, in terms of job separations, between dynastic and non-dynastic CEO successions are significantly greater when labor markets are more frictional.

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1. Introduction

A growing body of literature studies the role played by CEO attributes in shaping employment policies within firms. However most of these papers have abstracted from the role played by CEO turnover in the design of labor contracts (Sraer and Thesmar, 2007). This is despite evidence from hostile takeovers that labor contract renegotiations are most likely to materialize when new executive management comes into the firm (Shleifer and Summers, 1987). The reason is that core elements of labor contracts are not explicitly contractible and thus rely heavily on implicit agreements the credibility of which depends on the attributes of and personal links to the acting CEO.

This is the first paper that provides a direct account of the impact of such CEO turnover events on labor contracts. We compare the evolution of unemployment risk and wages around CEO transitions depending on whether or not the CEO successor belongs to the same family as the departing CEO. Belonging to a dynasty of CEOs is one of the strongest signals of loyalty: family-promoted CEOs are likely to share their predecessor's attachment to the existing workforce and to eventually transmit similar preferences to future CEOs. The idea developed in this paper is that, in contrast to external professionals, CEOs promoted from within the family are bound by the employment promises of their predecessors and can credibly engage into new long term contracts.

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We examine this story in a well-suited differences-in-differences setting using matched employer–employee data from France.[1] The main prediction we test is that family-promoted CEOs, relative to external CEOs, are associated with (i) lower job separations for the incumbent workforce and (ii) lower wage raises for the incumbent workforce and lower entry wages for the arriving workforce. The intuition is that following an external CEO turnover workers need to be compensated for the greater termination risk they face (Azariadis, 1975; Bailly, 1974). We find that job separations following CEO turnovers are about 25% lower after a dynastic transition while wage growth is simultaneously 20% lower.

The main empirical challenge is that neither firms experiencing dynastic transitions nor firms experiencing transitions to external professionals can be considered random draws. To address this issue we first use as an instrument the information contained in the name of the firm prior to the transition about dynastic intentions of the incumbent CEO. The magnitude of all the estimates increases with respect to our baseline results.

Our implicit contract hypothesis can be further disentangled from alternative theories on the basis of industry differences in the benefits of wage insurance. Greater commitment to long-term contracts associated with family management should be more valuable in industries where (i) external labor markets are more frictional and (ii) labor relations are more conflictual. Indeed, we find evidence that differences between dynastic and non-dynastic CEO successions in terms of job separations are significantly stronger in those industries.

Finally we also show that differences in labor policies are (i) directly affected by private benefits from dynastic management, (ii) that these differences are not driven by the ex-CEO remaining on the board of the firm, (iii) are not driven by the composition of our control group, and finally (iv) are not driven by changes in the financial structure of the firm.

Our paper most directly contributes to the literature relating inherited management to employment policies. Sraer and Thesmar (2007) shows, in a cross-section of publicly listed French firms, that heir-managed firms offer lower wages but also shield their workforce from industry-wide shocks. It is not clear however whether these two stylized facts are linked to each other by an implicit contracting mechanism, let alone caused by the identity of the CEO, given that, in the cross-section, there cannot be any within-firm variation in either CEO identity or labor contracts. Ellul et al. (2014) also rely on a static definition of family involvement but extend the analysis to a cross country setting. Our paper makes similar predictions but relies instead on a dynamic definition of family involvement. This allows us to not only establish a direct link between dynastic management and the implicit contracts hypothesis but also to pinpoint the time at which commitment provided by CEO choice is of greatest importance.

Our paper also contributes to recent work that focused on the impact of large individual blockholders on human resource management. Bassanini et al. (2010) shows, in a cross-section of French firms, that firms with large individual blockholders provide more employment security to their workforce. Contrary to this paper we show that, in the particular case of employment policies, important differences arise on the basis of management rather than ownership characteristics. Management identity may indeed have a distinct effect on employment practices because CEOs interact with the workforce on a regular basis and thus are more likely to draw a private benefit from taking decisions that are advantageous to them (see Cronqvist et al. (2009)).

The remainder of the paper is organized as follows. Section 2 presents a detailed discussion of the dataset and of the variables used in the analysis. Section 3 presents the theoretical and empirical framework that embeds the analysis. Section 4 presents the main empirical results as well as various robustness checks. Section 5 concludes.

2. Data description

2.1. Data sources

Our empirical analysis combines a unique dataset on French CEO transitions for the period 1997 to 2002 together with balance-sheet and matched employer–employee datasets for the period 1995 to 2004. As in Bach (2010), we identify CEO transitions on the basis of CEO names available in the DIANE dataset, a dataset covering all French corporations. Firm- and industry-level datasets are based on accounting data extracted from tax files, as in Bertrand et al. (2007). Finally, our main source of information on firms' labor contracts comes from matched employer–employee data. This dataset consists of mandatory employer reports of the gross earnings of each employee subject to French payroll taxes and is similar to the one used by Abowd et al. (1999). It covers all employed persons in the economy and provides information about an individual's age, gender, occupation, total net nominal earnings during the year, and hours worked. In addition, it contains information about whether the individual began or left his employment at the plant during the year.[2]

2.2. Data organization

Between 1997 and 2002, we compare monthly issues of DIANE in order to track CEO successions. Given the occurrence of a succession, we compare the spouse and maiden name of both the departing and the incoming CEO in order to track the dynastic status of each CEO transition. Whenever departing and incoming CEOs share the same name, we classify a CEO succession as dynastic. We exclude foreign-owned firms as well as firms in which the arriving CEO is another corporation.[3] Focusing on firms that experienced

[1] We thus focus on the French economy, where Bach (2010) estimates that more than one in five employees in the private sector work in dynastically managed firms, in line with various countries including the US (Astrachan and Shanker, 2003; Franks et al., 2012).

[2] In this dataset there is, however, no employee identifier that would allow us to re-trace the entire sequence of labor contracts across more than two periods.

[3] For an in-depth discussion of the data we refer the reader to Bach (2010).

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