Journal of Corporate Finance xxx (2013) xxx–xxx

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Should I stay or should I go? Former CEOs as monitors

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ARTICLE INFO

Article history:
Received 2 October 2013
Received in revised form 25 November 2013
Accepted 9 December 2013
Available online xxxx

JEL classification:
G30
G38

Keywords:
Executive compensation
Board structure
Two-tiered board

ABSTRACT

In the German two-tiered system of corporate governance, it is not uncommon for chief executive officers (CEOs) to become the chairman of the supervisory board of the same firm upon retirement. This practice has been the subject of controversial debate because of potential conflicts of interest. As a member of the supervisory board, the former CEO must monitor his successor and former colleagues and is involved in setting their pay. We analyze a panel covering 150 listed firms over a 10-year period. Consistent with a leniency bias, we find evidence that firms in which a former CEO serves on the supervisory board pay their executives more. We further find weak evidence that the compensation of the members of the supervisory board is also higher. Short-run event study results indicate that the announcement of the transition of a retiring CEO to the supervisory board is considered good news. Thus, despite the increases in executive compensation we document, CEO transitions are not a cause of concern for shareholders.

1. Introduction

A distinguishing feature of the German corporate governance system is its two-tiered board structure with an executive board and a supervisory board. The executive board runs the firm while the main task of the supervisory board is to monitor the executive board. The members of the supervisory board are elected by shareholders and employees (according to German codetermination laws). The supervisory board, in turn, nominates the members of the executive board and sets their pay.

A person cannot be a member of both boards simultaneously. What can and often does happen, though, is that the chief executive officer (CEO),[3] after retiring, becomes a member of the supervisory board. We refer to this practice as a CEO transition. In the majority of the cases (about 60% in our sample), a former CEO who becomes a member of the supervisory board is then elected chairman of the board. This is potentially important because the chairman of the supervisory board almost always also chairs the compensation committee.

The transition of a former CEO to the supervisory board has been a controversial topic of discussion. On the one hand, the former CEO has accumulated firm and industry expertise, which should allow him to fulfill his monitoring task effectively. On the other hand, he becomes the supervisor of the management team that he just left. This entails the danger of relations that are too cozy. The personal connection likely leads to a leniency bias, which can result in higher executive compensation. In addition, the

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[3] The German Stock Corporation Act (*Aktiengesetz*) stipulates that board members manage a firm jointly and decide by majority vote. The law explicitly prohibits one member (or group of members) deciding against the majority of the members of the executive board. The executive board is not required to have a chairman. If appointed (as in most corporations), the chairman's powers are less broad than those of a CEO in a UK or US corporation. It may therefore be incorrect to translate *chairman of the executive board* as CEO. However, for expositional efficiency, we stick to the term *CEO*.

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http://dx.doi.org/10.1016/j.jcorpfin.2013.12.008

former CEO may be reluctant to criticize or revoke decisions he took during his tenure as CEO. He may even exert pressure on his successor not to challenge the strategy or organizational structure he implemented during his tenure. Consequently, a former CEO who becomes chair of the supervisory board may impede necessary changes.

These potential conflicts of interest have sparked regulatory change. In 2005, a provision dealing with the issue was added to the German Corporate Governance Code.[4] It recommended that "it shall not be the rule" for the former CEO or a former executive board member to become chairman of the supervisory board. This provision had little practical effect. Therefore a new law was enacted that came into force in 2009. It introduced a "cooling-off period" for former executives who wish to become supervisory board members. A person who was a member of an exchange-listed firm's executive board within the past two years cannot become a member of the same firm's supervisory board.[5] This provision is not limited to the position of chairman (as was the case under the code's recommendation).

It is a priori unclear whether the advantages or disadvantages of having a former CEO on the supervisory board dominate (and, consequently, whether or not the new law can be justified on economic grounds). We therefore address this issue empirically. We construct a panel data set covering 150 German listed firms over a 10-year period. We use this data set to analyze three questions. First, we ask whether the promotion of a former CEO to the supervisory board affects firm value. To answer this question, we perform both short- and long-run event studies. Second, we analyze whether the presence of a former CEO on the supervisory board affects the firm's operating performance. Third, we investigate whether the level of executive compensation or the level of director compensation[6] is different in firms in which a former CEO serves on the supervisory board. To this end, we estimate panel regressions and perform a difference-in-differences analysis.

Our findings can be summarized as follows. The short-run event study results indicate that firm value increases when a former CEO becomes a member of the supervisory board. The results of the long-run event study and of the analysis of operating performance point in the same direction but are mostly insignificant. Executive compensation increases in the amount of time the former CEO and the current executives were jointly sitting on the executive board. This joint tenure time is a proxy for the strength of the personal relation between the former CEO and current executives. In a difference-in-differences analysis, we find that per capita executive compensation increases after a CEO transition. This effect is not only statistically significant, but also economically significant. After controlling for other variables such as firm size, we find the annual per capita compensation of the members of the executive board to increase by €122,520 when the departing CEO becomes an ordinary member of the supervisory board and by €274,760 when the departing CEO becomes the chairman of the supervisory board. The results regarding director compensation are less clear but, if anything, point toward higher director compensation in firms with a former CEO on the supervisory board. When considered in isolation, the results on executive and director compensation appear to support the critics of CEO transitions. However, because the analysis of share price and operating performance indicates a positive performance effect of CEO transitions, our findings do not support the conclusion that CEO transitions are disadvantageous to shareholders.

Our paper is related to several strands of the literature. First and most importantly, it is related to recent papers that also analyze the transition of former CEOs to the supervisory board of German listed corporations. Both Bermig and Frick (2010) and Grigoleit et al. (2011) analyze whether firms with a former CEO at the helm of the supervisory board have higher firm values or deliver better operating performance. While Bermig and Frick (2010) find some evidence of a *negative* effect, Grigoleit et al. (2011, p. 608) conclude that there is "no significant relation between supervisory board membership of former executive board members and firm performance." Grigoleit (2011) uses short-run event study methodology and concludes that the announcement of a CEO transition has no significant impact on share prices. Bresser and Valle Thiele (2008) find that a firm's current CEO is more likely to be replaced in response to poor performance when a former CEO chairs the supervisory board. Fiss (2006) reports that executive compensation is lower in firms that have both a former CEO at the helm of the supervisory board and high ownership concentration. All the papers alluded to above focus on individual aspects of CEO transitions. Ours is the first paper to provide a comprehensive analysis of the economic consequences of CEO transitions. It is also the first paper to use a difference-in-differences approach to study the effects on executive compensation of CEO transitions, as well as the first paper that analyzes director compensation in addition to executive compensation.

More generally, our paper is related to the literature on the magnitude and determinants of executive compensation (see the surveys by Aggarwal, 2008; Frydman and Jenter, 2010; Goergen and Renneboog, 2011; Murphy, 1999; for evidence from Germany, see Elston and Goldberg, 2003; Haid and Yurtoglu, 2006; Kaserer and Wagner, 2004; Schmid, 1997). We draw on this literature to determine the set of control variables to be included in our analysis of executive compensation.

Our paper is further related to several papers that analyze the relation between executive compensation and board structure. Core et al. (1999) and Hallock (1997) report that executive compensation in US firms with reciprocally interlocking boards[7] is higher than in other firms. Agrawal and Nasser (2012), also using US data, find that the presence of an independent director who is also a blockholder reduces executive pay. Lawrence and Stapledon (1999), on the other hand, find no evidence that the proportion of independent directors on the boards of Australian firms affects executive compensation. Fahlenbrach et al.

[4] The German Corporate Governance Code works according to the comply-or-explain principle. Compliance is not mandatory. Rather, firms have to publish an annual declaration of conformity that states their degree of compliance. See Section 2 and Andres and Theissen (2008) for more details.

[5] There is an exception that is tailored to family firms. See Section 2 for details.

[6] We use the term *executives* for the members of the executive board and the term *directors* for the members of the supervisory board.

[7] Hallock (1997) defines an interlocking board as follows. "[T]he current CEO of firm A serves as a director of firm B and the current CEO of firm B serves as a director of firm A" (p. 331).

Please cite this article as: Andres, C., et al., Should I stay or should I go? Former CEOs as monitors, J. Corp. Finance (2013), http://dx.doi.org/10.1016/j.jcorpfin.2013.12.008