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# The incentives of grey directors: Evidence from unexpected executive and board chair turnover☆

Kenneth A. Borokhovich [1], Thomas J. Boulton *, Kelly R. Brunarski [2], Yvette S. Harman [3]

*Miami University, Farmer School of Business, MSC1042, 800 E. High Street, Room 2053, Oxford, OH 45056, United States*

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ABSTRACT

We study the stock market's reaction to the unexpected death of a top executive or board chair for insight into grey director incentives. Whereas there is little debate as to the motives of inside and strict outside directors, the allegiance of grey directors is less certain. We find that grey directors' dominant incentive depends on whether the firm has a succession plan or not. In firms with a succession plan, grey directors' primary motive is to maintain their business ties to the firm. Absent a succession plan, the stock market expects grey directors to use their influence to hire a higher quality replacement, particularly when these directors hold a large equity stake. Our findings suggest that grey directors place their interests as shareholders first when a replacement decision is likely to weaken their business ties with the firm. Grey directors appear to influence the choice of a higher quality replacement whether that person is an insider or outsider.



## 1. Introduction

Finance and economics researchers have examined the impact of board composition on issues such as firm value and corporate decision making with mixed results. These studies often focus on the impact of outside directors, who are believed to be better monitors of management than insiders.[4] Consistent with this notion, recent regulatory efforts, including the Sarbanes–Oxley Act of 2002, increase the emphasis placed on board independence and outside director membership on key board committees. However, many outside directors may not be completely independent. Examples include former managers or relatives of a former manager, attorneys, business consultants, commercial or investment bank executives, and insurance company executives. These directors have potential or existing business ties to the firm, yet are not principally employed by the firms that they advise. They are typically referred to as affiliated or grey directors, and according to Hermalin and Weisbach (2003), represent about 10% of board members.[5] We study unexpected executive and board chair turnover to provide the first evidence on the incentives of grey directors.

Although not all directors share the same motivations, the overriding incentives of some directors are more predictable than others. For instance, inside directors, which include firm executives and their relatives, are expected to exhibit allegiance to the

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* Corresponding author. Tel.: +1 513 529 1563.
*E-mail addresses:* borokhka@miamioh.edu (K.A. Borokhovich), boultotj@miamioh.edu (T.J. Boulton), brunarkr@miamioh.edu (K.R. Brunarski), harmanys@miamioh.edu (Y.S. Harman).
[1] Tel.: +1 513 529 1502.
[2] Tel.: +1 513 529 1564.
[3] Tel.: +1 513 529 5986.

[4] See, for example, Weisbach (1988), Byrd and Hickman (1992), Brickley et al. (1994), Cotter et al. (1997), and Ryan and Wiggins (2004).
[5] More recent studies, including Nguyen and Nielsen (2010) and Knyazeva et al. (2013) classify 20.4% and 14.0% of their sample directors as grey, respectively.

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firm's management. Because of their close connection to the firm, insiders often side with management on corporate initiatives. Knyazeva et al. (2013) find that board independence is positively correlated with CEO turnover and the proportion of a CEO's pay that is equity-based, which suggests that inside directors are more favorable for management than outside directors. Independent directors are individuals without links to the firm except as board members. To protect their reputations as expert decision makers, these directors are expected to advocate for shareholders in decisions where conflict exists (Fama and Jensen, 1983). Nguyen and Nielsen (2010) find that stock prices drop following the unexpected death of an independent director. This suggests that shareholders benefit from the presence of independent directors on a board.

The motivations of the grey directors are less obvious. Although neither insiders nor independent, grey directors share many of the incentives of these two groups. Grey directors' business ties to the firm might lead them to behave more like insiders. For instance, by voting with managers, they can reinforce those business relationships. Conversely, as employees of other firms, grey directors could act like independent directors to enhance their reputations as expert decision makers. When grey directors own stock in the firms on whose board they serve, their ownership provides another reason to align with shareholders. Depending on which incentive dominates, grey directors can sometimes behave like insiders, and at other times, like independent outside directors. When the two director groups oppose one another on an issue, grey directors can determine the board's course of action, particularly when neither inside nor independent directors hold a majority of board seats. In these instances, grey directors are in a position to cast the deciding vote.

The decision to retain or replace top managers is arguably the board's most important function. If grey directors' principal motivation is to either protect their reputations or maximize the value of their equity, they should favor hiring the most qualified replacement, independent of whether the individual is an internal or external candidate. However, grey directors' business relationships with the firm can encourage them to favor a less qualified individual who will secure those business ties. A successor from outside the firm is not invested in the current business arrangements of the firm and might weaken or sever existing business ties. An internal replacement, especially one who has been selected through succession planning, is more likely to be invested in the firm's current business arrangements. Faced with the choice of an internal or external successor, grey directors might favor a lower-quality internal candidate who will maintain established business relationships. In addition, grey directors would have little reason to oppose a presumed successor (heir apparent) because unsuccessful opposition could jeopardize their business ties with the firm. Ultimately, when a turnover event occurs, the equity market's assessment of firm value will reflect its perception of the motives of grey directors.

We provide evidence on grey director incentives by examining the relation between changes in firm value around the unexpected deaths of top executives and board chairs, and grey directors' stockholdings.[6] We also consider the impact of a succession plan on grey director incentives and on a board's propensity to hire a firm insider. We expect the stock price reaction to the announcement of an unexpected death to be positively correlated with grey director equity holdings if stockholdings motivate grey directors to support the highest quality replacement. However, when a succession plan exists, grey directors' desire to maintain business relationships may dominate their inclination to maximize the value of their stock. Thus, when a firm has an identified successor, the costs of casting a dissenting vote can outweigh the benefits for grey directors.

In a sample of 370 unexpected executive and board chair deaths that occur between 1978 and 2007, we find a positive relation between changes in firm value around death announcements and the equity holdings of grey directors.[7] Further analysis shows that this relation is driven by firms without a succession plan. Our results suggest competing motivations. When there is a perceived successor grey directors protect their business ties by supporting the majority board opinion, regardless of how much stock they hold. This is especially true when the board must replace the top-ranked executive. Absent an internal successor, grey directors' incentives are shaped by their equity ownership, which the market expects will contribute to the selection of a higher quality replacement. However, there is little evidence to suggest that grey director ownership is related to the decision to hire an outside replacement.

Our paper makes several contributions to the literature on corporate boards. First, it is the first empirical study to document the incentives of grey directors. A better understanding of the motives of grey directors is important because they are increasingly included on corporate boards (Linck et al., 2009). Second, we provide evidence that succession plans help to shape board actions around turnover events. Third, our results suggest that grey directors should be classified separately from outside directors. This is especially significant in light of recent legislation, including Sarbanes–Oxley, which emphasizes director independence. Our results suggest that grey directors tend to behave like inside directors when there is a change in management, except in instances where they have high equity ownership and the firm lacks a succession plan.

The remainder of this paper is organized as follows. Section 2 discusses director incentives and the related literature. Section 3 describes our data. Section 4 reports empirical evidence on the incentives of grey directors. Section 5 describes robustness tests of our results, and Section 6 concludes.

## 2. Related literature on director incentives

Prior literature on corporate boards highlights the impact of board composition on issues such as firm performance and board actions. Many of these studies focus on outside directors, who are believed to be better monitors than inside directors due to their independence. Because outside directors are often experienced professionals in fields such as business and academics, they value

[6] Following prior literature, we include individuals with the title of chairman of the board of directors, CEO, and/or president at the time of their death. We also report results for a subsample of executives possessing the top rank at their respective firm (typically the CEO).

[7] By studying changes in firm value around an exogenous, non-disciplinary event, we avoid the endogeneity problems inherent in the relation between board quality and board actions (Hermalin and Weisbach, 1998, 2003).

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