Journal of Corporate Finance 28 (2014) 201–217

Contents lists available at ScienceDirect

Journal of Corporate Finance

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

Outside options and CEO turnover: The network effect

Yun Liu [1]

School of Business Administration, University of California, Riverside, CA, United States

ARTICLE INFO

Article history:
Received 17 September 2013
Received in revised form 1 March 2014
Accepted 11 March 2014
Available online 19 March 2014

JEL classification:
G3
J4
L14

Keywords:
CEO turnover
CEO networks
Outside options

ABSTRACT

Most studies consider chief executive officer (CEO) turnover from the firm's perspective. In this paper, I suggest that the labor market conditions for CEOs affect turnover outcomes. I use CEOs' positions on corporate executive and director networks to assess their employment options. Controlling for performance, firm characteristics, and personal traits, I find that CEO connectedness significantly increases turnover probability, especially for poor performers. I also show that connectedness increases the likelihood of CEOs leaving for other full-time positions, or their retiring and taking part-time positions elsewhere, but does not have a significant effect on the likelihood that they will step down and remain with the firm in other capacities. The evidence supports the idea that a CEO's connectedness expands outside options and thus increases turnover probability.

1. Introduction

Chief executive officer (CEO) turnover is the severance of the relationship between two parties: the firm and the executive. It is not always a unilateral decision made by the firm. However, CEO turnover in the literature is examined more from the firm's perspective than from the executive's perspective (see an early survey by Murphy, 1999 and a more recent discussion by Brickley, 2003). Many researchers study how firms replace CEOs, but few have considered the decision-making on the other side: Could the CEO's own circumstance play a role in explaining the observed turnover outcome?

I posit that CEOs' outside options influence CEO turnover. Standard contracting models require parties involved in a contract to be no worse off than their outside opportunities—the "participation constraint". For a CEO with better external prospects, the participation constraint is harder to satisfy, which can lead to a breakdown of the contract between the individual and the firm.

CEOs are connected to other executives and directors through board linkages. The literature on networks and labor markets indicates that network connections reduce the search frictions present in the market for corporate executives and directors. Therefore, a CEO's position in a network can reflect outside employment options.

Using the biographical data on 128,324 executives and directors of 26,984 public companies in North America, I construct annual networks of corporate leaders for the 1990–2008 period. I calculate four centrality measures developed in the sociology literature to quantify CEO connectedness: degree, betweenness, closeness, and eigenvector centrality. I then test the effects of CEO connectedness on the likelihood of CEO turnover in the following year, while controlling for traditional explanatory variables such as firm performance and board composition.

E-mail address: yun.liu@uccr.edu.
[1] Tel.: +1 951 827 6447.

http://dx.doi.org/10.1016/j.jcorpfin.2014.03.004
0929-1199/

I find that CEO connectedness is positively associated with turnover probability. Subsample results indicate that this positive effect is significant in all ranges of performance, especially for poor performers. I further categorize turnover events based on the extent to which outside options are expected to play a role in turnover outcome. I show that connectedness increases the likelihood of CEOs leaving for other full-time positions, or their retiring and taking part-time positions elsewhere, but does not have a significant effect on the likelihood that they will down and remain with the firm in other capacities.

The finding that CEO connectedness increases the likelihood of turnover is subject to endogeneity issues. Omitted variables such as talent and personality could lead to a spurious correlation between CEO connectedness and turnover probability. I address this possibility by including variables for education, professional experience, and social background. I also use firm and CEO fixed effects to control for unspecific omitted variables. The positive effect of CEO connectedness on CEO turnover remains significant.

There is another endogeneity concern. CEOs might deliberately develop professional networks in anticipation of career moves. I employ an instrumental variable (IV) approach to avoid this problem. In particular, I use the average connectedness of a CEO's initial peers on the current network as an instrument for the CEO's own connectedness. The results of two-stage IV regressions confirm the positive effect of connectedness on the likelihood of CEO turnover.

This paper contributes to a large literature on CEO turnover, which has focused on forced CEO turnover as a disciplinary measure for poor performance (see, among many others, Denis et al., 1997; Jenter and Lewellen, 2010; Weisbach, 1988). I show that the CEO's own circumstance impacts the severance of the relationship between the firm and the executive.

This paper also contributes to the literature on the role of networks in the executive labor market. Several studies focus on networks in relation to CEO compensation. They consider CEO networks either as a sign of bad governance (for example, Hwang and Kim, 2010) or as valuable social capital to the firm (for example, Engelberg et al., 2013). I propose that networks play another role in the executive labor market: Network connections broaden CEOs' outside opportunities, which impact turnover probability.

The remainder of this paper proceeds as follows. In Section 2, I position the paper in the related literature and provide justification for the use of network position as a proxy for a CEO's outside options. In Section 3, I describe the construction of network measures. In Section 4, I describe the data. In Section 5, I present empirical results relating CEO connectedness to CEO turnover probability. Concluding remarks are provided in Section 6.

2. Literature

2.1. CEO turnover literature

Murphy (1999) provides an early review of the literature on CEO turnover. Kaplan and Minton (2012) describe recent trends in CEO turnover. The key issue in the literature is the relation between CEO turnover and firm performance. Most studies focus on the effectiveness of boards to discipline poorly performing CEOs by terminating their employment. For example, the sensitivity of turnover to performance is related to the fraction of outsiders on the board (Weisbach, 1988) and the ownership structure of the firm (Denis et al., 1997). Brickley (2003) points out that although many important insights have been identified along this line, the evidence for the effects of governance variables on CEO turnover is mixed, leaving much variation in CEO turnover yet to be explained.

The executive's perspective has been largely ignored in the CEO turnover literature, with the notable exceptions of Eisfeldt and Rampini (2008) and Eisfeldt and Kuhnen (2013). Both papers are based on the finding reported by Jenter and Kanaan (forthcoming) that CEO turnover is more likely to follow poor industry performance. Eisfeldt and co-authors propose that during an industry downturn, the utility of outside options, such as leisure or joining other sectors, is higher for the CEO than the expected payments received by staying with the firm. In their frameworks, however, outside options are reflected by aggregate industry conditions, which do not allow identification of their effect at the firm level. I use CEOs' connectedness as a proxy for their outside options as it allows a more detailed within-industry cross-firm variation.

This paper complements Parrino (1997), who finds that CEO turnover is more prevalent in industries comprised of similar firms than in less homogeneous industries, due to the availability of outside candidates. Parrino suggests that the firms' outside options influence CEO turnover, while I find that CEOs' outside options also play a significant role.

I propose that CEO turnover is affected by the prospects of post-turnover employment. In a related study, Brickley et al. (1999) find the likelihood that a retired CEO serves on his own board of directors, as well as the likelihood of serving on other boards, are positively related to his performance while CEO. I show that, controlling for performance, CEO connectedness increases the probability of obtaining a subsequent position with another firm, but does not affect the probability of remaining in the same firm.

2.2. Networks and executive labor market

Researchers find that connections among firms, managers, directors, investors, and analysts affect a wide variety of business activities.[2] Most studies on networks in the executive labor market suggest that network connections between a firm's CEO and its directors jeopardize corporate governance. For example, Hwang and Kim (2009) document that when the CEO and board members belong to the same social network, the CEO receives higher compensation, exhibits weaker pay-performance sensitivity, and is less likely to be dismissed for poor performance. Similar results are found in Hallock (1997), Nguyen (2012), and Kramarz and Thesmar (2013).

[2] Examples include venture capital fund performance (Hochberg et al., 2007), mutual fund investment (Cohen et al., 2008), private equity transactions (Stuart and Yim, 2010), corporate finance policies (Fracassi, 2012), and earnings management (Hwang and Kim, 2010).