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Managerial discipline and corporate restructuring following performance declines☆

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Abstract

We examine the incidence of disciplinary events that reduce the control of current managers, and corporate restructuring among firms experiencing a large decline in operating performance during an active takeover period (1985–1988) and a less active period (1989–1992). We document a significant decline in the disciplinary events from the active to the less active period that is driven by a significant decline in disciplinary takeovers, those takeovers that result in a top executive change. Following the performance decline, however, there is a substantial amount of corporate restructuring, and a significant improvement in operating performance, during both the active and the less active takeover period. We conclude that, although some managerial disciplinary events are related to overall takeover activity, the decline in takeover activity does not result in

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fewer performance-enhancing restructurings following performance declines.

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1. Introduction

Poorly performing managers face disciplinary pressures from both internal and external corporate control mechanisms. An important element of this control process is the threat that if managers deviate from value-maximizing corporate policies, their control will be reduced. Consistent with this view, Jensen and Warner (1988) characterize top executive changes as 'a key variable in understanding the forces disciplining managers'. In this paper, we focus on the three primary disciplinary events that represent explicit attempts to reduce or eliminate the control of current managers. These events are corporate takeovers, board dismissals, and shareholder activism. Using a sample of firms that experience a sharp decline in industry-adjusted operating performance, we provide evidence on (i) the frequency with which managers experience at least one of the above disciplinary events, and (ii) corporate restructuring and changes in operating performance following the performance decline.

Our motivation for pursuing this investigation is threefold. First, although several studies provide evidence on each of these control-reducing disciplinary events individually, none address the more fundamental issue of how frequently managers face some threat to their control when they perform poorly. Second, because the frequency of one of the disciplinary mechanisms, corporate takeovers, fell considerably in the early 1990s, we are interested in whether this decline is associated with a corresponding change in the overall frequency of control-reducing disciplinary events in recent years. Third, because previous studies suggest a strong link between control-reducing disciplinary events and corporate restructuring, we are interested in whether any change in the frequency of disciplinary events over time has changed the manner in which firms address poor performance.

Our sample consists of 350 firms that have total assets greater than $100 million, which achieve measurably high operating performance in one year, followed by a marked decline in performance the following year. The sample period, 1985–1992, encompasses an active takeover period (1985–1988) and a less active takeover period (1989–1992), thus allowing us to examine whether managerial discipline and corporate restructuring are linked with activity in the market for corporate control.