CEO SUCCESSION AND PROPRIETARY DIRECTORS: EVIDENCE FROM SPANISH LISTED FIRMS

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Abstract

This study advances research on CEO succession and board monitoring of senior executives by examining how proprietary directors can affect the probability of CEO dismissal. Drawing on our newly developed database covering all CEO successions occurring in all Spanish listed firms during the period 2007–2010, we propose that proprietary directors may increase the board's monitoring efforts over the chief executive, forcing him to resign in situations of poor performance. Hypotheses are tested longitudinally, using CEO succession data taken from 111 publicly-traded firms in the Spanish 'mercado continuo' over a four-year period.

Keywords: Proprietary Director, Board of Directors, ROA, Corporate Governance

INTRODUCTION

'The concept of proprietary director, called "patrimonial" in Mexico, is only consolidated in these two countries, but it will prevail in others where, for now, it only exists in latent form.'[3]

How can the monitoring efforts over a firm's chief executive officer be enhanced? Many studies in the literature on corporate governance and CEO succession address this issue by studying how different board configurations could improve vigilance of poorly performing chief executives. Thus, the presence of outside directors has been put forward in the literature on CEO succession as a factor that reduces agency costs by aligning the interests of managers and shareholders (Weisbach, 1988; Boeker, 1992; Cannella, Finkelstein and Hambrick, 2009).

Moreover, in recent years, studies such as Shen (2005), Hambrick & Jackson (2000), Hillman et al., (2010) and Finkelstein, Hambrick & Cannella (2009) have drawn attention to the desirability of outside directors holding significant stakes in a firm's equity in order to effectively improve board monitoring of the chief executive.

Contrary to other models of corporate governance, Spain's model is characterized by successive codes on good governance that define three director categories: executive, independent and proprietary. The unique feature of the Spanish system is the figure of the proprietary director as a special category of outside director. According to the Unified Good Governance Code, directors who own an equity stake above or equal to the legally determined threshold for significant holdings, or have been appointed because of their shareholder status or as representatives of such shareholders are classed as proprietary directors (CNMV, 2006)

Even though Spanish regulations consider owning a significant percentage of shares or representing such ownership, as a cause of loss of independence (CNMV, 2006), other codes around the world do not recognize any inconsistency (Mateu, 2007). Thus, the NYSE Listed Company Manual claims that 'as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.'[4]

According to data from the Observatorio de Gobierno Corporativo 2010 published by the Foundation of Financial Studies, in 2009, the ratio percentage of proprietary directors to total stock held by significant shareholders went from an average value of 2.49 in 2004 to 0.97 in 2009, and in the last three years, it has remained stable. Thus, the average values show proportionality, although with a high variability between companies: the mean moves between values of 0.86 in 2004 to 0.73 in 2009. This ratio of 0.73 suggests that shareholders are underrepresented on the board.

In our sample, which covers all publicly-traded firms during the period 2007–2010, the proportion of proprietary directors accounts for 42.8% of the total number of directors. With regard to executive and independent directors, their percentages are 20.6% and 31.3%, respectively.

Our study addresses these issues by exploring one question. How does board composition would affect CEO dismissal in situations of poor performance? While this is the main question we address in our research, our hypotheses and

[3] Manuel Conthe, former president of the National Securities Market Commission, Expansión, 2007.

[4] NYSE Listed Company Manual, Section 3 Corporate Responsibility, 303A.02 Independence Tests.

subsequent statistical analyzes also try different types of counselors who hold the board.

With these data, we assess one of the hallmarks of the Spanish model of corporate governance, namely the proprietary director, in his decision to dismiss a company's CEO. As a result, our model provides evidence of the beneficial role that can be attributed to proprietary directors in their CEO monitoring and surveillance function.

This paper proceeds as follows. First, we discuss how the board's composition and the directors' membership of other boards may affect the probability of CEO succession. The next section describes our sample, followed by a presentation of the logit regression. Finally, we summarize the results and discuss their implications.

THEORY AND HYPOTHESES

Board composition

One of the functions of the board on which there is a broad consensus in the very extensive literature on corporate governance is on the need of monitoring a company's chief executive. Thus, directors are called to exercise control over top management and, if necessary, fire the chief executive, followed by selection of a new CEO. However, it is not clear that directors on their own can accomplish the task of defending shareholders' interests, who are the principals in the agency problem. As Fama and Jensen (1984: 188) stated: 'the board is not an effective device for decision control unless it limits the decision discretion of individual top managers'.

This board vigilance is a central tenet for the agency theorist and is defined insofar as the board monitors and disciplines top executives (Cannella, Finkelstein & Hambrick, 2008). In the literature on corporate governance, board vigilance is seen as a power construct relative to the CEO (Westphal, 1999; Sundaramurthy & Lewis, 2003).

Contrary to authors such as Mace (1971), who described the board as a passive body with very limited capacity for controlling the senior management, agency theorists give the board a much more decisive and central role in corporate governance. Fama & Jensen (1983) considered that the board plays a key role in ensuring that managers act in the interest of shareholders, although there are other mechanisms for the surveillance of executive management: corporate control market, competitive forces in the capital and product markets, labor market executives and directors.

However, the board does not always act vigilantly. The reason for this is the distribution of power between the board and the CEO (Cannella, Finkelstein & Hambrick, 2009; Kosnik, 1987; Main, O'Reilly and Wade, 1993).

Cannella, Finkelstein and Hambrick (2009:244) affirm: "When the balance of power favors boards, they will be more vigilant in monitoring and disciplining top management, and to the extent that CEOs are more powerful, boards will be less effective monitors". Board vigilance has been measured in the literature through its determinants, and the proportion of outside directors has been one of the most used measures (Kosnik, 1987; Sundaramurthy, Mahoney & Mahoney, 1997; Weisbach, 1988; Finkelstein & D'Aveni, 1994; Main, O'Reilly & Wade, 1993).

According to agency theory, outside directors are believed to provide superior surveillance benefits as a result of their independence from firm management. Other scholars argue that independent directors are more likely to dismiss CEOs following poor performance due to the fact that they have incentives to monitor in order to protect their reputation as effective directors (Fama & Jensen, 1983). Furthermore, independent directors are not beholden to CEOs as insiders are (Walsh & Seward, 1990).

The first academics to suggest the general idea that the higher the proportion of inside directors, the longer the tenure of the chief executive officer, were Salancik & Pfeffer (1980). Moreover, Weisbach (1988), in his classical study, suggested that there is a stronger association between prior performance and the probability of a resignation for companies with outsider-dominated boards than for companies with insider-dominated boards. Boeker (1992): poorly performing organizations in which the proportion of inside to outside board members is high will be less likely to dismiss the chief executive than poorly performing organizations, in which the proportion of inside to outside board members is low. Nevertheless, a review by Dalton, Daily, Ellstrandn and Johnson (1998) of 54 studies on the performance effects of board composition shows that the proportion of independent directors on the board has no significant effect on firm performance.

Some studies have focused on specific corporate actions, such as paying greenmail, in their association with outside director representation. For example, Kosnik (1987) studied the board structure of 53 companies that privately repurchased stock at a premium above the marketplace (paid greenmail) and 57 companies that resisted greenmail. The decision to pay greenmail is considered to be contrary to the interests of the firm's shareholders, and consequently, in those companies that paid greenmail, their boards did not perform their responsibility to be effective. Boards that did not pay greenmail were found to be outsider-dominated.

Several authors have centered their studies on highlighting the benefits of the experience of outside directors that belong to the board of directors. These counselors, belonging to many boards simultaneously have more resources and opinions that are very useful to make key decisions for the company. (Salancik & Pfeiffer, 1980). On the other hand, the age of the directors in office, may be beneficial for the proper functioning of the company, as their working years playing the same position, it will let them how to act in the most efficient manner (Barroso & Villegas, 2010).

Other scholars have gone one step further and considered not only the proportion of outsiders on the board but also the equity stake of those outside directors. This is grounded on the idea that the directors' holdings represent an objective incentive to monitor the senior management, including the CEO (Cannella, Finkelstein & Hambrick, 2009; Shleifer & Vishny, 1986). More recently, McClain (2011) suggests that the negotiation that takes place between the CEO and outside directors regarding governance is not only affected by the fact that firms wish to align directors' marginal productivity with the firm's opportunities, but also with the directors' equity holdings.

Proprietary directors' equity stakes may create financial incentives that align the interests of both directors and shareholders. Moreover, there are reasons to suggest that proprietary directors' increased equity stakes will trigger greater identification by the directors with the company and thus they will devote more time and attention to the company's affairs. This provides the basis for our working hypotheses:

Hypothesis 1: The proportion of proprietary directors increases the likelihood of CEO dismissal in situations of poor performance.

Hypothesis 2: The proportion of executive directors decreases the likelihood of CEO dismissal in situations of poor performance.

Hypothesis 3: The proportion of independent directors has no effect on the likelihood of CEO dismissal in situations of poor performance.

METHODOLOGY

In the following sections, we address the methodology used in our research as well as the detailed explanation of the data on which the current investigation is grounded.

Data and Sample

This research draws on our own database developed to overcome the existing lack of evidence in the Spanish market. Thus, we have identified and documented all CEO successions that have taken place in Spain's listed companies during the period 2007–2010.

The study's sample consists of all Spanish listed companies in 2007–2010. Within the original sample of 141 companies, 30 were removed due to lack of data or delisting (departure from *mercado continuo*) in any of the years included in the range.

The following table summarizes the percentage share in total successions of top executives, by year and GIC sector.

Table 1. Percentage of top executives' successions, by year and GIC sector

	General Industry Classification					
Year	Industrial	Utility	Banks/Savings and Loan	Insurance	Other Financial	Total
2007	10%	11%	17%	0%	8%	11%
2008	6%	11%	0%	0%	8%	7%
2009	9%	0%	0%	0%	8%	8%
2010	8%	11%	17%	0%	0%	8%
Total	8%	8%	8%	0%	6%	9%

Variables and measures

Dependent variable. Ceo succession is coded as one if the firm experienced a succession in the year and zero otherwise. For each of the 111 companies included in our study, we identified top executive changes, based on the incumbent top executive at december 31, 2006, until the end of 2010. The top executives of each company have been identified by referring to the annual corporate governance reports. Each succession identified was studied individually using two sources of information: first, the dow jones databases (factiva) gave us the news media that covered the succession of the executive in question and, second, the cnmv releases "significant events" (hechos relevantes) whenever a succession of an incumbent top executive takes place. However, the usefulness of these "significant events" is less than the first source, because of the tendency to hide dismissals of top executives under euphemistic formulas (denis and denis, 1995; fredrickson, hambrick, and baumrin, 1988; weisbach, 1988). By analyzing both sources of information, non-routine turnover of chief executives was determined on the basis of the following criteria:

we identified a dismissal if a) the company or the press recognized the nature of the succession as a dismissal, b) the change took place in the midst of a debate about the company's poor performance, c) the replacement occurred unexpectedly and without naming a successor. Following this methodology, out of the 444 firm-year observations, 38 top executive successions, 69 chairman successions and 81 consejero delegado turnovers were identified.

Independent variables. The first independent variable considered is percentage of proprietary, executive and independent directors on the board. Board membership is measured by the percentage of each type of director on the board. This information is retrieved from the cnmv's annual corporate governance reports. For the years 2007, 2008, 2009 and 2010, the proportion of proprietary directors on the board was 43.8%, 42.0%, 42.8% and 42.8%, respectively.

Return on assets (roa) measures firm performance, a common indicator of short-term performance (finkelstein and d'aveni, 1994, zhang 2008). Roa data were obtained from worldscope. The average value of the sample's roa is 3.4%, with a minimum value of -63% and a maximum of 104%.

Control variables. Directors' outside directorships is taken from the annual corporate governance reports. 22.5% of the directors in the sample are also directors of other listed companies. Ceo duality is one of the key attributes that define the board's structure (finkelstein, hambrick, cannella, 2009).we included this variable to control for the impact of ceo power (finkelstein & d'aveni, 1994). This characteristic refers to situations in which the chairman of the board also holds the position of chief executive. Duality has been coded as one if the chairman of the board also holds the position of chief executive and zero otherwise. Duality situations have been obtained from the cnmv's annual corporate governance reports..

DATA ANALYSIS AND RESULTS

The data used in the analyses included annual observations during a four-year period. A maximum-likelihood logistic regression is appropriate due to the limited period of observations. The models' estimated parameters are reported in the results, along with their estimated standard errors.

Table 2 shows descriptive statistics and correlations for the variables used in this study.

Table 2. Descriptive Statistics and Correlations[5][6]

Variables	Mean	s.d.	1	2	3	4	5	6	7	8	9	10
1. CEO dismissal	0.09	0.28	1									
2. Proportion of proprietary directors	42.85	23.41	.11	1								
3. Proportion of executive directors	20.59	13.78	-.17	-.55	1							
4. Proportion of independent directors	31.10	18.49	-.03	-.66	-.14	1						
5. *Return on assets* (ROA)	3.43	10.47	-.11	.04	.09	-.08	1					
6. CEO duality	0.38	0.49	.12	.18	-.12	-.10	-.01	1				
7. Directors' outside directorships	22.48	19.26	.11	.05	-.27	.18	.12	-.04	1			

[5] N= 444 firm-years of data.
[6] Correlations larger than 0.10 are significant at the level of $p < .05$.

Table 3. Logistic regressions on the probability of CEO dismissal

Variables	Model 1		Model 2		Model 3	
Proportion of proprietary directors	0.02*	(0.01)				
Proportion of executive directors			-0.05**	(0.02)		
Proportion of independent directors					-0.01	(0.01)
Return on assets (ROA)	-0.04*	(0.01)	-0.03	(0.01)	-0.04*	(0.01)
CEO duality	0.81†	(0.39)	0.77†	(0.39)	0.88†	(0.39)
Directors' outside directorships	0.02†	(0.01)	0.01	(0.01)	0.02†	(0.01)
Constant	-4.82***	(0.81)	-2.71***	(0.63)	-3.54***	(0.62)
Log-likelihood	-116.1		-114.1		-117.5	
Wald chi-square	16.14*		17.98*		14.79*	

† $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

The logistic regression model (see Table 3) developed is justified given the dichotomous nature of the dependent variable.

The random effects logistic model used for the probability of dismissal has the estimated coefficients shown in Table 3. First, the model's significance is assured with a value of the Wald chi square of 18.89 (p <0.01).

As can be seen in Table 3, the coefficient for the variable *Proportion of proprietary directors* is positive and significant (p <0.05): proprietary directors increase the likelihood that the company's chief executive will be ousted.

On the other hand, the coefficient for the variable *Proportion of executive directors* is negative and significant (p <0.05) meaning that executive directors decrease the likelihood that the company's CEO will be ousted.

Finally, the variable *Proportion of independent directors* has no significant effect on the probability of CEO dismissal.

To test the significance of our results, we performed an analysis of robustness in Table 4 using different control variables. *Sales* is measured as the natural logarithm of total sales. According to Shen *et al.* (2002:1200): "firm size may influence the power dynamics within top management because the CEO succession process at a large corporation may have become formalized or institutionalized". *Board size* measured as firm's number of directors (Zajac & Westphal, 1996) is an important governance-related predictor of firm value (Coles, Daniel, and Naveen, 2008).

Equity held by significant shareholders measured as the percentage of shares held by significant shareholders.

The results of these variables do not provide any information to our model, since it does not change the results of our model thus confirming the importance of the presence of the directors on the board.

Table 4. Robustness Checks

Variables	Model 1		Model 2		Model 3	
Proportion of proprietary directors	0.02*	(0.01)				
Proportion of executive directors			-0.04*	(0.02)		
Proportion of independent directors					-0.02	(0.01)
Return on assets (ROA)	-0.05**	(0.02)	-0.05*	(0.02)	-0.05**	(0.02)
CEO duality	0.72†	(0.41)	0.74†	(0.41)	0.80†	(0.40)
Directors' outside directorships	0.02†	(0.01)	0.01	(0.01)	0.02†	(0.01)
Sales	0.13	(0.12)	0.11	(0.12)	0.09	(0.12)
Board size	-0.04	(0.07)	-0.03	(0.07)	-0.01	(0.07)
Equity held by significant shareholders	0.00	(0.01)	0.00	(0.01)	0.00	(0.01)
Constant	-4.38***	(1.03)	-2.75***	(0.93)	-3.19***	(0.90)
Log-likelihood	-102.81		-102.15		-103.91	
Wald chi-square	14.70*		14.96*		13.48*	

† $p < .10$
* $p < .05$
** $p < .01$
***$p<.001$

DISCUSSION

This study has been prompted by the lack of studies addressing the figure of the proprietary director in the literature on the succession of senior executives. This type of director, of undoubted interest both from a theoretical point of view, as has been shown by studies such as Shen (2005), Hambrick and Jackson (2000), Hillman et al. (2010), Finkelstein, Hambrick and Cannella (2008), who draw attention to the desirability of outside directors holding significant stakes in the firm's equity as a way to encourage their interest in creating value for the company, and from a practical point of view, as stated in 2007 by the previous Chairman of the CNMV, Manuel Conthe: 'the concept of proprietary will prevail in others countries where, for now, it only exists in latent form'.

As far as we know, this is the first study to show the positive effect that proprietary directors may have on the governance of listed companies, using data until now not collected or analyzed.

The main finding of this study is related to the existence within outside directors, who until now have only been studied in aggregate form, of a subset with an objective interest in the efficient running of the company – the holding of significant stakes in the firm's equity – and its effect on the decision to dismiss the top executive.

Studies like Weisbach (1988) had determined that the proportion of outside directors on the board increased the probability of CEO dismissal. However, we suggest that, in the Spanish market, the beneficial effect that the presence of outsiders on the board may have in monitoring ineffective managers is not due to these directors' independence but to their status as shareholders or representatives of such shareholders.

Another important result of our research is the negative effect of the ROA on the probability of dismissal. Lower annual ROAs increase the probability of dismissal of the chief executive. It is not surprising that the measure of profitability is significant for the same year in which the termination occurs because companies have regular reviews of their results within a year.

CONTRIBUTIONS AND IMPLICATIONS FOR PRACTICE

In the translation into the everyday work of managers and directors, this research provides elements of judgment and evidence for characterizing the role of an effective director. A director's formal independence does not really account for his behavior in the performance of his tasks.

This investigation may also provide significant contributions for policymakers in the field of corporate governance. The proprietary director has proven to be an efficient monitor of the top executive in our model. However, the current codes on good governance that are widely used all over the world do not recognize the role of this Spanish invention that may be beneficial for the alignment of interests between shareholders and management.

DIRECTIONS FOR FUTURE RESEARCH

The construction of the database contributes a potential fruitful ground for research on corporate governance from the point of view of the Spanish model. This enables us not only to deepen our knowledge of the Spanish system but also to test the peculiarities of this model in order to implement in other countries those features that may have proven to be efficient for the good governance of corporations.

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