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CEO Involvement in the Selection of New Board Members: An Empirical Analysis

Abstract

We study whether CEO involvement in the selection of new directors influences the nature of appointments to the board. When the CEO serves on the nominating committee or no nominating committee exists, firms appoint fewer independent outside directors and more gray outsiders with conflicts of interest. Stock price reactions to independent director appointments are significantly lower when the CEO is involved in director selection, and independent appointees are more likely to serve on large numbers of other boards, a practice disfavored by investor activists. Our evidence may illuminate a mechanism used by CEOs to reduce pressure from active monitoring, and we find a recent trend of companies removing CEOs from involvement in director selection.

CEO Involvement in the Selection of New Board Members: An Empirical Analysis

A board of directors serves as the pivotal mechanism for monitoring the managers of a public corporation. Directors are voted into office by stockholders and have a fiduciary responsibility to protect stockholders' interests. Along with their legal duties of reviewing the corporation's major plans and actions, directors are charged with selecting, compensating, evaluating, and when appropriate, dismissing top managers.

A long-standing criticism of this process is that in practice, directors are not selected by stockholders but rather by the very managers they are supposed to oversee. Mace (1971) discusses anecdotal evidence of CEOs exercising authority in selecting candidates for the board, in effect hand-picking nominees. Similarly, Lorsch and MacIver (1989) report survey evidence indicating that CEOs wield major influence in selecting new board members. Tejada (1997) presents a recent news account of an outside director of a prominent company being denied nomination for reelection after criticizing management. Such allegations have led to proposals that boards choose directors through nominating committees comprised only of independent members of the board (see, e.g., The Working Group on Corporate Governance, 1991).

Despite such views, prior research has not developed systematic evidence on the extent to which CEOs are directly involved in selecting new directors and whether such involvement affects

the nature of directors elected to the board. In this paper, we provide evidence on whether CEOs exert influence on the selection of new directors and test the hypothesis that when CEOs are involved in this process, directors less likely to monitor the CEO are appointed. We use a simple procedure to indicate CEO involvement in selecting new directors, defining a CEO as "involved" if a board has a separate nominating committee and the CEO serves as a member, or if such a committee does not exist, in which case directors are selected by the entire board including the CEO.

We examine the likelihood that appointees are independent outsiders, "gray" outsiders who have conflicts of interest, or corporate insiders. Based on results from numerous recent studies, we expect independent outside directors to be most predisposed to monitoring the CEO. Consistent with the hypothesis that nominees less likely to monitor are chosen when CEOs are involved in their selection, we find that when the CEO is involved, firms appoint fewer independent outside directors and more gray outsiders.

We study investor reactions to announcements of director appointments. We find that the market reaction to independent director appointments is significantly negative when the CEO is involved in director selection, and we find weak evidence of a positive reaction when CEOs are not involved. Cumulative abnormal stock returns for independent director appointments are significantly lower when the CEO is involved in director selection. These patterns persist when we examine abnormal returns in a two-stage framework that accounts for the prior anticipation of such appointments.

Our research extends a growing empirical literature examining patterns of director appointments. Hermalin and Weisbach (1988) study companies' decisions to appoint inside and outside directors, finding that inside appointments occur with greater frequency when CEOs

approach expected retirement age, while outside appointments are more likely following poor firm performance. Gilson (1990) finds more appointments of bankers and major outside stockholders when firms experience financial distress. Similarly, Kaplan and Minton (1994) study Japanese companies and find a greater intensity of outside appointments when those firms perform poorly. Rosenstein and Wyatt (1990) find that stockholder reactions to announcements of independent director appointments are significantly positive. While these studies provide some evidence on the factors that influence appointments of independent directors, the role of the CEO in this process remains unexplored.

In addition to this empirical research, Hermalin and Weisbach (1997) present a model of the balance of power between the CEO and other directors. They model the control of the firm as a bargaining game in which the CEO negotiates with the board over the board's degree of independence, among other variables. The authors argue that such a framework can help explain certain observed regularities about the composition and monitoring capabilities of many boards. Our paper seeks to assess empirically their underlying assumptions that CEOs will seek to acquire influence over the selection of new directors, and that directors chosen under these conditions will contribute to deterioration in the board's monitoring of the CEO. Our results are consistent with such a characterization of how board composition is determined.

Finally, we examine whether CEO involvement in the director selection process is a persistent phenomenon over our sample period. We document an overall trend away from CEO involvement in director selection in recent years.

The paper proceeds as follows. Section I describes our sample selection and variable definitions. Section II analyses patterns of director appointments, and Section III studies market

reactions to appointments. Section IV describes other attributes of independent director appointees. Section V discusses recent patterns in changes in CEO involvement status. Section VI concludes.

I. Data Description and Sample Selection

We study director appointments during the three-year 1994-96 period by companies in the 1995 *Fortune 500*. We exclude private firms as well as financial and utility companies, since firms in these industries typically have very large boards that tend to be drawn from specific constituencies, especially major customers and local business leaders.¹ We track appointments over three years because many companies have classified boards on which directors serve staggered three-year terms, and we want to ensure that during our sample period every board member's candidacy is reviewed at least once. We read proxy statements filed by each firm in 1994, 1995, and 1996 in order to identify director appointments, a process that yields a sample of 1,012 first-time appointments or nominations at 341 companies during 1,015 company-years (a few firms contribute less than three years of data due to acquisitions in 1996 or initial public offerings in 1994).

For each appointment, we classify the new director into one of the three categories widely used in prior studies of boards. Inside directors (246 appointments, or 24% of our sample) are current employees of the firm. Outside directors fall into two categories. Gray outsiders (107 appointments, 11%) include retired employees, relatives of the CEO, and persons with disclosed conflicts of interest such as outside business dealings with the company or interlocking director relationships with the CEO. Independent outsiders (659 appointments, 65%) include all other non-

¹ We drop one other firm (Nordstrom) because of a unique governance structure that includes four co-CEOs, none of whom is a member of the board.

employee director appointees. We gather data about each new director's age, occupation, other directorships, stock ownership, any family relationships or interlocked directorships with the CEO, and whether the appointment represents a board expansion or the replacement of an inside, gray, or independent retiring director. When two or more replacement appointments occur in a single year, we assume that each new director takes the seat of the exiting director who has the same, or alternatively, the most similar classification in the inside/gray/outside taxonomy.

Table I presents summary statistics about our sample of appointees. The typical new outside director of a *Fortune 500* firm is in his or her mid-50s, owns little stock, and already sits on two other public company boards. New inside directors are slightly younger and own more stock but do not ordinarily have other board seats. Thirty to 40 percent of all new appointments represent board expansions, and in cases that are not expansions, appointees are likely to replace exiting directors of the same class. Of the 107 gray outside appointees in our sample, 69% have disclosed business dealings with the firm either personally or through their principal employers, while 13% have direct interlocking relationships with the CEO (i.e. service on each other's boards) and 24% have interlocking relationships on the board of a third company. Some appointees qualify for gray status according to more than one criterion.

We merge our data for director appointments with a range of control variables gathered from proxy statements and Standard and Poor's Compustat. Certain variables describing the board of directors, including board size, the fraction of outside directors, board stock ownership, the fraction of outside directors appointed during the tenure of the current CEO, and the number of directorships held by all outside directors, are cumulated from director-by-director data transcribed from proxy statements. Because of the effort required to compile this information for approximately 4,000

individual directors, we collect these variables for each company in 1994 and repeat the variable values for appointments in 1995 and 1996. Variables relating directly to each company's CEO, including whether the CEO also serves as chairman of the board, the presence of a nominating committee, the CEO's membership on the nominating committee, the CEO's tenure in office, and the CEO's stock ownership, are gathered every year.

Table II presents mean and median values for important characteristics of our companies, their boards, and their CEOs. The typical board has approximately 11 directors, 46% of whom are independent outsiders and an additional 26% of whom belong to the gray outsider category. Several potential explanations exist for why the percentage of independent directors in the appointments sample is higher than the cross-sectional percentage of independent directors in our companies as of 1994. The difference could reflect more frequent turnover among independent directors or a recent tendency of boards to appoint more independent and fewer gray directors than in the past. Alternatively, some independent outside directors may acquire conflicts of interest over time and move to gray status.

Among both groups of outside directors, stock ownership is quite small, and slightly less than half of all outside directors joined their boards during the tenure of the current CEO. More than three-fourths of the boards have nominating committees or similar groups charged with the selection of new directors. When a nominating committee exists, it includes the CEO about one-third of the time. Among other variables that might indicate strong CEO influence in corporate governance, Table II shows that CEOs own a mean of 2.7% of their firms' stock, though the median is much smaller at 0.4%. In a large majority of firms, representing 84% of the sample, the CEO also serves as chairman of the board. Eighteen percent of CEOs in our *Fortune 500* sample either founded the

company or belong to the founding family, and CEOs have an average of more than eight years tenure. We define an indicator variable for independent boards and set it equal to 1 if independent outside directors comprise the majority of the board. Table II shows that 40% of our sample firms have independent boards according to this definition.

To identify whether the CEO has influence in the selection of new directors, we create an indicator variable labeled CEO involvement. CEO involvement equals 1 in two situations: (i) if the board has a nominating committee and the committee includes the CEO, which occurs for 25% of our companies, or (ii) if the board does not have a nominating committee, covering 22% of our firms, in which case the entire board including the CEO nominates new directors. Thus, we consider the CEO to be uninvolved if the board has a nominating committee that excludes the CEO, which occurs in 53% of our companies.

We suspect our variable indicating CEO involvement in director selection is underinclusive, because many board nominating committees may solicit advice from or simply ratify choices suggested by a CEO who is not a committee member. Along these lines, the General Motors Board Guidelines on Significant Corporate Governance Issues (1994), widely praised by shareholder activists, recommends that new directors be chosen by a committee of outside directors but "with the direct input from . . . the chief executive officer." If the CEO involvement variable is a conservative measure of the CEO's role, our analysis may under-state the influence of CEOs on the characteristics of new board members.

Table III presents a correlation matrix showing how CEO involvement is related to other important characteristics of the CEO, board, and company. The table highlights the importance of controlling for other variables when analyzing the association between CEO involvement and

characteristics of new directors. A CEO is more likely to be involved in director appointments if he has several common indicators of power, including long tenure in office, high stock ownership, or membership in the company's founding family, though this pattern fails to hold for the variable indicating the presence of a non-CEO chairman of the board. Small boards, boards without a majority of independent outside directors, and boards where no independent director is a major stockholder also have greater CEO involvement in director selection. When company size is large, the CEO is also less likely to be involved in nominating directors.

II. Board Composition and Director Status

We investigate whether CEO involvement affects the likelihood that new directors have independent outsider status. Numerous recent studies suggest that boards comprised of a large fraction of independent outsiders monitor managers more effectively. Weisbach (1988) shows outside-dominated boards are more likely to remove poorly performing CEOs; Byrd and Hickman (1992) find higher bidder returns from tender offers when the board has a majority of independent directors; Brickley, Coles, and Terry (1994) find more favorable announcement returns to poison pill adoptions; and Cotter, Shivdasani, and Zenner (1997) find that acquisition targets realize larger shareholder returns when they have independent boards. Although evidence of the effect of independent directors on firm performance has been harder to detect (see, e.g., Hermalin and Weisbach, 1991, and Bhagat and Black, 1996), Brickley and James (1987) in a study of banking firms, and Mayers, Shivdasani, and Smith (1997) in a study of insurance firms, document managerial perquisite consumption to be inversely related to the fraction of outside directors on the board.

We consider directors to be independent if they are neither insiders (corporate officers) nor

gray outsiders (those who are retired insiders, relatives of the CEO, interlocked with the CEO on another board, or have other disclosed conflicts of interest). We study both the cross-sectional association between CEO involvement and the fraction of directors in different categories, as well as the probability that a new director has independent or gray status. We expect our analysis of new appointments to have greater statistical power, since cross-sectional patterns of board composition result from the cumulation of many prior years of appointments. However, we still expect the cross-sectional model to provide insights into CEO influence, in part as a consistency check on our results for appointments, but also because data in Tables I and II raise the possibility that some directors change their status after being appointed. For example, an independent director might shift to the gray category as a result of being co-opted by a CEO who offers personal consulting fees or diverts company business to the outsider's principal employer.

A. Cross-sectional analysis of board composition

Table IV presents cross-sectional ordinary least squares models of the fraction of directors who have independent and gray status, using data for 1994. As an alternative specification, we also estimate a logit model for whether the board is independent.

We control for a number of factors, including firm size (log of total assets) and the pretax return on assets over the prior year, measured as the ratio of earnings before interest and taxes over assets, minus the median for all Compustat firms in the same two-digit SIC code. We include controls for board size (in a log specification, following Yermack, 1996), the fraction of outside directors appointed during the tenure of the current CEO, an indicator variable for a non-CEO chairman of the board, and an indicator for the presence of an independent director who is also a 5%

stockholder. We also control for several CEO characteristics, including the CEO's fractional equity ownership, the CEO's tenure, an indicator for whether the CEO is near expected retirement age (between 62 and 66, following Hermalin and Weisbach, 1988), and an indicator for CEOs who belong to the company's founding family.

Consistent with the hypothesis that involved CEOs select directors less likely to monitor, the CEO involvement indicator in Table IV has a negative estimated coefficient in the regression model for the fraction of the board that is independent, a positive estimate in the model for gray directors, and a negative estimate in the logit model for the probability that the board is independent. All three estimates are statistically significant, and all have large economic significance. The fraction of independent directors is estimated to be 13 percentage points lower than the mean of 46% if the CEO is involved in director selection, while the fraction of gray directors on the board is estimated to be 5 percentage points higher than the mean of 26%. The probability that a board is independent, based on an evaluation of the partial derivatives of the logit likelihood function, increases from 28% when the CEO is involved in the nomination process to 55% if the CEO is not involved.

Among the control variables included in the OLS models in Table IV, the presence on the board of an independent 5% stockholder-director appears especially important. When such a director is present, board composition seems predisposed to stronger monitoring, with a higher fraction of independent outside directors and a lower fraction of gray outsiders.

B. Analysis of board appointments

Having studied the association between CEO involvement in director selection and cross-sectional patterns of board composition, we next analyze how CEO involvement impacts changes

in the board. We begin by simply comparing the proportions of independent, gray, and outside appointments made when the CEO is involved and is not involved. Our sample includes 434 appointments made when the CEO is involved, including 253 independent outside directors (58%), 60 gray outsiders (14%), and 121 insiders (28%). For boards with uninvolved CEOs, the 578 total appointments include 406 independent outsiders (70%), 47 gray outsiders (8%), and 125 insiders (22%). The differences in proportions are significant at the 0.1%, 2%, and 7% levels, respectively. This simple evidence is consistent with the idea that independent directors, who are more likely to monitor the CEO, are appointed less frequently when the CEO is involved in director selection.

Table V presents logit analyses of appointments of independent and gray directors. The left column contains estimates for a logit model with the dependent variable set equal to 1 if the appointee is an independent outside director. The second column contains a similar model for the probability that an appointee is a gray outsider. These two models are estimated over our entire sample of appointments. As control variables, we include an indicator variable for whether the CEO is near retirement age, an indicator for whether the board is independent, indicators for the type of director replaced (these indicators equal zero for board expansions), and controls for firm size and performance. Although not included in the reported results, our inferences are robust to inclusion of the full range of regressors from Table IV.

Consistent with the cross-sectional results, Table V indicates that CEO involvement is significantly associated with a greater incidence of gray appointments and a lower incidence of independent appointments. Confirming the evidence in Table I, the estimates also indicate that appointees are substantially more likely to replace retiring directors of the same category than directors from other categories. When the CEO is near retirement age, fewer appointees are

independent or gray, reflecting the tendency documented by Hermalin and Weisbach (1988) of these firms to appoint inside directors as a prelude to CEO succession.

Conditional on the board replacing a retiring independent outside director, we study the likelihood that the new appointee is a gray outsider, a pattern that should imply deterioration in the board's monitoring capacity. A logit model of this choice appears in the third column of Table V, and the estimates exhibit a strong positive association between CEO involvement and the probability that an independent director is replaced by a gray director.

The final column of Table V presents logit estimates for whether a new director appointment shifts the composition of the board from one that is not independent to one that is. There are 58 such instances in our sample, 20 of which occur when the CEO is involved. Consistent with the previous results, our regression model indicates that boards are less likely to make a pivotal addition of this type if the CEO is involved in director selection. The estimate for CEO involvement is negative and significant at the 10% level in this model. Our sample also consists of 16 appointments of the opposite type, where the appointee shifts the composition of the board away from one that is independent. Of these 16 appointments, 11 occur when the CEO is involved. However, the small frequency of such observations precludes a logit estimation similar to that in Table V.

To understand the economic significance of the effect of CEO involvement, we compute estimated probabilities by evaluating partial derivatives of the logit models of Table V at the means for all variables. According to our estimates, CEO involvement lowers the probability of an independent appointment from 71% to 63% and raises the probability of a gray appointment from 7% to 12%. The likelihood that a gray outsider replaces a departing independent rises from 5% to 13%. Finally, the probability that an appointee shifts the board's composition to independent drops

from 7% to 4% when the CEO is involved. The economic magnitude of these estimates imply that the effects of CEO involvement on board composition are non-trivial.

Our analysis to this point has treated CEOs as involved in director selection both when they serve on the nominating committee and when the firm has no separate nominating committee. However, the relative degree of CEO influence may vary across these subgroups. For example, CEOs sitting on a nominating committee may find it easier to wield influence over the smaller number of individuals participating in director selection. It is equally possible however, that the presence of a separate committee indicates boards that attach special importance to director selection, in which cases CEO influence over appointments may be lower. To evaluate these possibilities, we reestimate our results including an interaction term that takes the value 1 if the CEO is involved but the firm does not have a nominating committee. Coefficient estimates for this interaction term indicate that in firms with no separate committee, outside directors are less likely, and gray directors are more likely to be appointed (both significant at the 10% level). However, such firms do not differ in the likelihood of gray appointees replacing independent incumbents, or the likelihood of appointments that shift the composition of the board to a majority of independent directors.

A limitation of our analysis is the implicit assumption that CEO involvement is exogenous. In practice, the CEO's power to select new directors may emerge endogenously from negotiations with other board members over the balance of power as suggested by Hermalin and Weisbach (1997). In untabulated tests, we attempt to control for the endogeneity of CEO involvement with a two-stage model in which the indicator for CEO involvement is replaced by its predicted value. We follow the methodology of Kovenock and Phillips (1997), who estimate a similar two-stage model of plant closings that includes a first-stage logit estimation of the probability that a firm alters

its capital structure.

We estimate a first-stage logit model of the likelihood of CEO involvement as a function of firm size and performance, CEO tenure, CEO stock ownership, CEO status as a chairman or firm founder, an indicator for expected retirement age, board size, and the presence of an independent 5% stockholder-director. To account for the possibility that CEOs are more likely to be involved when it is important to recruit gray or inside directors, we also include as first-stage variables the average fraction of gray and independent directors on boards of firms in each two-digit SIC code using our sample firms. Finally, we include in the first-stage logit model an indicator that equals one if the CEO had been hired from outside the firm within the prior three years. New outside CEOs may receive authority to oversee director selection as part of a mandate to "clean house" while restructuring the firm, and outside CEOs may also be more likely to recruit gray directors with whom they have had prior business relations.

Results from the first-stage model indicate that CEO involvement is negatively related to firm size and performance, and positively related to CEO tenure, CEO equity ownership, founder status, and the presence of a 5% independent director blockholder. CEOs hired from outside the firm within the prior three years are also more likely to have involvement status. Finally, CEO involvement is negatively related to the average fractions of gray and independent directors for firms in the same industry.

Replicating the analysis of appointments in the two-stage framework, we find the same sign and significance for the CEO involvement variable for the first three models reported in Table V. For the probability that a new director represents a "pivotal" appointment that moves the board to more than 50% independent however, the estimate on CEO involvement which was previously

marginally significant, loses significance. The basic finding that involved CEOs are likely to appoint fewer independent and more gray directors thus appears to hold in a framework where CEO involvement is treated as endogenous.²

III. Investor Reactions to Appointments

The preceding tests indicate that involved CEOs are less likely to nominate independent directors but do not tell us whether the attributes of independent nominees vary with CEO involvement. To assess differences in the quality of independent director appointees, we study investor reactions to the announcement of each appointment. We compute cumulative abnormal stock returns (CARs) over a three-day period running from the day before the announcement until the day after, using standard event-study methodology (Dodd and Warner, 1983). Market model parameters are estimated from one year of trading data preceding the event window.³ We identify announcement events by searching the Lexis/Nexis data retrieval system for newspaper stories and press releases. We exclude announcements where multiple directors are appointed on the same day to construct mutually exclusive categories of independent, gray, and inside appointments. We also restrict the analysis to those appointments that were not first announced in the company's proxy statement, a qualification met by about 76% of all appointments, in order to obtain distinct announcement dates for appointments.

² In additional tests, we also explore whether outside CEOs are more likely than other CEOs to appoint fewer independent and more gray directors to the board. Estimating the models reported with an interaction term between CEO involvement and an indicator for outside CEOs, we are unable to find such a pattern.

³ If appointments are made following periods of poor performance, the market model parameters may be biased. We repeat our analysis by using simple net-of-market stock returns instead of market model abnormal returns and find virtually no differences.

A. Univariate analysis

Panel A of Table VI presents mean and median CARs for the 626 announcements of director appointments for which announcement dates and usable stock market data are available. For the set of all independent outside appointments, we find that neither the mean nor median CAR is significantly different from zero. This result is similar to that in Rosenstein and Wyatt (1990) who document a small and statistically insignificant stock-price reaction for outside director appointments in large firms. Given the evidence on active monitoring by outside directors documented in prior studies, this suggests the decision to appoint an outside director may convey adverse information that offsets the positive effects of such appointments. For example, Hermalin and Weisbach (1988) show that inside appointments tend to precede CEO retirements. The appointment of an outside director may signal a diminished likelihood that the CEO plans to retire, news that might meet with unfavorable reactions in circumstances when the CEO is entrenched or underperforming. Alternatively, since a large fraction of independent appointees in the sample replace a departing incumbent who was also independent, such appointments may not be expected to generate enhanced monitoring benefits. Accordingly, it appears important to control for the information content and the type of director replaced when studying the market reaction to director announcements.

With these caveats in mind, we compare the CARs across subsamples of CEO involvement before proceeding to a multivariate analysis. The CARs are significantly negative with magnitudes of -0.92% (mean) and -0.71% (median) for independent appointments where the CEO is involved. In contrast, there is weak evidence of a positive CAR when the CEO is uninvolved in nominations. The mean CAR is 0.34% and significant at the 8% level using a t-test, but this pattern fails to hold for the median. Both t-tests and Wilcoxon rank-sum tests indicate that the CARs are significantly

lower for appointments where the CEO is involved compared to appointments without CEO involvement. One interpretation is that independent outsiders perceived to be of lower quality are chosen for board seats if the CEO is involved in their selection. Alternatively, it is possible that these appointments convey a diminished likelihood of CEO turnover, which may be more disappointing news for firms with involved CEOs.

We study CARs for appointments of gray outside directors with results reported in the center of Table VII. Overall, we find that appointments of gray directors lead to a significant negative stock price reaction. No significant difference in CARs for gray appointments exists, however, across subsamples of CEO involvement. The negative average market reaction to gray appointees is consistent with several explanations. Such appointees could be viewed as less likely monitors, could signal that the CEO is less likely to retire, or could signal adverse information about the state of the firm, if gray appointments often occur around periods of financial distress (Gilson, 1990). The right columns of Table VI present results about investor reactions to inside director appointments. We find no significant reaction to these appointments for the entire sample of 82 events, nor for either of the two subsamples sorted by CEO involvement status.

A potential problem with our comparisons of CARs across subgroups defined by CEO involvement is that the CEO's role in director selection is public information. In an informationally efficient market, one would expect investor expectations of low quality among future directors to be capitalized in stock prices once they know whether the board has a nominating committee and, if so, whether the CEO is a member. The negative CARs that we nevertheless observe when new independent directors are appointed with CEO involvement may be attributable to the resolution of uncertainty about the timing or frequency of these appointments, and the data also seem consistent

with a conjecture that involved CEOs appoint even lower quality independent directors than investors anticipate. Alternatively, independent appointments by involved CEOs may represent a larger surprise to the market, given its advance knowledge that such directors are less likely to be appointed when the CEO is involved. Therefore, the observed differences in CARs may simply reflect different market expectations of the probability of different types of director appointments by firms with involved and uninvolved CEOs.

In an attempt to evaluate the importance of prior anticipation across the two subsamples, we conduct a two-stage CAR analysis similar to that in Kang and Shivdasani (1996).⁴ In the first stage, we estimate the likelihood of an independent, gray, or inside director appointment for each firm-year in the sample. These probabilities are estimated using the first two models in Table V and an equivalent model for inside appointments. We use the forecast probabilities of appointments from this procedure to adjust the market model CARs by a factor of $1 / (1 - p)$, where p is the estimated probability of each type of appointment. Each adjusted CAR therefore represents an estimate of what the stock price reaction to the director appointment would have been if the event were unanticipated. Comparison of such CARs across subsamples by CEO involvement status should therefore be purged of bias arising from anticipation of appointments by investors.

The two-stage CARs, reported in Panel B of Table VI, provide strong support for the proposition that differences in market model CARs across subsamples sorted by CEO involvement are not caused by anticipation bias. The magnitude and significance of the results for independent appointees widens for the two-stage CARs compared to their market model counterparts. The inferences for appointments of gray and inside directors from market model CARs are similarly

⁴ A similar approach to account for prior anticipation appears in Bhagat and Jeffries (1991) in the context of antitakeover amendments and Chaplinsky and Hansen (1993) who examine debt issues.

robust to the two-stage procedure. We recognize potential limitations of the two-stage CAR analysis. To the extent that the first-stage models of board appointments are incorrectly specified, the probabilities of various types of appointments will be measured with error, reducing the precision of our second-stage tests. While we have no reason to expect the first-stage models are biased, we experiment with numerous alternative specifications and obtain very similar results. Nonetheless, the two-stage CARs need to be interpreted with caution, and we report them primarily as a robustness check.

B. Multivariate analysis

We conduct a multivariate analysis of market model CARs for announcements of independent appointments in Table VII. The regressions control for CEOs near retirement age to proxy for the market's prior anticipation of CEO retirement. Additional control variables include indicators for the type of director replaced (if any), firm size, performance, indicator variables for appointees' regular occupations, the number of other directorships held, and its square. Consistent with the univariate results, the CEO involvement indicator has a negative and statistically significant estimated association with investor reactions to independent board appointments. The coefficient estimate indicates that CARs are approximately 1.2% lower in these cases.

As discussed above, the CARs for independent outside appointments may be confounded by the additional news conveyed about the likelihood of CEO turnover, which may be viewed particularly negatively when the CEO is involved. To evaluate this possibility, we include interaction terms with CEO involvement and two variables that proxy for the market's prior anticipation of CEO retirement: the indicator for CEOs at expected retirement age and the ROA

variable for prior performance. As shown in the second column of Table VII, interactions between these variables and CEO involvement are not significantly related to CARs, while the coefficient on the CEO involvement variable is robust to their inclusion in the model. Thus, the association between CEO involvement and the stock-price reaction to independent director appointments does not appear to be driven by investors' expectations regarding CEO turnover.

In the third and fourth columns of Table VII, we present regression analysis of two-stage CARs calculated as described in the univariate analysis above. As was the case in Table VI, our results appear to strengthen after applying this adjustment to control for the *ex-ante* expectation of an independent director appointment.

IV. Other Directorships and Stock Ownership of Independent Appointees

Independent directors who have reputations as effective monitors might be recruited to serve on many boards, and researchers have therefore used the number of additional board seats as a measure of an individual director's quality. Kaplan and Reishus (1990), Gilson (1990), and Shivdasani (1993) present evidence supporting the idea that the number of directorships may serve as an indicator of director reputation. However, institutional investors and shareholder activists have recently questioned the effectiveness of directors that serve on many boards. According to such criticisms, additional directorships may reduce an individual's monitoring capability as their available time is spread thin. Some support for this view is found by Core, Holthausen, and Larcker (1997), who define directors to be "busy" if they serve on three or more other boards if they are employed, and six or more boards if they are retired. Core et. al find that the presence of busy directors is positively associated with measures of excess CEO compensation, suggesting that such

directors are less likely to engage in significant managerial monitoring than other directors who serve on fewer boards.

We investigate potential differences in the reputation of appointees by studying the number of additional directorships held. Estimates of the association between CEO involvement and independent appointees' other board seats appear in the first two columns of Table VIII. Control variables are similar to those used in our other models. We also include indicator variables for whether the new appointee is a current or former CEO of another firm, since such persons are often in high demand as outside board members. The first column of Table VIII presents a poisson maximum likelihood model of the number of other board seats held by independent appointees. The model estimates indicate that involved CEOs are more likely to appoint directors who serve on a large number of other boards. The second column presents a logit model of whether a new independent director fits the "busy" definition of Core et. al (1997). We find a positive association between "busy" appointments and CEO involvement, significant at the 5% level. If one believes that too many board seats indicate a director who is an indifferent or overtaxed monitor of top management, as suggested by investor activists, then the data are consistent with an association between less valuable appointments and CEO involvement. Given that the optimal number of directorships is an unresolved issue, however, such an interpretation should be viewed with caution.

We study the stock ownership of new independent directors, with the premise that appointees with high stock ownership have stronger incentives to monitor the CEO. However, appointments of directors with large stock ownership may also indicate external control pressures. If CEO involvement is positively associated with poor corporate governance or CEO entrenchment, outside investors may have incentives to purchase large amounts of stock and seek board representation in

hopes of instituting reforms (Shleifer and Vishny, 1986).

The right column of Table VIII presents Tobit estimates for a model with the dependent variable equal to the fraction of outstanding shares held by new independent directors. According to the first proxy statement filed after their election or nomination, new independent outside directors generally own very little stock, with 68% of our sample holding 1,000 shares or less and 25% owning no shares at all; the Tobit specification accommodates this high incidence of zero ownership. The coefficient estimate for the CEO involvement variable in this model is positive but lacks statistical significance. In unreported tests, we also estimate logit models of the probability that appointees have ownership stakes of 0.1%, 1%, and 5%, under the premise that such major stockholder-director appointments are more likely to represent external control pressures. These tests also do not suggest significant differences in equity ownership by appointees across CEO involvement status.

V. Changes in CEO Involvement Status

Evidence presented above suggests that when CEOs are involved in director selection, companies choose new directors who are less likely to monitor aggressively. This raises the question of why such involvement is widely observed. The evident importance of board characteristics in determining whether the CEO is involved suggests that it is not a straightforward device for CEO entrenchment. Rather, involved CEOs' recruitment of more gray and fewer independent directors might be expected by the board but still tolerated if some CEOs "earn" the right to choose their own monitors due to superior long-term performance, high personal stock ownership, membership in the company's founding family, or other personal or company attributes. In addition, we find that CEOs

hired from outside the firm are also more likely to have influence over director selection, an outcome probably anticipated by the boards who elect those CEOs. A question that deserves further attention is under what circumstances CEO influence over director selection represents an optimal governance arrangement.

If those instances of CEO involvement that we observe in our sample represent optimal governance arrangements for certain classes of companies, we might expect them to persist in those firms over time. The overall trend for our sample is clearly toward less CEO involvement. Thirty-nine of our 341 companies changed the CEO's involvement status during our three-year sample period, and a large majority (32 of 39) shifted an involved CEO to uninvolved status. Changes in CEO status from involved to uninvolved occurred contemporaneously with episodes of CEO turnover in 11 of the 32 cases. The 34.4% frequency of CEO turnover in this subsample is significantly greater than the 6.8% rate of CEO turnover for the remaining firms where CEO involvement does not change. This supports arguments advanced by Hermalin and Weisbach (1997) that CEOs acquire power in director selection over time. Thus, newly appointed CEOs should be less likely to have involvement status. However, a large fraction of changes in involvement status also occur in the absence of CEO turnover. We read news stories and proxy statements to understand other reasons for changes in CEO involvement. Public disclosures of such changes are rare, and only one company, the scandal-plagued Archer Daniels Midland, made a public announcement of the shift of its CEO's involvement status. In four other instances, proxy statements around the time of the change contained shareholder resolutions expressing dissatisfaction with the quality or composition of the board but not directly addressing the issue of the CEO's power to select new directors. Thus, for some firms, changes in CEO involvement status appear to be the result of

control changes or external pressure, but such forces do not appear to account for all changes.

VI. Conclusions

This paper investigates the role of the CEO in the director selection process. Our study is motivated by growing interest in director selection among institutional investors and other corporate governance activists, as well as recent theoretical work modeling the balance of power between the CEO and the rest of the board (Hermalin and Weisbach, 1997).

We find evidence consistent with the proposition that firms select directors less likely to monitor aggressively when CEOs are involved in the process. Companies are more likely to appoint gray outside directors who have conflicts of interest and less likely to appoint independent outsiders under these conditions, and also are less likely to make pivotal appointments that give the board a majority of independent outsiders. Stock price reactions to independent director appointments are significantly lower when the CEO is involved in director selection, and independent appointees are more likely to fit the "busy" definition of Core et. al (1997). A possible interpretation of this evidence is that influence in the director selection process is a mechanism used by powerful CEOs to curb the performance pressures that arise from monitoring by the board. More broadly, our results illuminate how the influence of the CEO serves as an important determinant of the governance structure of firms.

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Table I

Characteristics of directors appointed to the boards of *Fortune 500* firms. The sample, which excludes private, utility, and financial companies, consists of 341 firms during the three-year 1994-96 period.

	<u>Inside appointments</u>	<u>Gray outside appointments</u>	<u>Independent outside appointments</u>
Number of appointments	246	107	659
Median age of appointees	52	54	55
Median equity ownership of appointees (percentage of shares outstanding)	0.07	0.001	0.0004
Median number of additional outside directorships held by appointees	0	2	2
Fraction of appointees that share an outside directorship with the CEO	0	0.243	--
Fraction of appointees on whose board the CEO is an outside director	--	0.131	--
Fraction of appointees with business ties to the firm	--	0.692	--
Fraction of appointees that represent an expansion of the board	0.406	0.336	0.327
Fraction of appointees that replace an inside director	0.374	0.075	0.105
Fraction of appointees that replace a gray outside director	0.073	0.290	0.062
Fraction of appointees that replace an independent outside director	0.146	0.299	0.507

Table II

Summary statistics for firm characteristics and board composition in 1994 for 341 publicly traded *Fortune 500* firms, excluding those in the financial and utility industries.

<u>Variable</u>	<u>Mean</u>	<u>Median</u>	<u>Standard deviation</u>
Total assets (\$ million)	8,884.43	3,599.60	20,223.39
Sales (\$ million)	8,830.57	4,332.35	13,959.85
EBIT / total assets	0.170	0.156	0.123
CEO Tenure (years)	8.22	6.00	8.12
CEO ownership (% of shares outstanding)	2.70	0.40	7.57
Firms with non-CEO chairman of the board	0.164	--	--
CEOs who belong to firm's founding family	0.184	--	--
Outside directors appointed during current CEO's tenure	0.472	0.429	0.337
Boards of directors that have a nominating committee	0.775	--	--
Nominating committees with CEO as member	0.325	--	--
Board size	11.43	11.00	3.03
Firms with an independent board	0.40	--	--
Fraction of the board that are gray outside directors	0.258	0.250	0.158
Fraction of the board that are independent outside directors	0.456	0.462	0.190
Ownership by gray outside directors (% of shares)	1.03	0.01	7.12
Ownership by independent outside directors (% of shares)	0.01	0.0003	3.98
Boards with a 5% blockholder - independent outside director	0.047	--	--
Additional directorships held by gray outside directors	2.14	2.00	1.829
Additional directorships held by independent outside directors	1.81	1.75	1.06

Table III

Correlation matrix for key financial and corporate governance variables in 1994 for 341 publicly traded *Fortune 500* firms, excluding those in the financial and utility industries. The CEO involvement variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board.

	Firm size	ROA	CEO tenure	CEO in founding family	Equity ownership of CEO	Non-CEO chairman of board	Independent board	Independent 5% stockholder – director	Board size
CEO involved in director appointments (indicator variable)	-0.31 ***	0.07	0.22 ***	0.29 **	0.25 **	-0.04	-0.27 ***	-0.09*	-0.20 ***
Firm size (log of assets)		-0.20 ***	-0.19 ***	-0.31 ***	-0.28 ***	-0.10*	0.09*	-0.04	0.45 ***
Return on assets (Industry-adjusted EBIT / total assets)			0.07	0.10*	0.08	0.06	0.04	0.01	0.02
CEO tenure (log of years in office)				0.48 ***	0.33 ***	-0.23 ***	-0.08	0.04	-0.03
CEO as member of founding family (indicator variable)					0.56 ***	-0.07	-0.18 ***	-0.07	-0.24 ***
Equity ownership of CEO (% of shares outstanding)						-0.07	-0.12 **	-0.04	-0.17 ***
Non-CEO chairman of board (indicator variable)							0.03	-0.07	-0.08
Independent board (indicator variable)								0.08	0.08
5% stockholder serving as independent outside director (indicator variable)									0.04

Significant at 1% (***), 5% (**), and 10% (*) levels.

Table IV

Regression estimates of the fraction of independent directors and gray directors on the board. P-values appear in parentheses below each estimate. The sample includes all *Fortune 500* firms, except for private, financial, and utility companies, during 1994. The involved CEO variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board. ROA is computed as the ratio of earnings before interest and taxes to total assets net of the median for all firms in the same two digit SIC code.

<u>Explanatory variables</u>	Dependent variable		
	<u>Fraction of independent outside directors</u> (OLS)	<u>Fraction of gray outside directors</u> (OLS)	<u>Probability that board is Independent</u> (Logit)
Intercept	0.36 (0.00)	0.02 (0.86)	0.66 (0.59)
Involved CEO	-0.13 (0.00)	0.05 (0.01)	-1.16 (0.00)
CEO tenure (log, years in office)	-0.03 (0.10)	0.02 (0.38)	-0.14 (0.59)
Equity ownership of CEO (fraction of outstanding shares)	-0.23 (0.12)	0.05 (0.74)	0.66 (0.77)
Non-CEO chairman of board (indicator variable)	-0.05 (0.07)	-0.03 (0.25)	-0.39 (0.28)
CEO as member of founding family (indicator variable)	-0.03 (0.30)	-0.00 (0.95)	-0.99 (0.03)
CEO at retirement age (indicator variable, CEO between 62 and 66)	-0.02 (0.37)	0.02 (0.47)	-0.47 (0.15)
5% blockholder - independent director (indicator variable)	0.11 (0.01)	-0.08 (0.06)	0.89 (0.12)
Fraction of outside directors appointed during tenure of current CEO	0.09 (0.05)	-0.04 (0.40)	0.38 (0.55)
Log of board size	0.10 (0.00)	0.07 (0.00)	-0.03 (0.93)
Firm size (log of total assets)	-0.01 (0.59)	0.00 (0.59)	-0.03 (0.79)
ROA	0.03 (0.67)	-0.01 (0.89)	1.13 (0.21)
R squared (Pseudo R sq. for logit models)	0.23	0.04	0.09
Number of observations	336	336	336

Table V

Logit regression estimates of the probability that a board appointee is an independent or a gray director. P-values appear in parentheses below each coefficient estimate. The sample includes all director appointments by *Fortune 500* firms, except for private, financial, and utility companies, during the 1994-96 period. The involved CEO variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board. ROA is computed as the ratio of earnings before interest and taxes to total assets net of the median for all firms in the same two digit SIC code.

<u>Explanatory variables</u>	<u>Appointee is an independent outsider</u> (entire sample)	<u>Appointee is a gray outsider</u> (entire sample)	<u>Indep. outsider replaced by gray</u> (exiting indeps.)	<u>Appointee moves board to independent</u> (entire sample)
Intercept	1.47 (0.01)	-2.98 (0.00)	-3.32 (0.04)	-0.48 (0.69)
Involved CEO	-0.36 (0.02)	0.56 (0.01)	0.98 (0.01)	-0.48 (0.10)
CEO at retirement age (indicator variable, CEO aged 62 to 66)	-0.27 (0.17)	-0.16 (0.62)	0.24 (0.65)	0.24 (0.50)
Independent Board (indicator variable)	0.27 (0.08)	-0.17 (0.47)	-0.13 (0.73)	
Inside director replaced (indicator variable)	-0.81 (0.00)	-0.87 (0.03)		
Gray outside director replaced (indicator variable)	-0.68 (0.00)	1.50 (0.00)		
Independent outside director replaced (indicator variable)	1.08 (0.00)	-0.23 (0.39)		
Firm size (log of total assets)	-0.11 (0.11)	0.07 (0.47)	0.05 (0.79)	-0.27 (0.05)
ROA	0.61 (0.40)	0.12 (0.91)	1.23 (0.49)	1.36 (0.28)
Pseudo R squared	0.11	0.08	0.04	0.02
Number of observations	992	992	399	992

Table VI

Three-day cumulative abnormal returns (CARs) associated with announcements of appointments of directors by *Fortune 500* companies during the 1994-96 period. Numbers in parentheses represent p-values from two-tailed tests using a t-test for means, and a Wilcoxon signed-rank test for medians. Observations are excluded from the analysis if multiple appointments are announced on the same day. The involved CEO variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board. Two-stage CARs are computed by weighting the market model CARs by the reciprocal of $(1 - p)$, where p is the probability of director appointments of a given type, estimated as a function of CEO involvement, indicator variables for CEO retirement age, independent board, type of director replacement, firm size and industry-adjusted return of assets (ROA).

	<u>Independent Appointees</u>			<u>Gray Appointees</u>			<u>Inside Appointees</u>		
	<u>Mean CAR</u>	<u>Median CAR</u>	<u>Number of observations</u>	<u>Mean CAR</u>	<u>Median CAR</u>	<u>Number of observations</u>	<u>Mean CAR</u>	<u>Median CAR</u>	<u>Number of observations</u>
<i>Panel A: Market model CARs</i>									
All appointments	-0.0011 (0.53)	-0.0010 (0.30)	373	-0.0091 (0.05)	-0.0056 (0.06)	40	-0.0031 (0.55)	0.0002 (0.53)	82
Appointments where CEO is involved	-0.0092 (0.00)	-0.0071 (0.00)	133	-0.0095 (0.30)	0.0041 (0.64)	18	0.0000 (0.99)	0.0018 (0.99)	40
Appointments where CEO is not involved	0.0034 (0.08)	0.0006 (0.32)	240	-0.0088 (0.03)	-0.0092 (0.05)	22	-0.0060 (0.28)	-0.0014 (0.34)	42
t-statistic for difference in CARs	3.42 (0.00)			0.07 (0.95)			0.58 (0.56)		
Wilcoxon Z statistic for difference in CARs		3.12 (0.00)			0.86 (0.39)			0.45 (0.65)	
<i>Panel B: Two-Stage CARs</i>									
All appointments	0.0013 (0.88)	-0.0035 (0.49)	370	-0.0095 (0.08)	-0.0059 (0.12)	40	-0.0022 (0.84)	0.0000 (0.54)	80
Appointments where CEO is involved	-0.0380 (0.00)	-0.0186 (0.00)	131	-0.0103 (0.34)	0.0055 (0.73)	18	0.0005 (0.98)	0.0042 (0.80)	38
Appointments where CEO is not involved	0.0229 (0.05)	0.0028 (0.20)	239	-0.0089 (0.05)	-0.0099 (0.09)	22	-0.0047 (0.56)	-0.0034 (0.51)	42
t-statistic for difference in CARs	3.51 (0.00)			0.12 (0.90)			0.22 (0.83)		
Wilcoxon Z statistic for difference in CARs		3.02 (0.00)			0.69 (0.49)			0.04 (0.97)	

Table VII

Ordinary least squares regression estimates of the three day cumulative return (CAR) associated with announcements of independent director appointments to the board. The sample includes independent director appointments by *Fortune 500* firms, except for private, financial, and utility companies, during the 1994-95 period. Observations are excluded from the analysis if multiple appointments are announced on the same day. The involved CEO variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board. ROA is computed as the ratio of earnings before interest and taxes to total assets net of the median for all firms in the same two digit SIC code.

<u>Explanatory variables</u>	<u>Market Model CARs</u>				<u>Two-stage CARs</u>			
	<u>Estimate</u>	<u>p-value</u>	<u>Estimate</u>	<u>p-value</u>	<u>Estimate</u>	<u>p-value</u>	<u>Estimate</u>	<u>p-value</u>
Intercept	-0.010	0.54	-0.012	0.46	-0.003	0.97	-0.008	0.93
Involved CEO	-0.0122	0.00	-0.010	0.04	-0.060	0.00	-0.056	0.03
Involved CEO x ROA			-0.045	0.18			-0.174	0.32
CEO at retirement age (age 62 to 66)	-0.009	0.08	-0.010	0.11	-0.031	0.23	-0.049	0.13
CEO at retirement age x Involved CEO			0.002	0.82			0.045	0.42
Independent board	-0.002	0.66	-0.002	0.58	-0.006	0.76	-0.008	0.69
Inside director replaced	0.004	0.50	0.004	0.53	0.014	0.67	0.013	0.69
Gray outside director replaced	0.013	0.09	0.013	0.07	0.032	0.40	0.035	0.36
Independent outside director replaced	0.004	0.27	0.004	0.28	0.018	0.41	0.016	0.45
Executive	-0.003	0.61	-0.003	0.68	0.012	0.74	0.013	0.72
Academic	-0.006	0.48	-0.005	0.56	-0.019	0.67	-0.014	0.74
Lawyer	0.001	0.89	0.002	0.84	0.040	0.47	0.042	0.45
Commercial banker	-0.005	0.70	-0.003	0.80	0.017	0.80	0.022	0.74
Investment banker	-0.004	0.74	-0.003	0.80	0.002	0.97	0.005	0.94
Retired professional	-0.001	0.87	0.000	0.98	0.007	0.87	0.013	0.77
Consultant	-0.006	0.64	-0.006	0.63	0.004	0.95	0.004	0.95
Additional outside directorships	0.001	0.52	0.001	0.62	0.010	0.42	0.008	0.49
Additional outside directorships squared	-0.000	0.59	-0.000	0.75	-0.001	0.63	-0.000	0.76
Equity ownership of appointee (%)	0.014	0.88	0.026	0.77	0.316	0.50	0.39	0.41
Firm size (log of total assets)	0.002	0.35	0.002	0.32	0.000	0.97	0.001	0.93
ROA	-0.011	0.52	0.007	0.75	-0.088	0.31	-0.018	0.87
R squared	0.07		0.07		0.05		0.06	
Number of observations	370		370		370		370	

Table VIII

Regression estimates of the number of additional outside directorships held and the equity ownership of independent director appointees. The sample includes all independent director appointments by *Fortune 500* firms, except for private, financial, and utility companies, during the 1994-96 period. P-values appear below each estimate in parentheses. The involved CEO variable equals 1 if the CEO is a member of the board of directors nominating committee, or if no nominating committee exists and new directors are nominated by the entire board. ROA is computed as the ratio of earnings before interest and taxes to total assets net of the median for all firms in the same two digit SIC code.

<u>Explanatory variables</u>	<u>Number of Outside directorships</u> (Poisson)	<u>Appointee is a □ busy □ director</u> (Logit)	<u>Appointee's ownership (%)</u> (Tobit)
Intercept	-0.20 (0.40)	-3.04 (0.00)	0.12 (0.80)
Involved CEO	0.13 (0.03)	0.39 (0.05)	0.02 (0.13)
CEO at retirement age (indicator variable, CEO aged 62 to 66)	-0.08 (0.36)	-0.22 (0.43)	-0.01 (0.46)
Independent board (indicator variable)	0.00 (0.95)	0.11 (0.57)	-0.01 (0.52)
Inside director replaced (indicator variable)	-0.05 (0.65)	-0.47 (0.17)	0.00 (0.83)
Gray outside director replaced (indicator variable)	0.17 (0.14)	-0.01 (0.98)	0.00 (0.93)
Independent outside director replaced (indicator variable)	0.17 (0.01)	-0.07 (0.73)	0.03 (0.01)
Firm size (log of total assets)	0.09 (0.00)	0.20 (0.02)	-0.00 (0.37)
ROA	0.04 (0.89)	0.09 (0.92)	-0.04 (0.40)
Appointee is CEO in another firm	0.17 (0.00)	0.85 (0.00)	-0.01 (0.20)
Appointee is a former CEO in another firm	0.55 (0.00)	2.19 (0.00)	-0.02 (0.45)
Pseudo R squared	0.02	0.07	0.04
Number of observations	650	650	650