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Impact of Top Management Power on Corporate Divestiture

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Abstract. *This longitudinal study looked at the impact of top managers' personal power and structural power on divestiture two years later, using a sample of 46 sales and spin-offs and a set of 46 control firms matched by size and industry in the USA. The impact of divestiture on top managers' power during the two years following the divestiture was also looked at. Results of pair-wise matched t-tests reveal that firms whose top managers have less structural power are more likely to divest one year later. Logistic regression analysis shows that top managers' structural power continues to predict divestiture one year later, even after controlling for change in net income and change in earnings per share. Divestiture also seems to result in less structural power of top managers during the two years after divestiture.*

Keywords. Divestment, Senior management, United States of America.

The role of power in organizations has been relegated to the background by financial economists because power is irrelevant in a complete contract scenario. However, in an incomplete contract world that we face, power assumes importance. To date there is little evidence that managerial power is associated with divestiture decisions. This study presents such evidence by examining the divestiture decisions of 46 firms that voluntarily focused during the period 1993-1995. In this exploratory study, we propose two dimensions of power: personal power and structural power. We measure managerial power before and after the restructuring decision and compare our sample to a set of control firms matched on industry and size. We examine the role of managerial power in motivating firms to focus. Such an examination is important since focusing is spurred by external market discipline such as takeovers or institutional activism for a majority of firms. However, a significant minority of the firms does so without any such external threats (Berger and Ofek, 1999). This suggests that internal governance measures and other internal motives such as managerial reputation and the discipline of the managerial labor market, spur firms to focus. Since the decision to divest is taken by the top management team in an organization, the power that the top

managers have to implement the divestiture decision will have a bearing on the making of the decision itself.

Theory and Hypotheses

Empirical evidence on corporate restructuring (Berger and Ofek, 1999; John and Ofek, 1995) has documented that dispositions of assets outside the core business of a firm are viewed by the market as increasing value while disposing core assets is not. Daley, Mehrotra, and Sivakumar (1997) concluded that the increase in value arises because managers focus attention on the core operations they are best suited to manage. Berger and Ofek (1999) identified agency problems as playing a role in creating sub-optimal diversification strategies for the firm and showed that events of external market pressure are effective in inducing managers to undertake value-enhancing refocusing activity. Lang, Poulsen, and Stulz (1995) found evidence consistent with the financing hypothesis rather than the efficient deployment hypothesis and concluded that the agency costs of managerial discretion matter. What is puzzling is that market disciplinary events occur only after significant erosion of firm value over long periods. Why do firms hang on to losers for so long?

Causes of Divestiture

An obvious explanation is that costs involved in market disciplinary events inhibit frequent displays of external market pressure. Another reason could be that managers are reluctant to divest because a divestiture is an admission of a mistake and would affect the manager's reputation (Boot, 1992). Another possibility could be that only managers of targets with moderate asset specificity should consider the takeover threat credible (Boot, 1992). Jensen (1986) argued that manager's compensation is linked to firm size, and hence managers have an incentive to hang on to losers. Shleifer and Vishny (1989) contended that managers invest in value-reducing projects that make them indispensable to the firm. These studies thus support managerial entrenchment.

The question then arises: why do firms voluntarily focus without external threats? Are they financially constrained? If managerial power is primarily derived from entrenchment then firms should not divest. If managerial power is also derived from the managers' value in the labor market, then focus could be a rational decision.

According to the property rights view of the firm (Hart and Moore, 1990), power arises from the residual rights of control and protects asset-specific investments. Rajan and Zingales (1998) defined power in a firm as access to resources and stated that it is superior to ownership. People in central positions have greater access to, and potential control over, relevant resources such as information (Pfeffer, 1992). Rotemberg (1994) defined power as the ability of a person or group to have top management implement the organizational change that it favors. Rotemberg's model clarified that the economic view of the firm is not contradicted by evidence that individuals who control important resources get a lot of power. Pollock, Fischer, and Wade (in press) found that powerful CEOs have a greater ability to change the strike price of their options. Finkelstein (1992) proposed and validated four power dimensions relevant to top managers, which he termed structural, ownership, prestige, and expert power in an examination of top management teams. Finkelstein found support for an association between top management power and firms' diversification posture and acquisition activity.

Managers divest assets when the sale will increase shareholder wealth, but there is also evidence to the contrary (Lang et al., 1995). These contradictory views indicate that divesting assets could alleviate or aggravate agency problems. A negative relationship between power and likelihood to divest would indicate that agency costs matter; a positive relationship would indicate that managerial power is aligned with shareholder interests. Studies have generally shown that power of top managers is a significant predictor of diversification posture and strategies (Daily and Johnson, 1997; Finkelstein, 1992). If firms with top managers having more power tend to have higher levels of diversification, then similarly, diversification levels should decrease when the top managers are less powerful. Earlier studies also suggest that reputation and ownership power may not have much to do with corporate restructuring activities (Westphal, 1998). We therefore hypothesized:

Hypothesis 1. Structural power of top managers would predict divestiture such that firms are more likely to divest when they have top managers who are less powerful.

Control Variables

Top management power has been shown to explain more variance in diversification than what is already explained by traditional accounting variables. We used two of those variables as control variables in this study—the year-to-year percentage change in net income, and the year-to-year percentage change in earnings per share including extraordinary items and discontinued operations. While these two variables would predict divestiture, top management power would add to these two variables in explaining divestiture. Therefore:

Hypothesis 2. Structural power of top managers would negatively predict divestiture even after controlling for change in net income and change in earnings per share.

Effect of Divestiture

Top managers may pursue diversification simply to enhance their status and power. Just as powerful top managers resort to greater amount of diversification, greater amount of diversification would also result in greater power of top managers. Similarly, divestitures should result in top managers wielding less power. Hence:

Hypothesis 3. Divestiture would result in less structural power of top managers.

Method

We measured top managers' power along two dimensions—personal power and structural power (Raven, 1993). We included five proxies for personal power: number of titles, educational qualifications, elite educational institution, membership in external boards, and share ownership. Structural power was captured using four proxies: top managers' compensation, ratio of internal board members to external board members, number of board meetings, and benefits for directors.

Proxies for Personal Power

Number of titles. This variable was stated as the number of official titles a manager has. A higher number of titles imply a higher status and therefore a greater access to resources.

Educational qualifications. This variable was measured by using the highest educational qualification (graduate degree coded as 1, and zero otherwise).

Elite educational institution. Attending an elite educational institution enhances the power of a manager since the others develop an admiration for the manager. We used the list of elite institutions provided by Finkelstein (1992), and gave a score of 2 if the manager attended an elite school, and a score of 1 for attending a non-elite school.

Membership in external boards. This variable was measured by the number of companies of whose board the manager was a member. We distinguished between the external boards on which top managers sat, since sitting on the board of a reputed firm will add more prestige than sitting on the board of a relatively unknown firm. We classified the external firms into two groups—those that had a CUSIP listing, and those that did not have. We used assets and sales figures as weights to calculate the importance ratings of external boards.

Share ownership. This variable was defined as the percentage of shares owned by the managers. Higher share ownership implies stronger managerial power since others would attribute greater legitimacy to one who had greater stakes in the organization.

Proxies for Structural Power

Top managers' compensation. Compensation is the most frequently used surrogate measure of power. Miller, Wiseman, and Gomez-Mejia (2002) found support for the agency theory prediction that CEO compensation would be the highest under conditions of moderate firm risk. We used three different variables in this study: (a) Salary: The dollar value of the base salary (cash and non-cash) earned by the top manager during the fiscal year in thousands of dollars; (b) Salary plus bonus: Total current compensation comprised of salary and bonus; (c) Options ratio: The value of exercisable in-the-money options as a ratio of total compensation.

Ratio of internal board members to external board members. Studies have shown that board composition matters and that outside directors provide effective monitoring (Weisbach, 1988). A board with a majority of external board members restricts access to resources for managers. Ellstrand, Tihanyi, and Johnson (2002) found that boards with a higher percentage of inside directors were associated with international investment portfolios with lower levels of political risk.

Number of board meetings. Westphal (1998) found that increasing independence of the board resulted in CEO resorting to greater amount of influencing to offset the decrease in power. Power bases and influence tactics supplement each other in affecting various outcomes (Yukl, Kim, & Falbe, 1996). Board meetings provide room for the top management being monitored and therefore would be indicative of top management's power. The number of board meetings held in a year would be an indicator of top management's power such that the top managers would have less power if the board met more frequently.

Benefits for directors. Existence of a pension or retirement plan and options for directors (existence of a plan coded as 2, and 1 otherwise) is a symbolic measure of the power of external board members. It also suggests that external board members might feel more obliged to take an active role in monitoring the activities of the organization. Top managers would therefore have less power if there were a benefits scheme for directors.

Sample Selection

The sample of asset sales was obtained from the list of top 25 divestitures from the Mergers and Acquisitions Almanac for the period 1993-1995. The sample of spin-offs was

obtained from the NYSE/NASDAQ CRSP files for the same period. We used sales or spin-offs of at least \$100 million only. We eliminated firms that were in the financial sector industry. We also required the firms to have complete data in CRSP, Compustat, and ExecuComp for two years before and after the divestiture. Our final sample consisted of 36 sales (16 in the year 1993, 11 in 1994, and 9 in 1995) and 10 spin-offs (5 in the year 1993, 1 in 1994, and 4 in 1995). We then obtained data on a set of 46 control firms matched by size and industry.

Results

All individual-level variables for board members and CEOs were aggregated to the firm level. We used pair-wise matched sample t-tests to compare the divesting firms with the control firms on all the power variables and the two control variables for the two years preceding divestiture. ***There was no significant difference between the divesting firms and the control firms in the case of any of the personal power variables.*** The results of t-tests for structural power and control variables are provided in Table I. All the three compensation variables—top managers' salary, salary plus bonus, and options ratio—were significantly ($p < 0.05$) lower in the divesting firms than in the control firms, 1 year before divestiture. The number of board meetings held in a year was significantly higher in the divesting firms than in the control firms, and a greater number of divesting firms had a director pension or retirement plan as compared to control firms, 1 year before divestiture. There was however no significant difference in the internal-external board member ratio between the divesting firms and control firms. Thus, Hypothesis 1 was supported for all structural power variables other than board ratio measured one year before divestiture. Year-to-year percentage change in net income and year-to-year percentage change in earnings per share including extraordinary items (our two control variables) were also lower in the divesting firms than in the control firms, 1 year before divestiture.

We used logistic regression to test whether the structural power variables (excluding board member ratio) we measured one year earlier significantly predicted divestiture, after controlling for change in net income and change in earnings per share. We excluded board member ratio because it did not predict divestiture even without controlling for change in net income and change in earnings per share. The results of logistic regression are shown in Table II. The table presents three sets of output—(a) Whether each of the two control variables and each of the five structural power variables predicted divestiture; (b) Whether the five structural power variables predicted divestiture when change in net income was also included in the model; (c) Whether the five structural power variables predicted divestiture when change in earnings per share was also included in the model. Looking at the first set of output shows that each of the seven variables predicted divestiture one year later. The second and third sets of output show that ***when either change in net income or change in earnings per share was included in the model, the structural power variables other than salary plus bonus continued to predict divestiture.*** Thus, our Hypothesis 2 was supported for salary, options ratio, board meetings, and pension.

Table I also presents the results of the pair-wise matched sample t-tests comparing the divesting firms with the control firms for the two years after divestiture. Salary was significantly ($p < 0.05$) lower in the divesting firms than in the control firms, 1 year after divestiture. A greater number of divesting firms had a director pension or retirement plan as compared to control firms, during the two years after divestiture. The value of exercisable in-the-money options divided by total compensation was lower in the divesting firms than in the control firms, during the two years after divestiture. Number of board meetings was higher

($p < 0.10$) in divesting firms as compared to control firms, 1 year after divestiture. Our Hypothesis 3 was thus supported except in the case of salary plus bonus and board member ratio.

Discussion

None of the measures of personal power showed any significant difference between divesting and control firms. Elite educational background of top managers, which could serve as a basis of power, did not predict divestiture. Similarly, educational qualifications also did not make any difference. There was no support for any relationship between number of official titles and divestiture. This suggests that divestiture is perhaps not a result of top managers being personally powerless. The top managers being high on reputation and other sources of personal power may not be as relevant as their having structural sources of power when it comes to corporate restructuring.

Results indicate that salary, salary plus bonus, and value of exercisable in-the-money options divided by total compensation, are all significantly lower for the CEO and the top management team in firms that focus. Salary and value of exercisable in-the-money options divided by total compensation also continue to be lower in divesting firms as compared to control firms even after the divestiture. Divestiture negatively affects top managers' salary and the value of exercisable in-the-money options divided by total compensation. The results suggest that CEOs and the top managers lose because of divestiture. The overall results are consistent with agency-based theories and suggest that equity-based compensation, managerial reputation, and an effective board of directors align the incentives of managers and shareholders, and cause managers to refocus.

The most interesting finding of this study is probably the role of board meetings and the existence of director's retirement plans. The boards of divesting firms meet more frequently than the boards of control firms. Existence of a retirement plan for directors appears to be both a cause and consequence of divestiture. ***The findings overall seem to suggest that divestiture is a result of top managers having no structural power base to tap. Divestiture also results in top managers losing in terms of compensation and benefits.*** The directors on the other hand seem to gain from divestiture. The findings support the possible claim that top managers may never voluntarily agree to go in for divestiture.

Limitations and suggestions

Sample size was the most serious limitation in this study. Lack of significant findings might have been partly because we used data on only 46 test firms and 46 control firms. Replicating this study with a wider sample could help in validating the findings of this study. Moreover, we used only six variables to capture structural power of top managers. Future researchers could use more proxies for measuring structural power, and might thereby be able to identify some sub-factors of structural power that are most strongly related to divestiture.

Conclusion

The findings of this study strengthen our understanding of the relationship between top management power and corporate restructuring. Firms resort to divestiture when its top managers have less structural power. Divestiture also results in top managers having less structural power as compared to firms that do not divest. This study provides preliminary support for a relationship between top managers' power and corporate divestiture that

continues to remain significant even after controlling for traditionally known predictors of divestiture. As more studies provide greater support, our understanding of and capacity to manage corporate divestitures would be enhanced.

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Table I. Causes and effects of divestiture: Means for divesting units, control units, and t-statistic.

	<i>2 years before</i>			<i>1 year before</i>			<i>1 year after</i>			<i>2 years after</i>		
	Sample Mean	Control Mean	t Value	Sample Mean	Control Mean	t Value	Sample Mean	Control Mean	t Value	Sample Mean	Control Mean	t Value
Salary	601.19	659.01	-0.55	546.71	767.12	*-2.42	632.83	731.49	*-2.91	704.88	707.15	1.05
Salary plus bonus	981.05	1042.66	-0.54	901.95	1617.08	** -3.01	1372.25	1992.64	-1.06	1609.1	1977	1.45
Total compensation	2943.98	2818.74	0.80	2124.89	2609.56	-0.98	3911.83	4170.15	-0.56	6885.62	4199.69	1.63
Exercisable in-the-money Options	1270.75	625.28	0.81	939.26	2449.58	-0.94	2598.45	4828.75	-1.67	4328.49	6768.99	-1.71
Options/compensation ratio	1.44	0.68	1.53	0.46	1.29	*-3.27	1.37	1.18	*-2.25	1.43	2.68	*-2.36
No. of internal board members	2.98	2.65	0.94	2.85	2.67	0.95	2.74	2.72	0.91	2.48	2.58	0
No. of external board members	9.47	9.27	1.52	9.61	8.94	†1.86	9.55	9.26	0.81	9.86	9.61	0.82
Internal/external board ratio	0.4	0.33	0.71	0.38	0.33	0.61	0.34	0.36	1.05	0.3	0.3	-0.14
No. of board meetings in a year	9.1	7.21	†2.11	9.4	7.61	**3.02	8.9	7.68	†1.91	9.1	7.67	1.68
Existence of director pension plan	1.67	1.29	†2.16	1.73	1.52	*2.27	1.76	1.47	***3.86	1.55	1.44	*2.25
Change in Net Income	466.22	-19.25	-0.42	-47.26	34.96	*-2.24	150.93	30.21	0.83	11.17	-37.46	1.47
Change in Earning per Share	458.29	-18.9	-0.63	-48.95	35.33	*-2.30	164.46	32.01	0.93	13.36	-10.22	0.17

† p < 0.10. * p < 0.05. ** p < 0.01. *** p < 0.001.

Table II. Logistic regression for predicting divestiture with variables measured one year before: Analysis of maximum likelihood estimates.

Parameter	Estimate	Standard Error	Chi-Square	<i>With NI change included</i>				<i>With EPS change included</i>			
				Parameter	Estimate	Standard Error	Chi-Square	Parameter	Estimate	Standard Error	Chi-Square
NI change	-0.01	0.01	* 3.85								
EPS change	-0.01	0.01	* 3.98								
Salary	-0.01	0.01	** 6.86	Salary	-0.01	0.01	* 6.30	Salary	-0.01	0.01	* 6.31
				NI change	-0.01	0.01	† 3.03	EPS change	-0.01	0.01	† 3.30
Salary+bonus	-0.01	0.01	† 3.68	NI change	-0.01	0.01	2.33	EPS change	-0.01	0.01	2.63
				Salary+bonus	-0.01	0.01	2.02	Salary+bonus	-0.01	0.01	2.16
Options ratio	-1.67	0.75	* 5.00	Options ratio	-1.44	0.78	† 3.40	EPS change	-0.01	0.01	† 2.73
				NI change	-0.01	0.01	2.49	Options ratio	-1.41	0.79	† 3.24
Meetings	0.24	0.10	* 6.16	Meetings	0.23	0.11	* 4.46	Meetings	0.23	0.11	* 4.38
				NI change	-0.01	0.01	† 3.22	EPS change	-0.01	0.00	† 3.36
Pension	1.39	0.62	* 4.93	Pension	1.20	0.65	† 3.45	Pension	1.20	0.65	† 3.42
				NI change	-0.01	0.01	2.69	EPS change	-0.01	0.01	† 2.90

† p < 0.10. * p < 0.05. ** p < 0.01.