- Ottensmeyer, E. J. 1983. *Entering the fray: Determinants of organizational political activity during a time of regulatory change*. Paper presented at the 43rd annual meeting of the Academy of Management, Dallas.
- Pittman, R. 1977. Market structure and campaign contributions. *Public Choice*, 31: 37-52.
- Pfeffer, J., & Salancik, G. 1978. *The external control of organizations: A resource dependence perspective*. New York: Harper & Row Publishers.
- Ritz, P. M. 1979. The input-output structure of the U.S. economy, 1972. *Survey of Current Business*, 59 (2): 34-72.
- Post, J.E., Murray, E. A., Jr., Dickie, R. B., & Mahon, J.F. 1983. Managing public affairs: The public affairs function. *California Management Review*, 26 (1): 135-150.
- Salamon, L. M., & Siegfried, J. J. 1977. Economic power and political influence: The impact of industry structure on public policy. *American Political Science Review*, 71: 1026-1043.
- Thoma, G. A. 1983. The behavior of corporate political action committees. *Business and Society*, 22: 55-58.
- U.S. Department of Commerce. 1981. *1977 Census of manufacturers: Volume 1: Subject statistics*. Washington, D.C.: U.S. Government Printing Office.
- U.S. Federal Election Commission. 1980. *FEC reports on financial activity: 1977-1978: Final report: party and non-party political committees*, vol. 3. Washington, D.C.: U.S. Government Printing Office.
- U.S. Federal Election Commission. 1982a. *Campaign guide for corporations and labor organizations*. Washington, D.C.: U.S. Government Printing Office.
- U.S. Federal Election Commission. 1982b. *FEC reports on financial activity: 1979-1980: Final report: party and non-party political committees*, vol. 3. Washington, D.C.: U.S. Government Printing Office.

Marick F. Masters is an assistant professor of management at Texas A&M University. He received his Ph.D. degree in industrial relations from the University of Illinois. His main research interests are in labor and corporate political action. Dr. Masters' articles have appeared in such journals as *Industrial and Labor Relations Review* and *Industrial Relations*.

Barry D. Baysinger is an associate professor in the Department of Management at Texas A&M University and holds the Ph.D. degree in economics from Virginia Polytechnic Institute and State University. He is leader of the Business and Public Policy Group at Texas A&M University and has served as a consultant to the Business Roundtable's Task Force on Corporate Constituencies. Dr. Baysinger's articles have appeared in such journals as *Strategic Management Journal* and *Public Affairs Review*.

©Academy of Management Journal
1985, Vol. 28, No. 3, 664-671.

THE COMPOSITION OF BOARDS OF DIRECTORS AND INCIDENCE OF GOLDEN PARACHUTES

PHILIP L. COCHRAN

ROBERT A. WOOD

THOMAS B. JONES

Pennsylvania State University

Golden parachutes are a new and controversial management perquisite that allow covered managers to voluntarily resign and collect substantial

remuneration—in some cases several million dollars—after a triggering event, usually a hostile takeover. This ability to unilaterally pull a ripcord has provoked much criticism of this perquisite.

Critics of golden parachutes see them as evidence that senior managers can be more interested in maximizing their own incomes than in shareholder returns. *Business Week*, for example, in an editorial entitled "The Gilded Ripoff," stated that the ethical difference between golden parachutes and theft is "hard to discern" (1982:136). On the other hand, proponents of golden parachutes justify them as a means of attracting and keeping new managerial talent as well ensuring that current management remains objective, loyal, and on board during a hostile takeover attempt.¹

What characteristics are firms that give managers contracts with golden parachutes likely to have? One possible factor is the composition of a firm's board of directors, since it is the board that must ultimately approve such arrangements. Perhaps directors who are insiders are likely to be less independent of the CEO and senior management than are directors who are outsiders. Bacon and Brown reported general agreement among board members of major U.S. corporations that "the board should have a majority of outside directors. . . . [to] properly carry out its responsibilities and maintain its necessary independence of management" (1977:91). This suggests that if managers want golden parachutes they are more likely to get them in firms that have a high percentage of directors who are insiders. Thus we expect:

Hypothesis 1: The probability that firms will give their management golden parachute contracts is positively related to the percentage of directors who are insiders.

Another factor likely to be related to whether or not firms provide golden parachutes is the amount of stock that members of boards of directors own. Directors who own substantial amounts of stock should be more inclined to put the interests of stockholders above those of management. To the extent that golden parachutes are unwarranted diversions of stockholder monies, they should be more common in firms with boards that own relatively little of the firms' stock than in firms with boards that own much stock. Thus:

Hypothesis 2: The probability that firms will grant golden parachute contracts is negatively related to the percentage of total stock outstanding that their boards of directors own.

The size of firms is likely to be related to their propensity to issue golden parachutes. Large firms, at least until 1984, were not considered likely takeover targets, so their managements had less incentive to acquire this particular perquisite than did small firms' managers. In addition, small firms may feel more need to offer such an exotic perquisite than do large firms. Thus:

Hypothesis 3: The probability that firms will grant golden parachute contracts is negatively related to their size.

---

¹See, for example, the Superior Oil (1982) proxy statement, p. 15.

Firms that are underperforming and therefore not achieving full potential profits are more likely to be takeover targets than are firms with healthy profits. Further, underperformers are more likely than strong firms to find it difficult to attract and retain qualified managers. Thus:

Hypothesis 4: The probability that firms will grant golden parachute contracts is negatively related to their financial performance.

Finally, since debt is unattractive to a potential raider, firms that are highly leveraged are less likely takeover targets than those that are not. In fact, adding financial leverage is a defensive tactic often used to avoid takeovers (Brealey & Myers, 1981: 674). Thus we expect:

Hypothesis 5: The probability that firms will grant golden parachute contracts is negatively related to their debt.

DATA AND METHODS

In order to test the stated hypotheses, the 1982 proxy statements of the Fortune 500 firms were examined and the following variables derived for each firm. For each director of the 406 firms for which relevant information was available, we determined employment status and number of shares owned. From this data, we derived three measures of the status of board members. *INSIDER1* is the number of directors who were current employees of a firm divided by the total number of directors. *INSIDER2* is the number of directors who were current or former employees divided by the total number of directors. *INSIDER3* is the number of directors whose status was one of the following—current employee, ex-employee, employee of a customer or a supplier, employee of a firm's investment bank or corporate counsel, employee of its parent company or a subsidiary—divided by the total number of directors. *INSIDER1* corresponds to the technical or narrow definition of inside directors, and *INSIDER3* counts all affiliated directors as insiders.

The percentage of stock owned by a board was measured in terms of shares owned by directors divided by total shares outstanding. To measure firm size we used (1) book value of total assets, and (2) rank within the Fortune 500, based upon sales volume, or *FORTUNE*.

Four measures of financial performance were initially employed: (1) Operating income divided by total assets, or ROA, measures use of assets. A major strength of this measure is that it is free from the effects of bias that can result from differences in capital structure between firms. However, the effect of inflation on the book value of assets can distort it. (2) Net income divided by common equity, or ROE, measures effects of firm actions on stockholder funds more directly than the first financial measure does. Though it is also free of bias effects caused by differences in leverage, it suffers from distortion of depreciation due to inflation. (3) Operating income divided by sales measures management's ability to generate profits from sales. This performance measure is largely free from inflation bias. (4) The excess value ratio, or *EXCESS*, a relatively new measure of financial performance, mea-

asures the difference between the total market value of a firm (market value of equity and book value of debt) and the book value of its assets normalized by sales—that is, the value premiums or discounts the market accords to each firm. A major advantage of this measure is that it reflects market evaluation of firms. Since firms whose market value is below their book value are more likely takeover targets than firms in the opposite situation, this measure may be more closely related to the incidence of golden parachutes than the other financial performance measures.²

Financial leverage was measured by interest-bearing debt divided by total assets. Our initial analysis employed three measures of insider status, two of firm size, and four of financial performance in order to assure that results would be independent of the idiosyncrasies of any particular measure. Results that are largely unaffected by the particular insider, size, and financial performance measures employed should inspire more confidence than results that are so affected.

Proxy statements for the firms in the sample were examined for evidence of granting golden parachutes, narrowly defined as a guarantee of severance pay after a triggering event related to a change in control, even in cases of voluntary termination. We found 52 of the 406 firms for which adequate data were available to have such agreements with their executives. Existence of a golden parachute agreement, or *GOLDENP*, was a categorical variable set to 1.0 if firms had no such agreement and 2.0 if they did.

Initial data analysis consisted of calculating Spearman correlations for all combinations of variables. Because the financial performance, insider status, and size measures would incur multicollinearity problems if an analysis contained more than one of each group at the same time, we tested each possible combination separately. After this initial screening, we employed logit analysis (Doyle, 1977).

RESULTS

Initial analysis of the Spearman correlation matrix (Table 1) revealed some interesting, and in certain cases, surprising, results. Contrary to expectations, the incidence of golden parachute agreements was negatively correlated with the percentage of a board who were insiders. In fact, there was a significant negative correlation for all three insider measures.

The correlation between the existence of golden parachute agreements and ownership was both weak and insignificant. Therefore, it appears that the percentage of total stock outstanding that boards own is not significantly related to firms granting golden parachutes. Likewise, the correlation between leverage and incidence of golden parachutes was weak and insignificant. Thus we eliminated these two variables from further analyses.

However, the financial performance measures were all negatively correlated with incidence of golden parachutes. This is consistent with Hypothe-

---

²For a more complete discussion of excess value, see Errunza and Senbet (1981).

sis 4, that firms that are relatively weak financially are more likely to issue golden parachutes than are stronger firms.

The correlations between existence of a golden parachute agreement and the size measures, book value of total assets and rank in the *Fortune* 500 in terms of sales volume, showed similar results. However, the correlation between this sales volume measure and existence of a golden parachute agreement was somewhat stronger than that between the latter and the asset measure. Relatively small firms, as expected, appear more likely to give management golden parachutes.

Thus, the most significant explanatory variables were (1) percentage of insiders on a board, (2) financial performance, and (3) size. Further examination of the correlation matrix showed little evidence of multicollinearity of the financial performance measures with the *Fortune* 500 sales volume rank. Though some of the correlations between the insider measures and both the excess value ratio and rank in the *Fortune* 500 were statistically significant, the correlations themselves were weak and so multicollinearity was not a problem with these relationships either.

After eliminating financial leverage and director stock ownership because of insignificant correlations, and focusing on *Fortune* 500 sales volume rank as the measure of size, we tested the following logit model for all three insider status measures and for all three financial performance measures:

$$\text{GOLDENP} = a_1 + a_2 \text{INSIDER} + a_3 \text{FORTUNE} + a_4 \text{FIN} + \epsilon,$$

where $\text{INSIDER} = \text{INSIDER1, INSIDER2, or INSIDER3,}$

and $\text{FIN} = \text{ROA, ROE, or EXCESS.}$

Though ROA and ROE showed results similar to those for the excess value ratio in the correlation analysis, EXCESS proved to be the only significant financial performance variable in the logit regression, confirming our belief that the excess value ratio would be more closely related to incidence of golden parachutes than would the other measures of financial performance.

Table 2 shows the results of the logit regression. These results did not confirm Hypothesis 1, which stated that the probability that firms will give their management golden parachute contracts is positively related to the percentage of the boards of directors who are insiders. In fact, the opposite statement—that the probability that firms will give their management golden parachute contracts is negatively related to the percentage of the boards of directors who are insiders—is significant for all three insider measures.

However, results did confirm Hypothesis 3, that firm size is negatively related to the probability that firms will grant golden parachute contracts. Likewise, Hypothesis 4, that firms that are underperforming financially will be more likely than others to provide golden parachute contracts, was also confirmed.

TABLE 1
Spearman Correlation Coefficients

	1	2	3	4	5	6	7	8	9	10	11
1. Existence of golden parachute agreement ^a											
2. Current employee-directors ^b	-.11*										
3. Current & past employee-directors ^b	-.13**	.93***									
4. Current, past, & affiliate ^c employee-directors ^b	-.14**	.71***	.73***								
5. Interest-bearing debt/total assets	.02	-.06	-.08	-.03							
6. Director-owned shares/total shares	-.05	.23***	.24***	.16**	.06						
7. Operating income/sales	-.07	.11*	.12*	.16**	-.20***	-.06					
8. Net income/common equity (ROE)	-.14**	.11*	.12*	.07	-.31***	.10	.50***				
9. Operating income/total assets (ROA)	-.13**	.18***	.19***	.15**	-.44***	.11*	.69***	.70***			
10. Excess value ratio ^d	-.14**	.20***	.22***	.14**	-.34***	.19***	.52***	.64***	.73***		
11. Total assets	-.06	-.15**	-.10	.01	.02	-.56***	.21***	.00	-.09	-.15**	
12. Rank in Fortune 500 ^{e,f}	-.10*	-.14**	-.07	-.00	-.06	-.51***	.07	.09	-.02	-.07	.94***

^aDummy variable, with 1 = no such agreement, 2 = agreement exists.

^bDivided by total number of directors.

^cAffiliates = firm's customer, supplier, investment bank, counsel, parent, or subsidiary.

^dFirm's total market value less book value of assets.

^eIn terms of sales volume.

^fSign reversed so that two size measures would be consistent.

*p < .05

**p < .01

***p < .001

TABLE 2
Logit Analysis Results

Variable	Coefficient Estimate	Chi-Square Statistic	R ²
Intercept	-2.100	18.04***	.112
Current employee-directors/total number of directors	-2.665	4.79*	
Rank in Fortune 500 ^{a,b}	0.003	7.04**	
Excess value ratio ^c	-1.718	5.79*	
Intercept	-1.980	14.48***	.114
Current or past employee-directors/total number of directors	-2.752	5.18*	
Rank in Fortune 500 ^{a,b}	0.003	6.43*	
Excess Value ratio ^a	-1.657	5.39*	
Intercept	-1.799	10.89***	.092
Current, past, and affiliates ^d employee-directors/total number of directors	-2.472	6.24*	
Rank in Fortune 500 ^{a,b}	0.003	5.65*	
Excess value ratio ^c	-1.700	5.77*	

^aIn terms of sales volume.

^bSign is reversed.

^cFirm's total market value less book value of assets.

^dAffiliates = firm's customer, supplier, investment bank, counsel, parent, or subsidiary.

*p < .05

**p < .01

***p < .001

DISCUSSION

The principal, and surprising, result of this study was that firms with comparatively higher percentages of directors who are insiders are less likely to give management golden parachute contracts. These suggestive results raise doubts about the theory that insider-dominated boards allow managers to consume higher levels of perquisites than do boards having other compositions. The effect of board composition on other perquisites and compensations should be investigated. If such investigations showed that the results of the present study could be generalized, then scholars and practitioners would have to question pressure to increase percentages of outside directors on corporate boards.

REFERENCES

- Bacon, J., & Brown, J. K. 1977. *The board of directors: Perspectives and practices in nine counties*. New York: The Conference Board.
- Brealey, R., & Myers, S. 1981. *Principles of corporate finance*. New York: McGraw-Hill Book Co.
- Business Week*. 1982. The gilded ripoff. 2759:136.
- Doyle, P. 1977. The application of logit, probit and tobit in marketing: A review. *Journal of Business Research*, 5:235-248.

Errunza, V. R., & Senbet, L. W. 1981. The effect of international operations on the market value of the firm: Theory and evidence. *Journal of Finance*, 36:401-417.

Superior Oil. 1982. Proxy statement.

Philip L. Cochran earned his Ph.D. degree at the University of Washington. He is currently Assistant Professor of Business Administration at the Pennsylvania State University. His current research interests include corporate governance and issues management.

Robert A. Wood earned his Ph.D. degree at the University of Pittsburgh. He is currently Associate Professor of Finance at the Pennsylvania State University. His current research interests include securities markets and corporate governance.

Thomas B. Jones is a doctoral candidate in the College of Business Administration at the Pennsylvania State University. His current research interests include corporate governance and corporate social responsibility.

©Academy of Management Journal
1985, Vol. 28, No. 3, 671-680.

PUBLIC AND PRIVATE SECTOR DIFFERENCES: CEOS' PERCEPTIONS OF THEIR ROLE ENVIRONMENTS

RAN LACHMAN
Tel-Aviv University

Comparative studies of private and public sector organizations often consider organizations with dissimilar tasks or business purposes: profit-making business firms commonly represent the private sector, and nonprofit service or government regulatory agencies commonly represent the public sector. However, these studies generally have not accounted for this difference in business purpose, and have attributed the differences that have frequently been observed to organizations' affiliations with the presumably different sectors (e.g., Blumenthal, 1979; Buchanan, 1975; Buyot, 1962; Rainey, 1983; Rainey, Backoff, & Levine, 1976; Wamsley & Zald, 1976). The argument for this all too common use of the distinction between public and private sectors as the basis of a framework for interpreting observed differences is that the legitimizing goals and basic orientations of the two sectors vary, and so determine different institutional milieux for organizations affiliated with each. Hence, investigators expect differences between the two sectors in organization-environment relations and in managerial practices.

This study is part of the State Owned Enterprises Research Program, carried out at the Israel Institute of Business Research, Faculty of Management, Tel-Aviv University. I am indebted to Yair Aharoni for allowing me access to the data. I thank him and two anonymous reviewers for their comments on an earlier draft of this paper.