

Target Director Turnover in Acquisitions: A Conceptual Framework

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ABSTRACT

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Research Question/Issue: Post-acquisition director turnover is a complex and multi-faceted phenomenon that needs to be examined beyond the agency lens. In this article, we examine the likelihood of non-executive director turnover in target firms following an acquisition.

Research Findings/Result: Acquisitions present an interesting case where conflict of interests may arise between shareholders and directors. This study proposes that the likelihood of target non-executive director turnover depends on the factors that determine the performance of directors in their monitoring, advisory and social roles pre-acquisition and during the acquisition process.

Theoretical Implications: While there are multiple studies examining the likelihood of turnover of executive directors (TMTs) following an acquisition, there is no systematic conceptual research explaining the likelihood of turnover of non-executive directors. We draw on three theoretical perspectives—agency theory, resource-based view and the social capital perspective to comprehensively investigate target non-executive director turnover post-acquisition. We further clarify the boundaries of these theoretical arguments concerning their implications for target non-executive director turnover.

Practical Implications: One of the most important tasks for the newly formed firm post-acquisition is to build the new leadership team, including a new board. In view of the important roles directors take on in modern corporations, it is critical to understand how the new board should be constituted and what members of the target firm are more likely to join that new board.

Keywords: Board Leadership, Corporate Governance, Mergers & Acquisitions, Corporate Control Market, Evaluation of Directors, Individual Director Issues

INTRODUCTION

When acquisition¹ occurs, corporate governance undergoes substantial changes. The completion of an acquisition will be followed by the constitution of a new board of directors that will be part of the new leadership team for the newly formed firm. While some directors from the target firm will remain as part of the new leadership team, others will leave – most often involuntarily. For example, in the deal between British Petroleum PLC and Amoco Corp in 1998, eight out of the 13 Amoco board directors remained as part of the board of the newly formed firm, BPAmoco, in 1999. In

contrast, in the deal between Daimler-Benz and Chrysler, only four out of the original 12 Chrysler board directors joined the board of the newly formed firm, DaimlerChrysler. In view of such heterogeneity in director turnover, this study seeks to conceptually understand which directors from the target firm are more likely to stay with the newly formed firm and which directors are more likely to leave post-acquisition. By post-acquisition, we mean immediately after the newly merged company announces the new board.

This study focuses specifically on the turnover of non-executive directors in the target firm immediately following the acquisition. The corporate governance literature differentiates between two types of directors—executives and non-executives. Executive directors are those individuals who sit on the board and also have executive positions in the firm. Non-executive directors sit on the board, but do not get involved in the firm's daily operations. Extant studies have offered insights into the likelihood and rate of top

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management turnover following an acquisition, including turnover of executive directors (e.g., Krishnan, Miller, and Judge, 1997; Krug and Hegarty, 1997; Lubatkin, Schweiger, and Weber, 1999; Walsh, 1988). To the best of our knowledge, the current study represents the first attempt to systematically analyze non-executive director turnover post-acquisition. As non-executive directors represent the interests of various stakeholders, losing non-executive directors in acquisition could be costly to the newly formed firm in an era when companies in most countries are pressured for more transparency and accountability (Millar, Eldomiaty, Choi, and Hilton, 2005). Additionally, since non-executive directors represent important human resources and intangible assets, losing non-executive directors is also costly in terms of knowledge accumulation in the newly formed firm. Finally, as non-executive directors usually serve as the bridge to the broader business and social communities, their departure can cause loss of social capital for the newly formed firm. For these reasons, it is important to better understand under what conditions non-executive directors in target firms would be more likely to leave post-acquisition.

This study examines director turnover in the context of acquisition because acquisition represents a critical strategic change for both the target firm and the acquiring firm. Directors play prominent roles in times of strategic changes. Only the board has the authority and responsibility to call for a meeting of the shareholders to approve an acquisition (Bange and Mazzeo, 2004). On the other hand, once the acquisition is completed, target directors may lose their board seats and consequently lose compensation and control benefits as well as possibly future directorships (Coles and Hoi, 2003; Harford, 2003). Who stays and who leaves is thus not a trivial issue in the acquisition context.

Our research is also motivated by the recent call for board reforms and regulatory changes about corporate governance at the country level (Aguilera and Cuervo-Cazurra, 2004). In the wake of meltdowns at WorldCom, Tyco, and Enron, among others, enormous attention has been focused on the boards' role in corporate accountability (Aguilera, 2005; Sonnenfeld, 2002). Boards have come under increasing scrutiny from regulators, from shareholders (particularly in large institutions), and from other stakeholders (Stiles, 2001). In light of increased shareholder activism and public scrutiny, even in emerging markets where institutional transparency has traditionally been nonexistent (Millar *et al.*, 2005), there is an increasing demand for "board building" (Nadler, 2004) and board reform. At the same time, individual directors are held accountable for more responsibility and have become personally liable for their decisions to the extent that in some cases it is hard to staff boards (Aguilera, Williams, Conley, and Rupp, 2006). One high priority task for the newly formed firm post-acquisition is to build a new leadership team. Effective leadership requires the efforts and capabilities of both the board of directors and the top management team (Walsh and Seward, 1990). Building a new board is often not straightforward since target directors are seldom completely retained or completely dismissed. Thus, a better understanding of who should stay and who should leave through a comprehensive examination of the roles directors undertake helps facilitate how to build a new board and a new leadership team.

This study draws upon three theoretical perspectives to explore the likelihood of target non-executive director turnover post-acquisition. From the agency perspective, directors perform the "monitoring and control" role (Berle and Means, 1932; Fama, 1980). From the resource-based view, directors perform the "advisory and strategic" role. From the social capital perspective, directors perform the "boundary-spanning and social" role. The central proposition of this study is that performance of these three director roles influences the likelihood of target non-executive director turnover post-acquisition. In addition, this study discusses several contingency factors that influence the relationship between performance of director roles and the likelihood of target non-executive director turnover.

The remainder of the paper is organized as follows. First, we examine each of the three director roles and analyze how performance of the three roles will influence the likelihood of target non-executive director turnover. Then, we discuss extensions of our conceptual framework and investigate the impact of several contingent factors including target and acquirer characteristics, the nature of acquisition, and international corporate governance systems. We conclude with suggestions about how to empirically test the propositions.

DIRECTOR ROLES AND TARGET DIRECTOR TURNOVER

Directors' principal roles fall into two broadly defined categories – one internally focused and the other externally oriented (Deutsch and Ross, 2003; Finkelstein and Hambrick, 1996). Internally, directors are responsible for monitoring managers' actions and protecting shareholder interests (Fama and Jensen, 1983; Fama, 1980), as well as providing advice and counseling to management. Externally, the board of directors facilitates access to important resources and information in the firm's environment (Pfeffer, 1972; Pfeffer and Salancik, 1978), and helps the firm gain legitimacy (Meyer and Rowan, 1977; Selznick, 1957). Extensive research has provided insightful discussions about these director roles (Johnson, Daily, and Ellstrand, 1996; Zahra and Pearce, 1989). In the following sections, we address how directors' performance in each role affects the likelihood of target non-executive director turnover post-acquisition.

The Monitoring Role and Target Director Turnover

From the agency perspective, the board of directors is presumed to carry out the functions of monitoring management and safeguarding shareholder interests or shareholder value (Fama and Jensen, 1983; Fama, 1980). Because of the separation of ownership and control, management may engage in self-serving behavior that may not necessarily maximize shareholder value. With dispersed ownership, shareholders would find it costly to exercise their control over management. Thus, a primary function of the board of directors is to serve as the internal control mechanism, reduce the potential divergence of interests between shareholders and management, minimize agency costs, and protect shareholders' investments.

Existing studies suggest that, in comparison with executive, inside directors, non-executive, outside directors are more likely to be independent of management influence and are more effective in their monitoring role, because non-executive directors are less attached to management personally, professionally, and economically. Weisbach (1988) finds that, as the proportion of non-executive, outside directors on a board increases, the board has a greater tendency to make CEO retention decisions responding to corporate performance, whereas CEO turnover in executive, insider-dominated boards is not performance-driven. Several other studies (Borokhovich, Parrino, and Trapani, 1996; Huson, Parrino, and Starks, 2001) also observe that non-executive, outsider-dominated boards are more likely than insider-dominated boards to replace a CEO with someone from outside the firm. Finally, existing studies suggest that non-executive directors have positive performance implications. For example, corporations with active and independent boards appear to have performed much better in terms of "economic profits" in the 1990s than those with passive, non-independent boards (Millstein and MacAvoy, 1998). Firms that have greater institutional ownership and stronger outside control of the board enjoy lower bond yields and higher ratings on their new bond issues (Bhojraj and Sengupta, 2003). Non-executive directors also make a difference in firms' sales growth (Peng, 2004). While the above evidence suggests that non-executive director-dominated boards are more effective in their monitoring role, it is short of suggesting under what conditions non-executive directors are more likely to leave in the context of acquisition.

When the board of directors does not effectively perform the monitoring role, the internal control mechanism may break down. The breakdown can be attributed to several factors. First, directors may not have enough influence over managerial behavior due to lack of information. Because of their involvement in the daily operations, management develops an intimate knowledge of the business, putting the board, and particularly non-executive directors, at a disadvantage as to information level (Eisenhardt, 1989). Second, managers in profitable organizations can reduce their dependence on shareholders for equity capital by using retained earnings to finance investment decisions and hence enhance their control (Mizruchi, 1983). Third, directors may not have enough incentives to exercise their fiduciary duty. In fact, management can have significant influence over the nomination and election of some directors (Johnson *et al.*, 1996). Such board members will likely be more attached to management rather than to shareholders. As a result, these directors may do little else than agree with the decisions of the management silently and dutifully. Such directors have been viewed as "rubber stamps" (Herman, 1981), tools of top management (Pfeffer, 1972), or creatures at the will of CEO (Mace, 1971).

When the internal control mechanism breaks down, the external market for corporate control will come to play and the firm will likely become an acquisition target (Fama and Jensen, 1983). Unlike those directors who have attempted to exercise their fiduciary duty but do not have enough influence over management, directors whose interests are aligned with those of management are likely to act for their personal gains at the expense of shareholder value. It follows

from the agency theory that pre-acquisition misalignment of interests between target directors and shareholders would lead to a higher likelihood of target non-executive director turnover post-acquisition.

Target non-executive directors are also more likely to leave post-acquisition, if, during the acquisition process, they serve to advance their own private gain rather than to maximize shareholder value. Although both theoretical accounts and empirical evidence suggest that non-executive directors tend to monitor management more effectively and contribute positively to firm performance, acquisition presents a special situation where non-executive directors may not have strong enough incentives to serve shareholders' interests. Upon acquisition, the likelihood of a non-executive director losing his or her seat in the newly formed firm is pretty high (Kini, Kracaw, and Mian, 1995). Further, just as target managers will suffer significant losses in terms of compensation and control benefits (Agrawal and Walkling, 1994; Cotter and Zenner, 1994; Martin and McConnell, 1991; Walkling and Long, 1984), so will directors lose their income from the loss of a board seat. In fact, the financial compensation upon losing a board seat usually does not provide enough of a gain to offset the lost stream of income² (Harford, 2003). Because of the possible loss of the board seat and the income upon acquisition, non-executive directors may not have sufficient incentive to act in the best interests of the shareholders during the acquisition process. They may attempt to oppose or reject an acquisition offer that is beneficial to target shareholders. The decision to accept an acquisition offer is often made by managers with a group of influential shareholders and directors (Bange and Mazzeo, 2004). Individual managers or directors may not succeed in preventing the acquisition offer from being accepted. Once the acquisition is completed, however, those directors with misaligned interests will be more likely to leave. In fact, existing research suggests that these directors may not only lose their directorships in the target but also find it more difficult to obtain future directorships. For example, Coles and Hoi (2003) find that compared with directors retaining all anti-takeover provisions of Pennsylvania Senate Bill 1310, directors rejecting all protective provisions of this bill are three times as likely to gain additional external directorships and are 30 percent more likely to retain their internal slot on the board of that same Pennsylvania company.

In summary, target non-executive directors are more likely to leave post-acquisition when they have chosen to serve as a directors to advance the personal gains of themselves and management at the expense of shareholder value, either prior to acquisition or during the acquisition process. Conversely, target non-executive directors that have fought to maximize target shareholder value are likely to be rewarded for their performance of the monitoring and control role. It can be expected that such directors are also more likely to exercise their fiduciary duty effectively in the newly formed firm post-acquisition. Hence, we propose that:

Proposition 1: The more a target non-executive director has acted to create value for target shareholders, the less likely the director will leave post-acquisition.

The following corollary suggests that target non-executive directors have the strongest incentive to act to create value

for target shareholders when they also hold significant ownership stakes in the target. First, because of the ownership stakes, non-executive directors have incentives to protect shareholder interests prior to acquisition. Existing research has indicated that directors with a meaningful stake are a pivotal factor in improved governance. In fact, Hambrick and Jackson (2000) find that non-executive directors' holdings are positively associated with subsequent corporate performance. If so, non-executive directors are also likely to be valuable assets for the newly formed firm in terms of value creation and shareholder interest protection. Retaining a director that has acted in the best interests of the target company will also bring more legitimacy and cause less resistance to the acquisition from management or other stakeholders. Second, non-executive directors with significant ownership in the target will have a stronger incentive to protect target shareholder value in the acquisition process. After all, as a shareholder with significant ownership, the director will be better compensated from the acquisition premiums that are commonly observed for the target. As a result, the director will face less pressure from both the acquirer and the shareholders to leave post-acquisition. Recent research suggests that directors who own relatively large equity stakes and are not aligned with the CEO are also more likely to acquire additional directorships and less likely to leave upon forced CEO turnover (Farrell and Whidbee, 2000). In line with Proposition 1, we propose the following:

Corollary 1a: Target non-executive directors with significant equity ownership are less likely to leave post-acquisition than directors with little equity ownership.

The monitoring role is particularly critical when a firm is likely to suffer severe agency problems. The key condition giving rise to agency problems is separation of ownership and control (Berle and Means, 1932). In a context where there is no such separation, it is less likely that the owner-managers would pursue their personal gains to the detriment of the firms' growth and profitability. For example, in a family-controlled firm, the founder and the family members usually have the desire for control and continuity of family involvement in the business (Romano, Tanewski, and Smyrniotis, 2001). Because the founder family assumes both ownership and management of the firm, the interests of owners and managers are well aligned. As a result, agency costs are likely to be much lower in family controlled firms. The importance of non-executive directors with equity ownership to protect shareholder value will be reduced. In fact, existing research suggests that family-controlled firms may require a different corporate governance structure than firms with separation of ownership and control. Randoy and Goel (2003) show that firms *without* founding family leadership (CEO or board chair) benefit from a low level of inside ownership and a high level of blockholder ownership and foreign ownership. On the other hand, for firms *with* founding family leadership, firm performance increases with inside ownership, but decreases with blockholder ownership and foreign ownership. Thus, extending the agency argument, we propose the following corollary:

Corollary 1b: For a target without separation of ownership and control (e.g., a family-controlled firm), the negative effect of equity ownership on the likelihood of non-executive director turnover will be weaker.

It is important to note two points about the above agency discussion. First, the agency argument assumes that there is an active market for corporate control. In governance environments where acquisition is rare or constrained, even when a non-executive director acts against the interests of the shareholders, acquisition may not take place and the director may stay with the company unless the agency problem is addressed within the company. Second, many small private firms do transition from founder family control to professional management when their continual growth requires funding from external investors. These firms will experience a "professionalization" process (Hellmann and Puri, 2002), in which they increasingly rely on hired managers from outside the founder family to manage the operations. Once there is separation of ownership and control and when ownership becomes less concentrated, managerial objectives may become incongruent with owner objectives and agency problems will ensue.

The Advisory Role and Target Director Turnover

As part of the strategic leadership, the board of directors not only acts as the fiduciary of shareholders, but may also offer advice and counseling to top management (Lorsch and MacIver, 1989; Zahra and Pearce, 1989), participate in strategy formulation and implementation (Judge and Zeithaml, 1992; Pearce and Zahra, 1991), and initiate strategic changes (Golden and Zajac, 2001; Goodstein, Gautam, and Boeker, 1994; Westphal and Fredrickson, 2001). In fact, Pfeffer and Salancik (1978: 170) identify the exercise of control and the provision of advice as two primary components of a board's internal administrative function. Departing from the self-interest assumption of agency theory, stewardship theory suggests that management may have a sense of achievement and personal satisfaction from a firm's successful performance (Donaldson and Barney, 1990), and suggests a more active role of the board in contributing to the overall stewardship of the company (Hung, 1998). From a practical point of view, boards are under pressure to develop a broader mindset and new skills to deal with facets of corporate strategy when traditional forms of governance are challenged by major shifts in public opinion, and by societal changes such as new technologies, globalization, and new forms of competition (Ingley and Van der Walt, 2001).

Existing research offers support for this notion of an advisory and strategic role for the board of directors. For example, survey data uncovers that the board of directors is responsible for setting the vision and mission of a company and for enshrining the corporate values as well as serving as the confidence builder (Stiles, 2001). Other studies indicate that directors can help the firm deal with the complexity and uncertainty in strategic decision making, when directors possess valuable problem-solving expertise that can be applied to a variety of contexts (Rindova, 1999). Nevertheless, presidents and outside board members usually agree that the role of directors is largely advisory and not of a

decision-making nature (Mace, 1971). The board would make most decisions on a review and approve basis, but in times of strategic change such as an acquisition, the board does become much more proactive in a firm's strategic decision making (Stiles, 2001). Sometimes, the board's influence on strategic decisions may be masked by the more conspicuous role of executives as decision-makers. For example, a board may conceive some strategic changes and then select new CEOs who have prior experience with similar strategies to facilitate implementation. In fact, recent research shows that while the experience of new CEOs appears to predict corporate strategic changes, these effects disappear after accounting for board experience (Westphal and Fredrickson, 2001).

Whether it is an advisory or a strategic role and regardless of directors' incentives or power to perform the role, carrying out this function effectively depends on directors' capabilities or expertise (Certo, 2003; Ingley and Van der Walt, 2001). Directors' expertise is built upon their education, prior work experience, and their functional backgrounds, among other factors (Pennings, Lee, and van Witteloostuijn, 1998).

Concerning director turnover in acquisition, we propose that target non-executive directors with expertise that is valuable to the acquirer are less likely to leave post-acquisition. First, without sufficient expertise or capabilities, target non-executive directors would face significant challenges to make meaningful contributions to the corporate strategy of the newly formed firm post-acquisition, such as setting the overall direction of the company and allocating scarce internal and external resources on a sustained basis (Lorsch and MacIver, 1989; Westphal and Zajac, 1997). Existing research shows that if a board has a clear understanding of how their companies are meeting customers' needs and how their marketing strategies drive top-line growth, the board can expose inadequate marketing campaigns, direct management to address the problem, and monitor progress (McGovern, Court, Quelch, and Crawford, 2004). On the other hand, if the board lacks the strategic understanding of the business necessary to give due diligence to choosing a new CEO, CEO replacement will not likely lead to improved performance and may actually backfire (Wiersema, 2002). Second, target non-executive directors without sufficient expertise may not contribute significantly to the target's value creation or competitive advantage. In fact, if the target's corporate strategy fails, these non-executive directors may have to take part of the blame. For both reasons, we expect that:

Proposition 2: The more valuable a target non-executive director's expertise, the less likely the director will leave post-acquisition.

Directors in their advisory or strategic role can be viewed as part of organizational human capital (Certo, 2003). Becker (1975) distinguishes between general and specific human capital. General human capital refers to an individual's expertise that is useful in multiple contexts, whereas specific human capital refers to human capital that is embedded in the firm and will lose its value when separated from the firm. In correspondence, we can distinguish between general and specialized expertise of directors.

The resource-based view posits that firm-level value creation and competitive advantage are based upon possession and deployment of firm-specific, costly-to-imitate resources (Barney, 1991; Mahoney and Pandian, 1992; Penrose, 1959). A director's general expertise can be built upon education or prior work experience and usually is valuable and transferable to the newly formed firm post-acquisition. However, because of the imitability or replicability of such expertise, the acquirer can find a replacement with comparable general expertise for a relatively low cost. On the other hand, if a director is closely associated or even identified with the development of the target's critical technology, product, or capability, such specialized expertise is costly to copy or acquire from a third party. Thus, specialized expertise is likely to be more valuable to the acquirer. Further, specialized expertise will likely have a stronger signaling effect concerning the target's value to the acquirer's shareholders and the larger business community. This line of reasoning suggests the following:

Corollary 2a: Target non-executive directors with specialized expertise are less likely to leave post-acquisition than target non-executive directors with general expertise.

According to the resource-based view, the capabilities to effectively develop and deploy resources as the environment changes are just as critical for a firm's competitive advantage as the firm's resource endowments (Eisenhardt and Martin, 2000; Teece, Pisano, and Shuen, 1997). Capabilities involve purposive and collective activities (Dosi, Nelson, and Winter, 2000), by which resources are assembled in integrated clusters spanning individuals and groups so that they enable distinctive activities to be performed. Capabilities are characterized by their degree of coherence, or the degree to which one element reinforces or complements other elements (Teece, Rumelt, Dosi, and Winter, 1994). In this regard, capabilities are highly "combinatorial" and require complementarity between various routines and resources (Levinthal, 2000).

In the context of acquisition, if a target non-executive director's expertise is complementary to that of the acquirer's board of directors and top management team, it is easier and faster to integrate the target director's expertise with that of the acquirer. Such integration will help strengthen the capabilities of the newly formed firm to deal with environmental challenges and to generate or sustain competitive advantages. In the case of top management turnover, existing research shows that target managers with complementary expertise are less likely to leave post-acquisition (Krishnan *et al.*, 1997). Similarly, we expect that the degree of complementarity between target non-executive directors' expertise and the expertise of the acquirer's leadership will be an important determinant of the fate of target directors post-acquisition. Hence:

Corollary 2b: The more complementary is a target non-executive director's expertise to that of the acquirer's board of directors and top management team, the less likely the director will leave post-acquisition.

The Social Role and Target Director Turnover

While both the monitoring and advisory roles are internally focused, the social role that the board of directors performs

is externally-oriented and boundary-spanning. Specifically, the directors can serve as the linkage between the firm and its external environment, and through the linkage with the external environment, secure resources (Adler and Kwon, 2002; Pfeffer, 1972; Pfeffer and Salancik, 1978), obtain information (Burt, 1992; Granovetter, 1985), and gain legitimacy from the broad business and social communities (DiMaggio and Powell, 1983; Meyer and Rowan, 1977).

This social role of directors has been discussed in several perspectives. From a resource dependency perspective, the ability of directors to secure critical resources through their linkages to the external environment is critical to the firm. It is proposed that the board of directors is a mechanism for managing external dependencies and reducing environmental uncertainty (Hillman, Cannella, and Paetzold, 2000; Pfeffer, 1972; Pfeffer and Salancik, 1978). Several studies suggest that increasing the size and diversity of the board will lead to strengthening of the links between the firm and its environment and securing of critical resources (Goodstein *et al.*, 1994; Pearce and Zahra, 1991). The social networks perspective holds that competitive advantages come from information access and control (Burt, 1992). Networks that span structural holes provide broad and early access to, and control over, information. Directors may use their networks to form direct and indirect links to other individuals and organizations. These linkages would in turn facilitate exchanges with the external environment (Nahapiet and Ghoshal, 1998). Through these exchanges directors can obtain information, influence and solidarity for the firm (Adler and Kwon, 2002). Finally, from the institutional perspective, directors' networks enhance organizational legitimacy, which allows the firm to influence the perceptions of customers, suppliers, and investors, and helps the firm acquire resources and survive (DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Pfeffer and Salancik, 1978). In this regard, Pfeffer and Salancik (1978: 145) note that "prestigious or legitimate persons or organizations represented on the focal organization's board provide confirmation to the rest of the world of the value and worth of the organization."

These three perspectives about the social role of directors share the view that directors can help the firm obtain resources, information, and legitimacy through their relationships with the external environment, thus contributing to the firm's performance and survival. Carrying out this social role depends on the advantages directors enjoy in their networks, or their social capital. Social capital is

the sum of the resources, actual or virtual, that accrue to an individual or group by virtue of possessing a durable network of more or less institutionalized relationships of mutual acquaintance and recognition (Bourdieu and Wacquant, 1992: 119).

While carrying out the monitoring and advisory roles depends on the incentives and expertise of directors as individuals, performing the social role is dependent upon directors' social capital derived from their positions in their networks (Burt, 1992; Coleman, 1990).

In the context of acquisition, target non-executive directors can bring valuable social capital to the acquirer and the newly formed firm. For example, target non-executive direc-

tors' close relationship with financial institutions may help the acquirer or the newly formed firm obtain access to much needed financial capital. Directors with extensive social networks in an industry may also provide valuable information about the strategies and practices of other firms (Haunschild, 1993). Target directors that have achieved reputation and prestige in their networks of relationships can help enhance the performance and strengthen the legitimacy of the acquirer. A recent study by Kim (2005) finds that board members' elite school networks are positively associated with firm performance. Thus, we expect that, other things being equal, target non-executive directors with valuable social capital will stay post-acquisition.

Proposition 3: The more valuable a target non-executive director's social capital to the acquirer, the less likely the director will leave post-acquisition.

A director interlocking between the target and the acquirer plays a particularly important role in achieving a successful acquisition. The acquisition process is fraught with information asymmetry and uncertainty. The target and the acquirer each have private knowledge about the other's behavioral tendencies and true value. Further, whether the integration of two independent entities will bring about synergies in the future is not clear at the outset. Under such circumstances, a target director interlocking between the boards of the target and the acquirer can help reduce information asymmetry and uncertainty during the acquisition process. First, the interlocking director serves as a direct link between the target and the acquirer, which helps pre-acquisition certification of both the target and the acquirer, as well as the assessment of the target's true value. Second, as a leadership member of both the target and the acquirer, the interlocking director is likely to be centrally located in the linkage between the target and the acquirer, and thus the certification and assessment from the director are likely to be visible and credible. Finally, such an interlocking director will also be helpful in post acquisition transition and integration because of the familiarity with both firms' strategies and operations. This line of reasoning suggests that:

Corollary 3a: A target non-executive director interlocking between the boards of the target and the acquirer is less likely to leave post-acquisition than are other target directors.

Target non-executive directors that provide non-redundant sources of information will likely have social capital highly valued by the acquirer. According to the social capital perspective, there are disconnections of contacts or "structural holes" in the social structure of the market (Burt, 1992). Those individuals whose relationships span the holes have a competitive advantage, because they are in a position to broker the flow of information between people who are otherwise "insulated" from each other, and control the projects that bring together people from opposite sides of the hole. When two firms are integrated and a target non-executive director is able to provide non-redundant sources of information in the networks of the newly formed firm, the director essentially bridges and even expands the networks of the new firm. Hence we have the following corollary:

Corollary 3b: A target non-executive director that adds non-redundant sources of information to the networks of the acquirer board and top management team is less likely to leave post-acquisition.

EXTENSIONS

Our conceptual framework on the relationship between performance of director roles and target non-executive director turnover post-acquisition can be extended in several ways. In particular, target non-executive director turnover can also be influenced by target and acquirer characteristics, the nature and rationale for acquisition, and differences in international corporate governance systems. We address these factors below.

Target Characteristics

While the “mega-mergers” between large, publicly-traded firms are the most visible mergers and/or acquisitions, many acquisition targets are small, private entrepreneurial firms backed by venture capital (VC). As entrepreneurial firms are often wealth-constrained (Evans and Leighton, 1989), they have to rely upon VC funding for survival and growth (Sahlman, 1990). In return, VC firms take equity stakes in entrepreneurial firms and share control rights with entrepreneurs through board representation. Venture capitalists sitting on the board can be viewed as non-executive directors, as they do not get involved in the daily operations of entrepreneurial firms. When entrepreneurial firms show great growth potential, they may become acquisition targets. For VC firms, acquisition is an attractive channel to exit their investments. Upon exit, VC directors are expected to leave entrepreneurial firms.

What about non-executive directors that do not come from VC firms? While the resource-based and social capital views on target director turnover still hold in the context of acquisition of VC-backed entrepreneurial firms, the agency argument is worth further investigating. The monitoring role of non-executive directors may not be as prominent in VC-backed firms, because other mechanisms can be used to mitigate information asymmetry and agency costs (Gompers and Lerner, 2002; Sahlman, 1990). First, VC financing usually involves elaborate contractual designs, such as staging (Neher, 1999), syndication (Lerner, 1994) and convertible securities (Repullo and Suarez, 1998), that can be used to align the interests of the VC investors and entrepreneurs. Second, VC firms can also reduce agency costs by having the due diligence process and monitoring start-up performance and entrepreneurs’ decision-making (Gompers, 1995). Third, when entrepreneurs invest a substantial portion of their personal wealth in the entrepreneurial firms, such investments are usually transaction-specific assets that cannot be redeployed or recouped if the entrepreneurial firms fail (Arthurs and Busenitz, 2003). Thus, entrepreneurs have a strong incentive to strive for entrepreneurial firms’ long-term growth and profitability, which in turn ensures shareholder value creation. For these reasons, we expect from an agency perspective that in acquisitions of VC-backed entrepreneurial firms, the negative effect of

equity ownership by target non-executive directors (excluding VC directors) on the likelihood of director turnover post-acquisition will be weaker.

Acquirer Characteristics

What if the acquirer is an entrepreneurial firm? Among the monitoring, advising, and social roles, the non-executive directors’ social role is particularly important for entrepreneurial firms (Certo, 2003; Daily and Dalton, 1992; Daily and Dalton, 1993; Deutsch and Ross, 2003). Establishing relationships with other entities in their environment is typically more difficult for entrepreneurial firms (Pfeffer and Salancik, 1978). The inability of young organizations to develop relations with potential stakeholders is a major determinant of their relatively high mortality rate (Stinchcombe, 1965).

The social capital of target non-executive directors can be especially valuable to an entrepreneurial firm for two reasons. First, non-executive directors with strong or extensive relationships can help the entrepreneurial firm gain access to financial and non-financial resources from the external environment by providing direct connections to important stakeholders (Mizuchi, 1996). Second, non-executive directors’ relationships can also have reputational or signaling effect on the success of the newly formed firm following the acquisition (Certo, 2003; Pfeffer and Salancik, 1978). Since entrepreneurial activity occurs in the uncertain and dynamic conditions, resource holders will seek information to gauge the underlying potential of an entrepreneurial firm. Entrepreneurs can seek legitimacy to reduce this perceived risk by associating with, or by gaining explicit certification from, well-regarded individuals and organizations (Shane and Cable, 2002). Prestigious individuals can provide cues to the firm’s environment regarding the firm’s social responsibility, wealth, and value (Pfeffer and Salancik, 1978). At the organizational level, Stuart, Hoang, and Hybels (1999) find that private biotechnology firms with prominent strategic alliance partners are able to go public faster and at higher market valuation. We expect a similar beneficial effect of non-executive director’s relationships on an entrepreneurial firm’s competitiveness and performance. It follows that target non-executive directors with valuable social capital will be particularly less likely to leave when the acquirer is an entrepreneurial firm.

Nature and Reasons for Acquisition

Whether an acquisition is cross border or domestic can influence target director turnover. Target non-executive directors’ knowledge about local markets and their social capital are especially valuable to a foreign acquirer. First, foreign entry usually encounters the liabilities of foreignness attributable to lack of information and legitimacy. The acquirer needs to obtain information about the local market, including the supply and demand conditions, the competitive environment, and government regulations. Lack of such experiential knowledge will increase the uncertainty of foreign entry and thus the costs of cross border acquisitions. Targets are usually the first available sources of such knowledge that can help the entering firm overcome the liabilities of foreignness (Zaheer, 1995). Target non-executive directors

with such local knowledge can thus provide valuable information and support. This line of reasoning suggests that target non-executive directors with more valuable knowledge about the local market are less likely to leave post-acquisition. Second, we also expect that target non-executive directors with valuable social capital are less likely to leave in cross-border acquisitions than in domestic acquisitions for two reasons. First of all, the information asymmetry problem in acquisition is exacerbated by cross-border cultural and institutional differences. As compared with executive directors or top management, non-executive directors with valuable social capital will likely provide a more objective assessment of the target's true worth. After all, a distortion of the target's true value will only serve to damage such directors' social capital in the future. In addition, in a cross border acquisition, the acquirer may lack institutional support from the target or the local community. Target directors' social capital can be utilized by the acquirer to bring legitimacy and galvanize support for the acquisition. Non-executive directors' social capital can also help post-acquisition integration and increase the chance of acquisition success.

Target performance prior to acquisition matters as well. If a target is performing well prior to acquisition, the market can infer that target non-executive directors have performed well their monitoring, advisory, and social roles. As a result, the value of non-executive directors from well-performing targets increases to the newly formed firm. On the other hand, if the target has a poor performance, the leadership including the directors will have to take some blame. Their performance in any of the roles will be cast into doubt. In fact, a target's poor performance can have long-term adverse consequences. For example, when directors of a poorly performing firm successfully block an acquisition offer, these non-executive directors have fewer future directorships in other firms; however, if directors of a poorly performing firm engineer a completed acquisition transaction for their shareholders, directors do not have fewer other directorships in other firms in the future (Harford, 2003). We thus expect that when the target has a poor performance, the negative effect of performance of the three director roles on the likelihood of target non-executive director turnover post-acquisition will be weaker.

The acquisition process is also important. While a negotiated offer is extended to the shareholders of the target through the management and the board of directors, a bypass offer is extended directly to the shareholders without going through the management and the board. Such bypass offers are thus more likely to cause resistance from the management and directors and lead to hostile takeovers. If the market for corporate control is efficient, we expect that target non-executive directors are more likely to leave with bypass offers.

International Corporate Governance Systems

While the monitoring, advisory, and social roles of directors are universal, their importance may vary across different corporate governance systems. For example, Millar *et al.* (2005) have discussed three major corporate governance systems in the world: the Anglo-American governance

system of the U.S., U.K., Canada, and Australia, the Communitarian system of continental Europe and Japan, and the relationship-based governance system in some emerging markets such as China. While the Anglo-American governance system is shareholder-interest driven, the Communitarian system is stakeholder driven. In a Communitarian system where unions are active participant members of the board, the monitoring role might be more diligently performed than in the Anglo-American governance system. Consequently, union directors in a Communitarian system may be less likely to leave post-acquisition. In an emerging market where the governance system tends to be relationship-based, non-executive directors' social boundary-spanning role is especially important. Thus, we conjecture that non-executive directors with valuable social capital will be less likely to leave post-acquisition in a relationship-based governance system than in a market-based governance system.

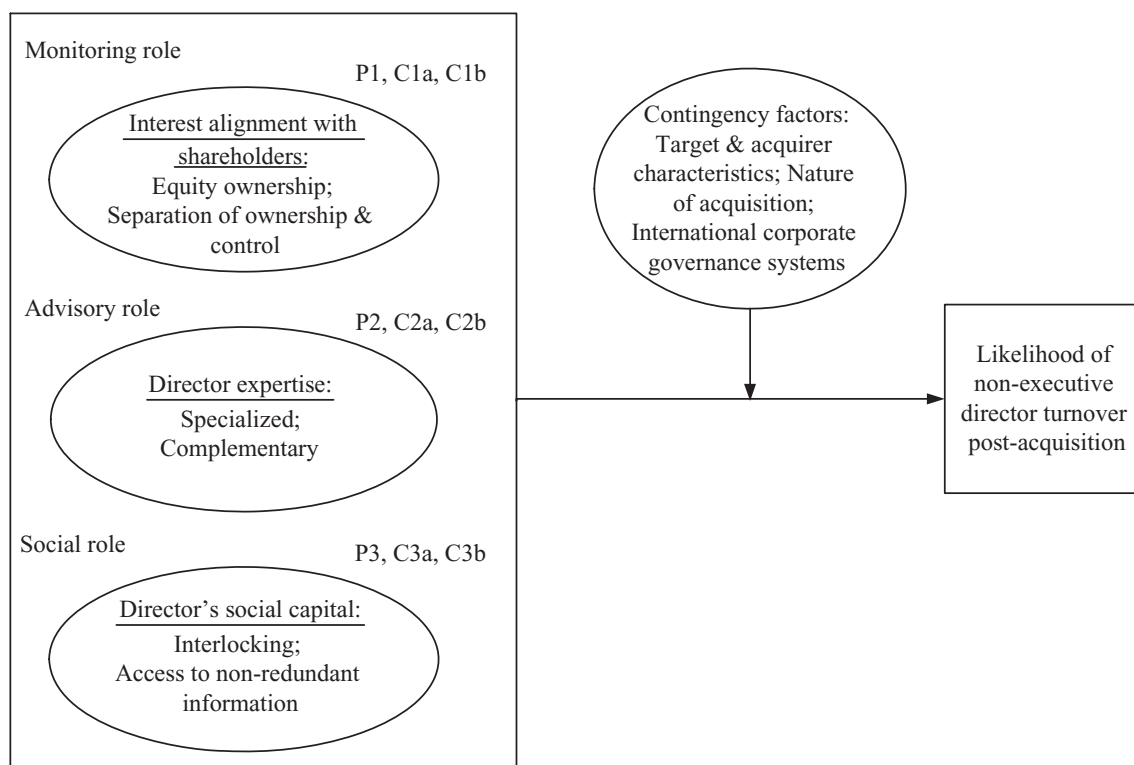
Future research may examine the influence of corporate governance systems on target director turnover in two steps. First, it is necessary to assess whether the monitoring, advisory and social roles are equally important across these corporate governance systems. One practical way to make this comparison is to have surveys in the U.S., Germany, and China, three countries that presumably have vastly different governance systems (Millar *et al.*, 2005). Second, if the importance of director roles varies systematically across the three corporate governance systems, it is incumbent upon academic researchers to analyze how such differences in the corporate governance systems influence the likelihood of target non-executive director turnover post-acquisition.

DISCUSSION AND CONCLUSION

This study developed a conceptual framework to explain target non-executive director turnover post-acquisition. Figure 1 summarizes the proposition, corollaries, and contingency factors. From the agency theory, we proposed that target non-executive directors are less likely to leave post-acquisition when they have acted to maximize target shareholder value prior to acquisition or during the acquisition process. Such non-executive directors are likely to be those with significant equity ownership in the target. From the resource-based view, we proposed that target non-executive directors with expertise that is valuable to the acquirer are less likely to leave post-acquisition. Non-executive directors' expertise that is specialized or complementary is particularly valuable for the newly formed firm to gain competitive advantage. Finally, from the social capital perspective, non-executive directors with valuable social capital, such as those having interlocking directorships or adding non-redundant sources of information to the newly formed firm, will likely stay post-acquisition.

Our analysis drew upon multiple theoretical perspectives to analyze director turnover in acquisition, an approach called for by recent reviews on corporate governance research (e.g., Daily, Dalton, and Rajagopalan, 2003). Our multi-theoretic approach is justified by two considerations. From a scholarly perspective, no single theoretical perspective, be it agency, resource-based view or the social capital

FIGURE 1
Performance of Director Roles and Non-executive Director Turnover Post-Acquisition



perspective, can incorporate the multiple roles that a director typically performs. As this study shows, director turnover is more complex and multi-faceted than the predominant agency arguments suggest. By examining the performance of monitoring, advisory and social roles simultaneously, our study strives for a comprehensive account for target non-executive director turnover post-acquisition. From a practical point of view, it is critical for the newly formed firm to build an effective and efficient new leadership post-acquisition. A look at director roles from multiple perspectives helps the new firm have a better understanding of both director turnover and the new leadership building process.

While our proposed framework on non-executive director turnover focuses on the performance of director roles that should be common across acquisition markets, new issues emerge that may require additional conceptualization and analysis in the future. The acquisition map has changed dramatically over the last five acquisition waves in history. First, since the early 2000s, a significant new type of acquirers has surfaced from the emerging markets. As Gaughan (2007: 66) states, many acquiring companies were built "through acquisitions of privatized businesses and consolidation of relatively small competitors in emerging markets." Second, many of these emerging market firms have acquired large western firms. For example, Mittal of India acquired Arcelor in 2006 and Lenovo of China acquired IBM's PC business in 2005. A few non-executive directors from IBM's PC business sit on the board of

Lenovo. We believe that our proposed framework can be used to explain such director turnover in these new types of acquisitions as well. At the same time, we suggest that future research address whether and how such acquisitions from the emerging markets differ from traditional acquisitions and what would be the implications for director turnover post-acquisition.

Future Empirical Research

Our study has the potential to be the foundation for rich and interesting empirical findings since our propositions can be developed into testable hypotheses. We have several specific suggestions about future empirical research in this direction. First, data should be collected about the board of directors for both the target and the acquirer pre-acquisition, and about the new board of directors in the newly formed firm post-acquisition (e.g., within one year). A comparison of the boards pre- and post-acquisition will show who stays and who leaves. A logit or probit model can be specified to test the likelihood of director turnover based on our propositions about the influence of ownership, expertise, and social capital.

Second, an empirical analysis requires the operationalization of the major explanatory variables. While measures for some variables such as equity ownership and directorship interlocking are straightforward, other variables are much more difficult to measure and may need proxies. For example, a director's general expertise can be proxied by

levels of education and prior work experience, whereas specialized expertise can be measured as firm- and industry-specific experience (Certo, 2003; Gimeno, Folta, Cooper, and Woo, 1997; Pennings *et al.*, 1998).

Existing research also shows that complementarity of a target director's expertise with that of the acquiring board and top management team can be measured by determining whether the target director has overlapping or redundant functional backgrounds with those of the acquirer. Finally, a target director's social capital should be measured not only by the number of directorships in other organizations, but also by whether a target director can bridge the structural holes in the inter-firm networks of the newly formed firm and offer non-redundant sources of information.

Third, future empirical research should carefully design the sampling frame and control for the influence of several contingency factors such as established versus entrepreneurial firms, cross-border versus domestic acquisitions, international corporate governance systems, negotiated versus bypass offers, and target pre-acquisition performance. For example, it is interesting to see whether non-executive directors with significant equity ownership have a lower likelihood of turnover in acquisitions involving separation of ownership and control than in acquisitions of family-controlled firms without such separation.

Finally, director turnover, like employee turnover, can be voluntary or involuntary (e.g., Shaw, Delery, and Jenkins, 1998). We expect that director turnover driven by the factors examined in this study tends to be involuntary for two reasons. First, it is reasonable to assume that directors would like to stay, other things being equal, when the financial and non-financial impact of a completed acquisition tends to be negative for directors (Harford, 2003). Second, we adopt an instrumental approach towards directors and director turnover and essentially propose that poor performance of the monitoring, advisory and social roles leads to an increase in the likelihood of non-executive director turnover post-acquisition. Nonetheless, we recognize that a director perceiving status loss post-acquisition may choose to leave voluntarily (Hambrick and Cannella, 1993; Lubatkin *et al.*, 1999). Such turnover driven by behavioral and emotional factors is beyond the scope of the current study.

In conclusion, we hope that this conceptual study will encourage corporate governance scholars to pay more attention to the behavior of what has become a key figure in modern boards – the non-executive or independent director during a strategic decision-making process such as an acquisition. Research in this direction is important not only for the Anglo-American corporate governance system but also for corporate governance systems in emerging markets and continental Europe where family control and foreign ownership figure more prominently in acquisition.

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NOTES

1. We define a corporate *acquisition* as “the process by which the stock or assets of a corporation come to be owned by a buyer. The transaction might take the form of a purchase of stock or purchase of assets” (Reed, Lajoux, and Nesvold, 2007: 4). Acquisitions are sometimes referred to as mergers; takeover is also broadly used although it is vaguer and has the connotation of a hostile or unfriendly acquisition (Gaughan, 2007).
2. One exception to this point is that venture capital (VC) investors usually have representatives sitting on the board of VC-backed entrepreneurial firms. Upon exit through successful M&A, VC directors will get well compensated and leave. See our discussion below.

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