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# Internal Corporate Control and the Dynamics of Post-Acquisition Boards: Evidence of U.S. Life Insurers

Xiaoying Xie[a], Wanke Cai[b], Weili Lu[c]
Laura Yue Liu[d], Aaron Takumi[e]

*[a] Professor of Finance, Mihaylo College of Business and Economics*
*California State University, Fullerton, CA 92831*
*xxie@fullerton.edu*
*[b] Senior researcher, Fixed Income Investment Department*
*Pacific Asset Management Co., Ltd.*
*caiwanke@cpic.com.cn*
*[c] Professor of Finance, Mihaylo College of Business and Economics*
*California State University, Fullerton, CA 92831*
*wlu@fullerton.edu*
*[d] Assistant Professor of Finance, Mihaylo College of Business and Economics*
*California State University, Fullerton, CA 92831*
*yueliu@fullerton.edu*
*[e] Senior Financial Analyst, Herbalife, Ltd.*
*990 West 190th Street, Torrance, CA*
*aaront@herbalife.com*

**ABSTRACT**

We study the role of target insurer boards and the post-acquisition retention of target directors in U.S. life insurer mergers and acquisitions. Our results indicate that board characteristics affect the likelihood of acquisition. Smaller boards, boards with better reputations and boards without CEO dominance are more likely to agree to acquisition. Boards with a larger proportion of outside directors are less likely to agree to acquisition, especially when firms perform well. In terms of post-acquisition director retention, we find that outside directors are more likely to lose their seats after acquisition, especially when firms underperform. Directors holding more directorships in other firms or having experience as top management are more likely to be retained. Outside directors are less likely to be retained if they are from a firm with CEO duality, and inside directors are more likely to be replaced if the takeover is disciplinary.

*JEL Classifications:* *G22, G30, G34*

*Keywords:* *mergers and acquisitions; board of directors; life insurers*

## I. INTRODUCTION

A large number of mergers and acquisitions (M&As) have been observed in the U.S. insurance industry in the past decade. In general, these transactions are found to enhance the value and improve the efficiency of target firms (Cummins et al., 1999; Cummins and Xie, 2008, 2009; Boubakri et al., 2008). Meanwhile, the literature on corporate governance shows that directors of target firms face board seat loss and a negative financial impact after M&As (Kini et al., 1995; Becher and Campbell, 2005; Harford, 2003). This raises questions about the role and fate of target firm boards in the M&A process. What types of boards are more likely to agree to value enhancing takeovers? Are certain types of directors more likely to be retained in post-acquisition firms than others? Despite the rich literature on takeover and corporate governance, few studies tackle the retention of post-acquisition boards, and none focus on the insurance industry in particular.

Unlike non-financial firms that are solely monitored by non-regulatory groups, insurance companies are monitored by both regulators and non-regulatory groups.[1] It then becomes interesting to examine whether the non-regulatory groups monitor insurance companies in the same way as they do non-financial firms. In particular, we study the role of target boards in acquisition decision making and the post-acquisition dynamics of these boards in the U.S. life insurance industry. We first investigate whether the corporate governance of a company affects its likelihood of being acquired. We then examine the characteristics of target company directors and whether these characteristics will determine their retention after a takeover.

This study contributes to the M&A and corporate governance literature in several important ways. First, the study improves the understanding of the role played by the board of a target company during the M&A process in the insurance industry. Despite the importance of a board's role in an M&A, surprisingly little research has been conducted to examine that role in the insurance industry, with the exception of Boubakri et al. (2008), which examines the influence of corporate governance on the long run performance of bidders in the property and liability insurance industry. Our study investigates the influence of the target company board on the likelihood of successful acquisition. Since hostile takeovers in the insurance industry are rare and difficult to carry out due to regulatory hurdles,[2] the role of corporate governance in the target company may be different from that of other industries (Shivdasani, 1993), further contributing to the significance of this study. Additionally, using homogenous insurance companies as our sample allows us to investigate the role of corporate governance without cross-industry contaminations, avoiding possible spurious correlations caused by unobservable differences across industries.

Second, our study enriches the understanding of the determinants of post-acquisition director retention. Most previous research discusses the impact of corporate governance on acquisition performance and the influence of M&A on CEOs, with very little research investigating the factors affecting the retention of directors. For example, Allen and Cebenoyan (1991) and Subrahmanyam et al. (1997) examine the effect of management incentive and corporate governance variables on bidder returns in bank acquisitions. Lehn and Zhao (2006) investigate the effect of corporate governance on the relationship between the likelihood of CEO turnover and bidder returns after M&A. Cotter et al. (1997) examine the impact of the target firm's independent outside directors on takeover premiums during takeover attempts by tender offers. Only a few papers examine post-merger individual board members. Among them, Harford (2003) investigates the influence of M&A on the board of directors in relationship to its financial effect and the loss of board seats for a sample of targets that were in the *Fortune 1000*, and McLaughlin and Ghosh (2008) examine the factor of expertise in director retention for a sample of large mergers. Our paper is the first that studies the post-acquisition retention of directors in the insurance industry.

Third, this study examines both public and private targets, while the existing literature on corporate governance and M&A focuses mainly on public targets. In the U.S. life insurance industry, a significant number of M&A transactions involve private targets. Therefore covering both public and private targets in the sample provides a more complete picture of the M&A process in this industry.

Our results provide evidence that board characteristics affect the likelihood of acquisition in the life insurance industry. Boards of smaller size, better reputation, and separation of CEO and chairman roles are more likely to accept acquisition offers. Boards with a higher proportion of outside directors are less likely to accept a takeover offer, and this is especially true for good performance firms. In terms of post-acquisition director retention, we find that outside directors are more likely to lose their seats after the acquisition, especially in poor performance firms. Holding more directorships in other firms or having experience as a CEO will increase the chance of retention. In addition, directors are more likely to lose their seats after acquisition if a target firm has a powerful CEO (e.g., the CEO is also the chairman) or if the takeover is disciplinary.

The remainder of the paper proceeds as follows: in Section II we briefly review the relevant literature and develop hypotheses; in Section III we discuss the sample and the data; in Section IV we present corporate governance and the likelihood of acquisition; in Section V we examine the determinants of post-acquisition director retention; and in Section VI we conclude.

## II. LITERATURE REVIEW AND HYPOTHESES

### A. Literature on M&A in the Insurance Industry

While many studies in recent years (e.g., Chamberlain and Tennyson, 1998; Cummins et al., 1999; Akhigbe and Madura, 2001; Cummins and Xie, 2008, 2009; Cummins, Klumpes, and Weiss, 2015) have examined various aspects of the M&A process in the insurance industry, few of these have investigated corporate governance issues in M&A events, with the exception of Chamberlain and Tennyson (1998) and Boubakri et al. (2008).

Chamberlain and Tennyson (1998) study M&A transactions in the U.S. property-liability insurance industry during 1980-1990, and find that financial synergies were important motivations for M&As in that period. They also investigate the replacement of top management (CEO or president) in target firms and conclude that replacing management at target firms is not a major objective of acquisition. Using a sample of 177 M&A transactions from 1995 to 2001, Boubakri et al. (2008) provide evidence for the impact of corporate governance on value creation in the U.S. property-liability insurance industry, and find that CEO ownership is negatively related to the long run performance of bidders, but board independence positively affects bidders' long term performance.

Concerning M&As in the U.S. life insurance industry, Cummins et al. (1999) examine the relationship between M&As and the efficiency of targets, and find that acquisitions in this industry are mainly driven by economic considerations and lead to improvements in efficiency and productivity. However, they do not address the role of corporate governance in acquisition decisions or post-acquisition dynamics of the board.

In the global insurance industry, Cummins, Klumpes, and Weiss (2015) examined the value created by M&As between 1990-2006 and found that M&As increased the value of target firms significantly. M&As also increased the value of acquirer firms slightly, but only if they were acquiring other insurance firms. Again, they do not assess the impact of corporate governance or board dynamics on M&A events.

Our paper fills the gap in M&A research in the insurance industry by highlighting the role of target insurer boards and the post-acquisition retention of target directors. We develop hypotheses regarding these two questions from the literature on corporate governance and M&A.

## B. Corporate Governance and M&A

Numerous studies have examined the effectiveness of the board around M&A decisions made by both targets and acquirers, and the results are mixed. The literature can be classified into three categories: (1) corporate governance and post-acquisition performance (e.g., Lehn and Zhao, 2006; Brown and Maloney, 2008; Cotter et al., 1997; Franks and Mayer, 1996; Allen and Cebenoyan, 1991; Subrahmanyam et al., 1997; and Cornett et al., 2003); (2) corporate governance and the likelihood of acquisition (e.g., Hadlock et al., 1999; Mikkelson and Partch, 1989; Song and Walkling, 1993; Shivdasani, 1993; Khorana et al., 2007);[3] and (3) the dynamics of post-merger management and the board (e.g., McLaughlin and Ghosh, 2008; Becher and Campbell, 2005; Davidson et al., 2004; Harford, 2003; Franks and Mayer, 1996). Since this paper focuses on the effect of corporate governance on the likelihood of firm acquisition and the post-acquisition retention of the board, we rely on the literature in the latter two categories to develop our hypotheses.

### 1. Corporate governance and the likelihood of acquisition

Jensen (1988) and Shleifer and Vishny (1988) set the foundation on the relationship of takeover and corporate governance with the argument that takeover is an efficient means to replace inefficient managers of target companies (the corporate control hypothesis). Kini et al. (1995) and Harford (2003) find that the effect of a completed takeover on target executives and directors is generally negative (the penalty hypothesis). This is consistent with the argument that outside takeover breaks the internal corporate control mechanism and devaluates the human capital of directors and executives. It is therefore important to investigate empirically whether the internal control mechanism affects takeover probability. We look at the common structures of a board: board size, proportion of outside directors, reputation (the average number of directorships held by its directors), and CEO duality (CEO is also chairman of the board).

a. Board size

Lipton and Lorsch (1992) and Jensen (1993) argue that larger boards can be less effective than smaller boards because of coordination costs and director free-riding issues. Supporting this view, Eisenberg et al. (1998) provide evidence that larger boards are associated with lower firm value, and Yermack (1996) find that smaller boards are more likely to initiate CEO turnover following poor performance. If board size is related to effectiveness, we expect that firms with smaller boards are more likely to make value-maximizing decisions: i.e., smaller boards will be more likely to seek or approve a takeover deal rather than resist it if they perceive that the deal will enhance firm value, especially when the target firm performs poorly.

b. Board independence

The effectiveness of corporate governance is correlated with the independence of a board. The literature shows that more independent boards are more likely to serve shareholder interests and provide more effective monitoring (e.g., Baysinger and Butler, 1985; Weisbach, 1988; Cotter et al., 1997).[4] It is also argued that takeover markets and (effective) outside directors can serve as substitute control mechanisms (Shivdasani, 1993, Mayers et al., 1997; Fama and Jensen, 1983). In addition, Harford (2003) suggests that target directors, and outside directors in particular, are unlikely to be retained on the new board following a successful merger; they also tend to hold fewer directorships in other firms following a completed merger. The penalty of losing board seats cannot be offset by financial gains from the takeover transaction. In this case, it is no longer clear whether outside directors would align themselves with target shareholders during a takeover offer. As a result, we expect that firms with a higher proportion of outside directors, particularly firms with good performance, will be more resistant to takeover offers out of concern for directorship loss and potential financial loss.

Alternatively, Harford (2003) shows that if a poorly performing firm blocks a takeover offer, the outside directors may face the loss of other directorships in the future, while directors of poorly performing firms who support takeover transactions do not suffer loss of directorships in other firms. Therefore, the probability of takeover could be positively related to the proportion of outside directors for poorly performing firms (for which the takeover market is the "court of last resort" to replace ineffective management (Jensen, 1986)), due to outside directors' concern for their reputations.

c. Dual role of CEO and chairman (CEO duality)

Some financial economists challenge the ability of outsiders to make independent judgments on management decisions, arguing that outside directors are mainly appointed by the CEO or President, and board independence is related to the CEO's bargaining power over the board-selection process (e.g., Vancil, 1987; Hermalin and Weisbach, 1998). Fama and Jensen (1983) argue that combining the role of decision management and decision control in one individual reduces a board's effectiveness in monitoring top management. Jensen (1993) and Goyal and Park (2002) provide similar arguments and empirical evidence that it is more difficult for a board to perform critical functions without the direction of an independent leader; for example, combining the CEO and chairman roles makes it difficult for the board to remove poorly performing CEOs.

If the dual role of CEO and chairman leads to higher agency costs in making value-maximizing decisions for shareholders, we expect that a company with CEO duality is more resistant to takeover offers. The effect will be particularly significant for poorly performing firms where the CEO is more likely to be replaced after the acquisition (Martin and McConnell, 1991; Krug and Hegarty, 1997).

#### d. Board reputation

A board composed of directors with more directorships in other companies is considered more effective because holding more directorships indicates higher ability and accomplishment (Ferris and Jagannathan, 2001; Ferris et al., 2003). The potential disadvantage of holding more directorships is that the director may be less attentive to any one company's affairs; however this is not supported in the literature (Ferris and Jagannathan, 2001).

In the context of mergers and acquisitions, the reputation cost of directors resulting from an improper decision regarding a takeover strategy may force them to better align their interests with the shareholders (Harford, 2003). As a result, we predict that a company with more reputable directors is more likely to be acquired, *ceteris paribus*.

In summary, based on previous research, we hypothesize that boards of smaller size, with better reputations, a higher proportion of outsiders and no CEO dominance are more likely to accept acquisition offers after controlling for firm performance and other financial characteristics.

### 2. Post-acquisition retention of target board members

Several empirical studies have investigated determinants of target director retention after acquisition, such as Kini et al. (1995), Harford (2003), Davidson et al. (2004), Becher and Campbell (2005), and McLaughlin and Ghosh (2008). Factors examined by these studies include M&A transaction characteristics, director characteristics, and target and acquirer firm characteristics.

#### a. Inside directors vs. outside directors

When a board of directors does not effectively perform the monitoring role, the internal corporate control mechanism may fail, leading to poor firm performance and making the firm a potential target of takeover (Jensen, 1986). As a penalty, directors will lose their directorships on the target board after acquisition. Consistent with the penalty hypothesis, Harford (2003) finds that target directors, and outside directors in particular, are less likely to be retained on the new board following a successful merger. The paper argues that the higher retention of insiders than outsiders may represent either continuation of target management or firm-specific knowledge possessed by the insiders that is valuable to the new board. The paper also shows that the retention of outside directors is not affected by pre-acquisition performance, but inside directors are more likely to be retained following good performance.

b. Top management experience of directors

The literature shows that the market responds more positively to the appointment of outside directors with CEO experience than to those without CEO experience (Fich, 2005). In the context of takeover, Harford (2003) and McLaughlin and Ghosh (2008) find that inside directors working as CEOs are more likely to be retained in a surviving board. This evidence suggests that experience as top management is granted high human resource value. In particular, inside directors with top management experience are more knowledgeable about the firms. As a result, we expect that directors with CEO experience (past or current) are more likely to be retained after takeover, *ceteris paribus*.

c. Disciplinary takeover

When the acquirer intends to replace inefficient management teams of targets (a disciplinary takeover), the target board is assumed to have failed to effectively monitor and control the management. Therefore, the target board is very likely to be disciplined as well. Kini et al. (1995) provide evidence for this argument and find that the replacement of directors is more pronounced in disciplinary takeovers, i.e., those with CEO turnover.

d. Director's reputation

Previous studies show that directors who have multiple board seats often serve on the boards of large corporations that perform well relative to their peers who serve on a single board (Li and Ang, 2000; Ferris and Jagannathan, 2001; Ferris et al., 2003; Harris and Shimizu, 2004). McLaughlin and Ghosh (2008) find that inside directors with more than two additional directorships are more likely to be retained after takeover. Based on these findings, we expect that target directors with multiple board seats are more likely to be retained in a post-acquisition board.

e. Other characteristics

Other characteristics, such as those of the target and acquiring firms, as well as the M&A transactions, are also suggested to be related to the retention of directors. For example, Davidson et al. (2004) examine stock-for-stock mergers and find that the retention of target directors in the combined firm is positively related to the relative size of the firms and to the proportion of inside directors of the target firm, and they provide weak evidence that directors from targets with good pre-merger performance are more likely to be retained.

Becher and Campbell (2005) examine how CEO and non-CEO directors increase their own benefit in banking merger negotiations, and also find that the retention of non-CEO target directors is positively related to the relative size of the targets and acquirers, and is not related to pre-merger firm performance.

McLaughlin and Ghosh (2008) examine post-merger board construction by including more variables that are potentially related to the retention of directors from both targets and bidders. In addition to director characteristics, they find that a cash acquisition will reduce the likelihood of inside director retention. The likelihood of retention of outside directors is found to be lower if a merger deal is financed by stock, if the target has a relatively smaller size or if the outside directors have less CEO experience. The paper also finds that the tenure of directors, CEO duality, board independence and pre-merger performance have no impact on both outsider and insider retention.

In this paper, we include in the retention analysis the payment method (cash vs. other), target size, target pre-acquisition operating performance (industry-adjusted), target board independence and CEO duality. Since the effects of these variables are mixed in the literature, we make no clear cut prediction about them.

## III. DATA AND SAMPLE

This paper focuses on the U.S. life insurance industry. The M&A data used in this study are from SNL DataSource compiled by SNL Financial. We study merger and acquisition transactions between 1998 and 2006. The demographic and financial information about firms is obtained from the National Association of Insurance Commissioners (NAIC) – Life-Health insurance database. Data from 1996-2006 are used. The corporate governance information is collected from NAIC and Best's Insurance Reports, and data from 1997-2008 are utilized.

We conduct analysis at the individual insurance company level. If a target is a group or holding company under common ownership, we break it down into individual companies. We consider a company as a target if it was successfully acquired and if the acquisition resulted in changes in ownership control. We also create a control sample of "non-target". A company is defined as a non-target if it does not have the same NAIC group code as a target or an acquirer during the period t-2 to t+2, that is, it was not involved in any takeover activities during t-2 to t+2, where t represents the year of acquisition. We eliminated firms with unusual characteristics such as zero or negative net worth or assets.

According to these criteria, 316 targets and 6,837 non-targets are identified in the final sample during 1998-2006 (see Table 1). The majority of target firms are affiliated firms (insurers with group affiliation). We perform analysis of post-acquisition retention on 2,218 directors identified from the boards of these 316 target firms.

## IV. CORPORATE GOVERNANCE AND THE LIKELIHOOD OF ACQUISITION

To examine whether internal corporate control affects the likelihood of acquisition, we regress a target dummy (target=1 if a firm is successfully acquired, and 0 otherwise) on corporate governance variables, pre-acquisition performance (return on assets), and other control variables (such as firm size, business mix, diversification, group affiliation, and organizational form) that have been expected to affect the likelihood of being targets in the literature (Cummins et al., 1999). The summary statistics on these variables are presented in Table 2, and the probit analysis is presented in Table 3.

**Table 1**
Number of target and non-target firms, 1998-2006

| Year | Target | | Non-target | |
|---|---|---|---|---|
| | Affiliated companies | Unaffiliated companies | Affiliated companies | Unaffiliated companies |
| 1998 | 44 | 11 | 563 | 409 |
| 1999 | 60 | 11 | 504 | 391 |
| 2000 | 45 | 6 | 484 | 337 |
| 2001 | 28 | 3 | 497 | 314 |
| 2002 | 11 | 6 | 472 | 304 |
| 2003 | 15 | 5 | 405 | 257 |
| 2004 | 24 | 0 | 457 | 271 |
| 2005 | 35 | 7 | 400 | 157 |
| 2006 | 3 | 2 | 438 | 177 |
| Total | 265 | 51 | 4220 | 2617 |

Note: "Affiliated companies" refer to insurance companies with group affiliation; "Unaffiliated companies" refer to insurance companies that have no group affiliation.

**Table 2**
Summary statistics on targets and non-targets

| Variables | Target | | Non-target | | Difference |
|---|---|---|---|---|---|
| | Mean | Std. dev | Mean | Std. dev | Target – Non-target |
| Observations | 316 | | 6837 | | |
| *Size and Financial Ratios* | | | | | |
| Size: Ln(assets) | 18.794 | 2.493 | 17.625 | 2.712 | 1.169*** |
| Surplus / assets | 0.328 | 0.301 | 0.420 | 0.301 | -0.092*** |
| *Operating Performance* | | | | | |
| Return on assets | 0.006 | 0.077 | 0.023 | 0.085 | -0.017*** |
| *Business Mix and Diversification* | | | | | |
| Proportion of premiums in individual annuities | 0.195 | 0.298 | 0.118 | 0.243 | 0.077*** |
| Proportion of premiums in group annuities | 0.056 | 0.175 | 0.031 | 0.134 | 0.025** |
| Geographic Herfindahl, premiums written | 0.358 | 0.357 | 0.571 | 0.401 | -0.213*** |
| *Premium Growth Rate* | | | | | |
| Change in premiums, t-1 to t | 0.043 | 0.465 | 0.125 | 0.491 | -0.082*** |
| *Group Affiliation and Organizational Form* | | | | | |
| Unaffiliated insurer dummy | 0.161 | 0.368 | 0.383 | 0.486 | -0.222*** |
| Stock insurer dummy | 0.953 | 0.213 | 0.903 | 0.296 | 0.050*** |
| *Corporate Governance* | | | | | |
| Board size | 7.022 | 3.079 | 7.257 | 3.681 | -0.235 |
| Proportion of outside directors | 0.461 | 0.287 | 0.489 | 0.299 | -0.028* |
| Board reputation | 2.222 | 2.189 | 1.064 | 1.338 | 1.158*** |
| CEO is chairman | 0.671 | 0.471 | 0.740 | 0.438 | -0.069*** |

Note: *Significant at the 10% level. **Significant at the 5% level. ***Significant at the 1% level. The asterisks illustrate whether the difference between targets and non-targets is significant based on T-test. Board size: the number of directors on a board. Board reputation: average number of directorships held by the directors of the board in other insurance companies. Proportion of outside directors: the number of outsiders divided by the board size. Similar to He and Sommer (2011), we define an outside director as a director who is not a current or former officer or their family members. "CEO is chairman" is a dummy variable equal to 1 if a CEO is also the chairman of a board, and 0 otherwise.

Table 2 above shows that the average board size (number of directors on a board) of target firms is 7.022, while the average board size of non-targets is 7.257. Target firms on average have a smaller proportion of outside directors (0.461 vs. 0.489).[5] We use the average number of directorships held by the board members in other insurance companies as a proxy to measure target board ability or reputation. The directors of target boards on average hold 2.222 seats in other insurance companies, while the directors of the non-target boards on average have 1.064 seats, suggesting that target boards on average have a better reputation. Table 2 also shows that in life insurance companies it is common for a CEO to also hold the position of chairman of board (duality). About 67 percent of target firms and 74 percent of non-targets combine the position of CEO and chairman. The difference between the two groups is significant.[6]

Summary statistics on other variables are largely consistent with the findings in the literature for non-financial firms. Target firms are bigger than non-targets based on total assets. They are also financially vulnerable, with a lower surplus to asset ratio than non-targets (0.328 vs. 0.420). Target insurers on average underperform significantly compared to non-target insurers (with ROA 0.006 vs. 0.023). Targets tend to underwrite more business in individual annuities and group annuities and are more geographically diversified than non-targets. The premium growth rate of targets averages 0.043, much lower than that of the non-targets (0.125). Only a small percentage of target firms are unaffiliated single firms (firms without group affiliation) (16.1 percent), but the percentage is higher for non-target firms (38.3 percent). Targets and non-targets alike are mostly composed of stock companies, but the percentage of stock firms is slightly higher for targets (95.3 percent vs. 90.3percent).

Table 3 presents the probit regression analysis of the likelihood of being a target. To control for the structural difference of board behavior in good performance and poor performance firms, separate regressions are conducted for firms that perform better than the industry median and for those that perform worse than the industry median, as measured by return on assets.[7] A likelihood ratio test is conducted and rejects the equality of coefficients of the two regressions, suggesting that factors affecting the likelihood of being a target differ between good performance and poor performance firms.

We find that in general firms with smaller boards are more likely to be involved in takeover activities regardless of firm performance, suggesting that smaller boards are more likely to agree to acquisition decisions. This is somewhat consistent with Lipton and Lorsch (1992) and Jensen (1993), who find that a smaller board is more effective in maximizing firm value. Table 3 also shows that boards with more reputable directors are more likely to accept takeover offers, which holds for both good performance and poor performance samples.

Consistent with the penalty hypothesis (Harford, 2003; Jensen, 1986), our results show that boards with a higher proportion of outsiders are less likely to be acquired; the result is significant for good performance firms only. A possible explanation is that directors of good performance companies are more likely to avoid the uncertainties inherent in M&As.

Consistent with the predictions, we find an inverse and significant relationship between the CEO duality and the likelihood of an acquisition, regardless of firm performance. This indicates that the dual CEO–chairman role tends to reduce the independence of the board, which may make the board less effective when making

M&A decisions. This also complements the findings of Shivdasani (1993), that the presence of a powerful CEO on the board lowers the probability of a hostile bid.[8]

Results for non-governance variables are mostly consistent with the existing literature in non-financial firms. Overall, firms with lower return on assets are more likely to be acquired. For firms that underperform in comparison to the industry median, those with relatively lower premium growth rate and stock organizational form are more likely to be acquired, however the likelihood of acquisition is lower for unaffiliated single firms. For firms that perform better than the industry median, the likelihood of acquisition decreases with their return on assets. Consistent with Cummins et al. (1999), firms that are more geographically diversified are more attractive to acquirers, and this effect holds for both good performance and poor performance firms. In addition, life insurers with a higher percentage of business in annuity products are more likely to be acquired.

**Table 3**

Probit analysis—likelihood of targets

| Variables | Whole Sample | Good Performance | Poor Performance |
|---|---|---|---|
| Board size | $-0.023^{**}$ | -0.028 | -0.019 |
| | [0.011] | [0.019] | [0.015] |
| Board reputation | $0.130^{***}$ | $0.242^{***}$ | $0.087^{***}$ |
| | [0.017] | [0.032] | [0.021] |
| Proportion of outside directors | -0.199 | $-0.338^{*}$ | -0.095 |
| | [0.130] | [0.199] | [0.176] |
| CEO is chairman | $-0.288^{***}$ | $-0.354^{***}$ | $-0.257^{***}$ |
| | [0.071] | [0.110] | [0.095] |
| Firm Size: Ln(assets) | -0.007 | 0.002 | -0.024 |
| | [0.021] | [0.033] | [0.028] |
| Return on assets | $-0.952^{**}$ | $-1.503^{*}$ | -0.555 |
| | [0.465] | [0.793] | [0.711] |
| Surplus / assets | -0.191 | -0.084 | -0.271 |
| | [0.163] | [0.237] | [0.239] |
| Geographic Herfindahl | $-0.524^{***}$ | $-0.512^{***}$ | $-0.572^{***}$ |
| | [0.110] | [0.163] | [0.156] |
| Proportion of premiums in annuities | $0.291^{**}$ | $0.396^{*}$ | $0.262^{*}$ |
| | [0.118] | [0.221] | [0.150] |
| Premium growth rate | $-0.294^{***}$ | -0.130 | $-0.468^{***}$ |
| | [0.080] | [0.113] | [0.121] |
| Stock insurer | $0.285^{**}$ | 0.250 | $0.307^{**}$ |
| | [0.125] | [0.231] | [0.151] |
| Unaffiliated insurer | $-0.183^{**}$ | -0.021 | $-0.273^{***}$ |
| | [0.085] | [0.128] | [0.118] |
| Observations | 5529 | 2742 | 2776 |
| Pseudo R-square | 0.146 | 0.201 | 0.125 |
| Likelihood ratio test on equality of coefficients | | LR chi2(20) = 33.13 | |
| P-value | | Prob > chi2 = 0.0448 | |

Note: Dependent variable is target dummy (target=1 if a firm is successfully acquired, and 0 otherwise). Independent variables take value one year prior to the acquisition. Constant term and year dummies are not reported. $^{*}$Significant at the 10% level. $^{**}$Significant at the 5% level. $^{***}$Significant at the 1% level. Standard errors in brackets.

Board size: the number of directors on a board. Board reputation: average number of directorships held by the directors of the board in other insurance companies. Proportion of outside directors: the number of outsiders divided by the board size. Similar to He and Sommer (2011), we define an outside director as a director who is not a current or former officer or their family members. "CEO is chairman" is a dummy variable equal to 1 if a CEO is also the chairman of the board, and 0 otherwise. A firm is considered as "good performance" if its return on assets (ROA) is higher than the industry median ROA, and as "poor performance" otherwise.

## V. POST-ACQUISITION RETENTION OF TARGET DIRECTORS

Table 4 provides descriptive statistics of characteristics for both retained directors and non-retained directors. A director is considered "retained" if the director continues to serve on the surviving board of a target (if the target maintains its independence after being acquired) or starts to serve on the acquirer's board (if the target loses its independence after being acquired) in the year when the acquisition is complete.

Out of 2,218 directors of target firms, 1,118 directors are retained and 1,100 directors leave the board after their firms are acquired. About 46.2 percent of retained directors are outside directors, while 53.8 percent of retained directors are insiders, suggesting that outside directors are more likely to lose their seats after takeover. On average, retained directors hold 2.577 board seats in other insurance companies before acquisition, which is significantly higher than non-retained directors (average 1.872 seats). About 41.1 percent of retained directors have experience working as a CEO in the life insurance industry, while the number for non-retained directors is only 28.4 percent. This disparity is significant and indicates that directors working as CEOs (past or current) are more likely to be retained after acquisition because of their experience as decision makers.

Table 4 also summarizes target characteristics and transaction characteristics. On average, the majority of non-retained directors come from smaller firms, firms with a higher proportion of outside directors, firms whose CEO also holds the position of chairman, firms with disciplinary CEO turnover (CEO is replaced within two years after acquisition) and firms that receive cash financing.

We run several probit regressions to examine the determinants of director retention after acquisition. To address the concern that observations from the same target firm are not independent, we run the probit regression specifying that the standard errors allow for intragroup correlation. The dependent variable is a dummy variable indicating retention (=1) or departure (=0) from a post-acquisition board. The independent variables include characteristics of individual directors such as director reputation, status as insider or outsider, CEO experience in the target or other insurance firms; target firm characteristics, such as pre-acquisition performance, size of targets, CEO duality, the proportion of outside directors of a board, and whether the CEO of the target experiences disciplinary turnover after acquisition; and transaction characteristics such as the payment method (cash vs. stock and other payments). Organizational form and group affiliation are also included in the regression.[9]

Differences in determinants of retention between outside and inside directors are discovered by running regressions based on two sub-samples that consist of insiders or outsiders only. In addition, to control for structural differences between firms with good performance and poor performance, we conduct separate regressions for firms that perform better than, and worse than, the industry median. The results are reported in Table 5.

**Table 4**

Summary statistics on target director retention

| Variables | Retained Directors Mean | Retained Directors Std. dev | Non-retained Directors Mean | Non-retained Directors Std. dev | Difference Retained – Non-retained |
|---|---|---|---|---|---|
| Director Characteristics | | | | | |
| Number of observations | 1118 | | 1100 | | |
| Director - outside director | 0.462 | 0.499 | 0.566 | 0.496 | -0.104*** |
| Director - inside director | 0.538 | 0.499 | 0.434 | 0.496 | 0.104*** |
| Director reputation | 2.577 | 3.467 | 1.872 | 2.668 | 0.705*** |
| Director - top management experience | 0.411 | 0.492 | 0.284 | 0.451 | 0.127*** |
| Target or Transaction Characteristics | | | | | |
| CEO is chairman | 0.569 | 0.495 | 0.725 | 0.446 | -0.156*** |
| Proportion of outside directors | 0.490 | 0.288 | 0.539 | 0.282 | -0.049*** |
| Pre-acquisition operating performance | -0.001 | 0.047 | -0.003 | 0.062 | 0.002 |
| Disciplinary CEO turnover | 0.572 | 0.495 | 0.802 | 0.399 | -0.230*** |
| Cash payment | 0.453 | 0.498 | 0.495 | 0.500 | -0.042** |
| Target size: ln(asset) | 19.472 | 2.400 | 18.929 | 2.582 | 0.542*** |

Note: *Significant at the 10% level. **Significant at the 5% level. ***Significant at the 1% level.
"Director - outside director" equals 1 if a director is an outsider, and 0 otherwise. "Director - inside director" equals 1 if a director is an insider, and 0 otherwise. "Director Reputation" is measured by the number of directorships held by a director in other insurance companies. "Director - top management experience" is a dummy variable equal to 1 if a director had CEO experience before acquisition, and 0 otherwise. "CEO is chairman" is a dummy variable equal to 1 if a target firm's CEO is also the chairman of the board, and 0 otherwise. "Proportion of outside directors" is the proportion of outsiders in a target board, calculated by the number of outsiders divided by the board size. Pre-acquisition operating performance is the industry-adjusted average return on assets for the two years prior to the acquisition. "Disciplinary CEO turnover" is a dummy variable equal to 1 if the CEO of a target loses the CEO position within two years after acquisition, and 0 otherwise. "Cash payment" equals 1 if the acquisition is financed by cash, and 0 otherwise.

The overall sample shows that outside directors are less likely to be retained after acquisition. Directors with better reputations and experience as top management are more likely to be retained, but directors from targets that experience disciplinary CEO turnover after acquisition are less likely to be retained. In general, these findings are consistent with the predictions from our hypothesis section. Furthermore, we find that directors from firms that combine the position of CEO and chairman or have a larger proportion of outside directors are less likely to be retained. This suggests that the takeover market penalizes boards with extremely powerful figures and less effective directors, or boards with more independent directors whose value is depreciated in the post-acquisition firm. Target firm size is not a significant determinant of director's retention.[10]

When comparing the regressions for insiders and outsiders, we find that holding more directorships in other insurers, which is a measure of director's reputation, matters more for insiders than for outsiders. This suggests that acquirers value both the reputation and inside knowledge of the directors of target firms when deciding retention. Top management experience is also an important factor in retention for both insiders and outsiders. CEO duality has a negative impact on the retention of outsiders, but no effect on the retention of insiders, suggesting a heavier "penalty" for outside directors who are less capable of performing effective independent monitoring duties. Inside directors are less likely to be retained if the takeover is disciplinary; however the retention of outside directors is not affected by this factor. Consistent with Becher and Campbell (2005) and McLaughlin and Ghosh (2008), pre-acquisition performance (industry adjusted) has no significant impact on the retention of either inside or outside directors. Cash financing of acquisitions deals is negatively related to target firms' director retention, but not statistically significant after adjusting intragroup correlation in the regression.

**Table 5**

Probit analysis—likelihood of target director retention

| Variables | Whole Sample | Outside Directors | Inside Directors | Good Performance | Poor Performance |
|---|---|---|---|---|---|
| Director - outside director | -0.134** | | | -0.118 | -0.146* |
| | [0.055] | | | [0.081] | [0.080] |
| Director reputation | 0.033* | 0.009 | 0.047* | 0.046* | 0.036 |
| | [0.019] | [0.029] | [0.025] | [0.025] | [0.027] |
| Director - top | 0.242*** | 0.299*** | 0.226*** | 0.190* | 0.290*** |
| management experience | [0.062] | [0.109] | [0.080] | [0.101] | [0.078] |
| CEO is chairman | -0.406*** | -0.567*** | -0.227 | -0.204 | -0.519*** |
| | [0.145] | [0.192] | [0.152] | [0.227] | [0.189] |
| Proportion of outside | -0.429* | -0.620 | -0.281 | -0.993*** | -0.065 |
| directors | [0.241] | [0.405] | [0.278] | [0.376] | [0.321] |
| Pre-acquisition operating | 0.318 | -0.482 | 1.059 | -2.248 | 0.867 |
| performance | [1.054] | [1.425] | [1.167] | [1.867] | [1.486] |
| Disciplinary CEO turnover | -0.598*** | -0.332 | -0.971*** | -0.313 | -0.794*** |
| | [0.151] | [0.203] | [0.156] | [0.229] | [0.190] |
| Cash payment | -0.066 | -0.043 | -0.151 | -0.189 | 0.033 |
| | [0.137] | [0.182] | [0.142] | [0.205] | [0.183] |
| Target size: ln(assets) | 0.032 | 0.025 | 0.038 | 0.028 | 0.047 |
| | [0.031] | [0.040] | [0.033] | [0.045] | [0.044] |
| Stock company | -0.141 | -0.141 | -0.157 | -1.012 | 0.07 |
| | [0.289] | [0.350] | [0.356] | [0.635] | [0.324] |
| Unaffiliated company | 0.043 | 0.061 | -0.012 | 0.073 | 0.052 |
| | [0.209] | [0.262] | [0.223] | [0.337] | [0.279] |
| Constant | 0.317 | 0.417 | 0.349 | 1.296 | -0.268 |
| | [0.796] | [1.107] | [0.815] | [1.207] | [1.076] |
| Observations | 2,019 | 1,048 | 971 | 812 | 1,207 |
| Pseudo R-square | 0.082 | 0.067 | 0.120 | 0.086 | 0.119 |

Note: *Significant at the 10% level. **Significant at the 5% level. ***Significant at the 1% level. Standard errors allowing for intragroup correlation are in brackets. "Director - outside director" equals 1 if a director is an outsider, and 0 otherwise. "Director - inside director" equals 1 if a director is an insider, and 0 otherwise. "Director reputation" is the number of directorships held by a director in other insurance companies. "Director - top management experience" is a dummy variable equal to 1 if a director had CEO experience before acquisition, and 0 otherwise. "CEO is chairman" is a dummy variable equal to 1 if a target firm's CEO is also the chairman of the board, and 0 otherwise. "Proportion of outside directors" is the proportion of outsiders in a target board, calculated by the number of outsiders divided by the board size. Pre-acquisition operating performance is the industry-adjusted average return on assets for the two years prior to the acquisition. "Disciplinary CEO turnover" is a dummy variable equal to 1 if the CEO of a target loses the CEO position within two years after acquisition, and 0 otherwise. "Cash payment" equals 1 if the acquisition is financed by cash, and 0 otherwise.

We also compare the determinants of retention for directors from good performance firms and poor performance firms, benchmarked by the return on assets of the industry median firm. We find that outside directors are less likely to be retained if they are from poor performance firms, while the result is not significant for good performance firms. This suggests that if the outside directors fail to work as effective monitors, resulting in poor performance, they are more likely to be dismissed than the insiders. Director reputation helps a director to be retained in a good performance firm, but not if the firm perform poorly. For both types of firms, top management experience are important for retention, which is in line with the findings of McLaughlin and Ghosh (2008) and Harford (2003), suggesting that acquirers prefer directors with better reputations and CEO experience, i.e. those with more valuable human and social capital. Directors of poor performance firms with CEO duality are more likely to lose their directorships, indicating that these directors are more dispensable because of their limited and poor contribution to management monitoring. For poor performance firms, directors are less likely to be retained if the takeover is disciplinary.

## VI. CONCLUSION

The board of directors is considered to have a monitoring role, overseeing the decisions of management in order to protect the interests of the firm and the shareholders. In this paper, we study the U.S. life insurer mergers and acquisitions between 1998 and 2006 to understand the role of target insurer boards in acquisition decisions and the post-acquisition retention of target directors.

We find evidence that board composition does affect the likelihood of acquisition in the life insurance industry, and boards from firms with good and poor performance behave differently. A smaller board is more likely to accept takeover, and boards with a larger fraction of outside directors are more resistant to takeover, especially when their firms perform well. Firms with more reputable boards are more likely, while firms with CEO/chairman duality are less likely, to be acquired, regardless of performance. The results suggest that boards of insurance firms react rationally regarding acquisition decisions.

We also investigate target director retention after acquisition. Outside directors are less likely to be retained than insiders in general, especially if firms underperform in comparison to the industry median, because they are considered ineffective monitors and therefore dispensable. For outside directors, those with CEO experience are more likely to be retained, suggesting acquirers value effective decision makers; while those from firms with CEO dominance are more likely to be removed. For inside directors, experience as CEO or holding directorships in other insurance companies more often results in retention after acquisition. Serving firms with post-acquisition disciplinary CEO turnover tends to reduce the likelihood of retention for insiders.

For directors from targets that perform better than the industry median, better reputation and experience as top management increases chances of retention, but the likelihood of retention is negatively related to the proportion of outsiders on a board. We find no evidence that outsiders are more likely to leave in good performance firms.

Directors from poor performance targets are less likely to be retained if they are outsiders, if CEO duality exists, or if the takeover is disciplinary. This suggests that directors are punished if they are ineffective monitors and are held responsible for a firm's poor performance. Having top management experience increases the chances of retention.

In conclusion, our paper finds that the takeover market is an effective way to enhance corporate governance of firms even in the heavily regulated U.S. life insurance industry. Directors with good reputations, strong executive experience, and rich inside knowledge of the target firm are more likely to be retained post acquisition, whereas directors without these qualities are less likely to be retained.

## ENDNOTES

1. Mutual companies also exhibit a different organizational structure than stock firms, which further differentiates the insurance industry and its governance (Boubakri, 2011).
2. For example, the NAIC model law on Insurance Holding Companies, which has been adopted by the majority of U.S. states, stipulates that when mergers or acquisitions are being considered, acquirers are required to file documents for approval that include all details of the transaction (called Form A filings). For a transaction to be valid, approvals must be obtained in multiple states where the involved parties have operations.
3. A significant number of papers focus on the relationship of management ownership and the likelihood of acquisition; however, we are not able to obtain data on management ownership for this study, so we do not look at ownership in the paper.
4. In contrast, Masulis, Wang, and Xie (2012) found that independent directors based in foreign countries may provide less oversight since they are more likely to miss board meetings. They found that firms with foreign independent directors are associated with higher CEO compensation, higher chance of financial fraud, and slower replacement of poorly performing CEO's.
5. The proportion of outside board members is calculated as the number of outside directors divided by board size. Similar to He and Sommer (2011), we define an outside director as a director who is not one of the current or former officers or their family members. Since a large percentage of firms in our sample are private companies, we are unable to obtain more detailed information about the directors, such as whether they are the friends of officers, consultants, or business partners of the firms.
6. The literature often includes a director's tenure in the analysis; however, we are only able to identify the tenure for a small subset of directors in our sample. The result shows that directors of target firms on average have a shorter tenure than the directors of non-target firms.
7. The sample size of regression is smaller than the number reported in table 1 because of missing observations of some explanatory variables. If an insurer's ROA is exactly on the industry median, the firm is excluded from the subsample regression.
8. In a subsample of firms with director tenure available, we run the probit regression with the average director tenure, and find that the variable is negatively related to the takeover likelihood, which is significant in the regressions of entire sample and poor performance firm sample. This result is consistent with the argument that directors with longer tenure may have more firm-specific human capital, which

makes them more likely to spurn an acquisition offer (Hadlock et al., 1999).

9. We also run probit analyses on a subsample where we can identify a director's tenure. The result shows that outside directors with a longer tenure are less likely to be retained. The result is not significant for inside directors.
10. The literature also uses the relative size of target to acquirer as one explanatory variable. However, because our analysis is at the individual firm level with private targets included, we are not able to calculate accurately the relative size. Nonetheless, we conducted a robustness test using two alternative definition of relative size: (1) target size at (t-1)/size of lead firm of acquirer at (t-1); (2) target size at (t-1)/acquirer size at (t-1) if target is an unaffiliated single firm or a sold subsidiary of a seller; target group size at (t-1)/acquirer size at (t-1) if the whole target group is acquired. The result of this variable is not significant and is therefore dropped from the regression.

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