



American Finance Association

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Source: *The Journal of Finance*, Vol. 58, No. 1 (Feb., 2003), pp. 197-230

Published by: Blackwell Publishing for the American Finance Association

Stable URL: <http://www.jstor.org/stable/3094485>

Accessed: 24/11/2009 08:54

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New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310*

JEFFREY L. COLES and CHUN-KEUNG HOI

ABSTRACT

We examine the relation between a board's decision to reject antitakeover provisions of Pennsylvania Senate Bill 1310 and subsequent labor market opportunities of those same board members. Compared to directors retaining all provisions, directors rejecting all protective provisions of SB1310 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. For external board seats, the results are driven by nonexecutive directors who are not members of the management team; for internal board seats, the results are driven by executive directors.

LABOR MARKET DISCIPLINE—BY MEANS of *ex post* settling up—can motivate managers and directors to act in the interests of the shareholders of the firms they serve (e.g., Fama and Jensen (1983)). If the labor market, either internal to the firm or externally, provides opportunities that managers and directors care about, and the availability of those opportunities is sensitive to “on-the-job” performance, then the incentives of managers and directors will be aligned, at least somewhat, with shareholder interests. On the other hand, if performance has little connection to future opportunities, then the incentive effects of the labor market are minimal and shareholders must rely on other mechanisms to align the incentives of managers and directors with shareholder interests.

In this paper, we use the passage of Pennsylvania Senate Bill 1310 (hereafter SB1310, Act, or Bill) and related events to investigate the operation of the labor market for directors. In particular, we study the relation between the decision by boards of Pennsylvania companies covered by the Bill to reject or retain antitakeover provisions of SB1310 and subsequent service by those board members as directors. Our study is quite broad in that we include both executive and nonexecutive directors and subsequent service both on the board of the relevant Pennsylvania firm and on boards of other companies.

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The sample contains approximately 1,000 directors of the Pennsylvania firms examined in Szewczyk and Tsetsekos (1992) and Wahal, Wiles, and Zenner (1995). We track the board service of these directors for three years following the enactment of SB1310. We find a statistically significant and economically important relation between a board's decision to reject or retain protective provisions of the Act and directors' subsequent service on boards of directors.

On average, directors of firms that rejected all or some of the law's antitakeover provisions gain external directorships over the three years after SB1310. This effect is driven by the subsample of nonexecutive directors¹ (i.e., directors who are not CEO, president, chairman, a family member, or any other current or recent member of management), and the effect is not statistically significant in the subsample of executive directors. In our multivariate formulation, nonexecutive directors are almost three times as likely to obtain at least one additional external directorship as are directors of companies who decided to retain all of the law's provisions. This relation holds only when nonexecutive directors control the board, a circumstance under which such directors are more likely to have had meaningful influence over the "opt-out" decision.

We also examine whether a director's tenure on that Pennsylvania firm's own board is affected by the opt-out decision. For executive directors, there is a strong relation, particularly when executive directors control the board. When management controls the board, an executive/management director of a Pennsylvania company that decides to reject all or some of the law's provisions is roughly 30 percent more likely to retain the board slot with that same Pennsylvania company by the third fiscal year after SB1310. In contrast, there is little evidence of a relation between the opt-out decision and retention of nonexecutive directors on the board.

This study contributes to the literature in several ways. In specific terms, to our knowledge, this paper is the first to provide evidence on how the actions of nonexecutive directors on one board affect opportunities for those directors to serve externally as a director on another board. The results suggest that the external labor market values a nonexecutive director's performance in guiding and limiting managerial discretion. In broader terms, the analysis provides evidence on how performance affects the internal and external prospects for both executive and nonexecutive directors. Our results on the opt-out decision complement the evidence of Gilson (1989, 1990) on bankruptcy; Kaplan and Reishus (1990) on dividend cuts; and Brickley, Coles, and Linck (1999, 2000) on stock and accounting performance. Along with other major corporate events, such as bankruptcy and large dividend cuts, the SB1310 opt-out decision has significant power to explain labor market prospects for directors.

The rest of the paper proceeds as follows. Section I provides relevant background and motivation for our study. Section II describes the sample, explains the data collection procedure, and defines variables used in the empirical analy-

¹In this study, we use the terms non-executive directors and non-management directors interchangeably. Thus, the terms executive directors and management directors are also synonymous.

sis. Section III describes the results on the effect of the opt-out decision on retention of directors on the board of the Pennsylvania firm. Section IV, which contains the central results of this study, examines the effect of the opt-out decision on external opportunities for directors. Section V concludes.

I. SB1310 and the Market for Directors

In this paper, in the context of the decision by the board of whether to reject the restrictive antitakeover provisions of Pennsylvania Senate Bill 1310, we examine the relation between a director's reputation in monitoring managers and his subsequent service on boards of directors. With a few notable exceptions, the primary focus of prior work on the labor market for directors and managers has been on retention and turnover of top executives. Numerous empirical studies provide evidence on turnover of the top management team when firm performance is poor² or when the firm faces financial distress.³ Studies that broaden the focus to encompass the external labor market and/or all members of the board of directors tend to examine board membership. This is quite natural because, just as managers and directors care about promotion and compensation in their own organizations, they also are likely to care about board seats in other companies. In addition to status and visibility in the community, pension plans, insurance, and other benefits and perquisites, board service can be lucrative.⁴ Proceeding on the assumption that managers and directors care about board seats, several studies examine the relation between board service and performance. Kaplan and Reishus (1990) find that executives of companies that reduce dividends are about 50 percent less likely to receive additional external directorships than are top executives of companies that do not cut their dividends. Brickley et al. (1999) find that both the likelihood that a retired CEO serves on his own board after retirement and the likelihood of serving as an external director on other boards are positively and strongly related to firm performance while CEO. Furthermore, Gilson (1990) examines a sample of companies that either file for bankruptcy or restructure their debt and finds that only 46 percent of incumbent directors remain on the board afterward and that directors who depart hold significantly fewer seats on other boards than remaining directors.

These and other papers tend to support the claim that the labor market helps to align managerial incentives with shareholder interests. Accordingly, it is not a controversial proposition that the external labor market rewards good managers. Certainly, it is difficult to provide a plausible explanation for why firms systematically would hire outside managers who did a poor job elsewhere.

² See, for example, Coughlan and Schmidt (1985); Warner, Watts, and Wruck (1988); Klein and Rosenfeld (1988); and Blackwell, Brickley, and Weisbach (1994).

³ For example, see Gilson (1989) and Cannella, Fraser, and Lee (1995).

⁴ Byrne (1996) finds that average annual pay for an outside director serving on a single board in the mid-1990s was \$44,000 (with a maximum of \$368,000 per year at United Healthcare). Brickley et al. (1999) estimate that Allen Jacobson, after retiring as CEO of 3M a decade prior, was receiving approximately \$595,000 per year for serving on the boards of 11 large companies.

It remains unclear, however, whether the external labor market provides corporate directors, particularly those who do not also hold an executive position, with significant incentives to supervise and guide the exercise of managerial discretion on behalf of their shareholders. The underlying reason is that directors are chosen using a process under which top management has a significant amount of discretion and control. This observation suggests at least two scenarios. First, given the selection process, it is reasonable to posit that management is most likely to nominate a director who would comply with management desires on important issues. For example, in terms of the demand for Pennsylvania firm directors to serve on other boards, other firms may be disinclined to appoint directors with a propensity to dilute the power and control of a management team (e.g., directors who favor rejecting the protective provisions of SB1310). Second, the ability of management to co-opt directors could lower the power of inference from observing board actions about directors. Since the inside operation of a board is not very visible to outsiders, the external market must assess director performance by means of observable board decisions. But, if the market perceives nonexecutive directors as co-opted by top management, board decisions, which presumably are determined by top management, would provide little information on nonexecutive directors. Then the market for external board seats, in assessing nonexecutive directors, would ignore board decisions. Under both of these scenarios, there is a nontrivial possibility that there will be no observable relation between board decisions and prospects in the external market for board seats. In sum, therefore, it is an open empirical question whether the external labor market provides incentives for directors to perform by connecting board decisions and external labor market opportunities.

Pennsylvania Senate Bill 1310 presents a natural opportunity to provide evidence on the market for directors. SB1310 is generally perceived to be the most sweeping of the many state antitakeover laws adopted over the last 15 years (Karpoff and Malatesta (1989), Szewczyk and Tsetsekos (1992), Janjigian and Trahan (1996)). Szewczyk and Tsetsekos find that, on average, Pennsylvania firm abnormal stock returns were -9.093 percent from introduction (October 20, 1989) to enactment (April 27, 1990) of the Bill. Based on this figure, Szewczyk and Tsetsekos estimate that SB1310, presumably by insulating firms and the corresponding managers and directors from the market for corporate control, cost shareholders of Pennsylvania companies at least \$4 billion. Consistent with the anticipation of such costs, the Bill drew strong opposition from numerous parties, including major institutional investors, the financial press, and academic observers.

While the five central provisions⁵ in SB1310 provide extreme protection against hostile takeovers, the Bill also contained a provision allowing boards of

⁵SB1310 contains three provisions, the control share provision, the disgorgement provision, and the fiduciary duty provision, that protect the company and management from hostile takeovers. In addition, SB1310 contains two provisions designed to protect employees against loss of pay and loss of job in the takeover process, the employee severance provision and the labor contracts provision.

directors of firms incorporated in Pennsylvania to opt out within 90 days of the enactment date, without shareholder approval,⁶ from one or more of the antitakeover provisions.⁷ Some boards chose to do so, and those firms that rejected all provisions of the Bill averaged a statistically significant, positive, abnormal, two-day, announcement-period stock return of 0.650 percent (Szewczyk and Tsetsekos (1992)).⁸ Furthermore, firms that opted out exhibited significantly better accounting performance two years after enactment (Janjigian and Trahan (1996)). Thus, the right to opt out of (or remain covered by) the provisions of Pennsylvania SB1310 provides the opportunity for a natural experiment. In deciding whether to exempt the firm from the protective provisions of SB1310, board members will have balanced the concerns of shareholders against their own interests, including the potential loss of compensation, firm-specific human capital, and control, as well as reputation effects in the labor market. For nonmanagement directors, the decision is likely to be affected by the fact that such directors, to some extent, serve at the pleasure of top management. It is in this context that our paper examines the relation between the board's opt-out decision and the subsequent opportunities of members of that board, including both management and nonmanagement directors, to continue to serve on the same board and to serve on other boards.

II. Sample Construction and Control Variables

A. Sample Design

Our sample is based on the 109 firms incorporated in Pennsylvania at the time of enactment of SB1310 (April 27, 1990) that were also listed on NYSE, AMEX, or NASDAQ.⁹ This set of firms excludes the Pennsylvania firms for which we could not obtain proxy statements either before or after the opt-out decision (five firms) and those that were acquired (four firms), merged (two firms), or filed for bankruptcy (one firm) within three years after the enactment of SB1310. We exclude firms that are involved in control actions and financial distress because these circumstances are likely to affect materially directors' career prospects.¹⁰

⁶ After the 90-day period, shareholders can opt out of some or all provisions by majority vote.

⁷ Since the employee severance and labor contracts provisions are triggered by control share approval, a firm that opts out of the control share provision is also considered to have opted out of these two provisions protecting interests of employees. See Szewczyk and Tsetsekos (1992) and Wahal et al. (1995) for detailed descriptions of the provisions and further discussion of the decision to opt out.

⁸ Other estimates of the advantage to opting out are higher. For example, Swartz (1996) finds that firms that opted out had 18 percent higher stock returns than firms that did not opt out over a 190-day event window containing passage of the Act.

⁹ We are grateful to Szewczyk and Tsetsekos (1992) and Wahal et al. (1995) for providing their data.

¹⁰ Complete information is available for only three of the six firms involved in control transactions. When the analysis includes the firms involved in control actions, the results are essentially the same as those reported below.

Consistent with Szewczyk and Tsetsekos (1992), who find that the stock market reacts more positively to the decision to reject all antitakeover provisions in SB1310, we partition the firms into three groups. There are 24 firms that rejected all antitakeover provisions (ALLOUT) stipulated by Pennsylvania SB1310. The group of SOMEOUT firms consists of 33 firms that rejected some (but not all) provisions. The 52 NONEOUT firms chose to retain full protection of SB1310. Our primary hypothesis is that subsequent opportunities in the labor market are different across these three groups of Pennsylvania firms differentiated by the opt-out decision.

An *incumbent director* is a member of the board of one or more of the 109 firms in the sample before Pennsylvania SB1310 was introduced. The firm's senior executives are included if they also serve as board members. For each firm in our sample, we obtain the most recent proxy statement mailed on or before October 20, 1989, the day SB1310 was introduced before the Pennsylvania legislature. This *year - 1* proxy identifies all incumbent directors as well as the other (external) board seats they held within a year before SB1310 was introduced and, thus, prior to the opt-out decision. The snapshot at this time point provides the benchmark for the analysis.

The *year + 3* date is the proxy mailing date closest to three years after SB1310 was signed into law (April 27, 1990). At this time point, the market has observed the board's decision of whether to opt out of SB1310 and has had time to reward or penalize incumbent directors. We collect the proxy statements for *year - 1* and *year + 3* from the Q-file. Most base statements (*year - 1*) were mailed in the first six months during 1989. Generally, there is a time lapse of between three and four calendar years between the base statement and the *year + 3* proxy statement date.

For incumbent directors who remain with their firms, we obtain the necessary information on *external* board seats, that is, seats held on the board of another company, from the Pennsylvania firm proxy statements. But, if an incumbent director leaves his board, then the Pennsylvania firm's proxy statement in *year + 3* will no longer list his external directorships. In this case, we determine his external directorships from the proxy statement of any other public company on which board he serves, either as a director or as an executive, and from *Standard and Poor's Register of Corporations, Directors, and Executives*. As a final check, we use the December 1993 edition of Compact Disclosure to search for all directors whose information after SB1310 remains unavailable given the above procedures.

Based on the *year - 1* proxies, the entire sample contains 1,005 incumbent director observations. Following Kaplan and Reishus (1990), we exclude 17 directors who are confirmed as dead or retired before 1993. We use the 988 remaining directors to study the incumbent's *internal* prospects (i.e., director turnover/retention) in the Pennsylvania firm. Of these, 166 also are CEO, president, and/or chairman of the board of the Pennsylvania firm at *year - 1*. Of the 822 directors who did not hold at least one of these three positions in 1989, 243 satisfy one or more of the following: (1) formerly (prior to 1989) was the CEO, president, and/or chairman of the board; (2) held in 1989 or formerly held a position as some other officer or executive (e.g., CFO, vice president, COO); and/or (3) was a relative of a

1989 member of top management. Thus, the sample contains 409 (243+166) management (executive) directors and 579 *nonexecutive* directors.

When examining external directorships, we exclude 209 incumbent directors for whom information in the sources described above was insufficient to identify the external board seats held after SB1310. Thus, the subsample used in analyzing external directorships contains at most 779 incumbent directors. Of these, 137 initially are CEO, president, and/or chairman of the board of the Pennsylvania firm, 308 are classified as executive directors, and 471 are nonexecutive directors.

We note that corporate directors often serve as board members in nonprofit organizations, local banks, and small local companies. To the extent that these organizations are not publicly-traded companies, the importance of these appointments is difficult to interpret. For this reason, most studies do not include board seats in private organizations (e.g., Gilson (1990), Kaplan and Reishus (1990), and Booth and Deli (1996)). We follow this convention. We use CRSP, COMPUSTAT PC Plus, *Compact Disclosure*, *Standard and Poor's Register of Corporations, Directors, and Executives*, and *Moody's Manuals* to determine whether a firm is publicly traded. We include only board seats held in firms covered by these sources. Once again, in this study, an external directorship is defined as an appointment on the board of directors of another publicly traded firm. Such board seats are held in addition to the internal seat on the board of the original Pennsylvania firm.

The change through time in the number of external directorships held is defined as the net addition in the total number of external directorships held by the director. When a director gives up an external directorship for another, the net change is zero. If a director in the sample loses an external directorship because the firm on whose board he serves is taken over or merged into another company, we do not count that as a lost board seat. These procedures are consistent with Kaplan and Reishus (1990).

B. Other Variables

Any experiment that isolates successfully the implications of the opt-out decision must control for the quality of the Pennsylvania firm and the associated board of directors. Thus, we include a range of explanatory variables that represent firm characteristics and director attributes. We collect from the base (year -1) proxy statement information concerning the incumbent director's age, tenure, occupation, and other board seats. Director tenure is the number of years the incumbent director has served on the Pennsylvania firm's board before Pennsylvania SB1310 was introduced in 1989. Following Weisbach (1988), Byrd and Hickman (1992), Brickley, Coles, and Terry (1994), and others, we rely on the base year proxy statement to apply a three-way classification scheme to categorize corporate directors. *Outside* directors are board members who do not have any obvious relationship with the firm or its senior executives that potentially would give rise to a conflict of interest. *Inside* directors are current or past employees of the firm and their relatives. All other directors are defined as *gray* directors. Gray directors include lawyers, consultants, bankers, and investment bankers

who are either currently providing or have provided services to the firm. Gray directors also include interlocking directors and executives from buyers of output(s) or suppliers of input(s).

Finally, we obtain accounting data from COMPUSTAT PCPlus and stock return data from CRSP. Firm size is measured either as net sales or total assets at fiscal year-end 1989. Research intensity is the ratio of research expenditures to net sales for the 1989 fiscal year. In cases where R&D expenditure is missing, one convention, which we follow, is to set R&D equal to zero (e.g., Bizjak, Brickley, and Coles (1993), among others). Consistent with Kaplan (1989) and Denis and Denis (1995), accounting (operating) performance is defined as the ratio of operating income before depreciation divided by the book value of total assets. We calculate performance for fiscal year 1989 and the yearly average based on the 1990, 1991, and 1992 fiscal years. Performance is adjusted by subtracting the median of the same performance measure over the same time period of firms in the same industry (two-digit SIC).

C. Sample Statistics

Table I provides background information on the 109 sample firms and 988 incumbent directors before the introduction of Pennsylvania SB1310. We report information for the entire sample and for the three groups defined by the opt-out decision. Table I indicates that NYSE/AMEX firms opted out of at least some of the protections of SB1310 relatively more often than did Nasdaq firms (34 of 51, or 66.6 percent, versus 23 of 58, or 39.6 percent). Furthermore, firms that opt out of more provisions tend to have higher sales, more assets, and lower research intensity. This result on R&D to sales is consistent with Wahal et al. (1995), who find that higher research intensity is associated with a lower probability that a Pennsylvania firm will reject at least one SB1310 provision. There is no obvious relation between the extent of opting out of the protections of SB1310 and accounting and stock performance. Nevertheless, in part because of the evidence in Brickley et al. (1999, 2000) on prior performance and directorships held by retired CEOs, it appears that any experiment that isolates the effects of the opt-out decision on labor market prospects must control for firm performance.

Board size and the proportion of nonexecutive (outside and gray) directors on the Pennsylvania firm board are positively associated with whether the board opts out of some or all provisions of SB1310. As shown in Panel B, director age and tenure are not strongly associated with the opt-out decision. Directors in companies that opt out are more likely to hold a high-profile board seat in a *Fortune* 1000 firm and are less likely to hold the CEO, president, and/or chairman of the board title in the Pennsylvania firm.

For 779 directors, information on subsequent director positions on other boards is available. We use this subsample in all tests concerning the opportunity to serve on other boards. Selection bias does not appear to be an issue. Comparing Panels B and C, we find there are no statistically significant differences, in terms of representation across the three opt-out categories and other director

attributes, between the full sample of 988 directors and the subsample of 779 directors with complete data on external board seats.

III. The Opt-Out Decision and Director Retention

Numerous studies provide evidence on top-management turnover (see footnote 1), and a few papers—including Kaplan and Reishus (1990), Gilson (1990), and Brickley et al. (1999, 2000)—examine director turnover. Tables II–IV present results complementing and extending this latter group of studies. In particular, we examine the relation between the opt-out decision and retention of incumbent directors in the Pennsylvania firms covered by SB1310. Retention is when an incumbent director who serves the Pennsylvania firm before introduction of SB1310 continues to serve on that board by the third year ending after enactment of SB1310.

A. Incidence of Pennsylvania Firm Director Retention Surrounding PA SB1310

Table II shows that about 71 percent (703 of 988) of incumbent directors remain by the third fiscal year ending after the opt-out decision.¹¹ Directors from firms that rejected all or some provisions of SB1310 are less likely to depart. Of directors in the *ALLOUT* group, 72.5 percent retain their board slot, while 73.8 percent in the *SOMEOUT* group remain. By way of comparison, 68.1 percent of the directors in the *NONEOUT* group retain their board slot. These proportions are not significantly different using the χ^2 goodness-of-fit test ($p = 0.202$). Nevertheless, the difference between the *NONEOUT* directors and the *SOMEOUT* and *ALLOUT* directors grouped together is significant at the 10 percent level ($p(\chi^2) = 0.079$). Table II reveals a similar pattern for the subsets of incumbent executive directors (Panel B) and nonexecutive directors (Panel C). These proportions, however, are not significantly different at conventional significance levels based on the χ^2 -test.

B. Logit Analysis of Director Retention

Having provided weak univariate evidence that directors from Pennsylvania firms rejecting all or some antitakeover laws of SB1310 are more likely to be retained on their own boards, we use multiple regression to examine further the linkage between the opt-out decision and director retention. The dependent variable in the logit models is a dummy variable that takes on the value of one if an incumbent director still holds his Pennsylvania firm board seat by the third fiscal year ending after SB1310; it equals zero otherwise.

¹¹The implied frequency of director turnover is comparable to that reported in other studies. Hermalin and Weisbach (1988) examine a sample of NYSE-listed firms during 1971 to 1983. They find turnover of approximately one director per year. Since the median firm in their sample has 13 members on the board, their finding implies an annual director turnover ratio of approximately 7.7 percent. Over a four-year interval, the implied turnover rate should be roughly 30.8 percent, which is comparable to the 29 percent turnover rate reported in Table II.

Table I
Summary Statistics for Selected Firm Characteristics and Board/Director Attributes

The sample consists of 109 firms incorporated in Pennsylvania before SB1310 and 988 associated (in 1989) directors. Data are collected from the firms' proxy statements with mailing dates in 1989 preceding the introduction of SB1310 and from COMPUSTAT for the same fiscal year before SB1310 and from CRSP for 1989 to 1993. Executive directors are incumbent directors who are CEO, president, chairman, CFO, COO, family member, and/or any other present or past member of the management team. Statistics are presented for the full sample and by opt-out decision.

Variable	All firms/directors	Sample firms/directors by PA SB1310 opt-out decision		
		<i>ALLOUT</i> (rejected all provisions)	<i>SOMEOUT</i> (rejected some provisions)	<i>NONEOUT</i> (rejected no provisions)
<i>Panel A: Characteristics of the firm and the board in the full sample</i>				
Number of firms	109	24	33	52
Number of NYSE or ASE firms	51	16	18	17
Mean net sales (in \$millions)	945.93	1535.78	929.75	683.96
Mean book total assets (in \$millions)	1,874.82	3,067.60	2,595.67	866.85
Mean R&D to net sales	0.038	0.015	0.037	0.049
Median operating income before depreciation scaled by book total assets, 1989	0.121	0.121	0.116	0.132
Median operating income before depreciation scaled by book total assets, 1990 to 1992	0.110	0.113	0.100	0.116
Median stock return, 1989	0.149	0.144	0.197	0.157
Median stock return, 1990 to 1992	0.174	0.061	0.273	0.198
Mean board size	9.23	10.25	10.30	8.07
Mean proportion of executive directors on the board	0.409	0.389	0.392	0.483
Proportion of boards with at least 50% executive directors	0.346	0.320	0.305	0.500

<i>Panel B: Characteristics of incumbent directors in the full sample</i>				
Number of directors (% of total)	988	240 (24.3%)	340 (34.4%)	408 (41.3%)
Proportion CEO, chairman, and/or president of Pennsylvania company	0.168	0.158	0.147	0.191
Proportion CEO, chairman, and/or president of another company	0.509	0.508	0.556	0.471
Proportion holding a <i>Fortune</i> 1000 board seat	0.314	0.433	0.362	0.203
Mean age of directors	57.3	57.9	58.0	56.3
Mean number of years as director	9.42	9.11	9.60	9.46
<i>Panel C: Characteristics of incumbent directors in the subsample with data on external directorships (board seats held in other firms)</i>				
Number of directors (% of total)	779	194 (24.9%)	278 (35.7%)	307 (39.4%)
Proportion CEO, chairman, and/or president of Pennsylvania company	0.176	0.165	0.151	0.205
Proportion CEO, chairman, and/or president of another company	0.525	0.510	0.568	0.495
Proportion holding a <i>Fortune</i> 1000 board seat	0.341	0.448	0.378	0.241
Mean age of directors	56.7	57.0	57.2	56.1
Mean number of years as director	9.19	8.77	8.88	9.75

Table II
Proportion and Total Number of Incumbent Directors Who Retain a Seat on the Pennsylvania Firm's Board
Three Years after Pennsylvania SB1310

An incumbent director is a board member serving at least one of the 109 publicly traded Pennsylvania firms in 1989 before the introduction of Pennsylvania SB1310. Seventeen incumbent directors that died or retired before 1993 are excluded from the sample. Nonexecutive directors are those who are not CEO, president, chairman, CFO, COO, a family member, and/or any other present or past member of management.

	All directors	Incumbent directors by PA SB1310 opt-out decision		
		<i>ALLOUT</i> (rejected all provisions)	<i>SOMEOUT</i> (rejected some provisions)	<i>NONEOUT</i> (retained all provisions)
<i>Panel A: All incumbent directors</i>				
Number of directors	988	240	340	408
Proportion (number) of incumbent directors who continue to serve on the board of the Pennsylvania firm three years after PA SB1310	0.712 (703)	0.725 (174)	0.738 (251)	0.681 (278)
Test for differences in proportions				
1) Across all three groups			$p(\chi^2) = 0.20$	
2) <i>NONEOUT</i> vs. Other groups			$p(\chi^2) = 0.08$	
<i>Panel B: Incumbent executive directors of a Pennsylvania firm</i>				
Number of directors	409	88	122	199
Proportion (number) of incumbent executive directors who continue to serve on the	0.694 (284)	0.727 (64)	0.705 (86)	0.673 (134)

board of the Pennsylvania firm three years after PA SB1310 Test for differences in proportions		$p(\chi^2) = 0.63$ $p(\chi^2) = 0.37$	
1) Across all three groups			
2) <i>NONEOUT</i> vs. other groups			
<i>Panel C: Incumbent non-executive directors of a Pennsylvania firm</i>			
Number of directors		152	209
Proportion (number) of incumbent non-executive directors who continue to serve on the board of the Pennsylvania firm three years after PA SB1310		0.723 (419)	0.757 (165)
Test for differences in proportions			
1) Across all three groups			$p(\chi^2) = 0.29$
2) <i>NONEOUT</i> vs. other groups			$p(\chi^2) = 0.16$

Most control variables are based on the 1989 fiscal year—that is, just prior to the introduction of Pennsylvania SB1310. The intention is to ensure that the control variables are predetermined in relation to the opt-out decision. We include measures of firm size (book value of total assets) and research intensity (ratio of R&D expenditures to net sales) for two reasons. First, Wahal et al. (1995) find that research intensity and firm size significantly affect a firm's decision to reject at least one provision stipulated by Pennsylvania SB1310. Second, some firms, with long-term investment projects such as R&D, may actually benefit from retaining the protections of SB1310 (e.g., Chordia and Hirshleifer (1992) and Bizjak et al. (1993)).

We include operating performance for 1989 as well as for the three-year period following the passage of SB1310 (1990 to 1992, annualized) as control variables. Performance is adjusted by subtracting the time and industry matched (two-digit SIC) median.¹² Other variables are included in the regression models to control further for the influence of director attributes. One measure of director quality, beyond firm performance, is whether the director sits on the board of another firm that is a *Fortune* 1000 company. The idea is that only those perceived to be top directors will hold such a board seat. *FORTUNEDIR89* equals one if the director holds such a board seat in a *Fortune* 1000 company in 1989 and zero otherwise. Some firms require their board members to *retire* at the age of 70. Thus, we include a dummy variable, *RETIRE*, that takes on the value of one if the director is between 65 and 69 years old during 1989. We use two dummy variables to identify directors who are also top managers. *OWNTOPMGR* takes on the value one if the director is also the chairman, CEO, and/or president of that Pennsylvania firm; it equals zero otherwise. *OTHTOPMGR* takes on the value of one if the director is the chairman, CEO, and/or president of any other publicly traded company. In some specifications, we also control for whether the board member is an affiliated director. *AFFDIR* equals one if the director is either a gray director or an inside director who is not CEO, chairman, or president. Consistent with Kaplan and Reishus (1990), we control for the number of external board seats a director held before SB1310 as well as own-firm director turnover. Our specification permits a nonlinear relation with respect to the number of external board seats held by directors. This allows for the possibility that the first couple of board seats are a reflection of the attractiveness of the director, but too many board seats would make it difficult for a director to fulfill the obligations of any one board position. *NDIR2* is the minimum of the external board seats held in 1989 and 2, while *NDIRG2* is the maximum of the number of external board seats held in 1989, minus 2, and 0.

¹² We also estimate every specification controlling instead for either industry-median-adjusted stock performance (including distributions) and change in operating performance (1989 versus 1990 to 1992). In the latter case, the idea is to control for a contemporaneous shift in accounting performance over the period in which changes in directors' career opportunities are measured (Janjigian and Trahan (1996) and Brickley et al. (1999, 2000)). For both stock performance and change in accounting performance, the regression results are similar to the results reported herein based on median-adjusted accounting performance.

We use dummy variables to represent the extent of opt-out. The variable *ALLOUT* (*SOMEOUT*) takes on the value of one if the director's board rejected all (some, but not all) antitakeover provisions of SB1310; it equals zero otherwise. *OPTOUT* equals one if *ALLOUT* or *SOMEOUT* equals one. Some specifications include both *ALLOUT* and *SOMEOUT* on the presumption that the market views a partial opt-out less favorably than a full opt-out. Other specifications include *OPTOUT* only. In either case, a positive coefficient on the *ALLOUT* (*SOMEOUT*/ *OPTOUT*) variable indicates that an incumbent director of a firm that rejected all (some/some or all) antitakeover provisions of SB1310 is more likely to retain his board seat vis-à-vis a director of a firm that retained the complementary set of the law's provisions, holding other factors in the model constant.

Table III reports the results of six multivariate logit regressions relating the probability that an incumbent director is retained on his own board to the opt-out decision and other control variables. Models 1 and 2 rely on the full sample of incumbent directors ($N = 988$), excluding only those board members who are verified as either dead or retired according to proxy statements. The coefficients on the variables representing the opt-out decision are positive and generally significant at conventional levels. When the model combines both full and partial rejection of the provisions of SB1310 (Model 1), the estimated coefficient on *OPTOUT* is significant at five percent ($p = 0.023$). When the model distinguishes between partial and full opt-outs (Model 2), the corresponding coefficients are significant at five percent (*SOMEOUT* $p = 0.033$) and 10 percent (*ALLOUT* $p = 0.099$).

We perform a similar analysis for the subsamples of executive and nonexecutive directors. The only modification is that we interact the opt-out dummies with dummy variables that indicate whether the corresponding type of director controls the board.¹³ The logic behind this is that directors of a certain type will have a meaningful influence over the opt-out decision only when such directors have significant representation on the board. *EXECBRD* equals one if the percentage of executive directors is at least 50 percent, in which case executive directors are likely to have substantial influence over board decisions; *EXECBRD* equals zero otherwise. $NONEXECBRD = 1 - EXECBRD$ equals one if the percentage of non-executive directors on the boards exceeds 50 percent; it equals zero otherwise. In Model 3 of Table III, the estimated coefficient on the interaction of *OPTOUT* and *EXECBRD* is highly significant ($p = 0.013$). In Model 4, the coefficients on the interaction of *EXECBRD* with *ALLOUT* ($p = 0.051$) and *SOMEOUT* ($p = 0.073$) are significant at the 10 percent level. In contrast, using the subsample of nonexecutive directors (Models 5 and 6), none of the analogous coefficients (on the interaction of opt-out dummies with board control dummies) are significant. In sum, Table III indicates that the results for the full sample appear to be driven by the subsample of executive directors when those directors control the board.

Other coefficients, including those meant to proxy for director quality and firm performance, by and large behave as expected. Prior industry-median-adjusted

¹³ We are grateful to the referee for suggesting this specification.

Table III
Logit Estimates of the Probability of Director Retention

Logit estimates of the probability of retaining own-firm board seats as indicated by the proxy statement for the third fiscal year ending after the decision whether to opt out of Pennsylvania SB1310. Observations in Models 1 and 2 include the entire sample ($N = 988$) of incumbent directors serving the 109 Pennsylvania firms before the opt-out decision. Models 3 and 4 include executive directors who are CEO, president, chairman, CFO, COO, a family member, and/or any other past or present member of management ($N = 409$). Models 5 and 6 include non-executive directors ($N = 579$). Sample size varies due to missing data. Note: $p(t)$ -values are in parentheses.

Dependent variable equals 1 if incumbent director retains his board seat in the Pennsylvania firm by the third fiscal year ending after the opt-out decision, 0 otherwise						
Variables	All incumbent directors (<i>N</i> = 988)		Executive directors (<i>N</i> = 409)		Non-executive directors (<i>N</i> = 579)	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Intercept	1.003 (0.000)	1.004 (0.000)	0.479 (0.011)	0.483 (0.010)	0.903 (0.000)	0.904 (0.000)
<i>OPTOUT</i> (1 = rejected some or all provisions of SBI310, 0 otherwise)	0.357 (0.023)					
<i>ALLOUT</i> (1 = rejected all provisions of SBI310, 0 otherwise)		0.331 (0.099)				
<i>SOMEOUT</i> (1 = rejected some provisions of SBI310, 0 otherwise)		0.372 (0.033)				
<i>OPTOUT</i> × <i>NONEXECBRD</i> (1 = the proportion of nonexecutive directors on the board exceeds 50%, 0 otherwise)			− 0.044 (0.874)		0.295 (0.195)	
<i>OPTOUT</i> × <i>EXECBRD</i> (1 = the proportion of executive directors on the board is at least 50%, 0 otherwise)			0.816 (0.013)		0.478 (0.181)	
<i>ALLOUT</i> × <i>NONEXECBRD</i>				− 0.130 (0.742)		0.206 (0.487)
<i>ALLOUT</i> × <i>EXECBRD</i>				0.921 (0.051)		0.263 (0.589)
<i>SOMEOUT</i> × <i>NONEXECBRD</i>				0.004 (0.989)		0.341 (0.173)
<i>SOMEOUT</i> × <i>EXECBRD</i>				0.740 (0.073)		0.682 (0.165)
Industry median adjusted annual accounting performance, 1989	2.878 (0.000)	2.886 (0.000)	3.044 (0.005)	3.052 (0.005)	3.435 (0.003)	3.491 (0.003)
Industry median adjusted annual accounting	0.239 (0.784)	− 0.244 (0.780)	− 1.107 (0.399)	− 1.146 (0.385)	0.740 (0.556)	0.742 (0.547)

[illegible]

Table IV
Implied Probabilities of Director Retention

Probability of the incumbent director continuing to serve the Pennsylvania firm board three years after the opt-out decision, as implied by the estimates of the logit regressions reported in Table III. The probabilities are calculated based on all control variables, including indicator variables, set at median values, unless otherwise specified. An incumbent director is a board member serving at least one of the 109 publicly traded Pennsylvania firms in 1989 before the introduction of Pennsylvania SBI310. Seventeen incumbent directors died or retired before 1993 and are excluded from the sample. Executive directors are those who are CEO, president, chairman, CFO, COO, a family member, and/or any other past or present member of management.

Independent Variables	Incumbent directors by PA SBI310 opt-out decision		
	ALLOUT (rejected all provisions)	SOMEOUT (rejected some provisions)	NONEOUT (retained all provisions)
<i>Panel A: Probabilities implied by estimates of Model 2 in Table III (entire sample of incumbent directors, N = 988)</i>			
Base case (FORTUNEDIR89 = 0, other variables set at median values)	0.805	0.811	0.747
Served externally as a director of a Fortune 1000 firm in 1989 (FORTUNEDIR89 = 1, all else base case)	0.862	0.867	0.818
1989 accounting performance higher than mean by two standard deviations (all else base case)	0.905	0.909	0.873
<i>Panel B: Probabilities implied by estimates of Model 4 in Table III (incumbent executive directors, N = 409)</i>			
Base case (NONECECIRD = 0, EXECEIRD = 1, FORTUNEDIR89 = 0, other variables set at median values)	0.806	0.776	0.624
Proportion of nonexecutive directors on the board is at least 50% at the opt-out decision in 1989	0.592	0.625	0.624

(<i>NONEXECBRD</i> = 1, <i>EXECBRD</i> = 0, all else base case)				
Served externally as a director of a <i>Fortune</i> 1000 firm in 1989 (<i>FORTUNEDIR89</i> = 1, all else base case)	0.836	0.809		0.669
1989 accounting performance higher than mean by two standard deviations (all else base case)	0.919	0.904		0.819
<i>Panel C: Probabilities implied by estimates of model 6 in Table III (incumbent nonexecutive directors, N = 579)</i>				
Base case (<i>NONEXECBRD</i> = 1, <i>EXECBRD</i> = 0, <i>FORTUNEDIR89</i> = 0, other variables set at median values)	0.756	0.780		0.716
Proportion of non-executive directors on the board is at least 50% at the opt-out decision in 1989 (<i>NONEXECBRD</i> = 0, <i>EXECBRD</i> = 1, all else base case)	0.767	0.833		0.716
Served externally as a director of a <i>Fortune</i> 1000 firm in 1989 (<i>FORTUNEDIR89</i> = 1, all else base case)	0.807	0.827		0.773
1989 accounting performance higher than mean by two standard deviations (all else base case)	0.885	0.899		0.863

accounting performance (1989), though not adjusted 1990 to 1992 accounting performance, has a significantly positive effect on the probability of director retention. Holding a *Fortune* 1000 board slot increases the likelihood of director retention, while retention is less likely when the firm is larger, when the director is nearing retirement age, and when the CEO departs during 1990 to 1992. This last result, in part, is due to members of the departing CEO's management team departing as well. Thus, based on the demonstrated association in the literature between CEO turnover and performance, it is possible that the CEO turnover indicator variable subsumes the explanatory power we expect from firm performance during the 1990 to 1992 period.

Table IV provides estimates of the probability that a director will be retained based on the parameter estimates from the logit models. Unless otherwise specified, explanatory variables are set at the sample median. The results indicate that the univariate findings of Table II are robust to controlling for other factors. For the full sample and both subsamples based on the executive/nonexecutive distinction, the probability of director retention is higher when the board opts out of the provisions of SB1310, when accounting performance is high, and when the director holds an external seat on the board of a *Fortune* 1000 firm.

The subsample of executive directors drives the Table III regression results for director retention. Accordingly, Panel B of Table IV (based on the parameter estimates for Model 4 of Table III) shows that there is a 62.4 percent chance that an executive director (with no *Fortune* 1000 board seat) on a management-controlled board from a *NONEOUT* firm will still be on the board by year +3. By way of comparison, an executive director of a *SOMEOUT* firm has a higher probability of retaining his board slot of 77.6 percent, while the probability for his counterpart in the *ALLOUT* firm is 80.6 percent. All else equal, these parameter estimates imply that a Pennsylvania firm director is 29.2 percent more likely to retain his board slot in that same Pennsylvania firm when the board decided to reject all provisions of SB1310 [$0.292 = (0.806 - 0.624)/0.624$]. In contrast, there is very little variation in executive director retention probability based on the opt-out decision when management does not control the board. The opt-out decision is important for retention of executive directors on the Pennsylvania firm board, but it is important only when those directors control the board and, presumably, have substantial influence over the opt-out decision.

Based on Panel B, compared to the base case, holding the opt-out decision constant, the retention rate for management/executive directors is substantially higher when prior (1989) industry-median-adjusted accounting performance is increased by two standard deviations and is somewhat higher when the director holds a high-profile (*Fortune* 1000) external board seat. In contrast, while not reported in the table, the number of external board seats held by an executive director has very little economic importance for the probability of director retention. This is a reflection of the nonlinear specification employed.

IV. The Opt-out Decision and External Board Service of Incumbent Directors

To this point, the evidence suggests that the internal market for directors rewards directors for actions perceived to be consistent with shareholder interests. Just as the internal labor market provides incentives for directors, so would the external labor market. According to this argument, we expect that directors of companies rejecting all or some provisions of SB1310 were more likely to gain board seats in other companies. We now examine the effect of the opt-out decision on directors' external opportunities.

A. Net Change in External Directorships Surrounding SB1310

Table V documents the mean and total number of external board seats held by incumbent directors before introduction and after enactment of Pennsylvania SB1310—that is, before and after the opt-out decision. Panel A reports information for all 779 incumbent directors with complete information on external directorships three years after SB1310. In the entire sample, the average number of external seats held by incumbent directors increases slightly from 0.659 before introduction of PA SB1310 to 0.737 three years after the opt-out decision.¹⁴ In the aggregate, the net change in external directorships held by incumbent directors amounts to 0.078, which is significantly different from zero at the one percent level of significance using the standard *t*-test ($p = 0.004$) and the Wilcoxon signed-rank test ($p = 0.006$).

The aggregate net change masks a significant difference across the three groups of directors partitioned by the opt-out decision (Panel A). Directors of firms that opted out of all SB1310 provisions on average gained 0.165 external board seats (0.763 to 0.928) over the period from year -1 to year $+3$, while directors of firms that opted out of some antitakeover provisions gained 0.090 directorships (0.701 to 0.791). In both subsamples, the standard *t*-test and the Wilcoxon signed-rank test reject the null hypothesis of zero net change at the six percent level or better. Although directors of firms that did not opt out of any SB1310 provision gained an average of 0.013 external board seats (from 0.554 to 0.567), neither the *t*-test nor the Wilcoxon signed-rank test reject the null hypothesis of zero net change at conventional significance levels.

More to the point, the data reject the hypothesis that net changes in external board seats held by directors are equal across the three groups defined by the opt-out decision. The null hypothesis is rejected at the 10 percent level using the parametric *F*-test for a standard ANOVA ($p = 0.090$) and the Wilcoxon rank-sum test ($p = 0.051$). Thus, there is some evidence that the magnitude of the change in external board slots held is significantly more positive for directors of companies

¹⁴ These figures are below the mean values of 2.0 and 0.93, reported by Booth and Deli (1996) and Kaplan and Reishus (1990), respectively. These other papers, however, limit their samples to top executives who serve as directors of their own firms. In addition, while we include relatively small firms in our sample, Booth and Deli study a sample of S&P 500 firms and Kaplan and Reishus employ a sample of *Fortune* 500 firms. Differences in sampling are likely to explain the difference in mean number of external directorships.

Table V
External Board Seats Held and Gained

Mean and total number of external directorships (in other firms) held by incumbent directors of 109 publicly traded Pennsylvania firms and proportion and total number (reported in parenthesis) of incumbent directors who, on net, gain at least one additional external directorship by the third fiscal year after the opt-out decision. Changes in external directorships held by directors are identified by comparing the proxy statements before (1989) and after (1993) the introduction of Pennsylvania SB1310. Incumbent directors with complete external board seat information before and after SB1310 ($N = 779$) are included in the analysis. Nonexecutive directors are those who are not CEO, president, chairman, CFO, COO, a family member, and/or any other past or present member of management.

Director type	All directors	Incumbent directors by SB1310 opt-out decision		
		<i>ALLOUT</i> (rejected all provisions)	<i>SOMEOUT</i> (rejected some provisions)	<i>NONEOUT</i> (retained all provisions)
<i>Panel A: All incumbent directors</i>				
Number of incumbent directors	779	194	278	307
Mean number (number) of external directorships held by incumbent directors 1 year before SB1310	0.659 (513)	0.763 (148)	0.701 (195)	0.554 (170)
Mean number (number) of external directorships held by incumbent directors 3 years after SB1310	0.737 (574)	0.928 (180)	0.791 (220)	0.567 (174)
Change in external directorships (after – before) $p(t)$ /Wilcoxon signed-rank p	0.078 (61) 0.00/0.01	0.165 (32) 0.02/0.01	0.090 (25) 0.04/0.06	0.013 (4) 0.73/0.77
Test for differences across groups	—	$p(F) = 0.09$, Wilcoxon rank-sum $p = 0.05$		
Proportion (number) of incumbent directors who, on net, gained one or more external board seats from before (1989) to after (1993) SB1310	0.139 (108)	0.186 (36)	0.169 (47)	0.081 (25)
Test for differences across all groups	—	$p(\chi^2) = 0.00$		
<i>Panel B: Incumbent non-executive directors of the Pennsylvania firm</i>				
Number of incumbent directors	471	122	184	165
Mean number of external directorships held by incumbent directors 1 year before SB1310	0.837 (394)	0.869 (106)	0.859 (158)	0.788 (130)
Mean number of external directorships held by incumbent directors 3 years after SB1310	0.911 (429)	1.041 (127)	0.978 (180)	0.739 (122)
Change in external directorships (after – before) $p(t)$ /Wilcoxon signed-rank p	0.074 (35) 0.06/0.08	0.172 (21) 0.10/0.10	0.120 (22) 0.03/0.04	– 0.048 (– 8) 0.42/0.34

Test for differences across groups			
Proportion (number) of incumbent directors who, on net, gained one or more external board seats from before (1989) to after (1993) SB1310	—	0.153 (72)	$p(F) = 0.06$, Wilcoxon rank-sum $p = 0.04$
Test for differences across groups	—		0.197 (24) 0.190 (35) 0.079 (13)
$p(\chi^2) = 0.01$			
<i>Panel C: Incumbent executive directors of the Pennsylvania firm</i>			
Number of incumbent directors	308		
Mean number of external directorships held by incumbent directors 1 year before SB1310	0.386 (119)	72	94
Mean number of external directorships held by incumbent directors 3 years after SB1310	0.471 (145)	0.583 (42)	0.394 (37)
Change in external directorships (after – before)	0.084 (26)	0.736 (53)	0.426 (40)
$p(t)$ /Wilcoxon signed-rank p	0.01/0.02	0.153 (11)	0.032 (3)
Test for differences across groups	—	0.03/0.05	0.64/0.76
Proportion (number) of incumbent directors who, on net, gained one or more external board seats from before (1989) to after (1993) SB1310	0.117 (36)	$p(F) = 0.43$, Wilcoxon rank-sum $p = 0.36$	0.128 (12)
Test for differences across groups	—	0.167 (12)	0.085 (12)
$p(\chi^2) = 0.19$			

that opted out of one or more provisions of SB1310 relative to directors of companies that chose to retain those provisions.

One possibility is that results from the full sample are driven only by those incumbent directors who are also members of management of the Pennsylvania firms. Indeed, if gray directors are ineffective monitors and outside directors are passive “pawns” of senior executives (e.g., Mace (1986), Herman (1989)), then opt-out decisions most likely will provide very limited information concerning these directors’ inclination and ability to monitor managers. In this case, subsequent opportunities of board members who do not belong to the management team should not be related to the opt-out decision. Our findings are inconsistent with this view.

To the contrary, the statistical ability of the opt-out decision to explain variation in external board seats is strongest in the subsample of nonexecutive directors (Panel B). For firms that opted out of all (some) provisions of SB1310, nonexecutive directors gained on average 0.172 (0.120) external board seats. In contrast, nonmanagement directors of firms that retained all protective antitakeover provisions *lost* an average of 0.048 external board seats. These differences based on the opt-out decision are statistically significant ($p(F) = 0.06$; Wilcoxon rank-sum $p = 0.04$). In contrast, as Panel C indicates, the opt-out decision does not have much power to explain the number of external board seats held by management directors of the Pennsylvania firm ($p(F) = 0.43$; Wilcoxon rank-sum $p = 0.36$).

B. Incidence of Gaining External Directorships after SB1310

Section IV.A indicates that directors of Pennsylvania companies that opt out of one or more provisions of SB1310 tend to gain on net more external directorships than directors of Pennsylvania companies that choose to retain those provisions. In a closely related test, Table V also documents the proportion (number) of directors who obtain at least one additional external directorship by the third fiscal year ending after enactment of SB1310. Panel A ($N = 779$) reveals that the proportion of incumbent directors gaining at least one external directorship in the three-year interval after SB1310 is indeed higher for those who rejected all or some SB1310 antitakeover provisions. Of incumbent directors rejecting all antitakeover provisions of SB1310, 18.6 percent gain at least one external directorship. By way of comparison, 16.9 percent of directors in the *SOMEOUT* sample and 8.1 percent in the *NONEOUT* sample gain at least one external directorship in the three-year interval after the opt-out decisions. The χ^2 goodness-of-fit test rejects the null hypothesis that an equal proportion of *ALLOUT*, *SOMEOUT*, and *NONEOUT* directors gain at least one additional external board seat in the three-year interval after the opt-out decision at the one percent level ($p(\chi^2) = 0.00$).

Panel B reveals a similar pattern for the subset of 471 incumbent nonexecutive directors. The proportions of such directors gaining an additional board seat three years after SB1310 are 19.7 percent for *ALLOUT*, 19.0 percent for *SOMEOUT*, and 7.9 percent for *NONEOUT*. These proportions are significantly different at the one percent level ($p(\chi^2) = 0.01$). Panel C examines the subsample of 308 execu-

tive directors. The proportions of executive directors gaining an additional board seat three years after SB1310 are 16.7 percent for *ALLOUT*, 12.8 percent for *SOMEOUT*, and 8.5 percent for *NONEOUT*. These proportions are not significantly different ($p(\chi^2) = 0.19$).

C. Logit Analysis of the Incidence of Gaining External Directorships

While suggestive, the results reported above could be driven by variables, such as director and firm “quality,” that drive both the opt-out decision and outcomes in the external market for directors. In this section, controlling for these potentially confounding effects, we use regression models to further examine the linkage between opt-out decisions and directors’ subsequent career opportunities in the external labor market.

Table VI presents estimates for logit models that examine the relation between the opt-out decision and the likelihood that an incumbent director will gain at least one external board seat by the third fiscal year ending after enactment of SB1310. The dependent variable is a dummy variable that takes the value of one if the director, on net, gains at least one additional external board seat by the third year after SB1310; it equals zero otherwise. The specifications (and sample size) differ by the sample, by which variable(s) represent the opt-out decision, and by variables identifying which type of director controls the board.

Models 1 and 2 of Table VI show that the opt-out decision provides explanatory power in the full sample. The estimated parameters are statistically significant for *OPTOUT* alone ($p = 0.005$) and, when distinguishing between full and partial opt-outs, for *ALLOUT* ($p = 0.007$) and *SOMEOUT* ($p = 0.018$). We also estimated both specifications in two subsamples. Though not reported in the table, the results are similar in the subsample of 471 nonexecutive directors: *OPTOUT* included alone is significant ($p = 0.012$) and both *ALLOUT* ($p = 0.019$) and *SOMEOUT* ($p = 0.024$), when included together, are significant. In contrast, the opt-out variables are insignificant in the complementary subsample of executive directors. The estimates imply that, controlling for other factors in the model, nonexecutive directors who choose to reject all or some of the SB1310 antitakeover provisions are significantly more likely to gain at least one external directorship by year +3 after the opt-out decision.

These results for the sample of nonexecutive directors suggest that the external market not only views such nonexecutive directors as having had a meaningful influence on the decision to opt out, but also rewards those nonexecutive directors who voted in favor of opting out. This inference would be more credible, however, if the results were associated with a greater relative presence of nonexecutive directors on the board. The idea is that only when nonexecutive directors have a nontrivial presence on the board and, therefore, meaningful influence over the opt-out decision, will the external market attribute responsibility for the opt-out decision to nonexecutive directors. In Models 3 and 4 of Table VI, we estimate the model over the cases in which nonexecutive directors control the board (*NONEXECBRD* = 1, *EXECBRD* = 0) and executive directors control the board (*EXECBRD* = 1, *NONEXECBRD* = 0). When full and partial rejections

Table VI
Logit Estimates of the Probability of Gaining an External Board Seat

Logit estimates of the probability of gaining at least one external directorship by the third fiscal year ending after the decision whether to opt out of Pennsylvania SB1310. Director observations in Models 1 and 2 include the entire sample of incumbent directors serving the 109 Pennsylvania firms before 1989 for whom verifiable information on external directorships held after SB1310 can be obtained ($N = 779$). Models 3 to 6 include non-executive directors who are not CEO, president, chairman, CFO, COO, family member, and/or other past or present member of management ($N = 471$). Note: $p(t)$ -values are in parentheses.

Variables	Dependent variable equals 1 if incumbent director on net gains at least one external directorship by the third fiscal year ending after the opt-out decision, 0 otherwise					
	All incumbent directors ($N = 779$)			Nonexecutive directors ($N = 471$)		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Intercept	- 3.072 (0.000)	- 3.066 (0.000)	- 2.979 (0.000)	- 2.984 (0.000)	- 3.566 (0.000)	- 3.581 (0.000)
$OPTOUT$ (1 = rejected some or all provisions of SB1310, 0 otherwise)	0.731 (0.005)					
$ALLOUT$ (1 = rejected all provisions of SB1310, 0 otherwise)		0.819 (0.007)				
$SOMEOUT$ (1 = rejected some provisions of SB1310, 0 otherwise)		0.669 (0.018)				
$OPTOUT \times NONEXECBRD$ (1 = the proportion of nonexecutive directors on the board exceeds 50%, 0 otherwise)			1.054 (0.004)		0.552 (0.235)	
$OPTOUT \times EXECBRD$ (1 = the proportion of executive directors on the board is at least 50%, 0 otherwise)			0.201 (0.708)		- 0.080 (0.889)	
$ALLOUT \times NONEXECBRD$				1.156 (0.006)		1.087 (0.074)
$ALLOUT \times EXECBRD$				0.191 (0.789)		- 0.409 (0.591)
$SOMEOUT \times NONEXECBRD$				0.993 (0.011)		0.261 (0.625)
$SOMEOUT \times EXECBRD$				0.204 (0.772)		0.219 (0.767)
Industry median-adjusted annual accounting performance, 1989	- 1.172 (0.449)	- 1.291 (0.404)	- 0.229 (0.916)	- 0.366 (0.868)	- 2.226 (0.360)	- 2.595 (0.294)
Industry median-adjusted annual accounting performance, 1990-92	3.677 (0.079)	3.696 (0.078)	4.598 (0.086)	4.705 (0.082)	3.245 (0.345)	3.809 (0.011)

<i>OWNTOPMGR</i> (1 = chairman, CEO, or president of the Pennsylvania firm, otherwise 0)	0.443 (0.160)	0.427 (0.177)		1.171 (0.011)	1.166 (0.011)
<i>AFFDIR</i> (1 = gray directors or inside directors who are not <i>OWNTOPMGR</i>)	-0.157 (0.594)	-0.166 (0.573)	0.247 (0.564)	0.233 (0.588)	
<i>OTHTOPMGR</i> (1 = chairman, CEO, or president of any other publicly traded firm, otherwise 0)	0.152 (0.555)	0.167 (0.519)	-0.001 (0.999)	0.014 (0.960)	
<i>RETIRE</i> (1 = age between 65 and 69 before SB1310, otherwise 0)	-1.683 (0.002)	-1.684 (0.002)	-1.931 (0.010)	-1.922 (0.010)	-0.965 (0.266)
<i>OFF-OWN-BOARD</i> (1 = director no longer on PA firm board, otherwise 0)	0.488 (0.146)	0.490 (0.145)	-0.009 (0.983)	-0.010 (0.982)	1.436 (0.015)
<i>NDIR02</i> = min{number of external directorships held in 1989, 2}	0.316 (0.062)	0.312 (0.065)	0.384 (0.052)	0.377 (0.058)	0.067 (0.854)
<i>NDIRG2</i> = max{number of external directorships held in 1989 - 2, 0}	-0.110 (0.578)	-0.111 (0.575)	-0.122 (0.565)	-0.117 (0.584)	-0.293 (0.624)
<i>FORTUNEDIR89</i> (1 = served externally as a director of a <i>Fortune</i> 1000 firm in 1989, otherwise 0)	1.049 (0.000)	1.050 (0.000)	0.746 (0.038)	0.771 (0.036)	1.818 (0.001)
Firm size (book value of total assets in billions as of 1989 fiscal year)	-0.011 (0.337)	-0.012 (0.297)	-0.012 (0.365)	-0.014 (0.320)	-0.014 (0.569)
Research intensity (R&D expenses divided by net sales, 1989 fiscal year)	1.929 (0.129)	1.899 (0.134)	2.794 (0.094)	2.778 (0.097)	0.623 (0.781)
<i>p</i> -value of likelihood ratio test	0.000	0.000	0.000	0.000	0.000

of SB1310 provisions are grouped together (Model 3), the estimated coefficient on $OPTOUT \times NONEXECBRD$ is positive and significant ($p = 0.004$) and the estimated coefficient on $OPTOUT \times EXECBRD$ is slightly positive and insignificant ($p = 0.708$). When the model further distinguishes between full and partial opt-outs (Model 4), both $ALLOUT$ and $SOMEOUT$, interacted with $NONEXECBRD$, are positive and significant ($p = 0.006$ and $p = 0.011$, respectively). In contrast, none of the opt-out decision indicator variables interacted with the dummy for board control by executive directors is significant. The opt-out decision indicator variables have explanatory power for external board seats for nonexecutive directors only when nonexecutive directors control the board. For the subsample of executive directors, Models 5 and 6 of Table VI show that the opt-out decision continues to have very little explanatory power even when partitioning the data by who controls the board.

This seems odd. Why would the external market for directors reward nonexecutive directors but not executive directors for their firm's decision to opt out? One possibility relates to our taxonomy for directors. The group of executive directors, in addition to the CEO, chairman, and president, by definition also includes past management, current management of somewhat lower position, and past and present family members. These are not people who are as likely to be on other boards of directors, regardless of board decisions. Consistent with this hypothesis, in the subsample of executive directors, serving as chairman, CEO, or president of the Pennsylvania firm enhances external opportunities relative to the other types of executive directors. In both Models 5 and 6, the p -value on $OWNTOPMGR$ is about 0.01. Moreover, when we reestimate Models 5 and 6 restricting the subsample of incumbent executive directors to those who are also CEO, chairman, or president, the opt-out variables are marginally significant ($OPTOUT$ $p = 0.11$ and $ALLOUT$ $p = 0.10$). Thus, there is some evidence that the opt-out decision affects external board seats held by directors who are CEO, chairman, or president of the Pennsylvania firms.

Considering variables that measure director and firm quality, the strongest results are for industry-adjusted accounting performance over 1990 to 1992, which is significant at the 10 percent level or better. The coefficient on whether the director holds a board seat in a *Fortune* 1000 firm ($FORTUNEDIR89$) is positive and stable ($p < 0.05$) for all six models in Table VI. Such directors are significantly more likely to gain external board seats. In the full sample and the subsample of nonexecutive directors, prior number of external seats less than or equal to two ($NDIR2$) is always positive and significant at the 10 percent level. $NDIR2$ is insignificant in the subsample of executive directors, and in no case is the number of external seats beyond two ($NDIRG2$) significant.

The dummy variable, $OFF-OWN-BOARD$, takes the value of one if the director leaves the Pennsylvania firm's board by the third fiscal year after SB1310; it equals zero otherwise. *Ceteris paribus*, directors who leave the Pennsylvania firms' boards may be less likely to gain external directorships. If director departures are due to age and health reasons, or departing directors are board members who are deemed by their own firms to be poor performers, the estimated coefficient on $OFF-OWN-BOARD$ should be negative. Interestingly, as Table VI

indicates, the parameter estimates for *OFF-OWN-BOARD* tend to be close to zero (nonexecutive subsample) or *positive* and significant (*p*-values around 0.01 in the subsample of executive directors). In this latter case, perhaps executive directors, once released from their obligations as a director of a Pennsylvania firm, have the time to devote to service on other boards.

All else equal, incumbent directors near the retirement age of 70 (*RETIRE* = 1) appear to be less likely to gain external board seats, though the estimated coefficient is significant only in the subsample of nonexecutive directors and in the full sample. Research intensity is positive and, in some specifications, significant at the 10 percent level, but firm size is always insignificant. The indicator for holding the position of CEO, chairman, or president in another company (*OTH-TOPMGR* = 1) provides little power. Finally, as always, any conclusions based on these parameter estimates should allow for the possibility that the regression models do not include all relevant explanatory variables.

D. Economic Significance of the Opt-out Decision for the External Market for Directors

Holding firm characteristics and other director attributes constant, nonexecutive directors who choose to reject some or all of the provisions of SB1310 are significantly more likely to gain, on net, at least one external directorship three years after the opt-out decision. This effect is apparent only when nonexecutive directors control the board. To assess the economic significance of these results, based on the estimates reported in Table VI, we calculate the probability of gaining at least one external directorship three years after SB1310, for various types of directors, grouped by opt-out decision, based on various samples. The probabilities are calculated based on using the median values for all explanatory variables, unless otherwise specified.

Because of the importance of the subsample of nonexecutive directors, we focus our discussion on the probabilities implied by estimates of Model 4 of Table VI. As the base case in Panel B of Table VII indicates, a nonexecutive director on a board controlled by like directors (*NONEXECBRD* = 1) of a *NONEOUT* firm (also *FORTUNEDIR89* = 0) has a 5.0 percent chance of gaining at least one external directorship by the third year after SB1310. By comparison, a nonexecutive director from a *SOMEOUT* firm has a 12.4 percent chance of gaining at least one external directorship, while a nonexecutive director from an *ALLOUT* firm has a 14.3 percent chance of gaining at least one external board slot. Thus, compared to his counterpart in the *NONEOUT* firm, a nonexecutive director from a Pennsylvania firm that chose to reject all of the protective provisions of SB1310 was nearly three times as likely to gain at least one additional external board seat during the three years after the opt-out decision ($2.86 = 0.143/0.050$). By way of comparison, a dividend cut reduces the probability that executives of that company receive additional external board seats by a factor of two (Kaplan and Reishus (1990)).

Examining Panel B of Table VII further, note that the extent of variation of external opportunities in the opt-out decision is negligible when executive

Table VII
Implied Probabilities of Gaining at Least One External Board Seat

Probability of gaining at least one external directorship, as implied by the estimates of the logit regressions reported in Table VI. The probabilities are calculated based on all control variables, including indicator variables, set at median values, unless otherwise specified. An incumbent director is a board member serving at least one of the 109 publicly traded Pennsylvania firms in 1989 before the introduction of Pennsylvania SB1310. Seventeen incumbent directors who died or retired before 1993 are excluded from the sample. A total of 209 directors included in the full sample do not have adequate information after SB1310 to determine external directorships, which leaves 779 observations. Executive directors are incumbent directors who are CEO, president, chairman, CFO, COO, a family member, and/or any other past or present member of the management team of a Pennsylvania firm.

	Incumbent directors by PA SB1310 opt-out decision		
	<i>ALLOUT</i> (rejected all provisions) <i>ALLOUT</i> = 1 <i>SOMEOUT</i> = 0	<i>SOMEOUT</i> (rejected some provisions) <i>ALLOUT</i> = 0 <i>SOMEOUT</i> = 1	<i>NONEOUT</i> (retained all provisions) <i>ALLOUT</i> = 0 <i>SOMEOUT</i> = 0
<i>Panel A: Probabilities implied by estimates of model 2 in Table VI (entire sample, N = 779)</i>			
Base case (<i>FORTUNEDIR89</i> = 0, other variables set at median values)	0.118	0.103	0.055
Served externally as a director of a <i>Fortune</i> 1000 firm in 1989 (<i>FORTUNEDIR89</i> = 1, all others base case)	0.276	0.247	0.144
1990–1992 accounting performance higher than mean by two standard deviations (all others base case)	0.215	0.191	0.108
<i>Panel B: Probabilities implied by estimates of model 4 in Table VI (incumbent non-executive directors, N = 471)</i>			
Base case (<i>NONEXECBRD</i> = 1, <i>EXECBRD</i> = 0, <i>FORTUNEDIR89</i> = 0, other variables set at median values)	0.143	0.124	0.050
Proportion of non-executive directors on the board is less than 50% at the opt-out decision in 1989 (<i>NONEXECBRD</i> = 0, <i>EXECBRD</i> = 1, all others base case)	0.060	0.060	0.050
Served externally as a director of a <i>Fortune</i> 1000 firm in 1989 (<i>FORTUNEDIR89</i> = 1, all others base case)	0.265	0.234	0.102

case)				
1990-1992 accounting performance higher than mean by two standard deviations (all others base case)	0.253	0.224	0.097	
One additional external directorship held in 1989 (all others base case)	0.195	0.171	0.071	
<i>Panel C: Probabilities implied by estimates of model 6 in Table VI (incumbent executive directors, N = 308)</i>				
Base case (<i>FORTUNEDIR89</i> = 0, other variables set at median values)	0.038	0.031	0.025	
Executive directors who are also chairman, CEO or president of the Pennsylvania firm (<i>OWNTOPMGR</i> = 1, all others base case)	0.122	0.103	0.083	
Served externally as a director of a <i>Fortune</i> 1000 firm in 1989 (<i>FORTUNEDIR89</i> = 1, all others base case)	0.184	0.157	0.128	
1990-1992 accounting performance higher than mean by two standard deviations (all others base case)	0.078	0.065	0.052	
One additional external directorship held in 1989 (all others base case)	0.042	0.035	0.028	

directors control the board ($EXECBRD = 1$). By choosing to opt out of all provisions of SB1310 instead of no provisions, the nonexecutive director gains only 0.01 ($= 0.060 - 0.050$) in additional probability of obtaining an external board seat, as compared to 0.093 ($= 0.143 - 0.050$) when nonexecutive directors control the board ($NONEXECBRD = 1$).

Table VII shows other factors that have a large impact on the probability of a director gaining additional external board slots. Industry-adjusted accounting performance over 1990 to 1992 has a large effect. In general, for the full sample, based on a two-standard-deviation increase in accounting performance, the probability of gaining external board seats nearly doubles. From Panel A, the percentage increases range from 82 percent ($0.82 = (0.215 - 0.118)/0.118$) for *ALLOUT* to 96 percent ($0.96 = (0.108 - 0.055)/0.055$) for *NONEOUT*. The effect of accounting performance is somewhat smaller (larger) than this for nonexecutive (executive) directors.

Serving on a *Fortune* 1000 board increases the probability of gaining external board seats by an even larger proportion. From Panel A, the percentage increases in probability range from 134 percent ($= (0.276 - 0.118)/0.118$) for *ALLOUT* to 162 percent ($= (0.144 - 0.055)/0.055$) for *NONEOUT*. Once again, the effect is somewhat larger (smaller) than this for the subsample of executive (nonexecutive) directors. Finally, holding an additional external board seat in 1989 increases the probability of gaining at least one additional external board position by somewhere between 11 percent and 42 percent.

E. Additional Sensitivity Checks

As mentioned above, we also estimate every specification controlling instead for either industry-median-adjusted stock performance (including distributions) or industry-median-adjusted change in operating performance (1989 versus 1990 to 1992). Using stock performance and change in accounting performance produces results similar to those reported in Tables III, IV, VI, and VII.

Because our analysis excludes 209 incumbent directors that lack information on external board seats held after SB1310, one concern is whether the findings are robust to sample selection. To address this issue, we estimate the models in Table VI using the full sample of 988 incumbent directors. In the full sample, we exclude only the 17 directors who are verified as dead or retired using proxy statements. We assume that those 209 incumbent directors with incomplete external directorship information do not gain additional external directorships by the third year ending after SB1310. The results, not presented in detail here, are similar to those reported in Table VI.

As a final specification check, we regress (OLS) the net change in external directorships over year -1 to year $+3$ held by incumbent directors on the same sets of explanatory variables used in Table VI. We do so for the full sample and for the subsamples of executive and nonexecutive directors and obtain results similar to those in Table VI. Based on the full sample, these linear specifications suggest that, holding other factors constant, rejecting all provisions of SB1310 benefits

the incumbent director with 0.14 additional external board seats relative to incumbent directors who retain all provisions.

V. Conclusion

This study documents labor market consequences for directors in the event of a specific board-sponsored decision. Our analysis differs from that in prior literature by extending the analysis beyond top management and to the labor market external to the firm.

Directors who served Pennsylvania firms that decided to reject all or some antitakeover provisions of SB1310 are more favorably received in the market for external board seats than are directors who served Pennsylvania firms that decided to retain all of the law's provisions. These results are driven by the subsample of directors who are not CEO, president, chairman of the board, family member past or present, and/or any other member of the management team. More precisely, controlling for various director and firm characteristics, including prior performance, nonexecutive directors of Pennsylvania companies that rejected protective provisions of SB1310 are nearly three times as likely to gain external board slots. This effect appears in the data only when nonexecutive directors control the board, in which case the market for external board seats appears to believe that such directors had meaningful influence over the opt-out decision. If a board's decision to reject some or all antitakeover provisions of SB1310 is perceived as an outcome of effective board monitoring, then these results imply the presence of a vital external labor market—an external labor market that values the ability and inclination to guide managerial discretion.

We also find some evidence of an active internal labor market by estimating the extent to which the opt-out decision affects an incumbent director's tenure on his own Pennsylvania firm's board of directors. For executive directors, there is a strong relation, particularly when executive directors control the board. When management controls the board, an executive/management director of a Pennsylvania company that decided to reject all or some of the law's provisions is roughly 30 percent more likely to retain the board slot with that same Pennsylvania company by the third fiscal year after SB1310. In contrast, there is little evidence of a significant relation between the opt-out decision and retention of nonexecutive directors on the board.

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