THE EFFECTS OF BOARD HUMAN AND SOCIAL CAPITAL ON INVESTOR REACTIONS TO NEW CEO SELECTION

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This study extends work on independent directors to examine the influence of their human capital and social capital on investor reactions to the board’s CEO selection decision. We predict that human capital, as represented by the board’s CEO experience and industry experience, and social capital, as represented by directors’ co-working experience on the board and external directorship ties to other corporate boards, will influence the stock market reactions to new CEO appointments. In a sample of 208 new CEO appointment events in U.S. manufacturing firms between 1999 and 2003, we found that the stock market reacted favorably to the appointments made by boards with higher levels of human and social capital. We also found that the effect of internal social capital was stronger when the new CEO was an insider rather than an outsider. The implications of the results for director selection and CEO succession are discussed.

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INTRODUCTION

Agency theory assumes that independent outside directors are more effective than inside directors in monitoring management and protecting shareholder interests (Fama and Jensen, 1983). However, the empirical evidence on the link between board structural independence—most often measured as the proportion of independent directors—and board effectiveness has been far from conclusive (Johnson, Daily, and Ellstrand, 1996; Zahra and Pearce, 1989). This absence of an empirical link may stem from prior work treating independent directors as a homogenous group, rather than examining differences among them in terms of their knowledge and skills. Reflecting this concern, emerging theoretical work on ‘board capital’ argues that while independent outside directors may have the motivation to be effective monitors, a board also needs sufficient ability, in the form of relevant experience, to make the best decisions (Hillman and Dalziel, 2003).

The literature on board capital identifies two key elements of board ability: human capital,
defined as context-specific knowledge and skills obtained through work experience; and social capital (also known as relational capital), defined as the resources accessible through the network of relationships possessed by an individual or a social unit (Hillman and Dalziel, 2003). Although recent empirical research supports the argument that board human capital influences corporate outcomes (e.g., Kroll, Walters, and Wright, 2008; McDonald, Westphal, and Graebner, 2008; Westphal and Fredrickson, 2001), only limited empirical work has examined board human and social capital simultaneously (Kor and Sundaramurthy, 2009). Previous studies on board capital are also limited in the sense that they lack a systematic, task-relevant classification scheme of board capital and a focus on corporate decisions that are most likely to be made by the board of directors. To gain a better understanding of how board capital affects the board’s effectiveness in its key decisions, we develop a framework of board human and social capital and board effectiveness in chief executive officer (CEO) selection. Hiring the CEO is the most important decision the board makes (Vancil, 1987). In this study, we examine how board effectiveness in CEO selection is influenced by two types of board human capital—board CEO experience (i.e., directors’ experience of serving as CEOs at other companies) and board industry experience (i.e., experience of working in the focal firm’s industry)—and two types of board social capital—internal social capital (i.e., directors’ co-working experience on the focal board) and external social capital (i.e., the board’s external directorship ties to other corporations).

Consistent with prior studies (e.g., Borokhovich, Parrino, and Trapani, 1996; Brickley, Linck, and Coles, 1999), we examine board effectiveness by assessing investor reactions to the appointment of a new CEO, measured as the abnormal stock returns following the appointment announcement. Since the board’s primary responsibility is to increase firm value, abnormal stock returns can be seen as an appropriate board effectiveness measure. More broadly, in the CEO succession literature, abnormal stock returns around the time of CEO succession are an appropriate firm performance measure because they represent an unbiased estimate of investors’ expectations and allow the isolation of reaction to a specific event (Kesner and Sebora, 1994). The board of directors has been viewed as an ‘initiating force’ in CEO dismissals (Friedman and Singh, 1989: 723) and board-initiated CEO dismissals in poorly performing firms are associated with positive stock market reactions (e.g., Borokhovich et al., 1996; Weisbach, 1988). Interestingly, though, compared with its role in firing an incompetent CEO, the board’s role in finding a new CEO has been studied less often (Zajac, 1990). Overall, we attempt to answer the following question: does the stock market value independent board members’ human and social capital in the context of new CEO selection?

THEORY AND HYPOTHESES: BOARD CAPITAL AND CEO SELECTION

Agency theory contends that due to their independence from the CEO, boards consisting primarily of independent outsiders have greater motivation to monitor management than insiders (Fama and Jensen, 1983). Building on agency theory work, board capital theory argues that board independence is a necessary, but not sufficient, condition for effective monitoring and that assessing board ability in the form of board capital is also needed.1 Research on board capital draws on work on human capital (Becker, 1975) and social capital (Nahapiet and Ghoshal, 1998) and defines human capital as directors’ experience and expertise and social capital as the resources available to the board through its internal and external networks (Hillman and Dalziel, 2003). The two elements of board capital differ from each other as human capital refers to experience embedded within an individual, whereas social capital refers to the access to useful information and resources through social relationships (Burt, 1997). We argue that boards will have access to better-quality information and will develop more effective information processing capabilities if they have high levels of human and social capital. In particular, board capital is expected to have a positive effect on board effectiveness in CEO selection as perceived by stock market investors.

1 To capture both board motivation and ability, we assess board capital for independent directors. By focusing on independent directors, we can isolate the effects of board capital (i.e., board ability) that exist beyond that of structural independence (i.e., motivation) variables, and thus help clarify performance implications of board independence.
The effects of human and social capital can be analyzed with regard to how they affect directors’ performance in the key tasks in the CEO selection process. The board’s first task is to establish a strategic mandate for the new CEO, which includes ‘a forecast of the future environment facing the corporation, an assessment of the degree and rate of change that will be required to cope with that environment, and an identification of the skills, experience, and foresight required of the next CEO’ (Vancil, 1987: 27). Its second task is to identify potential internal and external CEO candidates and assess their knowledge and skills (Vancil, 1987).

We argue that board performance in the first task depends on the degree to which directors have human capital developed through their job- and industry-specific experience. Prior work consistent with a board human capital perspective suggests that the more the directors know about the firm’s business environment and the nature of the CEO’s job, the better they can match the CEO to the firm conditions (Vancil, 1987). Therefore, we argue that directors should make better CEO selection decisions if (1) they have CEO experience, that is, experience of working as CEOs at other companies, which improves the directors’ familiarity with the typical job tasks facing a CEO, and (2) industry experience, that is, experience of working in the focal firm’s industry, which improves directors’ understanding of the firm’s business environment. We thus link these two types of board human capital to board effectiveness in CEO selection.

Human capital and board effectiveness in CEO selection

Board CEO experience

Experience with performing a certain task leads to improved task expertise. More specifically, individuals with high levels of task experience are better able to judge the qualifications of others who perform similar tasks (Bandura, 1997). Consistent with this notion, expert performance is specific to a particular knowledge area (McDonald et al., 2008) because individuals with experience in an area have more densely developed knowledge structures relevant to that area (Day and Lord, 1992). Directors who have experience of working as CEOs at other companies (‘CEO directors’) have developed expertise specific to the CEO’s job position. We predict that directors with CEO experience will be better able to judge whether a potential CEO candidate has the attributes that meet the firm’s strategic requirements. This ability stems from the director’s own understanding of the content of the CEO’s job and the corresponding skill requirements for the job. A CEO’s job knowledge has a significant tacit element as the knowledge is not readily available from secondary sources. Rather, the CEO can only learn from direct experience of handling complex job tasks, ranging from integrating functional executives’ diverse information and expertise, which requires of the CEO skills in such areas as communication, leadership, and conflict resolution (Mintzberg, 1973; Zhang and Rajagopalan, 2004), to developing a strategic vision for the firm, representing it to outside constituents, and making complex strategic decisions (Lorsch and Khurana, 1999). Given their valuable skill set stemming from CEO experience, current or retired CEOs are more likely than non-CEOs to gain seats on the boards of their own firm or other firms and investors react positively when firms appoint directors with CEO experience to their boards (Brickley et al., 1999; Fich, 2005). These arguments and evidence lead to our first hypothesis:

Hypothesis 1: There will be a positive relationship between independent board members’ CEO experience and investor reactions to a new CEO appointment.

Board industry experience

To hire a CEO, the board must also understand the industry environment facing the firm (Vancil, 1987). Firms operating in the same industry are faced with similar sets of technologies, competitive rules, customer needs, supplier capabilities, and government regulations (Kor and Misangyi, 2008). Previous research has shown that decision makers’ industry-specific experience is a valuable, rare, and hard-to-imitate resource (Castanias and Helfat, 1991) and that positive performance effects follow from senior executives’ industry-specific experience (Kor, 2003). Independent directors with work experience in the focal firm’s industry will have particularly relevant knowledge of that industry. There has been evidence that directors’ industry-specific experience affects board decisions. For
example, it has been reported that outside directors’ industry-specific experience enables boards to make acquisition decisions that are positively received by investors (Kroll et al., 2008). In the context of CEO selection, reflecting the importance of industry-specific knowledge, boards are more likely to hire from within the industry even when they seek a new CEO from outside the firm (Parrino, 1997). Moreover, directors who have had firsthand work experience in the firm’s industry are likely to have tacit knowledge of industry opportunities and constraints and to develop a more nuanced understanding of the industry (Rajagopalan and Datta, 1996; Vancil, 1987). This allows for a more accurate assessment of the fit between potential CEO candidates and industry contingencies. These benefits of directors’ industry-specific experience may be particularly salient for nondiversified firms. In sum, directors equipped with industry experience should make better-informed CEO hiring decisions. This brings us to our second hypothesis:

**Hypothesis 2:** There will be a positive relationship between independent board members’ industry experience and investor reactions to a new CEO appointment.

**Board social capital and board effectiveness in CEO selection**

In addition to human capital, social capital should also affect board outcomes. Group performance depends in part upon members’ capabilities to process and share information obtained from their internal and external networks of relationships (Borgatti and Cross, 2003). Boards with strong ties within the firm and to other strategically related firms enjoy better access to more and higher quality information, which results in superior advice to the firm and better financial outcomes (Carpenter and Westphal, 2001). Based on prior literature, we distinguish between two types of board social capital—internal and external—and explain their impact on board effectiveness in CEO selection as follows.

**Internal social capital and board co-working experience**

In work groups, internal social capital is developed through group members’ experience of working together. Shared co-working experience makes it possible for group members to develop a ‘bonding’ form of social capital owned collectively by all group members (Adler and Kwon, 2002). In the board context, we argue that directors’ co-working experience provides the board with both ability and opportunity benefits. First, co-working experience improves board ability by allowing directors to develop tacit firm-specific knowledge. Given that most independent directors have primary, full-time positions outside the firm and only serve their board duty on a part-time basis, their experience of working together on the focal board provides them with perhaps the only chance to learn about the firm’s idiosyncratic strategic issues. The importance of group co-working experience as a source of valuable firm-specific knowledge has been discussed as early as in Penrose’s (1959) seminal work. She observed that a collection of individuals who have had experience working together are able to provide ‘production services’ that are valuable and unique to the firm. Admittedly, independent directors can obtain information about the firm’s business from secondary sources (e.g., from corporate documents or business media), but it is difficult for directors to put secondary information ‘into perspective’ and interpret its meaning within the firm’s context if they do not have adequate firm-specific knowledge. Every firm faces a unique set of challenges at the time of CEO selection (Conger, Finegold, and Lawler, 1998). Board members with little co-working experience may initiate a strategic mandate containing only generic or even misinformed descriptions about the firm’s strategic needs and the desired CEO characteristics (Khurana, 2001). By contrast, boards with long co-working experience may be better able to interpret the strategic implications of the challenges and specify the characteristics of the new CEO needed to address those challenges (Charan, 2005). In this sense, co-working experience can be seen as a strategic resource owned by the board (Castanias and Helfat, 1991).

Second, co-working experience creates opportunities for directors to share and coordinate their individual expertise and knowledge because, over time, directors tend to develop a common understanding of who knows what on the board. This understanding of expertise location among group members is particularly important for groups in which members’ special expertise or unique past
experiences provide some members with access to information that others do not have (Rulke and Rau, 2000), and it has been found to have positive effects on group task performance (Littlepage, Robison, and Reddington, 1997). Research shows that co-working experience allows group members to recognize, share, and coordinate their individual experience (Littlepage et al., 1997). In a similar vein, directors who share long co-working experience are likely to develop a group-level mutual knowledge based on their firsthand understanding of one another’s expertise and through the face-to-face interactional dynamics among themselves (Cramton, 2001). Equipped with firm-specific business knowledge and group-specific knowledge of who knows what, directors should be able to spend less time searching for necessary decision information and focus more on discussing substantive issues. Taken together, these arguments lead to our third hypothesis:

**Hypothesis 3:** There will be a positive relationship between independent board members’ co-working experience and investor reactions to a new CEO appointment.

**External social capital and external directorship ties**

The board’s network of external directorship ties is a major source of its external social capital (Hillman and Dalziel, 2003). Broader work on interlocking directorates has shown that ties play an important role in the dissemination of knowledge between firms (Burt, 1980). Such ties reduce scanning costs (Bazerman and Schoorman, 1983) and increase access to strategic information and opportunities (Pfeffer, 1991), which perhaps explains why the market responds positively when a CEO is asked to join another firm as a board member (Rosenstein and Wyatt, 1994).

In the process of searching for a new CEO, the board may benefit from independent directors’ experience of serving on other corporate boards. In other words, who board members know affects the quality of CEO candidate information available to the focal board. Through their communication with other directors and executives, the focal firm’s directors quite likely obtain valuable and up-to-date information about a broad pool of potential candidates. CEO hiring decisions are often ‘secrective,’ so candidate information from an authoritative and trusted source (such as directors in other companies) is a valuable resource. Independent directors’ external board ties serve as a window to the world (Andrews, 1980). In previous studies, external directorship ties have been variously viewed as a source of information, experience, and reputation (Carpenter and Westphal, 2001; Hillman, Cannella, and Paetzold, 2000; Perry and Peyer, 2005). Executives’ decisions to sit on other corporate boards increase the value of the executives’ home firm, indicating that the stock market values the external board seats earned by executives (Perry and Peyer, 2005). Similarly, Carpenter and Westphal (2001) found that directors who held board seats in strategically related firms were more effective in strategic decision making for similar firms than directors without such network ties. Their findings are consistent with the argument that director ties are associated with improving the flow of information to the focal firm.

In addition, external directorship ties may provide the board with expertise in evaluating CEO performance and hence an ‘alternative angle’ regarding what should be required of the new CEO. While board CEO experience provides a jobholder’s perspective and increases the board’s understanding of the CEO’s job, expertise in assessing CEO performance provides an evaluator’s perspective and increases the board’s ability to set up performance standards and evaluation criteria for the CEO. Directors with external board ties are more likely to learn the expertise of assessing CEO performance and thereby make positive contributions to the CEO selection decision. These well-connected directors would know more about evaluating a CEO’s ability in strategy formulation and implementation and about establishing appropriate performance metrics for the CEO (Conger et al., 1998). CEO evaluation is a task that cannot be delegated (Charan, 2005) and expertise in this task is valuable, rare, and hard-to-substitute because in most companies only board members have the authority and the data to evaluate the CEO (Conger et al., 1998). Last but not least, the market for directorships functions as an important source of incentives for independent directors to develop their professional reputation (Fama and Jensen, 1983). Not surprisingly, the number of external directorships has been linked to director reputation as perceived by investors.
(Ferris, Jagannathan, and Pritchard, 2003). Overall, external directorship ties are associated with high quality information about external CEO candidates, unique expertise in CEO evaluation, and good director reputation. Based on these observations, we propose our fourth hypothesis:

**Hypothesis 4:** There will be a positive relationship between independent board members’ external directorship ties and investor reactions to a new CEO appointment.

### Interaction effect of board social capital and succession type

The board is faced with a challenge in the process of hiring a new CEO: identifying and evaluating potential CEO candidates from both inside and outside the firm (Charan, 2005; Conger, Lawler, and Finegold, 2001; Vancil, 1987). We posit that while board human capital will likely have a beneficial effect for both internal and external successions, board social capital will have a differential effect depending on the succession type. Recall that human capital is captured by the board member’s prior CEO experience and industry experience. These types of experience are valuable whether the newly selected CEO is an insider or an outsider because in both types of successions the board needs to understand the nuances of a CEO’s job (an understanding that is derived from the board’s CEO experience) as well as key industry contingencies that affect the fit between a potential CEO candidate and the firm (industry understanding is enhanced by the board members’ industry experience). In contrast, the value of social capital is more likely to be contingent on the type of succession. Specifically, we argue that boards with greater internal social capital make better internal CEO selection decisions, while boards with superior external social capital make better external CEO selection decisions.

On the one hand, we expect that internal social capital in the form of co-working experience will have a greater positive effect on internal CEO selections than external ones. Companies choose internal promotion or external recruitment for different reasons. Internal promotion is associated with the objective of protecting the company’s current resource base and maintaining strategic stability, whereas external recruitment is used for the purpose of renewing resources and initiating strategic change (Kesner and Dalton, 1994; Vancil, 1987). Investors may prefer the internal promotion decisions made by boards with strong internal social capital because the directors tend to understand the firm’s strategic issues better and are more familiar with potential inside candidates.

On the other hand, we expect that external social capital will be more beneficial for external CEO selections. Arguably, access to superior information on external CEO candidates is enhanced by directors’ ties with other corporate boards. Research shows external directorship ties provide reliable, detailed, and timely information to the board (Carpenter and Westphal, 2001) and help reduce the costs of searching for external CEO candidate information (Williamson and Cable, 2003). Although firms often hire an executive search firm when initiating a CEO search, researchers have found that, in most successful CEO searches, it is the board of directors rather than headhunters that produces the list of primary candidates (Lorsch and Khurana, 1999). While search firms excel at verifying qualifications and references, the data they offer may lack details about a candidate’s working style, cultural values, or accomplishments (Khurana, 2001). Directors’ connections to external boards allow them to get fine-grained information on external candidates as evidenced by the following quote:

‘To get such fine-grained information on external candidates, directors rely largely on their connections to other directors. Since a large number of CEO candidates are themselves on boards, they are often connected to other board members. These connections, in turn, make the interlocking directorate particularly well suited for transferring specific information about potential candidates’ (Khurana, 2004: 114–115).

Overall, boards with rich internal social capital are better at finding an internal CEO successor whereas boards with rich external social capital are better at matching firm requirements to an external CEO successor. Different types of board social capital thus provide different benefits in different succession contexts. These arguments lead to the following hypotheses:

**Hypothesis 5a:** The positive effect of board co-working experience (i.e., internal social capital)
on investor reaction to a new CEO appointment will be stronger for internal than for external CEO successions.

Hypothesis 5b: The positive effect of external directorship ties (i.e., external social capital) on investor reactions to a new CEO appointment will be stronger for external than for internal CEO successions.

METHODS

Sample selection

The sample for this study consisted of new CEO appointment announcements made between 1 January, 1999, and 31 December, 2003, by large (average sales revenue greater than $50 million in the three-year period prior to CEO succession), nondiversified (over 70% of annual sales from a single industry in the three-year period prior to CEO succession), publicly traded U.S. manufacturing firms. The term ‘industry’ was defined using the four-digit Standard Industrial Classification (SIC) codes based on the segment data provided in COMPUSTAT. To filter out events of little importance, we limited our sample to permanent appointments (Furtado and Rozeff, 1987). Consistent with prior research, we identified the announcements from the Wall Street Journal’s (WSJ) ‘Who’s News’ and ‘What’s News’ columns (Friedman and Singh, 1989; Furtado and Rozeff, 1987). The initial sample included 316 announcements made by 295 companies. After dropping cases with missing data, our final sample consisted of 208 CEO succession events. We compared the firms in our final sample against firms dropped for missing data on total assets, total sales, or employment size. Based on z-tests for differences in means, no significant differences were found between groups, indicating that selection bias was not a problem in our sample.

Measures

Dependent variable

Abnormal stock return refers to the difference between the observed return and the predicted or normal return for the firm’s stock around the appointment of the new CEO. Thus, the impact of the event was measured by the portion of the return that is unanticipated by an economic model of anticipated, normal returns. This may be expressed mathematically as:

\[ E = R_{it} - (\alpha_i + \beta_i R_{mt}), \]

where \( R_{it} \) = return on stock \( i \) for day \( t \), \( R_{mt} \) = return on the market portfolio for day \( t \), \( \alpha_i \) = a constant, and \( \beta_i \) = beta of stock \( i \). To estimate \( \alpha \) and \( \beta \), we used an estimation period of 250 days, or approximately one year of trading days, from 295 days to 45 days before the event. Short event windows have the advantage of limiting possible confounding effects (McWilliams and Siegel, 1997), so the dependent variable in this study was measured as the cumulative abnormal return (CAR) over the two-day window (0,1) around the announcement date of CEO appointment.

To ensure that abnormal returns reflect the market’s reaction to the new CEO appointment, we identified the day on which the CEO selection news was first known to the public by comparing the publication date of the WSJ to the date of the hiring company’s own press release and choosing the earlier of the two as the event date. We found 17 sample firms had announced a succession plan and named the successor before the official appointment of the successor. Hence, we assigned these cases a new (more accurate) event date—the day when the succession plan was announced.

Independent variables

All board experience and external directorship ties variables were created for year \( t-1 \), treating the year in which the new CEO was appointed as \( t \), and they were measured only for the independent directors of the focal firm. We coded data on board-related variables from the sample firms’ proxy statements filed in year \( t-1 \). Corporate governance researchers have classified directors into three groups: inside, affiliated, and independent (Daily, Johnson, and Dalton, 1999). We coded a director as an insider if he or she was a current employee of the focal firm. An affiliated director was defined as being one or more of the following: a former employee, a service provider, a supplier, a customer, a recipient of charitable funds contributed by the firm, an interlocking or designated director, and/or a family member of a director or an executive. Finally, we coded a director as independent if he or she was an outside director not
affiliated with the company in any of the capacities listed above.

Board human capital was measured with two variables—board CEO experience and board industry experience. We first identified the name of each independent director’s current employer—or most recent employer if the director was retired—as well as his or her job title(s) with the employer. A ‘CEO director’ was defined as an independent director who currently was, or previously had been, the CEO of another firm. Board CEO experience was then measured as the percentage of independent board members who were CEO directors (Fich, 2005). Consistent with prior work (e.g., Kroll et al., 2008), board industry experience was measured as a dichotomous variable (= 1 if one or more independent directors had current or past work experience in the same industry as the focal firm, and = 0 if no independent director had current or past experience in the same industry).

We defined internal social capital in terms of the board’s co-working experience. Consistent with previous research (Barkema and Shvyrykov, 2007; Carroll and Harrison, 1998), board co-working experience was calculated as the overlap in independent directors’ board tenures based on the following formula:

\[
\text{Board co-working experience} = \frac{1}{n} \sum_{i \neq j} \min(u_i, u_j),
\]

where \(u_i\) is the board tenure of the \(i^{th}\) director and \(n\) is the number of pairwise comparisons. Finally, board external social capital was defined as external directorship ties, and consistent with prior studies (e.g., Ferris et al., 2003; Fich, 2005; Mitra and Hossain, 2007), measured as the average number of external directorship ties held by the independent directors of the focal firm.

Control variables

To rule out confounding explanations, we incorporated a set of control variables for outgoing (old) and incoming (new) CEO characteristics, succession context, board independence, board experience diversity, and the organizational and industry contexts.

CEO characteristics and succession context. Age is a proxy for a CEO’s experience and career expectations (Cannella and Shen, 2001). Therefore, we controlled for the old CEO’s and the new CEO’s ages. Because the new CEO’s characteristics may affect investors’ expectations for future firm value, we added in the model several variables measuring the characteristics of the new CEO. New CEO origin was coded ‘1’ if the new CEO was an insider and ‘0’ if he or she was an outsider (Zhang and Rajagopalan, 2004). We also controlled for three variables measuring the new CEO’s human and social capital. The first variable is the number of external directorships held by the new CEO. The second is the new CEO’s job experience, coded ‘1’ if the new CEO held the CEO title at his or her previous employing firm (when the new CEO was an outsider) or if the new CEO held the title of president, chief operating officer (COO), or both (when the new CEO was an insider, or more specifically, an heir apparent to the CEO position) (Shen and Cannella, 2003; Zhang and Rajagopalan, 2004), and ‘0’ if otherwise. This variable shows whether or not the new CEO had previous exposure to tasks specific to the CEO position. The third is the new CEO’s industry experience, coded ‘1’ if the new CEO had had work experience in the focal firm’s primary industry. Next, we followed previous work (Cannella and Lubatkin, 1993; Huson, Malatesta, and Parreno, 2004) and controlled for old CEO disposition, in which ‘1’ represents routine departures and ‘0’ represents nonroutine departures. Routine departures included (1) relay successions, in which an heir apparent became CEO and the outgoing CEO became board chairperson, and (2) retirement, in which the outgoing CEO retired but remained as the chairperson or a director. Nonroutine departures included (1) voluntary resignation, (2) forced resignation and dismissal, and (3) death or health problems. Characteristics of the arriving/departing CEOs and succession events were coded from the WSJ, company press releases, and corporate proxy statements.

Board independence. We controlled for outsider ratio, the most widely used measure of board independence (Zahra and Pearce, 1989). This variable was computed as the proportion of independent outside directors on the board. The departing CEO may also influence the choice of successor. For example, some independent directors are likely to have been handpicked by the old CEO (Shivdasani and Yermack, 1999), and as such they may be less
influential over the selection of a new CEO than directors who joined the board prior to the old CEO. For that reason, we controlled for the percentage of independent directors joining the board after the old CEO. The effect of inside directors’ experience on board performance may also be relevant in this context. Some researchers argue that insiders contribute to board performance by virtue of their firm-specific knowledge (Baysinger and Hoskisson, 1990), whereas others posit that insiders use information for their own interests rather than for the benefit of shareholders (Weisbach, 1988). To control for the effect of insiders’ experience, we incorporated insiders’ average board tenure into the analysis. Independent directors with a financial stake in the firm may be more motivated to monitor firm management (e.g., Hambrick and Jackson, 2000), so we controlled for director stock ownership, measured as the percentage of shares outstanding owned by all independent directors.

Organizational and industry context. Three firm-level controls were included. Because investors may respond differentially to CEO successions in large and small firms (Furtado and Rozeff, 1987), we controlled for firm size, measured as the logarithm of the firm’s total assets averaged over the three years prior to CEO selection. Pre-succession performance has also been regarded as an important contingency in CEO succession research. Following previous research (Zhang and Rajagopalan, 2004), we created a composite index of prior firm performance by standardizing the market-to-book-value ratio and return on equity (ROE) for the year prior to CEO succession (mean = 0, s.d. = 1) and then summing the two standardized values. We also controlled for prior industry performance, which was operationalized as the median firm performance—also computed as a composite measure of market-to-book value and ROE—in the focal firm’s primary industry. Data on the size and performance variables were obtained from COMPUSTAT. Finally, consistent with prior work, we controlled for industry instability (Boyd, 1990). We regressed time against industry sales using the following equation for each four-digit SIC industry:

$$Y_t = b_0 + b_1 \times t + \varepsilon_t,$$

where $Y_t$ is the total sales of all firms in an industry in year $t$, and $\varepsilon_t$ is the residual. Industry instability was then computed as the standard error of the estimated beta coefficient ($b_1$) divided by sales averaged over the five-year period prior to the year of CEO succession (from year $t-5$ to $t-1$). Data on these variables were obtained from COMPUSTAT.

Board experience diversity. The broader literature on top management teams and boards has argued that both the level and the diversity of experience may be relevant in examining group/firm outcomes. However, the empirical evidence about the relation between experience diversity and group performance has been mixed (Milliken and Martins, 1996). In this study, we incorporated four diversity measures. Board CEO experience diversity was measured using the formula developed by Tsui, Egan, and O’Reilly (1992):

$$\left[ \frac{1}{n} \sum_{j=1}^{m} (S_i - S_j)^2 \right]^{1/2}.$$  

It is the square root of the summed squared differences between a director $S_i$’s CEO tenure and the CEO tenure of every other director $S_j$, divided by the number of independent directors. Board co-working experience diversity was measured in the same way except that $S_i$ and $S_j$ represented directors’ board tenures. We controlled for board industry experience diversity based on the measure used by Cannella, Park, and Lee (2008). We checked each independent director’s primary or most recent employer and recorded the number of industries in which that company had operations from the business segment data of COMPUSTAT. Board industry experience diversity was then measured using the following formula:

$$\left[ \sum_{i=1}^{n} (1 - \sum_{j=1}^{m} p_{ij}^2) \right]/n,$$

where $p_{ij}$ equals the reciprocal of the number of industries (i.e., I divided by the number of industries in which a director’s primary or most recent employer operated), $m$ is the number of industries, and $n$ is the number of independent directors. A higher score represents greater industry experience diversity. While these three diversity measures address the board’s human capital and internal social capital, the effect of diversity may also be reflected in the number of industries to which the board is linked through directors’ external board ties. Therefore, we added another control variable, industry diversity of external directorship ties, measured as the number of two-digit SIC industries represented in the board’s external
directorship ties divided by the total number of external ties.²

RESULTS

Table 1 provides descriptive statistics and correlations for the variables used in the study. Table 2 reports the results of ordinary least squares (OLS) regression analysis for CAR (0, 1).³ Model 1 included the control variables only. Model 2 added the four board capital variables to Model 1. Model 3 added to Model 2 the two interaction terms between new CEO origin and (a) board co-working experience and (b) external directorship ties. Results from Model 3 were used to test the hypotheses.

The independent variables were mean-centered prior to creating the interaction terms to address the issue of potential multicollinearity between the main effects and the interaction terms (Aiken and West, 1991). We inspected the values of variance inflation factors (VIF) to assess our data for multicollinearity. The VIF values ranged between 1.06 and 2.05 for the variables in our regressions models, which is much lower than the commonly accepted threshold value of 10 (Hair et al., 1998) and demonstrates that multicollinearity is not a problem in our data.

Hypothesis 1 predicted a positive effect of board CEO experience on the stock market reaction to a new CEO appointment. Consistent with this hypothesis, the regression coefficient in Model 3 for board CEO experience is positive and significant (b = 4.23, p < 0.05). Hypothesis 2 predicted a positive relation between board industry experience and investor reaction to a new CEO appointment. The regression coefficient for board industry experience is positive and significant, supporting Hypothesis 2 (b = 2.62, p < 0.05). Hypothesis 3 predicted that board co-working experience should be positively related to CAR. The regression coefficient for co-working experience provides strong support for Hypothesis 3⁴ (b = 0.94, p < 0.001). Consistent with Hypothesis 4, the coefficient for directors’ external directorship ties shows a positive effect on CAR (b = 0.93, p < 0.05). The four independent variables as a group explain a significant proportion of the variance of the dependent variable. Compared with Model 1, the incremental variance explained by Model 2 is 13 percent (p < 0.001). These results support our theoretical premise that each of the four variables representing a different element of board human and social capital has a distinct impact on the stock market reactions to new CEO appointment.

Hypotheses 5a and 5b predicted moderating effects of new CEO origin on the relationships between board co-working experience, external directorship ties, and CAR, respectively. The coefficient for the interaction between board co-working experience and new CEO origin is positive and significant (b = 0.80, p < 0.05); therefore, the result supports Hypothesis 5a. Moreover, consistent with Hypothesis 5b, the interaction term between external directorship ties and new CEO origin is negative (b = −1.50, p < 0.10). But the marginal significance of the interaction term provides only limited support for Hypothesis 5b.

To further facilitate interpretation, we plotted the significant two-way interaction effect for co-working experience in Figure 1. All variables except the relevant independent variables were constrained to their sample means. Following Aiken and West (1991), we calculated the two simple slopes related to the interaction effect. The simple slopes refer to the regression coefficients of board co-working experience for insider successions and outsider successions, respectively. Consistent with Hypothesis 5a, in events in which the new CEO was hired from outside the firm, the simple slope for board co-working experience was not significant (b = 0.57, n. s.), while the slope was positive and significant in insider succession events (b = 1.33, p < 0.001). Investors appeared

² Of the firms in our sample, 60 percent did not have any external directorship ties with other companies in their own two-digit SIC industry, and 89 percent of firms did not have any external directorship ties with other companies in their own four-digit industry.

³ To assess the sensitivity of our findings, we also ran our analyses using (0, 2) and (0, 3) windows. We were able to replicate our findings using these additional windows, and these results are available upon request.

⁴ Previous work on ‘groupthink’ (Janis, 1972) suggests that shared group experience beyond a certain level may lead to suboptimal decisions. Hence, groupthink would be consistent with a nonlinear relationship between co-working experience and board effectiveness. To test for this possibility, we included a squared term for co-working experience in supplementary analysis, but we found no significant effect. Perhaps because boards meet less frequently and for shorter time periods than other groups within organizations (e.g., top management teams), they are less susceptible to groupthink.
Table 1. Mean, standard deviation, and correlations

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>s.d.</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
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<th>10</th>
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<tr>
<td>CAR (0.1)</td>
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<td></td>
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<td></td>
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</tr>
<tr>
<td>Old CEO age</td>
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<td>7.42</td>
<td>0.15</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>New CEO age</td>
<td>50.17</td>
<td>6.82</td>
<td>−0.20</td>
<td>0.11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New CEO origin</td>
<td>0.58</td>
<td>0.50</td>
<td>−0.09</td>
<td>0.13</td>
<td>0.01</td>
<td></td>
<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>New CEO external directorships</td>
<td>0.74</td>
<td>1.28</td>
<td>−0.05</td>
<td>−0.03</td>
<td>0.28</td>
<td>−0.14</td>
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<tr>
<td>New CEO job experience</td>
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<td>0.50</td>
<td>−0.06</td>
<td>0.15</td>
<td>0.00</td>
<td>0.32</td>
<td>−0.14</td>
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<tr>
<td>New CEO industry experience</td>
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<td>0.47</td>
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<td>−0.08</td>
<td>0.62</td>
<td>−0.08</td>
<td>0.11</td>
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<tr>
<td>New CEO external directorships</td>
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<td>0.42</td>
<td>0.13</td>
<td>0.26</td>
<td>−0.21</td>
<td>0.14</td>
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<td>0.11</td>
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<tr>
<td>New CEO job experience</td>
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<td>0.18</td>
<td>0.13</td>
<td>0.08</td>
<td>0.13</td>
<td>0.00</td>
<td>0.10</td>
<td>0.05</td>
<td>−0.01</td>
<td>−0.01</td>
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<tr>
<td>Outsider ratio</td>
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<td>0.39</td>
<td>0.07</td>
<td>0.13</td>
<td>−0.12</td>
<td>−0.03</td>
<td>−0.06</td>
<td>0.07</td>
<td>0.05</td>
<td>0.26</td>
<td>0.12</td>
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<td>Insiders’ average board tenure</td>
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<td>0.09</td>
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</tr>
<tr>
<td>Insiders’ average board tenure</td>
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</tr>
<tr>
<td>Director stock ownership</td>
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<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Firm size</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Prior firm performance</td>
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<td>0.03</td>
<td>0.02</td>
<td>−0.02</td>
<td>0.00</td>
<td>0.11</td>
<td>0.00</td>
<td>0.00</td>
<td>0.07</td>
<td>0.06</td>
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<tr>
<td>Industry instability</td>
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<td>3.07</td>
<td>0.14</td>
<td>0.20</td>
<td>0.09</td>
<td>−0.13</td>
<td>0.09</td>
<td>−0.10</td>
<td>0.15</td>
<td>0.09</td>
<td>0.08</td>
<td>0.05</td>
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<td>Board CEO experience diversity</td>
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<td>5.84</td>
<td>0.07</td>
<td>0.04</td>
<td>0.07</td>
<td>0.10</td>
<td>0.00</td>
<td>−0.04</td>
<td>−0.12</td>
<td>0.13</td>
<td>−0.01</td>
<td></td>
</tr>
<tr>
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<td>0.29</td>
<td>0.04</td>
<td>−0.05</td>
<td>−0.08</td>
<td>−0.01</td>
<td>0.05</td>
<td>0.02</td>
<td>−0.01</td>
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<td>0.21</td>
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<td>Board co-working experience</td>
<td>10.79</td>
<td>8.24</td>
<td>−0.12</td>
<td>0.31</td>
<td>0.02</td>
<td>0.17</td>
<td>0.02</td>
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<td>0.05</td>
<td>0.09</td>
<td>0.28</td>
<td>−0.06</td>
</tr>
<tr>
<td>Industry diversity of external ties</td>
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<td>0.96</td>
<td>0.02</td>
<td>0.02</td>
<td>−0.03</td>
<td>−0.03</td>
<td>0.00</td>
<td>0.03</td>
<td>−0.01</td>
<td>−0.02</td>
<td>−0.29</td>
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<tr>
<td>Board CEO experience</td>
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<td>−0.06</td>
<td>0.06</td>
<td>−0.03</td>
<td>0.17</td>
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<td>−0.01</td>
<td>0.00</td>
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<td>0.43</td>
<td>0.08</td>
<td>−0.16</td>
<td>−0.01</td>
<td>−0.03</td>
<td>−0.03</td>
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<td>−0.01</td>
<td>0.03</td>
<td>0.19</td>
<td>0.03</td>
</tr>
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<td>0.18</td>
<td>0.26</td>
<td>0.01</td>
<td>0.14</td>
<td>−0.09</td>
<td>0.10</td>
<td>0.10</td>
<td>0.15</td>
<td>−0.01</td>
<td>−0.06</td>
</tr>
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<td>0.96</td>
<td>0.11</td>
<td>−0.08</td>
<td>0.11</td>
<td>0.04</td>
<td>0.12</td>
<td>0.00</td>
<td>−0.07</td>
<td>0.01</td>
<td>0.12</td>
<td>−0.03</td>
</tr>
</tbody>
</table>

N = 208. † p < 0.10; * p < 0.05; ** p < 0.01; *** p < 0.001.
Table 2. Effects of board human and social capital on investor reactions to new CEO selection

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>s.e.</td>
<td>B</td>
</tr>
<tr>
<td>(Constant)</td>
<td>17.89**</td>
<td>(6.18)</td>
<td>14.03*</td>
</tr>
<tr>
<td>Old CEO age</td>
<td>−0.19*</td>
<td>(0.09)</td>
<td>−0.18*</td>
</tr>
<tr>
<td>New CEO age</td>
<td>−0.20**</td>
<td>(0.08)</td>
<td>−0.23**</td>
</tr>
<tr>
<td>New CEO origin</td>
<td>−0.29</td>
<td>(1.48)</td>
<td>−0.16</td>
</tr>
<tr>
<td>New CEO external directorships</td>
<td>−0.43</td>
<td>(0.46)</td>
<td>−0.43</td>
</tr>
<tr>
<td>New CEO job experience</td>
<td>−0.65</td>
<td>(1.15)</td>
<td>−1.35</td>
</tr>
<tr>
<td>New CEO industry experience</td>
<td>−1.26</td>
<td>(1.44)</td>
<td>−1.50</td>
</tr>
<tr>
<td>Old CEO disposition</td>
<td>2.14†</td>
<td>(1.37)</td>
<td>0.90</td>
</tr>
<tr>
<td>Outsider ratio</td>
<td>−3.33</td>
<td>(3.48)</td>
<td>−4.89†</td>
</tr>
<tr>
<td>% directors joining board later than old CEO</td>
<td>2.16†</td>
<td>(1.54)</td>
<td>3.30*</td>
</tr>
<tr>
<td>Insiders’ average board tenure</td>
<td>−0.14†</td>
<td>(0.10)</td>
<td>−0.22*</td>
</tr>
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<td>Director stock ownership</td>
<td>−0.24</td>
<td>(0.57)</td>
<td>−0.45</td>
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<tr>
<td>Firm size</td>
<td>0.71*</td>
<td>(0.35)</td>
<td>0.45†</td>
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<td>Prior firm performance</td>
<td>−0.03</td>
<td>(0.50)</td>
<td>−0.15</td>
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<td>Prior industry performance</td>
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<td>(0.44)</td>
<td>−0.72*</td>
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<tr>
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<td>(0.18)</td>
<td>0.30*</td>
</tr>
<tr>
<td>Board CEO experience diversity</td>
<td>0.18*</td>
<td>(0.09)</td>
<td>0.18*</td>
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<tr>
<td>Board industry experience diversity</td>
<td>−0.17</td>
<td>(1.88)</td>
<td>0.38</td>
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<td>Board co-working experience diversity</td>
<td>−0.07</td>
<td>(0.08)</td>
<td>−0.10†</td>
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<tr>
<td>Industry diversity of external ties</td>
<td>0.25</td>
<td>(0.58)</td>
<td>0.77†</td>
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<tr>
<td>Board CEO experience</td>
<td>4.56*</td>
<td>(2.23)</td>
<td>4.23*</td>
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<td>Board industry experience</td>
<td>2.50*</td>
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<td>2.62*</td>
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<td>Board co-working experience</td>
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<td>(0.22)</td>
<td>0.94***</td>
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<td>Board external directorship ties</td>
<td>0.95*</td>
<td>(0.53)</td>
<td>0.93*</td>
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<tr>
<td>New CEO origin X Board co-working experience</td>
<td>0.80*</td>
<td>(0.44)</td>
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<tr>
<td>New CEO origin X Board external directorship ties</td>
<td>−1.50†</td>
<td>(1.01)</td>
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<tr>
<td><strong>R squared</strong></td>
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<tr>
<td><strong>R squared change</strong></td>
<td>0.13***a</td>
<td></td>
<td>0.02†c</td>
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</tbody>
</table>

* Values are unstandardized regression coefficients, with standard errors in parentheses. Coefficients and standard errors are multiplied by 100 to facilitate interpretation.

b Relative to Model 1.

c Relative to Model 2. † p < 0.10; * p < 0.05; ** p < 0.01; *** p < 0.001. N = 208. All are one-tailed t tests.

Figure 1. Interaction effect of board co-working experience and new CEO origin
to evaluate board co-working experience more positively when the new CEO was promoted from within.

**DISCUSSION**

This is, to the best of our knowledge, the first empirical paper providing evidence that board capital influences investor reactions to new CEO selection. Board capital theory suggests that board human capital comprises director experience and expertise, while board social capital consists of the resources available to the board through its network of relationships (Hillman and Dalziel, 2003). Because hiring the CEO is widely accepted as the board’s most important decision, and one in which the board is more directly involved than in any other (Vancil, 1987), we chose to examine the effect of board capital on board effectiveness in this highly relevant decision context.

Our study refines the agency theory-based suggestion that firms should select independent board members (Weisbach, 1988). Prior work on boards shows that board motivation associated with high structural independence may not be sufficient to ensure board effectiveness (Johnson et al., 1996). Our findings provide empirical credibility to this suggestion and clearly highlight the importance of selecting independent board members with relevant board capital. This study shows that the ability of independent directors in the form of board capital is valued by the market upon the firm’s announcement of appointing a new CEO. These results are consistent with the idea that both board motivation and ability are necessary for understanding board effectiveness. These findings parallel other work that has shown that ability is a critical determinant of task performance (Hunter and Hunter, 1984).

Emerging research on board human capital has shown that directors’ human capital, measured as strategic experience in their home companies, significantly influences the strategic changes observed in the firms where they serve on the board (Westphal and Fredrickson, 2001). Also, directors’ human capital in the form of prior acquisition-related experience impacts a focal firm’s acquisition outcomes (Kroll et al., 2008; McDonald et al., 2008). Consistent with these studies, our findings suggest that board human capital matters. We found that both CEO experience and industry experience of independent directors were positively related to investor reactions to new CEO selection. Our study further examined the role of board social capital in determining board effectiveness in CEO selection. By drawing a distinction between internal and external social capital, we were able to examine both direct and relative effects of these two types of social capital. We found evidence supporting the direct effect argument as stock market investors responded favorably to CEO hiring decisions made by boards with high levels of internal and external social capital. This evidence, combined with the effect of board human capital, suggests that board capital does explain a significant portion of board effectiveness in CEO selection as perceived by the market.

We then investigated if the two types of board social capital affect investor reactions differently depending on where the new CEO comes from. The new CEO’s origin (insider or outsider) is an important contextual factor not only because it is expected to influence the firm’s future strategic direction (Vancil, 1987) but also because prior research on the link between CEO origin and stock market reaction to CEO appointment has not been conclusive (Kesner and Sebora, 1994). An implication is that investors may look for firm value-enhancing factors other than CEO origin. In this study, we found some evidence that investor reactions might be affected by different ‘combinations’ of new CEO origin and the hiring board’s social capital. In particular, investors reacted most positively to internal promotions made by boards with high levels of internal social capital. While this is the first study of which we are aware that demonstrates the importance of board internal social capital (in the form of board co-working experience), the underlying logic for why internal social capital is crucial to group performance can be found in prior classic management work (e.g., Penrose, 1959). Board members with long co-working experience, by virtue of their tacit knowledge about one another’s expertise, the board, and the firm, are able to provide resources that cannot be provided by directors who have little time to get familiar with their job and with one another.

In sum, our study suggests that boards should ensure that the ‘experience profiles’ of independent directors meet the ability requirements of various board tasks, so that the board can have ‘the right information in the right format at the right time’ (Charan, 2005: 47). CEO experience
is regarded as an important source of business expertise (Bianco and Bryne, 1997; Hillman et al., 2000) and likely benefits a wide range of board decisions. In contrast, industry experience may be more context-specific and is likely more important for nondiversified companies than for diversified companies. In addition, the strong positive effect of board co-working experience implies the importance of maintaining board stability and hence its ability to develop internal social capital. Finally, firms may be better able to obtain valuable strategic information from the external environment if they recruit independent directors with more directorship ties with other companies, which, among other benefits, may allow them to access a broader pool of qualified candidates.

This study tested a comprehensive model of board effectiveness in CEO selection. We found significant effects of board capital variables on investor reactions to new CEO appointments even after we controlled for the effects of individual-, board-, organizational-, and industry-level factors. In particular, while one may argue that investors would focus more on the new CEO’s characteristics when evaluating the performance implications of CEO succession, our findings show that board capital matters more than the new CEO’s characteristics. When the characteristics of the new CEO (age, origin, prior job and industry experience, and external director ties) were added to a baseline model that included all the other control variables, they increased the model’s explanatory power by four percent (incremental R-square = 4%). In comparison, when the four board capital variables were added to the same baseline model, R-squared increased by 11 percent. These results suggest that, at least in our sample, investors valued the board’s human and social capital more than information about the new CEO. While our findings may be somewhat surprising, it is consistent with prior empirical research that has shown a rather weak relationship between the characteristics of the new CEO and firm performance (e.g., Datta and Rajagopalan, 1998).

We also acknowledge our study’s limitations and suggest ways in which future research can address these shortcomings. First, we used straightforward measures of board capital variables from publicly available data. Arguably, our context-specific measures are more informative than previously used ‘rough’ proxies for board composition (e.g., inside vs. outside directors). However, our measures still do not directly capture the underlying board processes through which members access, utilize, and synthesize each other’s knowledge. To address this limitation, future researchers should directly examine the board processes that facilitate (or hinder) board decision making. Second, although we found evidence that boards benefited from high levels of co-working experience in the process of CEO selection, some prior work has suggested that board stability may have a negative effect on performance. For example, long-serving boards have been shown to initiate fewer strategic changes (Goodstein and Boeker, 1991) or set higher pay for the CEO (Vafeas, 2003). Future work would benefit by investigating the situations under which board stability, which contributes to both firm- and team-specific knowledge of the directors, would be preferred over a rotation of board members, which allows for an infusion of new ideas. Third, we only examined nondiversified firms because we wanted to minimize heterogeneity and maximize internal validity. Hence, the generalizability of our results to a more diversified sample may be limited. Fourth, while we focused on a particularly critical decision context, that is, new CEO selection, the generalizability of our findings also has to be assessed in the context of other strategic decisions.

Board ability has received increasing public attention in recent years. As the ratios of independent directors have significantly increased in many large public corporations (Kor and Sundaramurthy, 2009), it has never been more urgent than it is now to explore how independent directors may contribute to the company. We hope the findings reported here will spur future efforts to examine how the effectiveness of boards of directors is affected by various types of board human and social capital.

ACKNOWLEDGEMENTS

We thank Pallavi Kumar and Warren Kang for their help in data collection. We also thank Editor Will Mitchell and two anonymous reviewers for their helpful comments and suggestions.

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