



The Influence Of Corporate Governance On Investor Reactions To Layoff Announcements

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Abstract

Researchers in strategy often use agency theory to explain problems arising from the separation of ownership and management in corporations. These so-called agency problems occur when managerial activities fail to maximize shareholder value. For example, managers might implement strategies that promote their own long-term interests rather than the interests of shareholders. Efforts to attenuate agency problems focus on adopting governance practices that seek closer alignment of share-holder and manager interests (Fama and Jensen, 1983). Agency theory proposes that the board of directors monitors managers and constrains implementation of inefficient strategies (Zahra and Pearce, 1989). Strategies ratified by the board that represent shareholder interests should be positively associated with shareholder value (Baysinger and Butler, 1985).

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The Influence Of Corporate Governance On Investor Reactions To Layoff Announcements

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Researchers in strategy often use agency theory to explain problems arising from the separation of ownership and management in corporations. These so-called agency problems occur when managerial activities fail to maximize shareholder value. For example, managers might implement strategies that promote their own long-term interests rather than the interests of shareholders. Efforts to attenuate agency problems focus on adopting governance practices that seek closer alignment of shareholder and manager interests (Fama and Jensen, 1983). Agency theory proposes that the board of directors monitors managers and constrains implementation of inefficient strategies (Zahra and Pearce, 1989). Strategies ratified by the board that rep-

resent shareholder interests should be positively associated with shareholder value (Baysinger and Butler, 1985).

Shareholder activists base their movement for corporate governance reform on principles of agency theory (Lorsch, 1996), arguing that agency-based corporate governance practices increase shareholder value. Through their collective influence, activist groups have brought about significant changes in governance practice. However, the impact of these changes has not consistently improved shareholder value in all strategic contexts, suggesting that research in this area should focus on individual strategies.

While often mentioned in accounts of poor governance (e.g., Byrne,

1997; Lear and Yavitz, 1997), a strategy unexplored in the research literature is layoffs — the most commonly used form of organizational downsizing (Cameron, 1994). *Business Week* reports, "Rarely a week passes without the announcement of yet more cutbacks, in what has become the most unsettling and disruptive event in corporate America. . . . In [1994's] first quarter, employers announced an average of 3,106 cutbacks per day" (Byrne, 1994: 61). Layoffs can cut costs and promote more efficient use of labor resources. On the other hand, they can have considerable negative psychological, social, and economic effects. Perhaps most obvious is the emotional trauma and economic hardship that laid-off employees must endure. Less obvious are unanticipated costs such as employee lawsuits, loss of innovation and productivity among survivors, additional consulting fees, hiring full- or part-time workers to fill unforeseen employee gaps, and negative reputation effects that make it difficult to hire qualified employees (Banham, 1995; Cameron *et al.*, 1991; Faltermayer, 1992). Because shareholders are removed from the managerial decisions that determine the ultimate costs of layoffs, they have turned to governance practices as a means of aligning managers' decisions with their interests.

Empirical research on the performance implications of layoffs generally focuses on the impact of layoff announcements on shareholder wealth (e.g., Chadwell and Filbeck, 1994; Chadwell and Webb, 1996; Lee, 1997; Palmon *et al.*, 1997; Ursel and Armstrong-Stassen, 1995; Worrell *et al.*, 1991). However, no study to date incorporates the effect of governance practices on shareholder wealth in

the context of layoff announcements. Effort in this direction seems to be useful given the simultaneous rise and importance of the governance movement and corporate layoffs. This study examines the impact of governance practices advocated by activist groups on shareholder value in the strategic context of layoffs. We draw from three conceptual perspectives to explore an empirical link between characteristics of governance and the market's assessment of managerial decisions to lay off employees. First, we use strategic management's proposition that managerial strategy influences firm performance. Second, as noted, agency theory is the basis for assuming that better governance practice influences the choice of strategies that maximize shareholder value. Third, we use capital market theory to capture investors' evaluation of a firm's layoff strategy on future performance. As for specific improvements in governance practice, we investigate the following, which are widely advocated by activist groups: (1) higher proportions of outside directors on corporate boards, (2) consolidated shareholdings by institutional investors, and (3) greater stock ownership by board members (Brown, 1996; Byrne, 1997). The following question guides the study: *Do governance practices recommended by activist groups influence shareholder anticipation of future performance in announced layoffs?*

Prior empirical research reveals that governance influences performance in some strategic contexts, yet not in others. Research studies focusing on the performance implications of governance across strategic settings persistently resist orderly findings, making generalizations difficult (for example, see reviews by Dalton *et*

al., 1998; Johnson *et al.*, 1996; Zahra and Pearce, 1989). We therefore extend prior work in governance into a new strategic context and examine its implications for shareholder wealth using a conceptually integrated framework. This article specifically tests the idea that strong corporate governance is likely to increase wealth effects associated with the announcement of a layoff.

The remainder of this article is organized as follows. First, we review relevant research on layoffs and governance. In the following sections we develop hypotheses for each governance practice, describe empirical methods, and discuss our findings. Finally, we present our conclusions and their implications.

LAYOFFS, SHAREHOLDER WEALTH, AND GOVERNANCE

Many research studies investigate the relationship between layoff announcements and shareholder returns. Worrell *et al.* (1991) and Ursel and Armstrong-Stassen (1995) find a significant negative share price movement following layoff announcements. Chadwell and Filbeck (1994) examine market response to layoff announcements in firms that suffered extreme losses in market value and also find a significant negative share price movement. Lee (1997) compares stock price reactions to layoff announcements in U.S. and Japanese firms over the period 1990-94, and similarly finds a significant negative effect. These findings are consistent with the popular belief that the stock price of firms announcing layoffs typically conveys negative information to the market (Cascio, 1993).

Most studies on the stock market's reaction to layoffs actually consider

two types of layoffs: those used as a stand-alone strategy and those that are part of a broader organizational restructuring (Cameron, 1994; Cascio, 1993; Lee, 1997; Palmon *et al.*, 1997; Worrell *et al.*, 1991). When layoff announcements mention that a layoff is used in conjunction with one or more other downsizing strategy, the market's reaction will be affected by the layoff as well as the other strategies. Evidence exists showing significant abnormal returns when each of the following are announced as a stand-alone strategy: sell-offs (Hirschey and Zaima, 1989), plant closings (Blackwell *et al.*, 1990), and early retirement programs (Davidson *et al.*, 1996). These findings raise an important issue about layoffs that are announced together with other forms of downsizing. Anticipated wealth creation due to the layoff cannot be separated from the market's reaction to the announcement. This has the effect of confounding the market's evaluation of the loss of human assets by including the loss or reconfiguration of other assets.

In this study, we use the more restrictive interpretation of layoffs. Our sample includes only layoff announcements that do not make reference to layoffs used in conjunction with another downsizing strategy. For example, we exclude announcement of layoffs resulting from a firm's sale or closing of manufacturing plants, or from internal consolidation. The layoffs in our sample may therefore be biased toward firms motivated by economic decline, which is not unreasonable given that most of the announcements occur between 1989 and 1992, a period of economic recession. Firms whose layoffs are not specifically tied to restructuring are more likely to signal attempts to bol-

ster competitiveness or to contain costs (Freeman and Cameron, 1993). When motivated by such factors, layoffs may signal bad news because they attempt to minimize losses rather than maximize profits. For example, the *New York Times* notes that recession "increases the likelihood that companies will cut staff, (but) decreases the likelihood that they will be satisfied with the results" (Bennett, 1991: B1). On the other hand, it is probable that some firms use layoffs to sustain or fortify competitive advantage when they are not tied to restructuring. These proactive layoffs would likely signal positive news to the market.

Worrell *et al.* note that shareholder returns are a key strategic variable that "reflect the bottom-line results of organizational layoff announcement strategies" (1991: 662). From a strategic management perspective, investors will use all important information that potentially affects performance (Lubatkin and Shrieves, 1986). We contend that, in addition to financial information conveyed in the layoff signal, investors view firms' governance practices as important information to help them assess the "bottom-line" results of the announced layoff strategy.

Governance and Shareholders' Perception of Layoff Strategies

In capital market theory, the stock market's reaction to an announced event reflects all available information (Fama, 1976). However, management has an information advantage over investors by knowing how much effort it actually intends to put into the short- and long-term activities that will create current and future earnings (Milgrom and Roberts,

1992). Such information asymmetries can compromise the accuracy of investors' evaluation of managers' strategies (Walsh and Seward, 1990). Valuable inside information influences the content of the signal that firms convey in announcements to investors (Asquith and Mullins, 1986). Lee notes that, besides signaling, firms use layoff announcements as a form of impression management by attempting to "make work force reductions appear proactive rather than reactive" (1997: 885). This implies that investors may receive inaccurate or incomplete information about how management intends to execute and implement its layoff strategy.

The basic problem in the preceding discussion can be viewed using the agency perspective. Some top executives would be expected to have the same values as their shareholders, while others may use their managerial discretion selfishly (Oviatt, 1988). Shareholders could minimize the agency costs of inaccurate or incomplete layoff announcements by engaging the monitoring activities conducted by the board of directors and major shareholders. Put differently, under stronger corporate governance, investors could evaluate a firm's layoff announcement with greater confidence.

HYPOTHESES

Of course, the ability to evaluate governance in a given firm assumes that shareholders are *aware* of the firm's governance practices when a layoff is announced. We contend that one reason why shareholders are likely to be aware of individual governance practices is because they draw widespread attention in the media, mainly through the efforts of

shareholder activist groups. Fortune 500 firms are routinely evaluated and ranked in the business press according to how well they conform to acceptable governance practices. A second reason is that majority shareholders are often those investors most active in governance reform and for whom governance practices would be essential information. As a next step, we make predictions about the impact of each governance practice on shareholder wealth in the context of layoff announcements.

Outside Directors

Agency theorists contend that outside directors who have no discernable ties to the corporation strengthen the ability of the board to monitor and ratify policies formulated and implemented by corporate managers. Outsiders have less allegiance to the CEO than inside directors and are more likely to question the policies of top management (Baysinger and Hoskisson, 1990). They more effectively align the goals of management with those of shareholders (Jensen and Meckling, 1976). In doing so, they enhance their reputations as expert and objective decision makers (Fama and Jensen, 1983).

Research shows that departing inside directors will likely be replaced by outsiders when a firm's stock returns are low (Hermalin and Weisbach, 1988), suggesting that the appointment of outsiders reflects shareholders' desire for improved monitoring (Weisbach, 1988). In support of this and also providing evidence that investors are aware of board composition, Rosenstein and Wyatt (1990) find positive abnormal market returns following the announcement of outside director ap-

pointments. Worrell *et al.* (1997) find that shareholders respond negatively to an increase in key executive plurality but positively when an outsider is hired into a plural position. Moreover, the business press reports that shareholders seek greater accountability of individual directors (Byrne, 1997; Dobrzynski, 1997b; Witte, 1997), suggesting an awareness of overall composition.

Investors may sense that a firm will incur post-layoff costs that exceed anticipated gains (Cascio, 1993; DeMeuse *et al.*, 1994) because managers fail to engage in proper planning and implementation (Cameron *et al.*, 1991) or lack relevant experience and training in layoff strategies (Cascio, 1993). The more objective views and expertise of outside directors can make restructuring strategies more effective (Jones, 1995; Lear and Yavitz, 1997; Nelson, 1995). The absence of objectivity and/or expertise on the boards of H.J. Heinz Company, AT&T, and Apple Computer can help explain layoffs that decreased shareholder value (Byrne, 1997; Kouskoulas and Raghavan, 1998; Dobrzynski, 1997a). Making better layoff decisions also requires developing board knowledge on human resource issues (Horton, 1991). It seems reasonable that part of this requirement can be met by appointing outside directors with expertise in downsizing strategies. Another compelling reason for using outsiders as objective and expert monitors stems from an increase in board liability litigation (Banham, 1995). By improving the quality of information and through more vigilant monitoring, outsiders could help reduce the risk associated with poor layoff decisions.

We propose that an agency-based analysis of the link between outside

directors and shareholder value leads directly to our first hypothesis.

Hypothesis 1: The market is likely to react less negatively, or positively, to layoff announcements made by firms with a greater proportion of outside directors than firms with a lower proportion of outside directors.

Institutional Investors

Institutional investors—public and private pension funds, investment firms, and insurance firms—have increased their ownership of corporate equity from less than 10 percent in 1970 to over 50 percent in 1998. Institutions manage shares for third-party investors, providing them with a strong incentive to influence the board and management to ensure that their investments are profitable. Consistent with an agency theory perspective, consolidation of ownership gives institutional investors the incentives and power to reduce agency problems associated with inefficient management (Demsetz, 1983; Demsetz and Lehn, 1985). Concentration of ownership also makes it increasingly difficult for investors to sell or buy shares, except to other institutions (Davis and Thompson, 1994; Pound, 1992). Instead, they create value for third-party investors by influencing managements' strategies (Bethel and Liebeskind, 1993). Large ownership provides economies of scale in gathering information needed to monitor management and vote according to their constituents' interests (Demsetz, 1983). Although state and federal laws restrict the percentage of its assets that an institution can invest in a single firm and the proportion of equity in a given firm that it can own, institutions have nonetheless become a powerful force by efficiently organizing within and

across corporations. Coordinating actions on the basis of their joint holdings has given institutional investors the ability to influence and even pressure management in poorly performing firms. The formation of activist organizations such as the Council of Institutional Investors has further strengthened the power of institutional investors by providing a singular identity and common base for collective action (Davis and Thompson, 1994). In an interview with *Fortune*, the General Counsel and Managing Director of Fidelity Investments draws an insightful agency-based analogy that captures the changing role of shareholders in corporate governance:

... I think more communication among shareholders, and between shareholders and management, is now playing some of the disciplinary role that the threat of takeovers used to play (Magnet, 1993: 60).

Interestingly, the role of institutional investors in creating value is a subject of some debate in the business press and academic literature (cf., Brown, 1996; Chaganti and Damanpour, 1991; Kouskoulas and Raghavan, 1998). With respect to corporate downsizing strategies, some large institutions such as TIAA-CREF and CalPERS, and activist organizations such as the Council of Institutional Investors, claim no involvement in managerial decisions. Others, however, may be more involved. In an interview with *Fortune*, the Corporate Affairs Manager for the Florida State Pension Fund reports:

The ability to generate return on equity for shareholders—not necessarily asset size—should be the determinant of the proper size of the corporation. They may need to downsize. . . . The key from our standpoint is to get the directors thinking about that (Magnet, 1993: 60).

Thus, it would appear that, in addition to voting in outside directors

who promote shareholder interests, institutions can at least indirectly influence directors and/or managers to use layoffs. The business press and specialty governance publications echo this notion (e.g., Heenan, 1993; *Pensions and Investments*, 1996). Useem (1996) reports that investor pressure to shrink costs can often be traced to the size of the workforce, leading managers to believe that "good" managements will reflexively initiate layoffs when employment and revenue trends are asynchronous or when operations are not lean and efficient. Not all institutions applaud management's use of layoff strategies, however. In the case of Apple Computer, investors recently chided management for not carefully evaluating the need for layoffs (Dobrzynski, 1997b). Shortly thereafter, institutions were instrumental in adding outside directors and changing management.

The foregoing research and anecdotal evidence suggest a link between institutional investors and the stock market's reaction to layoff announcements. When firms have a large percentage of shares held by institutions, they should signal greater oversight of layoff strategies. This would mitigate managerial indiscretions such as impression management and have positive implications for future performance. Consequently, we propose that the market will perceive layoffs

more favorably in firms having a greater proportion of institutional investors:¹

Hypothesis 2a: The market is more likely to react less negatively, or positively, to layoff announcements made by firms with a greater proportion of institutional investors than firms with a lower proportion of institutional investors.

The conditions that lead to a layoff will generally develop over a period of time as many firms will need to cut costs or choose to enhance efficiency. If institutional investment promotes efficiency and creates value for shareholders as proposed, then increases in institutional investment over time should signal to the market that a firm would be better managed and its layoff decisions will similarly create value.

Hypothesis 2b: The market is more likely to react less negatively, or positively, to layoff announcements made by firms whose institutional ownership increases over a three-year period preceding the layoff announcement than by firms whose institutional ownership did not increase.

Directors' Stock Ownership

Poor firm performance could reflect a board's disinterest or uninvolvement in corporate governance. For example, boards may not specify appropriate performance benchmarks to management (Walsh and Seward, 1990) or may fail in their ability to control management activities and proposals that are not in shareholder-

¹ One might argue that a more favorable stock market reaction could be the result of tightly connected institutions buying up stock and raising their price following management's layoff decision. Whereas some stock will be purchased by institutions, we suspect that *individual* investors will have a substantially greater impact on change in stock value. As Bethel and Liebeskind (1993) and Barr (1998) point out, high ownership concentration makes it difficult to sell and buy stock, except to and from other institutions. Blair (1965) notes that rapid turnover of institutional investments entails high transaction costs and is unlikely to consistently beat market averages. Further, federal and state regulations may constrain additional equity investment in a given firm or by a given institution.

ers' interests (Mallette and Fowler, 1992). Agency theorists and governance activists argue that stock ownership provides an incentive to directors to improve their effectiveness in monitoring managers' decision-making activities, increasing the likelihood that they will actively oppose unprofitable activities (Jensen and Meckling, 1976). Stock ownership gives directors a greater financial stake in the wealth effects of their decisions, leading some activist groups to recommend that all director retainers should be paid in stock (Byrne, 1997). Under such conditions, directors would be more inclined to increase their involvement in strategic monitoring (Johnson *et al.*, 1993).

Although we are unaware of supporting empirical evidence, there is reason to believe that investor awareness of director stock ownership has increased as a result of the governance movement. In a much publicized Harvard Business School study, for example, directors in the nine "most admired" companies were found to have median stock holdings eight times that of a group of nine companies that were the target of shareholder activist groups (McLaughlin, 1997). Given the greater attention focused on director stock ownership by shareholder activists and the media, analysts and investors are even more likely to consider this governance issue when they evaluate a layoff's impact on the firm. The closer alignment of shareholder and management interests anticipated when directors own greater shares should thus influence the market to react more favorably to layoff announcements.

Hypothesis 3: The market is likely to react positively, or less negatively, to layoff announce-

ments made by firms whose directors own a greater proportion of company shares than firms whose directors own a lower proportion of company shares.

METHOD

Sample Selection

Information on layoff events for the years 1989 to 1993 comes from announcements appearing in the *Wall Street Journal Index*. Of the 241 announcements found, we dropped 27 because daily stock market returns are unavailable for these firms on the Center for Research in Security Prices (CRSP) tapes. We read each *Wall Street Journal* article announcing a layoff and dropped 20 announcements that were part of another form of downsizing (e.g., voluntary separation agreements, early retirement, and plant closings).

We followed sampling procedures recommended by McWilliams and Siegel, who argue that information about the event must be *new* and relevant and that controlling for confounding events is "perhaps the most critical assumption of the (event study) methodology" (1997: 634). We therefore excluded announcements that were part of any previously announced downsizing strategy or showed evidence of prior information leakage. We excluded announcements of confounding events such as mergers, and changes in dividend policy, executives, earnings, and bond ratings. Our screening period is the layoff announcement day plus the four trading days preceding the announcement (a time frame that falls within a range used in most layoff event studies). We also excluded announcements of temporary layoffs because they convey different informa-

tion than permanent layoffs (Lee, 1997; Worrell *et al.*, 1991). A total of 170 announcements remained. After accounting for the availability of data for independent variables, our final sample consists of 136 layoff announcements for 103 different firms.

Independent Variables

Proportion of Outside Directors. We used proxy statements to identify outside directors. Following previous research (e.g., Daily, 1996; Daily and Dalton, 1994), we classified directors as outsiders according to SEC Regulation 14A, Item 6. We then divided outside directors by total board size to obtain their proportion.

Proportion of Institutional Investors and Change in Investment. Data for both measures of equity owned by institutional investors come from the *Value Line Investment Survey*. Proportion of institutional investment is the percentage of common shares held by institutions at the time that most closely preceded the announcement date. Change in level of institutional investment is the percentage increase or decrease in institutional ownership over the three successive annual reporting periods that concluded closest to the layoff announcement.

Control Variables. We tested for industry effects at the two-digit SIC level and found none to be a significant predictor in the subsequent regression. Results are not shown because of the many industries tested. The reason for a layoff classified as either cost-cutting or efficiency-enhancing (Freeman and Cameron, 1993) would be a useful control variable. Unfortunately, we found most layoff announcements to provide poor or ambiguous descriptions of the reason for layoffs.

We found the expected percentage of workers affected by the layoff in the announcement article. Prior research shows that the market evaluates high percentage layoffs more negatively than low percentage layoffs (Ursel and Armstrong-Stassen, 1995; Worrell *et al.*, 1991). A more negative market reaction may also occur when a firm makes a layoff announcement that is not preceded by previous announcements (Lee, 1997; Ursel and Armstrong-Stassen, 1995). Using a two-year window preceding the event, we searched the *Wall Street Journal Index* to find previous layoff announcements and dummy coded a control variable to indicate single or multiple announcements.

A firm's size may influence the market's reaction to a layoff announcement. Economies of scale and/or scope may enable large firms to operate more efficiently than their smaller counterparts. Large firms may have more expertise and resources and would thus be better able to research and implement strategies (Malette and Fowler, 1992). Because investors follow larger firms more closely, they may require less internal monitoring. Institutional investors may also prefer investing in larger, more stable firms (Bethel and Liebeskind, 1993). Using data from COMPUSTAT, we measured size as the logarithm of sales for the year preceding a layoff announcement.

Event studies show that layoff announcements by poor performers are more likely to elicit a greater decline in shareholder value than announcements by profitable firms. Profitability is an important control variable because investors' expectations of future performance will likely be influenced by a firm's operating efficiency. When used in the regression

equation, it should help explain how well each governance variable predicts abnormal returns after accounting for the market's expectation of future returns attributable to operating efficiency. Using data from COMPUSTAT, we measured profitability as a three-year average of return on sales.

Event Window

Capturing all new and relevant information about the layoff involves a tradeoff between longer and shorter event windows. Long event windows can capture more complete information about the event. As in any event study, layoff announcements may be preceded by information leakage. For example, some Wall Street analysts might access inside information that could leak prematurely and dampen the market's potential reaction to the layoff announcement. While leakage of information is a distinct possibility, we find arguments and evidence in favor of using shorter event windows to be more compelling (for a detailed discussion, see McWilliams and Siegel, 1997). Longer event windows reduce the power of the test statistic Z_{it} . They also increase the likelihood of including potentially confounding events and violate the assumption of market efficiency (Brown and Warner, 1985; McWilliams and Siegel, 1997). Empirical evidence suggests that short event windows generally capture the significance of an event (Lubatkin *et al.*, 1989; McWilliams and Siegel, 1997). In light of this evidence and the fact that firms generally announce layoffs during trading hours one day before they appear in the *Wall Street Journal*, it is not surprising that most layoff event studies to date use short event windows (e.g., Chad-

well and Filbeck, 1994; Chadwell and Webb, 1996; Lee, 1997; Palmon *et al.*, 1997; Ursel and Stassen-Armstrong, 1995). In this study, we used a two-day event window, covering the trading day preceding the layoff announcement and the announcement day.

Dependent Variable

We used cumulative average abnormal returns (CARs) as the dependent variable to test market reaction to layoff announcements. The abnormal return is the difference between the normal market return, predicted by the capital asset pricing model (CAPM), and the actual return. We used daily firm returns and equally weighted market returns from CRSP to compute market model parameters for each firm over a one-year (240 trading days) period from 331 to 91 days before the layoff announcement. We then computed CARs for each firm using the market model over the two-day event window ($t-1, t = 0$).

RESULTS

Table 1 reports the means, standard deviations, and Pearson product-moment correlations for the research variables. Table 2 presents the CARs for all layoff announcements. CARs are most significant for the fifty-day period preceding the event. The two-day window chosen ($t-1, t = 0$) has a significant, negative CAR ($p < .01$) and is likely to capture the greatest layoff-specific reaction to the announcement. We find that the ratio of positive to negative returns is 60:76, with a Z statistic of -2.95 .

Regression Analysis

We tested all hypotheses by regressing the cross-sectional variation in

TABLE 1
Means, Standard Deviations, and Correlation Matrix for All Variables

Variables	Means	s.d.	1	2	3	4	5	6	7	8
1. CAR (T-1,0)	-0.01	.05								
2. Proportion of outside directors	.60	.17	.24**							
3. Proportion of shares held by institutions	.53	.17	.11	.21						
4. Percentage change in institutional shares	-.05	.03	.25**	.08	-.21*					
5. Proportion of shares held by directors ^a	1.85	2.07	-.23**	-.38**	-.10	-.11				
6. Previous layoff announcements	1.39	.47	.10	-.09	.08	.04	.00			
7. Percentage layoff announced	6.51	5.65	-.03	.06	-.15	-.05	.11	-.14		
8. Change in ROS (3 year period)	.05	.36	.24**	.01	-.08	.20*	-.20*	.01	-.40**	
9. Sales ^a	8.25	1.61	.40**	.17*	.18*	.16	-.55**	.36**	-.32**	.31**

^aProportion shares held by institutions and return on sales transformed to natural log values.

*p < .05

**p < .01

TABLE 2

Cumulative Abnormal Returns Surrounding Layoff Announcements

<u>Days</u>	<u>CAR</u>	<u>Z</u>	<u>Positive:Negative</u>
-50 to +50	-3.60%	-1.61	57:79
-50 to 0	-7.23%	-4.80 ^{***}	50:86 ^{**}
-20 to -2	-2.12%	-1.44	61:75
-10 to +10	-1.29%	-0.39	64:72
-10 to - 2	-0.79%	0.00	60:76
-10 to 0	-1.89%	-1.27	63:73
-5 to +5	-1.19%	-1.16	64:72
-5 to 0	-1.16%	-1.09	68:68
-4 to 0	-1.02%	-1.06	66:70
-3 to 0	-1.12%	-1.75	67:69
-2 to 0	-0.99%	-2.42 [*]	60:76
-1 to 0	-1.09%	-2.95 ^{**}	60:76
-1 to +1	-.49%	-0.97	67:69
0 to +1	0.00%	-0.37	64:72
-1	-.46%	-0.83	60:76
0	-.63%	-3.24 ^{**}	54:82 [*]
+1	.62%	2.67 ^{**}	72:64
+2 to +10	-.07%	-.08	68:68
+2 to +20	-.99%	.90	69:67

*p < .05

**p < .01

***p < .001

CARs on the independent variables described above. Estimation of the equation reveals that multicollinearity is not a problem. Variance inflation factors were less than 2.0 for all variables, which is much lower than the rule-of-thumb upper bound of 10.0 (Neter *et al.*, 1989).

Table 3 presents the results of the full regression model. Hypothesis 1, which predicts that a greater percentage of outside directors is less negatively, or positively, related to the market's response to a layoff announcement, is not strongly supported. Its value ($p=0.056$) lies just below an acceptable significance level of $p<0.05$. We therefore suggest a weak positive relationship. Although positive as predicted by Hypothesis 2a, greater proportions of shares held by institutional investors is not statistically significant. As Hypothesis 2b predicts, there is a significantly ($p<.05$) less negative, or positive, stock market reaction when the proportion of institutional ownership increases over the three-year period preceding the layoff announcement. Director stock ownership is positively related to the market's reaction to the layoff announcement, but is not statistically significant, thus failing to support Hypothesis 3. Among control variables, more positive market reactions are significantly ($p<.001$) associated with larger firms. Given the "size effect" of a number of large firms included in the sample with a number of much smaller firms, we tested for a downward bias in t -tests associated with heteroscedasticity. Plots of residuals and least squares regression weighted by firm size failed to reveal heteroscedastic effects. We also tested (not shown) whether the addition of all governance variables to all control values significantly im-

proves the regression model's ability to predict CARs. The results show the change in $R^2 = .056$, with $F = 5.40$ and $p = .057$. This suggests a weakly significant relationship between the incremental gain in shareholder value attributable to governance practices.

DISCUSSION

A central tenet in agency theory is that governance practices act to align shareholder preferences and managerial initiatives. Such is the logic that buttresses recent growth in the shareholder activist movement. This study is the first to investigate the relationship between governance and shareholder wealth in the context of layoffs. Furthermore, it is the first to capture the market's response to layoff announcements that focus on human assets rather than layoffs announced as part of another downsizing strategy. Using an agency theory perspective, we provide the following evidence that the market considers governance practices in its assessment of layoff announcements: (1) a higher proportion of outside directors is modestly associated with less negative, or positive, abnormal market returns, and (2) an increase in the proportion of shares held by institutional investors during the three-year period prior to the layoff announcement is significantly associated with less negative, or positive, abnormal market returns. Overall, governance practices improve the regression model's ability to predict abnormal returns, although at just below a statistical significance level of $p = .05$.

Although not strongly supportive, the results of this study are suggestive and have several important implica-

TABLE 3

**Results of Regression Analysis of Determinants of
Market Reaction to Layoff Announcements^a**

Independent Variables	β	t-statistic	Incremental R ²
Proportion outside directors	.17 [†]	1.93	.02
Proportion shares held by institutions	.06	.73	.00
Change in level of institutional ownership	.17 [*]	2.06	.03
Proportion of shares held by directors	.08	.82	.00
Previous layoffs announced	-.02	-.20	.00
Percent layoff announced	.16 [†]	1.80	.02
Change in ROS (three- year period)	.16 [†]	1.82	.02
Sales	.39 ^{**}	3.52	.07
R ²	.25 ^{***}		
Adjusted R ²	.21		

^aStandardized regression for the full model is shown; n = 136.

[†]p < .10

*p < .05

**p < .01

***p < .001

tions. As predicted by agency theory and espoused by governance activists, the market reacts less negatively, or positively, to layoffs announced by firms whose boards have greater proportions of outside directors. Whether outsiders actually make for a more independent board that protects shareholder interests, or are merely perceived as such, the market reacts more negatively when outsiders comprise lower proportions of total board size. Therefore, the market appears to take into account the improved monitoring of outsiders in its assessment of layoff announcements. Our findings run contrary to those in other contexts where outsiders are not perceived as objective and independent. These results could be used by activist groups as justification for adding outsiders to the board. Moreover, because the findings focus on human assets, boards might be encouraged to add outsiders with relevant experience in human resource

management as a way to improve monitoring layoff strategies. We also find stock ownership by institutions to be consistent with the expectations of agency theory and governance activists, but instead of institutional ownership *per se*, the market places greater value on the trend in institutional investment. Besides having fiduciary responsibility to their clients, institutions often cannot easily buy and sell shares. They would likely be cautious investors, prepared to hold their investments for a longer time period and take measures to stem declining performance. After controlling for profitability, rising proportions of shares held by institutions over the three years prior to the layoff announcement appear to signal a higher level of commitment and monitoring capability to the market. Layoffs in firms that experience growth in monitoring over time would be moving toward closer alignment with shareholder interests and

evaluated less negatively, or positively, than layoffs in firms that stagnate or decline in monitoring over time. As Kochhar and David (1996) note, growth in institutional investment over time signals the firm's ability to make regular improvements in performance. This finding supports activists' general contention that institutions should continue to increase their investment in firms over time.

Our findings also show that investor reaction to layoff announcements depends largely upon the size of the firm, with big companies more likely to experience an increase in shareholder value. Because of their resources, large firms may be perceived as better able to cut employees as a response to stressful conditions. When not responding to stressful conditions, proactive measures taken to improve efficiency may well be perceived as a positive move toward trimming the fat that is frequently associated with large organizations.

This study should stimulate interest in related research. One reason why governance practices were not stronger predictors of the market's response to layoff announcements may have to do with the time frame

of our sample. The awareness of governance issues and practices has increased steadily since 1993, the last year in the sample. Future research should address this issue to capture changes in governance practice and their effect on the market's perception of layoffs over time. Such post-recession samples should similarly allow researchers to classify layoff announcements as reactive or proactive to determine the relative importance of governance in each case. We assume in this study that directors and institutional investors will monitor managers' layoff strategies. Although there is some supportive evidence of involvement in recent popular business publications, research studies need to further investigate this issue. Finally, prior research shows that the effectiveness of governance structures varies according to strategic context. Future research needs to consider the performance implications of governance structures in other types of corporate downsizing strategies, such as early retirement and voluntary separation agreements, divestitures and spinoffs, plant closings, and structural consolidations.

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