DEPARTURE STATUS: THE EFFECT OF DISSOLVING TIES WITH A MISCONDUCT FIRM ON DIRECTOR LABOR MARKET OUTCOMES

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INTRODUCTION

The subject of financial misconduct, and specifically accounting fraud, has recently become a topic of particular interest for accounting and organizational scholars. Much research has investigated the antecedents of fraud, and to a lesser degree, its consequences for the guilty organizations and other firms to which they are linked. Considerably less is known, however, about the consequences of illegitimate behavior across levels of analysis, and how fraud at the organizational level affects those tasked with organizational oversight. In particular, although scholars have demonstrated that revelations of misconduct lead to consequences for organizational elites (e.g., Srinivasan, 2005; Desai, Hogan, and Wilkins, 2006; Cowen and Marcel, in press) we still have scant theory explaining how the taint of fraud is transferred from organizations to individuals. Do all directors suffer the same consequences, or are labor markets more attentive to subtle cues in the social context, suggesting more severe consequences for some than for others? I focus on director outcomes on external labor markets to elaborate how the consequences of misconduct are transferred from organizations to individuals.

An important aspect of director behavior that has so far been neglected is dissociation from the misconduct firm. Cutting ties with a fraud firm is a particularly ambiguous signal to external labor markets. On the one hand, the theory of *ex post* settling up (Fama and Jensen 1983; Fama 1980) argues that directors of misconduct firms lose their positions, and subsequently find it harder to find new board appointments, because firm misconduct is a direct reflection of poor director quality. Although this offers a compelling mechanism, the theory of *ex post* settling up focuses on rational information processing and accurate inferences at the expense of other factors that have been shown to influence corporate boards. Given that corporate boards often make decisions not on the basis of economic soundness alone, but rather are influenced by symbolic concerns (e.g. Davis, 1991; Westphal and Zajac, 1995), we must consider how these forces inform labor markets.

Another possible interpretation of departure is that directors exit tainted firms to protect their reputations from damage through association with misconduct. This explanation is consistent with stigma theory (Goffman, 1963; Wiesenfeld, Wurthmann, and Hambrick, 2008), which holds that actors' social identities are tarnished by association with either discrediting characteristics or discredited others (Goffman, 1963). If read as a symbolic action aimed at avoiding becoming tarnished, dissociation could instead provide a positive signal, leading to better external labor market outcomes.

Because public accounts of the process leading to the dissolution of ties between director and firm are exceedingly rare, external labor markets must find a framework within which to interpret director departure from the misconduct firm. One useful heuristic for interpreting director exit is provided by social status, both of the individual and the organization. Status may buffer director reputations, leading to more positive affect affect (Zajonc, 1980; Wiesenfeld, et al., 2008) and more positive external evaluations (Geis, 1977; Giordano, 1983; D'Aveni, 1990). Consequently, high-status individuals may be perceived by outsiders as dissolving ties with misconduct firms to save their reputations. In contrast, high-status organizations are perceived to have access to better quality information and greater evaluative capacity than their low-status peers (Rao, 1998; Stuart, 2000). Because high-status organizations' evaluations are more salient to the public (Rindova, et al., 2005) and their reputations resilient to contravening evidence (Cianci and Kaplan, 2010), director departure from high-status boards may be perceived to indicate poor director quality. Thus individual and organizational status may moderate the relationship between director departure and subsequent labor market outcomes.

THEORY AND HYPOTHESES

Misconduct is a relatively understudied phenomenon given its pervasiveness in organizational life. Vaughan (1999: 288) defines misconduct as "[an act] of omission or commission by individuals or groups of individuals acting in their organizational roles who violate internal rules, laws or administrative regulations on behalf of organization goals." This definition allows for both organized and individual action, as well as purposive and unintended action, and allows misconduct to be rooted in the environmental, organizational, and individual levels. This also suggests that misconduct is a routine, predictable and pervasive consequence of social interaction found in any organization. Misconduct is so pervasive that the business press reported on misconduct at 40% of the Fortune 100 firms within a 5-year period (Clement, 2006).

Interpreting director departure

Despite its prevalence, revelations of wrongdoing continue to engender consequences for both organizations and organizational elites. One mechanism through which such consequences are transferred to individuals is signaling; organizational outcomes are seen as signals of director quality. Through the process of *ex post* settling up (Fama, 1980; Fama and Jensen, 1983), organizational leaders are penalized for negative outcomes or rewarded for strong performance on internal and external labor markets.

Empirical research has found support for the process of *ex post* settling up, demonstrating that external markets for directors do account for performance at the focal director's home organization, albeit imperfectly. In general, directors are better compensated and have more new offers of board seats when their firms perform well, but lose their positions when performance is poor (Yermack, 2004). Signals of sound corporate governance, such as rejecting anti-takeover provisions (Coles and Hoi, 2003) and forcing out under-performing CEOs (Farrell and Whidbee, 2000), also lead to longer tenure in existing board appointments and invitations to join new boards. Negative outcomes, particularly those that signal declining performance, dampen the future opportunities of professionals at all levels of the organization (Hamori, 2007) and perceptions surrounding their competence (McKinley, Ponemon and Schick, 1996).

According to this logic, the departure of a director from a firm known to have engaged in misconduct should have predictable results. If directors' labor market outcomes are a direct reflection of their oversight ability, external labor markets are likely to read the departure of a director from the misconduct board as an indication that the focal director is directly or indirectly responsible for the misconduct. This is consistent with scapegoating of individual directors, or shifting the perception of blame by severing relationships (Burke, 1969; Gephart, 1978).

Because of these attributions, directors departing misconduct firms are likely to suffer additional penalties on the external market for directors. Boards prefer directors who represent positive signals associated with social connectedness (Mizruchi, 1996), legitimacy (Pfeffer and Salancik, 1978) and strong organizational performance (Herman, 1981; Mace, 1986). In contrast, they sever ties with actors that present unfavorable signals of firm quality and poor performance (e.g., Lorsch and MacIver, 1989; Baum and Oliver, 1991; Jensen, 2006). Because organizations are seen as a reflection of their elites (Hambrick and Mason, 1984), evidence of poor oversight reflects badly on the organization itself, making affiliation with tainted directors a potentially negative signal. If read as involuntary departure, directors who leave the boards of misconduct firms should suffer labor market penalties beyond those experienced by their peers who remain. Hence, I predict:

H1. Dissociation from the misconduct firm will exacerbate the penalties suffered by the focal director on the external market for directors

Despite the evidence in support of *ex post* settling up, several studies find no significant evidence of that process at work following misconduct (Agrawal, Jaffe, and Karpoff, 1999; Beneish, 1999), casting doubt on the argument that the market alone accounts for director outcomes. Semadeni, Cannella, Fraser and Lee (2008) find that executives who depart in advance of organizational failure suffer fewer labor market consequences than those who remain, although they may also be responsible for firm failure. Because such information should be incorporated into market evaluations, this finding suggests that markets are responsive to symbolic action and social forces, highlighting the importance of considering the social context in which labor markets operate.

Fundamental to understanding the role of symbolic factors in allocating the consequences of misconduct is the concept of stigma. Stigmatization is the process through which actors' social identities are diminished through association with either discrediting characteristics or discredited others (Goffman, 1963). Stigmatization leads others to perceive the stigmatized actor as an unreliable interaction partner (Jones, et al., 1984; Kurzban and Leary, 2001), thus contaminating the stigmatized actor's social identity (Goffman, 1963; Jones, et al., 1984) and engendering discrimination (Link and Phelan, 2001; Devers, et al., 2009; Walker, 2008).

What distinguishes stigmatization from other types of negative evaluation, and what makes it analogous to the process of *ex post* settling up, is that it forms the basis for reduced social interaction (Kurzban and Leary, 2001; Link and Phelan, 2001; Pozner, 2008). Actors drop ties with stigmatized others because the association might compromise their own identities (Adut, 2005; Jensen, 2006; Jonsson, et al., 2009), a phenomenon known as stigma by association. Stigma by association is driven not by attributions of specific deviance, but rather by the fear that mere proximity might taint others, a symbol tied to social position rather than substantive evidence of wrongdoing.

Understanding the dynamics of stigma by association may lead to a different interpretation of director dissociation from misconduct firms. Instead of a mark of poor oversight capacity or possible culpability, dissolution of ties with a stigmatized firm may indicate that the focal director is interested in maintaining the integrity of his reputation. Leaving the tainted firm may therefore be seen as pro-active distancing on the part of the focal director in an attempt to avoid stigma by association. Because they are constrained in their ability to publicly critique the companies on whose boards they sit by rules of propriety and to avoid developing a reputation for being "difficult", exit from the misconduct firm is the only strategy for giving

voice to their concerns (Hirshman, 1970). Thus, when director reputation is critical, visible dissociation from a tainted firm may become a powerful symbol of director orientation toward and tolerance of misconduct, rather than a signal of director ability to detect and prevent misconduct. Thus, read as voluntary departure, external labor markets are less likely to penalize directors departing the misconduct firm than those who stay. Hence:
H1a. Dissociation from the misconduct firm will mitigate the penalties suffered by the focal director on the external market for directors

The effect of status

Individual status. Some directors may be less discreditable than others despite their association with financial misconduct because their positions within the social structure afford them personal status (Wiesenfeld, et al., 2008). Status is a symbol of quality that may or may not be linked to underlying objective measures of quality, but which confer advantages upon the status holder to which he might not otherwise have access and that perpetuate others' perceptions of his or her quality (Podolny, 1993; Washington and Zajac, 2005). Although some argue that social position exposes actors to greater potential denigration (Adut, 2005), others find that high-status, central actors may be protected from stigmatization because of the influence, solidarity and information inherent in their social status (Granovetter, 1973; Burt, 1997; Adler and Kwon, 2002). More central directors, who sit on multiple, influential boards (Davis, Yoo, and Baker, 2003) and have close ties with influential others (D'Aveni and Kesner, 1993; Westphal, 1999) are able to draw on their networks when faced with negative organizational outcomes (Wiesenfeld, et al., 2008). Better networked directors can rely on their many connections to disseminate information that contradicts negative attributions (Wiesenfeld, et al., 2008), resulting in fewer consequences of financial misconduct for those more central to the network of directors.

Moreover, as Wiesenfeld, Wurthmann and Hambrick (2008) point out, high-status directors are viewed differently by external audiences. Those that occupy central positions within networks are generally perceived as more competent, credible, and trustworthy than their lower-status peers (Geis, 1977; Giordano, 1983; D'Aveni, 1990), and thereby less susceptible to social sanctions than their less luminous peers. In addition, social capital may engender positive affect (Zajonc, 1980; Wiesenfeld, et al., 2008), which counters the negative affect-laden attributions inherent in stigmatization (Devers, et al., 2009). Central, high-status actors may also have more idiosyncrasy credits (Hollander, 1958) upon which they can draw to excuse their behavior. In addition, others may be ill-inclined to punish elites for their infractions, although their excuses are no better received than their lower-status peers (Ungar, 1981). Therefore, high-status, central social position is likely to reduce the effect of association with financial misconduct on director outcomes. Hence:
H2. Central social position will mitigate the penalties suffered by the focal directors of misconduct firms on the external market for directors

Perhaps more importantly, individual status is also likely to temper the way departure from the misconduct firm is interpreted by external labor markets. More central directors are found to be more concerned with the effects of financial misconduct on their reputation than are less well-networked directors (Hunton and Rose, 2008), making them more likely to pro-actively sever potentially damaging ties. If high-status directors are thought to be more credible, competent and trustworthy than their lower-status peers (Geis, 1977; Giordano, 1983; D'Aveni,

1990), external audiences are more likely to make favorable attributions and thus to view their actions as reflections of intentional, agentic behavior. Similarly, the positive affect generated by central status is likely to engender sympathetic, rather than antagonistic, interpretations of events. Highly-central actors are also better able than their less-connected peers to successfully utilize their networks to disseminate favorable private accounts of their departure from misconduct firm. In sum, high-status directors who leave the misconduct firm are more likely to be seen as having done so voluntarily to distance themselves from misconduct, whereas lower-status directors are more likely to be seen as having been dismissed involuntarily because of their poor quality. I therefore predict that highly central, high-status actors who depart the misconduct firm will suffer fewer penalties on external labor markets than lower-status actors. Hence:
H3. Central social position will mitigate the penalties associated with departing the misconduct firm on the external market for directors

Organizational status. In addition to individual status, organizational status may affect the impact of misconduct on directors' labor market outcomes. First, high-status organizations possess a broad array of high-status connections through which they can disseminate countervailing information (Rao, 1998; Rao, Greve, and Davis, 2001) when faced with attributions of deviance. D'Aveni (1990) shows that organizations with more influential and prestigious connections were less likely to go bankrupt than less well-networked firms, controlling for financial performance. High status actors are also perceived to have superior access to and capacity to evaluate information (Rao, 1998; Stuart, 2000), making their evaluations even more salient to the public (Rindova, et al., 2005). Research on organizational resilience likewise shows that the perception of reputation derived from third parties and network ties may also direct attention toward positive, non-stigmatized aspects of the firm or downplay the importance of the discrediting revelation (Masten, 2001; Rhee and Valdez, 2009).

Similarly, the Matthew effect (Merton, 1968) predicts that high-status organizations accrue greater rewards for the same positive outcomes and fewer sanctions for the same negative outcomes than lower-status firms (Podolny, 1993; Devers, et al., 2009; Ciancia and Kaplan, 2010). They further benefit from the favorable affective response and evaluation engendered by their prominence, making them less susceptible to social sanction (Wiesenfeld, et al., 2008). This is consistent with recent work which treats reputation as a "reservoir of goodwill" (Jones, Jones, and Little, 2000), which causes external stakeholders to react less severely to the announcement of bad news (Jones, et al., 2000; Pfarrer, Pollock, and Rindova, 2010). Because high-status organizations are themselves likely to be buffered from negative consequences of financial misconduct, their directors may be more likely to take the brunt of negative attributions, resulting in stronger labor market penalties.

An alternate mechanism leading to a similar result is suggested by recent evidence that high-status firms may suffer more than others after negative organizational outcomes. Rhee and Haunschild (2006) find that high-reputation organizations suffer more than others after product recalls. The mechanism proposed in this study is expectancy violation (Shapiro, 1982; Heath and Chatterjee, 1995), as consumers expect the products of high reputation firms to be of superior quality. Likewise, expectations of the oversight ability of the directors of high-status organizations are relatively high. When organizations are found to have engaged in misconduct, the violation of those expectations will result in more severe labor market penalties for affiliated directors than for directors associated with lower-status organizations. Thus:

H4. Central social position of the misconduct organization will exacerbate the penalties suffered by directors on the external market for directors

Organizational status is also likely to affect the way departure from the misconduct firm is interpreted on external labor markets. High-status organizations are able to spread favorable private accounts through their social networks (Rao, 1998; Rao, Greve, and Davis, 2001), leading to less organizational stigmatization, but worse outcomes for individual directors. Similarly, organizational resilience (Masten, 2001; Rhee and Valdez, 2009) and the positive affect derived from central social status and positive organizational reputation (Wiesenfeld, et al., 2008) are likely to engender favorable interpretations of organizational action, and less favorable interpretations of individual action. Thus external audiences are likely to read director departure from high-status misconduct firms as reflective of poor oversight capacity, suggesting the efficient functioning of the *ex post* settling up mechanism. This is likely to result in more severe penalties on external labor markets for directors who depart high-status boards than those who depart lower-status boards. Hence:

H5. Central social position of the misconduct firm will exacerbate the penalties accruing to directors who depart the focal firm on the external market for directors

DATA

To test my hypotheses, I collected data on firms restating earnings between 1997 and 2003 as reported by the GAO (D'Agostino 2002), a population of approximately 1,239 restatements. Availability of complete data resulted in a final sample of 311 restatements issued by 234 firms listed on the S&P 1500 Index. The observation window begins in 1997, when earnings restatements first became a salient phenomenon, based on press reports and results of the investigation of the U.S. General Accounting Office (D'Agostino 2002). I extended the observation period to 2003 to capture the period in which the number of restatements grew dramatically. My observation window extends to 2006 to account for staggered board elections.

Although the misconduct under investigation occurred at the organizational level, the outcome of interest is individual outcomes on external labor markets, which requires that the level of analysis be the individual director. I therefore gathered information on each restating firm's board of directors from annual proxy statements. I corrected for non-independence among directors nested within firms by specifying my models with robust clusters by firm. My sample includes 2,524 unique actor-firm-year observations. When analyzing the number of board appointments lost, I restricted my sample to those directors who sat on at least one other board at the time of restatement, resulting in a subsample of 1,404 observations. I test my hypotheses using Poisson regression. Because individual directors are clustered within organizations, a violation of the assumption of independence among observations, I calculated the standard errors of coefficient estimates using a robust estimation procedure and clustering within organizations.

REFERENCES AVAILABLE FROM THE AUTHOR