

A SELECTION THAT CANNOT STAND THE TEST: SUCCESSION CONTEXTS AND NEW CEO DISMISSAL

YAN ZHANG

Jesse H. Jones Graduate School of Management
Rice University
Houston, Texas 77005

ABSTRACT

This study examined “new CEO dismissal”, i.e., a new CEO is dismissed within three years after succession. Based upon agency theory and human capital theory, we argue that new CEO dismissal may represent a correction to an inappropriate CEO selection and accordingly, succession contexts that tend to lead to an inappropriate CEO selection will increase the likelihood of new CEO dismissal. With a sample of 204 CEO successions in the time period of 1993-1998, we find that the origin of the new CEO and the characteristics of the board of directors at the succession time have significant impact on the likelihood of new CEO dismissal.

INTRODUCTION

It has been noted that some new CEOs are dismissed with a brief tenure (Khurana, 2001). In this study, we refer to the phenomenon that a new CEO is dismissed (i.e., the new CEO leaves office against his or her will) within three years after succession as “new CEO dismissal.” Why are new CEOs dismissed? One answer to this question is that boards of directors often make poor choices in selecting a new CEO (Khurana, 2001). As a result, they need to remove the new CEO after succession. It is not an easy job to select a new CEO whose competencies fit a firm’s context. According to agency theory, a potential CEO candidate typically possesses more information on his or her true competencies than the board of directors, hence, he or she may misrepresent such competencies and the board becomes incapable of selecting a new CEO whose competencies fit the firm’s contextual contingencies (Zajac, 1990). Human capital theory suggests a new CEO’s human capital may be specific to his or her prior position and may not be transferable to the new position, and hence his or her track record is no guarantee that he or she will continue to be successful in the new job (Harris & Helfat, 1997; Zhang & Rajagopalan, 2004). Therefore, there is a possibility that a new CEO does not fit the CEO position.

According to agency theory (Holmstrom, 1982), a board of directors can update its evaluation on the match between a new CEO’s competencies and the firm’s context after succession. If in such updated evaluation it turns out that a new CEO is an inappropriate selection, the short time period after succession then represents an important window for the board to remove the new CEO. Studies on the dynamism of CEO leadership have generally suggested that CEO power increases over time (Hambrick & Fukutomi, 1991). Had the short window after succession been missed, a new CEO will become too powerful to be removable over time. Based upon these arguments, we argue that new CEO dismissal may represent a correction to an inappropriate CEO selection that was made at the succession time. Accordingly, we propose that succession contexts that tend to lead to an inappropriate CEO selection will increase the likelihood of new CEO dismissal.

RESEARCH HYPOTHESES

New CEO Origin and New CEO Dismissal

Origins of new CEOs have been typically divided into two categories: inside successions where new CEOs are hired from within the firms and outside successions where new CEOs are hired from outside the firms. From an agency perspective, Zajac (1990) argued that inside successions are characterized by a less extent of information asymmetry between the board and the new CEO because the board members and the candidate have co-work experience. In addition, human capital theory suggests that while inside new CEOs have firm-specific human capital, outside new CEOs lack it (Harris & Helfat, 1997). Hence, the chance of making an inappropriate selection is higher in outside successions than in inside successions; therefore, the likelihood of new CEO dismissal will be higher in outside successions than in inside successions.

Hypothesis 1: The likelihood of new CEO dismissal is higher in outside successions than in inside successions.

Inside successions can be further divided into relay inside successions in which a new CEO used to be the heir apparent of the predecessor CEO and non-relay inside successions (Vancil, 1987; Zhang & Rajagopalan, 2004). In a relay inside succession, the potential new CEO not only has firm-specific human capital but also has an opportunity to acquire and enhance his or her CEO position-specific knowledge, as well as to develop broader leadership skills consistent with the position (Zhang & Rajagopalan, 2004). Further, in relay inside succession, the firm can conduct a focused assessment of this particular candidate's competencies and continuously update its evaluation of whether the candidate's competencies fit the CEO position (Zhang & Rajagopalan, 2004). Accordingly,

Hypothesis 2: The likelihood of new CEO dismissal is lower in relay inside successions than in non-relay inside successions.

Outside successions can be further divided into two types: within-industry outside successions (in which new CEOs are hired from other firms in the same industry) and outside-industry successions (in which new CEOs are hired from outside the industry) (Harris & Helfat, 1997; Zhang & Rajagopalan, 2003). Within-industry outside new CEOs have industry-specific human capital that outside-industry new CEOs do not have. In addition, firms are relatively more familiar with executives in other firms in their industry via their competitive interactions with these firms than executives outside their industry. Hence,

Hypothesis 3: The likelihood of new CEO dismissal is lower in within-industry outside successions than in outside-industry successions.

Board of Directors at the Succession Time and New CEO Dismissal

We argue that vigilant boards of directors are more likely to make an appropriate new CEO selection. Board vigilance is at the center of agency theory and refers to "the extent to which boards effectively monitor and discipline top managers" (Finkelstein & Hambrick, 1996: 221-222). Previous studies have suggested that boards and predecessor CEOs may have different interests in new CEO selection. Predecessor CEOs tend to prefer replacements that have similar philosophies and skill repertoires and are more likely to preserve their vision for an organization (Zajac & Westphal, 1996). Boards have the responsibility of appointing a new CEO who can lead the firm to the next level. Hence, vigilant boards are more likely to get away from the influence of the predecessor CEO and make an appropriate new CEO selection decision.

Hypothesis 4: Board vigilance at the succession time is negatively related to the likelihood of new CEO dismissal.

The board of directors typically has a number of committees that are charged with particular duties. In the context of CEO succession, the most important board committee arguably is a nominating committee (Knepper & Bailey, 2004: 12). In this study, we will examine the independence and external directorships of a nominating committee. The independence of a committee refers to the relative representation of outside directors on the committee (Abbott, Park, & Parker, 2000). Outside directors are not employees of the

firm. It is these directors that lend a committee a degree of independence (Abbott, et al., 2000). Following this logic, we argue that a nominating committee composed mainly of outside directors is more likely to make an appropriate decision in new CEO selection. In addition, outside directors, who usually are senior managers of other firms and sit in other firms' boards, can bring information on more potential candidates (Khurana, 2002). Further, outside directors can bring an objectivity to the selection process that can help to challenge narrow thinking, escalating commitment, and weak analysis, and thereby, increasing the chance of making an appropriate new CEO selection. Thus,

Hypothesis 5: The likelihood of new CEO dismissal is lower in firms with a nominating committee that are composed mainly of outside directors than in other firms.

Previous studies have argued that directors' external directorships as their relational capital represent one primary antecedent to the board's provision of resources to the firm (Hillman & Dalziel, 2003). In the context of CEO successions, directors with extensive external directorships may use their contacts to help the company recruit new top managers (Barry, et al., 1990). Following this logic, a nominating committee composed of directors with extensive external directorships can be more capable to make an appropriate new CEO selection. Thus,

Hypothesis 6: The likelihood of new CEO dismissal is lower in firms with a nominating committee where outside directors have a large number of external directorships than in other firms.

METHODS

Sample Selection

The sample for this study was drawn from the population of relatively large (annual sales revenues greater than \$100 million), publicly traded, U.S. non-diversified (the firm had to derive at least 70% of its sales from a single 4-digit industry) manufacturing firms listed continuously on COMPUSTAT between 1993 and 1998. We first identified all such firms (768 in all) from COMPUSTAT. We then identified 220 CEO successions that had occurred within this group during the 1993-1998 time period from the on-line *Wall Street Journal* Index and Standard and Poor's *Executive Compensation* database. Data were collected both before and after successions to better understand causality. After excluding observations with missing information, our final sample included 204 CEO successions in 184 firms, where 164 firms had one CEO successions and 20 firms had two.

Measurements

New CEO dismissal referred to a situation in which a new CEO is dismissed within three years after taking office. Two research assistants collected all news reports on each of the new CEOs during a four-year period, from the year of succession to three years after the succession, from the *Dow Jones databases*. We relied upon these news reports to identify the date when the new CEO assumed the CEO position. We used various sources (e.g., the news reports, *Dun & Bradstreet Reference Book of Corporate Management*, and annual corporate proxy statements) to check whether the CEO was still in office three years after succession. For those where were no longer in office, we used the news reports to identify the dates when they left office. Overall 55 CEOs left office within 36 months (three years) after succession.

For those 55 CEOs who left office within three years, we relied upon the news reports to identify the circumstance in which these CEOs left office (voluntary turnover versus dismissal), using an approach adapted from the one used by Shen and Cannella (2002: 1198-1199). There were 4 cases where the CEOs left office but kept another position in the firm (e.g., chairman or vice chairman), 1 case where the CEO left office due to health issues, 11 cases where the CEOs

retired, 5 cases where there were mergers or acquisitions, 8 cases where the CEOs accepted a similar position at another firm, all which were identified as voluntary turnovers of the CEOs. There were 5 cases where the CEO was directly reported as having been fired or ousted, 20 cases where the CEOs were reported as having resigned unexpectedly or immediately, due to poor performance or for undisclosed personal reasons, and 1 case where the CEO was reported as having taken early retirement and there were discussions of performance problems, all of which were coded as dismissals of the CEOs. Overall we identified 26 new CEO dismissals on the basis of the news report analysis. *New CEO dismissal* was then coded 1 if the new CEO was dismissed within three years after assuming office and 0 otherwise. For CEOs who left office within three years after succession, the duration that they stayed in office was coded as the number of months they had been in office when they left office. For CEO who still remained in office after three years, the duration was coded 36 months.

Following prior research on CEO successions (Harris & Helfat, 1997), we first distinguished between inside and outside successions (using two-year firm tenure as a cutoff). Then we divided inside successions into relay and non-relay inside successions according to whether or not the new CEO was the heir apparent for the predecessor CEO (See Zhang & Rajagopalan, 2004). We also divided outside successions into intra-industry and outside-industry successions according to the industry experience of the new CEOs (see Harris & Helfat, 1997; Zhang & Rajagopalan, 2003). Using non-relay inside succession as the omitted base category, three dummy variables were created: *relay inside succession*, *within-industry outside succession*, and *outside-industry succession*. The primary data sources for these variables were the *Dun & Bradstreet Reference Book of Corporate Management* and annual corporate proxy statements.

Based upon Zajac and Westphal (1996), we derived a composite measure of *board vigilance* at the succession time, using data on the percentage of outside directors, outside directors' shareholding relative to CEO shareholding (the proportion of the firm's outstanding shares owned by outside directors divided by that owned by the CEO), outside directors' board tenure relative to CEO tenure (the average tenure of a firm's outside directors divided by its CEO's tenure), and the separation of the CEO and the chairman positions. Data were collected from the corporate proxy statement in the year prior to succession.

From the corporate proxy statement in the year prior to succession, we checked whether there was a nominating committee (NC) in a firm's board of directors. For firms that had a nominating committee, we counted the number of outside directors and inside directors on the committee. *Outside director dominated NC* was coded 1 if the board had a nominating committee where the number of outside directors is larger than the number of inside directors and 0 otherwise. *Inside director dominated NC* was coded 1 if the board had a nominating committee where the number of outside directors is equal or less than the number of inside directors and 0 otherwise. These two groups of firms were compared to firms without a nominating committee. For firms that had a nominating committee, we also counted the number of external directorships (other than the focal firm's board) that each of the outside directors in the committee was serving. *NC with more external directorships* was coded 1 if the board had a nominating committee where the average number of external directorships of the outside directors was larger than the sample median and 0 otherwise. *NC with less external directorships* was coded 1 if the board had a nominating committee where the average number of external directorships of the outside directors was equal or smaller than the sample median and 0 otherwise. These two groups of firms were compared to firms without a nominating committee.

In order to control for alternative explanations to new CEO dismissal, we controlled for the following variables: post-succession firm performance, pre-succession firm performance, post-succession industry performance, firm size, top management team size, whether the predecessor CEO stayed in the board after succession, new CEO age, whether the new CEO was also the chair of the board, and whether the new CEO had been a CEO of another firm.

DATA ANALYSIS AND RESULTS

Cox proportional hazards regression analysis was used to test the hypotheses. Hypothesis 1 suggests that the likelihood of new CEO dismissal is higher in outside successions than in inside successions. This hypothesis is supported because the coefficient for outside succession is positive and significant ($b = 1.68, p < 0.001$). The results do not support Hypothesis 2, which suggests that the likelihood of new CEO dismissal is lower in relay inside successions than in non-relay inside successions. The results did not support Hypothesis 3 either, which suggests that the likelihood of new CEO dismissal is lower in within-industry outside successions than in outside-industry successions.

Hypothesis 4 suggests that board vigilance at succession time is negatively related to the likelihood of new CEO dismissal. This hypothesis is supported because the coefficient for board vigilance is negative and significant ($b = -0.71, p < 0.05$). Hypothesis 5 suggests that the likelihood of new CEO dismissal is lower in firms with an outside director dominated nominating committee than in other firms. This hypothesis is supported because the coefficient for outside director dominated NC is negative and significant ($b = -0.92, p < 0.05$) and the coefficient for inside director dominated NC is not significant ($b = 0.01, n.s.$). Hypothesis 6 suggests that the likelihood of new CEO dismissal is lower in firms having a nominating committee where outside directors have a large number of external directorships than in other firms. The results suggest that the coefficient for NC with more external directorships is not significant ($b = -0.05, n.s.$); however, the coefficient for NC with less external directorships is negative and significant ($b = -1.52, p < 0.05$). These results thus do not support Hypothesis 6.

DISCUSSIONS AND CONCLUSIONS

Consistent with the prior literature on new CEO origin, this study found that new CEO origin influences the likelihood of new CEO dismissal. We found that outside new CEOs (both within-industry and outside-industry outside new CEOs) are more likely to be dismissed than inside new CEOs (both relay and non-relay inside new CEOs). As argued earlier, relative to inside new CEOs, outside new CEOs lack firm-specific knowledge and skills. There is also a greater extent of information asymmetry between a board of directors and a new CEO in outside successions than in inside successions. Hence the board is more likely to make an inappropriate selection in outside successions than in inside successions and accordingly, outside new CEOs are more likely to be dismissed than inside new CEOs after succession. These research evidences thus caution the tendency for firms to look outside for their new CEOs.

Findings of this study have supported the role of board of directors in new CEO dismissal. We found that vigilant boards at succession time are associated with a lower likelihood of new CEO dismissal, presumably because vigilant boards are more likely to make an appropriate new CEO selection. This study also examined the role of a nominating committee of a board. We found that firms with a nominating committee comprised mainly of outside directors have a lower likelihood of new CEO dismissal than other firms. However, firms with a nominating committee comprised mainly of inside directors are not different from those without a nominating committee. These results suggest that the mere presence of a nominating committee is not sufficient. Indeed, what matters is the independence of the committee. We further examined external directorships of outside directors on a nominating committee. Opposite to our hypothesis, we found that firms with a nominating committee in which outside directors have a large number of external directorships are not different from firms without a nominating committee. Instead, firms with a nominating committee in which outside directors have few external directorships have a lower likelihood of new CEO dismissal than other firms. These results suggest that we should re-consider the value of directors' external directorships. It should

be noted that directors' time and energy are limited. As they have too many external directorships, they become too busy to be good directors to a firm.

This study makes important contributions to the literature. It identified and examined an important, but largely ignored, question in the CEO succession literature, namely, why are some new CEOs dismissed soon after succession? In this study, we develop a novel theoretical argument suggesting that new CEO dismissal represents a correction to an inappropriate CEO selection that was made at the succession time and thus succession contexts that tend to lead to an inappropriate new CEO selection will increase the likelihood of new CEO dismissal. Results of this study have supported this theoretical argument. Findings of this study could direct future research on CEO succession to a new and fruitful direction.

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