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The Changing of the Guard: Causes, Process and Consequences of CEO Turnover

A thesis presented

by

Rakesh Khurana

to

The Committee for Business Studies

in partial fulfillment of the requirements
for the degree of
Doctor of Philosophy
in the subject of

Organizational Behavior

Harvard University
Cambridge, Massachusetts

May, 1998

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Abstract

To explain chief executive officer (CEO) succession, I examine the processes affecting forced CEO turnover, outsider succession, and the strategic and performance consequences of CEO turnover in 850 public corporations in the United States between 1980 and 1996.

Part I of this dissertation examines the factors affecting the rate of CEO dismissals. Statistical and field data show that the rate of CEO dismissals depends on the control the principal actors in the CEO turnover exercise over the CEO position. If the individual occupying the CEO position exercises complete control over the decision to leave the job, the position is closed and the rate of dismissal is unaffected by declining by firm performance. When a firm's board of directors control the vacancy decision, the position is open and the rate of CEO dismissals increases with declining firm performance.

Part II examines insider versus outsider CEO succession. I show that the major role of executive search firms in CEO search is as intermediaries to a complex labor market exchange, not as sources of information about potential candidates. This intermediary role arises as a consequence of the special nature of the CEO labor market.

Part II also examines the role of a firm's directors in outsider CEO selection. Results suggest that board interlocks are the primary mechanism for acquiring information about external CEO candidates.

In Part III, I examine the strategic and performance consequences of different types of CEO turnover for firms. Results suggest that forced turnover followed by outsider succession, on average, improves firm performance. Natural turnover, followed by an outsider CEO, on average, has a negative effect of firm performance. Natural turnover followed by an insider CEO and forced turnover followed by an insider CEO has no effect on firm performance. Differences in strategic choices cannot account for differences in performance outcomes.

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Zuckerman, John Kotter, and Bharat Anand.

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Contents

1 **Introduction** 5

1.1 CEO Succession 6

1.2 Outline of the Dissertation 9

1.3 Summary of Key Findings 10

1.3.1 Forced versus Natural Turnover 10

1.3.2 Insider versus Outsider Succession 11

1.3.3 Consequences of CEO Turnover 12

2 **Data Collection and Conduct of the Study** 13

2.1 Introduction 13

2.2 Research Design 14

2.3 Field Research 16

2.3.1 Getting Access 16

2.3.2 Analyzing the Field Research Data 19

2.4 Quantitative Research 20

2.4.1 Data Sources 20

2.5 Dependent Events 21

2.5.1 Turnover Event 21

2.5.2 Origin of Successor 22

2.5.3 Firm Performance 23

2.6 Independent Measures 23

2.6.1 Director Composition 23

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2.6.2 Founder . . . 23
2.6.3 Separation of Chairman-CEO Position . . . 24
2.6.4 Year of Hire . . . 24
2.6.5 Tenure . . . 24
2.6.6 Mergers . . . 24
2.6.7 Strategic Actions . . . 24
2.6.8 Analyzing the Quantitative Data . . . 25
2.7 Summary . . . 27

I CEO Turnover **28**

3 Forced Versus Natural CEO Turnover **29**
3.1 Introduction . . . 29
3.1.1 Information Sources . . . 31
3.2 Theory . . . 32
3.2.1 A Political Perspective on CEO Turnover . . . 32
3.3 Closing the CEO Position . . . 35
3.3.1 Institutionalization of Power . . . 35
3.3.2 Founder . . . 38
3.3.3 Control over Information and Agenda . . . 39
3.3.4 Board Size . . . 40
3.4 Factors Constraining Closure of the CEO Position . . . 41
3.4.1 Composition of the Board of Directors . . . 41
3.4.2 Market for Corporate Control . . . 45
3.5 Hypotheses . . . 46
3.6 Methods and Results . . . 47
3.6.1 Model . . . 47
3.6.2 Results . . . 49
3.7 Summary . . . 55

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II CEO Succession 68

4 Executive Search Firms and CEO Search 70

4.1 Introduction 70

4.2 What is unique about CEO search? 72

4.2.1 Characteristics of the Position 72

4.2.2 Characteristics of the Market 73

4.2.3 Characteristics of the Candidates 75

4.3 The Role of Executive Search Firms 76

4.3.1 The Search Process 76

4.3.2 Coordinating 78

4.3.3 Mediating 80

4.3.4 Legitimating 84

4.4 Summary 85

5 Replacing the CEO: Insider versus Outsider Selection 88

5.1 Introduction 88

5.2 Theory 89

5.2.1 Insider versus Outsider CEO Selection 89

5.2.2 Boards of Directors and CEO Selection 91

5.2.3 Information, Performance and Outsider CEO Selection 92

5.2.4 Board Interlocks, Information, and Outsider CEO Selection 94

5.3 Data 97

5.4 Summary 100

III Consequences of CEO Turnover 108

6 Strategic and Performance Consequences 109

6.1 Theoretical Perspectives 111

6.1.1 Substantive Perspective 111

6.1.2 Symbolic Perspective 112

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6.2 Data and Methods 114
6.2.1 Dependent Variable 115
6.2.2 CEO Turnover 115
6.2.3 Strategic Actions 116
6.2.4 Methods 116
6.3 Model and Results 121
6.3.1 Lagged OLS Model 121
6.3.2 Fixed Effects Model 122
6.3.3 Random Effects Model 123
6.3.4 Strategic Changes Before and After CEO Turnover 124
6.3.5 Performance Consequences of CEO Turnover and Strategic Changes . . . 125
6.4 Discussion 127

7 Conclusion and Implications for Research **139**
7.1 Summary of Findings 140
7.1.1 Forced versus Natural CEO Turnover 140
7.1.2 Insider versus Outsider Selection 141
7.1.3 Strategic and Performance Consequences of CEO Turnover 142
7.2 Implications for Future Research 143
7.3 Implications for Practice 147

A Research Setting and Strategy **150**
A.0.1 Executive Search Firms 150
A.0.2 Analytic Strategy 151
A.1 Early History of a New Industry 152
A.1.1 Geographic Reach 155
A.1.2 Loyal Customers 155
A.1.3 Service Organization 156

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Chapter 1

Introduction

Throughout early history, charismatic authority, which rests on the belief in the sancitity of the extraordinary, and traditional authority, which rests upon a belief in the sanctity of the everyday, governed the process by which authoritative relations were established. The charismatic individual's declarations–the prophecies of oracles or the edicts of charismatic warriors–could alone pronounce new laws that would enter the realm of laws that were upheld by tradition. New prophecies and military ambition could transform and destroy entire societies. Prophets declared the need to conquer new lands. New empires arose and old ones vanished. The steel weapons of victorious generals replaced the iron weapons of the defeated. In typical fashion, however, prophecies and conquests would eventually succumb to routinization as soon as their work was done.

With the death of the prophet or warlord, the question of leader succession arises. It was the work of Max Weber (1947) which first established this topic as sociologically relevant. Weber argued that by studying how authority in a society transitions from one individual to another, one could gain insight into the social structure of that society. Hence, the processes by which India's Rajs inherited their power or how China's bureaucrats came to occupy their position or how Christendom's clergy are elected says something sociologically meaningful about a particular society.

I would also suggest that the study of leadership succession is sociologically important for more pedestrian reasons as well. A focus on succession helps resolve two messy theoretical

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problems that confound many sociological analyses. First, a focus on succession helps answer the paradox of institutional change and institutional stability. Second, a focus of leadership succession allows individuals to be placed side-by-side with social forces and both can then be used to explain social dynamics. Thus, the English Parliament's rebellion against the ruthless King Richard II in the 14th century is more than an interesting historical footnote or fodder for Shakespearian drama, but a sociologically significant event. In order to justify their rebellion against the King, Parliament invoked the notion of the king's two bodies: the physical body and the "body politic." The "body politic", Parliament argued, was independent of the personal characteristics of the individual occupying the position. Consequently, Parliament could engage in what was previously a contradictory action–rebel against a king while arguing that such action was necessary to uphold the institution of the monarchy. This single Parliamentary action, alone, is suggested to have laid the foundation for the idea of the legal corporate body (see Kantorwicz, 1957).

The thesis of this dissertation is that focusing on the succession of modern corporate leaders, while more commonplace and usually less dramatic than the succession of kings, is no less sociologically significant an event. Thus, before introducing the outline of the dissertation, I want to briefly reflect on why the study of chief executive officer (CEO) succession is important and what makes changes to the CEO position different and of greater consequence than the dismissal of other top-level executives, managers, supervisors, or front-line employees. Many of the differences I discuss here, I will return to throughout the dissertation.

1.1 CEO Succession

While the succession of any individual–at whatever level–has profound consequences for that individual, the sphere of the disruption to the organization, as a whole, is relatively limited. The dismissal of a CEO, however, has much more expansive and intensive organizational effects. In the large, publicly held corporations, which are the focus of this dissertation, a CEO has extensive formal authority in the organization. This formal authority has both direct and indirect effects on the internal organization. For larger corporations, this sphere of influence extends beyond the firm and can impact a firm's shareholders, suppliers, and customers. For the

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largest corporations in this study, this sphere of influence can be argued to impact the societal level, with the recent spate of prominent CEO dismissals raising fundamental questions about corporate governance and the appropriate scope of responsibility of organizational directors.

The uniqueness of the CEO position is in some part due to the fact that the CEO reports to a group of individuals, not any single individual. Consequently, unlike most other persons in the organization, the CEO can only be dismissed by the board of directors, whereas persons in other positions in the organization can usually be dismissed by an individual or a small group of executives often controlled by the CEO (Boeker, 1988). Thus, the ouster of a CEO is a group or corporate decision rather than an individual one. Even though the move to oust the CEO may emerge from the coordinated efforts of only one or two individuals, the decision itself must be ratified by the majority of the board. Moreover, aside from the complexities that arise from group decision-making, a further complication associated with CEO succession is that over time, a CEO comes to exert considerable control over the system that supposedly monitors his or her performance. This control is usually exercised through the control of board meetings and board appointments. Hence, the question of the factors affecting forced versus natural turnover is an important one.

Another factor that distinguishes the CEO position from other positions in the firm is that unless the firm is either dissolved or taken over, the CEO position reproduces itself over and over again regardless of other positions which can disappear in downsizing or restructuring. The reproduction of this position is in part due to the functions a CEO performs, but it is also due to the demands of legal and institutional forces which require an unequivocal identification of the person who holds the position of CEO and, therefore, is accountable for the actions of the firm.

Given the above mentioned factors related to the status of the CEO position and CEO dismissal, CEO selection can have important implications for the firm. Here, the decision to appoint an insider versus outsider successor is the focus. This decision is of particular interest because the appointment of outsider CEOs in prominent firms is a relatively recent phenomenon and its implications are not yet well-understood or researched. However, preliminary evidence suggests that the decision to appoint an outsider has broad managerial and theoretical implications. For example, it is clear that the appointment of an outsider to the CEO position has

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implications for the internal management of the organization. The appointment of an outsider CEO reneges on the tacit understanding that while only one top executive can win the top spot, the winner will come from inside the firm. Appointing an outsider CEO alters this contest. While there is no research on the consequences of outsider CEO appointment on managers, it can be argued that the impact on managerial commitment, development, and motivation is likely to be profound.

The effects of outsider CEO appointment are felt outside the firm as well. The appointment of outsider CEOs is an indication of the emergence of a sizable category of managers whose skills are not specific to any single organization, but instead transferable across an array of organizations and industries. Moreover, it has been suggested by recent researchers that the CEO job is increasingly defined by a well-specified employment contract with sharply defined goals and timetables, not the ambiguous and emergent job description discussed by earlier researchers (Mintzberg, 1973; Pfeffer, 1981). At a societal level, the emergence of a general class of professional CEOs whose jobs are defined by performance-based short-term contracts is likely to further sharpen the boundaries between top management and other organizational members.

Given the emphasis and attention that organizations pay to the CEO turnover and selection decision, it is important to consider the consequences of these decisions on firm outcomes. One popular view suggests that replacing a poorly performing CEO can lead to strategic changes that, in turn, lead to improvements in firm performance. An alternative view, however, questions the ability of any single individual to significantly affect the fortunes of a firm. This view suggests that CEO turnover and succession choices are driven by legitimacy, not efficiency concerns. That is, concerns around CEO change are driven by organizational attempts to conform to inter-firm pressures, not efficiency factors. Consequently, CEO change is suggested to have little impact on subsequent firm performance. While researchers on both sides of the argument can cite empirical research supporting their respective views, much of this research is limited in that few studies consider both the context of CEO turnover and the origin of the successor. Further, several of the cited studies are based on sport teams, not business organizations. Finally, with few exceptions, much of this research has ignored the mediating strategic changes which are assumed to occur following the appointment of a successor to a poorly performing

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CEO. Consequently, given the divergence of the theoretical views and the empirical evidence, it is important to try and address the limitations of previous empirical research as well as evaluate the strengths of the two dominant views about CEO turnover and its subsequent consequences for the firm.

1.2 Outline of the Dissertation

The first part of this dissertation examines the factors affecting CEO dismissals. CEO dismissal is of great importance because it represents one of the fundamental mechanisms of organizational adaptation (Pfeffer & Salancik, 1978). Yet, whether or not poor performance always leads to CEO dismissal is subject to empirical debate. Consequently, in an attempt to address this issue more comprehensively, I have done what few other researchers have in their exploration of this issue; I have conducted field research. Through interviews with directors, I have tried to develop a refined understanding of the processes affecting CEO turnover. Despite the obvious importance of directors in the CEO dismissal decision, there is a surprising lack of research that has sought to elicit from these individuals a real understanding of the turnover process and the factors that either inhibit or facilitate the decision to dismiss a CEO. Consequently, based on these director interviews, I was able to develop a better understanding of the underlying mechanisms affecting CEO turnover. I use these insights to revise and refine propositions suggested by existing theories of corporate governance. I then test for the generalizability of both existing and modified propositions about the interactions between firm performance and the relative distribution of power between the CEO and the board on a longitudinal sample of 850 companies. The goal, then, in this first part of the dissertation is not only to establish empirical support for existing theory about CEO dismissal, but also to modify existing theory based on the insights gathered from the field research.

The second part of this dissertation examines the process of CEO selection. Specifically, I examine the factors influencing insider versus outsider CEO succession. Unlike the CEO dismissal decision which largely involves the firms primary political actors–the CEO and its directors–CEO succession typically involves a third actor, the executive search firm. Therefore, in addition to a statistical examination of the 850 largest public companies, I also take an in-

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depth look at the role of executive search firms in the CEO succession process. My field research reveals that with respect to external CEO search, the role of executive search firms is best understood as an intermediary in a complex labor market transaction, not as a primary source of information about potential candidates and their capabilities. Rather, as I first establish in Part II, much of this detailed information about candidates is gathered by the directors of a searching firm themselves. Directors rely on their own contacts within the interlocking directorate in order to gather detailed information about a candidate's capabilities and skills.

In the third part of the dissertation, I examine the consequences of CEO turnover for firms. Specifically, I analyze the implications of the combination of forced versus natural turnover and insider versus outsider succession for a firm's strategic choices and subsequent performance. A focus on consequences is important because CEO turnover and succession are decisions that affect a firm's chances for survival. While many theorists disagree about whether these decisions are motivated by efficiency or legitimacy concerns and whether the effects of these decisions are substantive or symbolic, there is agreement that these decisions can affect the firm in important ways. I test these dominant views about the consequences of CEO successions using a longitudinal sample of 200 corporations. The reduced sample was chosen because of the practical limitation of obtaining data on the behavior of all 850 companies. Where possible, however, I do test the generalizability of some key results using the entire 850 company sample.

1.3 Summary of Key Findings

1.3.1 Forced versus Natural Turnover

Consistent with existing theory, the key findings of this chapter suggest that the distribution of control over the CEO position among a firm's CEO and the board of directors affects the likelihood of CEO firings. However, significant modifications to existing theory are suggested. First, the results question the previously untested assumption that boards dominated by outsiders will always act more quickly in the face of poor performance than those dominated by insiders. My results suggest that insiders–who have vested career interests tied to the survival of the firm, access to more accurate information about the performance of the firm, and the ability to affect board dynamics–are more likely to dismiss a poorly performing CEO than outsider dominated

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boards. Additionally, the results suggest that board interlocks play an important role in CEO dismissal. I found that heavily interlocked firms are more likely to have access to information on how to undertake the complex task of removing a poorly performing CEO and are subject to more pressure from outside constituents to act quickly in removing an underperforming CEO than are firms in which outside directors serve only on a single board.

1.3.2 Insider versus Outsider Succession

The findings in this section highlight the importance of information in the CEO selection process. Here, I demonstrate that board interlocks are the primary mechanism through which candidates gather information on external CEO candidates necessary to make an outsider appointment. However, in contrast to previous research about information flow within the interlocking directorate, my findings suggest that the kind of information that moves through director interlocks is qualitatively different from previous researchers findings. I find that a distinct advantage of the information gathered through the interlocking directorate is that it is information that cannot be gathered through alternative sources. I call this particular information. Particular information, as opposed to general information, is that information which can only be gathered as a consequence of direct experience and observation. Particular information is the detailed information on the attributes, character, idiosyncrasies, and accomplishments of an individual as opposed to simple general information, such as work history and education credentials.

This section also examines the role of executive search firms (ESFs) in CEO search. Based on an extensive field study, I show that the major role of ESFs in CEO search is as intermediaries to a complex labor market exchange. This intermediary role arises as a consequence of the special nature of the CEO labor market and the relationships between CEO candidates, ESFs, and the firm searching for a CEO. The intermediary role consists of three important functions: coordinator, mediator, and legitimator. The role of coordinator is one in which an ESF draws on its experience to assist a searching firms board, which has more limited experience with CEO search. In the role of mediator, the ESF manages a gradual, synchronized and escalating commitment process during which both candidates and the searching firm gain each others trust through exposure to equal levels of risk. And, finally the ESFs involvement provides a

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sheen of professionalism that legitimizes what is, otherwise, an opaque and discrete process.

1.3.3 Consequences of CEO Turnover

In the final section of the dissertation, I find that CEO turnover has important implications for both firm performance and strategic directions. Consistent with existing theory I find that forced turnover does improve firm performance, but only when an outsider successor is present. Similarly, I find the impact of an outsider for improving firm performance is contingent on the predecessor having been fired. I also find little evidence that there is significant variance in the types of actions incoming CEOs take across different CEO turnovers.

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Chapter 2

Data Collection and Conduct of the Study

2.1 Introduction

This chapter serves a three-fold purpose. First, it outlines the research design used to gather the data for this study. Second, it introduces the reader to the primary sources of this data. Third, it describes the methodological techniques underlying the analyses in the next four chapters. Research design, sample selection, and methods for analysis are important aspects of any empirical work. In this dissertation these issues are particularly important and require extended comment because much of the empirical analysis combines both statistical and field data. While several researchers call for using multiple sources of data to explicate organizational phenomenon, there is no obvious template for executing and presenting such an analysis.

Combining research techniques within a single project opens up enormous opportunities in each of the three major phases of research: design, data collection and analysis. These opportunities go beyond the fact that more information is gathered using multiple techniques. Instead, as Sieber (1973: p. 1337) correctly notes, by combining field and quantitative research methodologies, "a new style of research is born". Done correctly, combining fieldwork with quantitative research can result in a rich understanding of a particular social event, the factors which precede and follow that event, and the events meaning to participants and spectators, both before and after its occurrence.

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I have divided this chapter into three sections. The first section discusses the general research design. Here, I describe the multiple phases of the research process and the motivating research questions guiding these phases.

The second section discusses the primary sources of information used in the analysis. In this section, I first turn my attention to the fieldwork. Here, I discuss the methods used to gain entry to the informants. Since my informants are business elites–a traditionally difficulty subject group for social scientists to access–it is important to describe the techniques I used to gain access to this group, as well as the limitations of these techniques. I then discuss the methods used to analyze the field data.

In the third section, I turn my attention to the quantitative data set and discuss the statistical sample, the operationalization of the main variables of interest, and introduce the primary methods used for the statistical analyses.

2.2 Research Design

A secondary objective of this dissertation project was to offer a methodological contribution, in the form of an empirical approach, for exploring complex organizational phenomenon. In an attempt to grapple with a complex phenomenon like CEO succession, I used a three-phased approach and combined data from both quantitative and field sources. A separate guiding research question motivated each of these phases. The approach is diagrammed in Figure 2-2.

The first phase of the project involved gathering statistical data on the Fortune 200 from 1978-1994[1]. The data was collected with the goal of determining the strategic and performance consequences of different types of CEO turnover.

The second phase of the project involved expanding the scope of the project to the entire Fortune 500 to understand the factors affecting insider versus outsider CEO succession. In addition to enlarging the quantitative sample, I also began gathering field data from executive search firms in order to understand their role in CEO search. Based on this field research, I modified the quantitative data set to include variables I had not previously considered important to the process of CEO succession. Consequently, by gathering this additional data, I was able

[1]This phase was related to a broader study on changes in the Fortune 100 that was being conducted during this period by Nitin Nohria. Some data collected from the Nohria study was used in the analysis of this dissertation.

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Figure 2-1: PHASES OF RESEARCH DESIGN. The study was conducted sequentially from Phase I to Phase III. However, because of the natural sequences of the CEO turnover process, the dissertation is presented in reverse order.

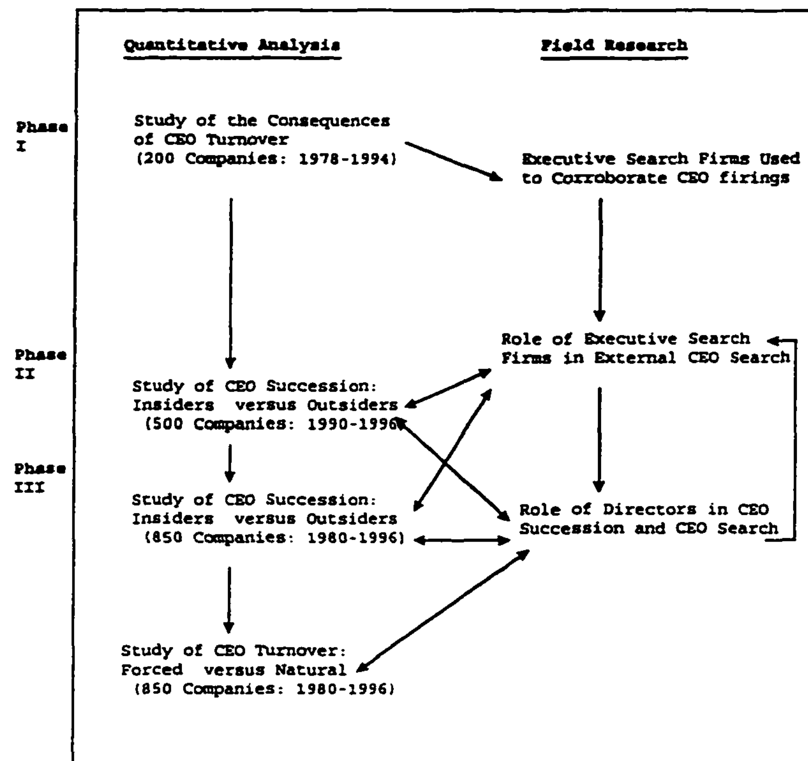

Figure 2-2:

to test several propositions regarding the factors affecting insider versus outsider CEO selection suggested by the fieldwork.

In the third phase of the research, I expanded both the quantitative data set and the scope of the field research to address the question of the factors affecting forced versus natural CEO turnover. The quantitative data set was expanded to 850 firms and covered the period from 1980-1996. This larger data set significantly increased the number of CEO turnover events and, therefore, increased the reliability of the findings. The expanded field research now also included directors who had been involved in a number of different types of CEO successions.

Including directors in the field research had three important benefits. First, several of the directors I interviewed were prominent CEOs or former CEOs themselves. Consequently, I was

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able to discuss with them their experiences from being on both sides of the CEO succession issue. Second, directors provided insight into the CEO turnover process that neither the speculations of the executive search consultants nor a quantitative data set could alone. Third, by understanding the role of directors and the role of executive search firms in the CEO selection process, I was able to test and validate the description of the process provided by both sets of actors.

2.3 Field Research

2.3.1 Getting Access

I conducted field research with 20 executive search consultants from two major executive search firms and with 17 corporate directors from various publicly held corporations.[2]

Gathering information from the directors and executive search firms proved indispensable. While several of the companies and CEO succession events I discussed with interview subjects did garner a great deal of media coverage, I found that the story that emerged from discussions with the directors and executive search firm consultants proved more complex and intriguing than the one that could be constructed from any public sources. In fact, many of my initial working hypotheses were soon discarded as the initial set of interviews came to reveal a set of unanticipated developments. As a result, the field process described here had a strong impact on my thinking and led me to revise several of my initial ideas.

Executive Search Firms

Gaining access to the executives running the executive search firms was essential and institutional affiliation proved the key. Relying on my connections at the Harvard Business School, I made contact with senior executives from major search firms. Once contacted, I outlined my general research objective of trying to develop a better understanding of the role of executive search firms in providing information about CEO candidates to firms searching for an external CEO. I also discussed with the search executives that this research would require interviewing

[2] In addition, I validated my findings of the role of exective search firms in CEO search through discussions with senior executives from two other large executive search firms.

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various search consultants at their firms, my spending some time observing the search consultants at work, and having access to confidential data regarding specific searches. I assured the executives that all the data I collected would be disguised in its final presentation and that I would periodically update them on the progress of my research. Subsequently, two search executives appointed a company liaison who served as my guide into the organization and helped arrange interviews with the search consultants.

As I alluded to earlier, the original field research was intended to be an examination of the role of executive search firms in providing information on potential CEO candidates. My intention was to develop an analysis of "information brokers", such as executive search firms, in the CEO labor market. However, during the course of my initial set of interviews with the executive search consultants and my observing the search consultants at work, it became clear that their primary role in CEO search was not as "information brokers", but rather as intermediaries who assist in negotiating a complex labor market exchange. The search consultants pointed out that while the availability of information about a candidate is a critical component of the boards decision to appoint an insider versus outsider CEO, it is the directors–not the search firm–that are the primary sources of this information.

This evidence forced me to re-evaluate my apriori assumptions about the role of executive search firms and the role of directors in the CEO selection process. Consequently, through consultation with colleagues, I modified my subsequent research questions for the search consultants and expanded my research design to include directors.

Directors

I contacted the directors using my faculty connections at the Harvard Business School and my newly established contacts at the executive search firms. I was surprised by the ease at which these affiliations provided an entry into the boardrooms and executive suites of America. In no instance when requesting an interview was I refused. The only request made of me was that all the information provided would be disguised in its final presentation. I agreed with this request and was able to interview four directors through this convenient sampling technique. Once having completed an interview with a director, I asked if there were any other directors they could think of who could provide some additional insight into the topic

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of CEO succession. In most cases this proved fruitful and I was given a name, phone number and permission to reference the name of the director providing the introduction. Again, this snowballing technique worked surprisingly well. The combination of a director reference and my institutional affiliation proved to be a useful passport. Using the combined convenient and snowball samples, I interviewed 17 directors who had participated in 45 different succession events in the Fortune 500 between 1990 to 1996[3]. The interviews took place over an 18 month time frame between 1996 and 1997.

The director interviews were semi-structured and lasted from one to three hours. I took extensive handwritten notes during the interviews . All the interviews were typed into a word processing program within two days of the interview. The interview questions were designed to stimulate discussion in four areas. First, the factors that led to the CEO turnover. Second, the factors that led to the decision to conduct an external search. Third, the role of the executive search firm in the CEO search process. And, finally, the role of the directors in the external search process. After brief introductions, I initiated the interviews by asking directors to describe the CEO succession cases they had participated in during the past six years. I always encouraged the directors to describe specific cases and events rather than speak in abstract or conceptual terms about the various successions.

While the above interview techniques proved useful, there are two apparent hazards using this technique. The first is related to sampling bias. By relying on convenient and snowball sampling techniques there is a possible bias in the field data reported. For example, all the directors I interviewed have witnessed forced CEO selection and outsider CEO succession, I did not interview directors who did not experience either of these events. A second source of bias is a period bias. I asked interview subject to discuss succession events occurring in the last six years. With respect to the issue of period bias, my response is that focusing on recent events ensured greater accuracy and detail about the specific succession events.

I have two responses to the issue of sampling bias. First, there are not many other techniques by which to access business elites. Hertz and Imber (1995) point out that random sampling and survey techniques do not work well with business elites. The typical answer to a random "cold

[3]The total number of turnover events that occured for the 850 firms between 1990 and 1996 is 612 turnovers. Additionally, the emphasis of discussion during the interviews was on forced and external successions.

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call" request for an interview is that the subject does not have time. Surveys, too, have low response rates, particularly when the topic is as sensitive as CEO succession. Second, by using two separate sources for accessing interview subjects–executive search firms and directors–I reduced the possibility of bias that arises from using only one source for interview subjects.

The second danger is the ever-present ethnographic hazard of "going native." As several researchers have pointed out there is always a danger that the supposedly objective observer may come to identify too well with his or her informants (Useem, 1984). This danger is particularly likely given my background as a business school student and the often not-so-subtle aspects of meeting with powerful people in settings chosen by them. In almost all the interviews, I met with the interview subjects in their offices. These offices were often richly furnished with a few conspicuous photographs of the interviewee with Presidents and other world leaders scattered around the waiting room and in their offices. Given the strong situations, I tried my best to achieve a balance between understanding the world of the interview subjects while still maintaining an academic's skepticism of their rendering of the events.

2.3.2 Analyzing the Field Research Data

Data analysis followed an iterative process of moving back and forth between the data, relevant literature, and the grounded theory (Glaser & Strauss, 1967).

Within two days of the interview, I transferred my handwritten interview notes to a word-processing format. With each set of two or three interviews, I would begin analyzing my findings against some working hypotheses about the CEO search process. I looked for specific examples that either refuted or supported aspects of the theory. I explored both refutations and support for the theory against the contextual nature of each CEO succession. I modified the theories that emerged based on these analyses and presented my findings in several research seminars and academic conferences.

Based on the feedback from these seminars and armed with a set of more focused questions to clarify certain ambiguities, I returned to the field to gather more data and would subsequently revise the theories. This process continued over a three year period.

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2.4 Quantitative Research

2.4.1 Data Sources

The final sample consists of the Fortune 500 for 1980 plus the 100 largest commercial banks, 100 largest financial service firms, 100 largest retail firms, and 50 largest transportation firms. This yielded a total sample of 850 firms .

The Fortune 500 in 1980 consisted of the 500 largest industrial corporations (by sales) in the United States and was identified using Fortune magazines annual compilation. The remaining firms were identified using Fortune magazines annual compilation of the largest service companies in the United States (April, 1981). I follow each of the identified firms through 1996. Using the Fortune firms as a distinct population of firms is very popular in the organizational literature (see Nohria, 1996 for a review and discussion of studies that analyze the Fortune firms). Moreover, the term "Fortune 500" invokes the companies, CEOs, and directors that people associate with big business. While the selection of only large and publicly held corporations limits the generalizability of the results, I decided on these firms because they are widely followed in the business media which in turn offers more complete information on critical company events such as CEO successions than is available for smaller firms.

The data for chief executive turnover, chief executive officer age, and tenure was collected from the Forbes Annual Executive Survey (hereafter, *Survey*). Missing information from the *Survey* was supplemented with information from the *Wall Street Journal* and required filings such as 10Ks and 10Qs which provide detailed information about company executives and officers.

Data on board of director composition was collected from Dun and Bradstreet's *Register of Corporate Management* (hereafter, *Register I*), Standard and Poor's *Register of Corporations* (hereafter, *Register II*), and firm proxy statements, annual reports, and 10K and 10Q filings. Board data was collected for the years of 1980, 1985, and 1990.

Financial data for the firms was collected from Standard and Poor's COMPUSTAT database. COMPUSTAT is an electronic database that contains firm and industry level financial data for several thousand publicly traded firms.

Data on major company events was collected from the Lexis-Nexis news database and from

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the *Directory of Mergers and Acquisitions.*

A summary of the data elements, operationalization, and sources is provided in Figure 2-2.

FIGURE 2-2: DATA ELEMENTS, OPERATIONALIZATION, AND SOURCES.

Elements	*Operationalization*	*Sources*
Forced Turnover	Forced turnover=1, natural turnover=0	Standard and Poor's, Forbes, WSJ, ESF
Outsider Successor	Outsider successor=1, insider successor=0	Forbes, Standard and Poor's, 10Ks, ESF
Firm Performance	OIBDT/TA	Compustat
Director Composition	Director Names	Register 1, Register 2, 10K
Insider Directors	Current Executives, Former Executives	Register 1, Register 2, 10K
Founder CEO	Founder CEO=1, non-Founder=0	Forbes, WSJ, New York Times
non-Chairman-CEO	non-Chairman CEO=1, Chairman-CEO=0	Register 1, Register 2, 10K
Year of Hire	Start Year of CEO	Forbes, 10K
Tenure	Last Year CEO-Start Year+1	Forbes, 10K
Merger Attempts	Merger Attempt=1, non-Merger Attempt=0	Directory of Mergers and Acquisitions
Downsizing	Employment Reduction>1%	WSJ, NYTimes
Capital Expenditures	Capital Expenditures	Compustat
Capital Structure	Total Debt/Total Equity	Compustat
Restructuring Activity	Divestitures/Acquisitions >10% Sales	Compustat

2.5 Dependent Events

2.5.1 Turnover Event

Turnover events are derived from the *Survey* which lists basic information about CEOs from the 800 largest publicly traded companies in the United States. Any company where the CEO changed between the annual *Survey* issues is coded as a succession event. Each event was then categorized into one of the following causes of succession: death of the CEO, illness, retirement, or left to accept another position, and forced exit. The forced categorization was based on extensive research and coding of reports of succession events from the *Wall Street Journal*, the

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New York Times, and *Businessweek*. Finally, the classifications were reviewed with a prominent executive search firm with intimate first-hand knowledge of many of the events surrounding the successions. While the executive search consultants were not familiar with all the CEO turnover events, I only found a few discrepancies in my coding of forced turnover situations. Consequently, it is not unreasonable to assume that errors in coding forced turnover are likely to be random.

For the purposes of the analyses, I created two discrete categories of turnover. Natural turnover and forced turnover. Forced turnover includes those cases where the CEO departs at age 60 or below and does not leave for an equivalent position at another firm. Natural turnover consists of those cases in which the reasons for departure are leaving for another job, retirement, illness, or death. This categorization method is similar to one used by Parrino (1996) and Borkovich et. al. (1996). Again, while the possibility of bias exists in coding CEO exit for legitimate personal reasons, this bias is likely to occur in the natural turnover direction because I coded CEOs who leave between the ages of 60-65 as natural turnovers. [4]

2.5.2 Origin of Successor

The origin of the CEO successors was coded using the *Survey* as well. There are a wide range of definitions used in other studies to identify an outsider CEO. For instance, Reinganum (1985) classifies executives who join the firm at the time of the succession as outsiders, while Vancil (1987) includes all executives who have been employed at the firm for five years or less.

For the purposes of the analyses, I define an outsider CEO appointment as one in which a new CEO assumes the CEO title within one year of the date that he or she joins the firm. I classify CEOs who join the firm as long as one year prior to their appointment as outsiders because new CEOs who have been employed at the firm for only one year are likely to have been hired with the expectation that they would eventually be appointed to the CEO position. This operationalization is consistent with the latest research on this subject (Parrino, 1996; Borkovich, et. al., 1996).

[4]Ideally, I would have also employed a separate coder and have this individual code the event. This would allow me to compute a reliability measure. However, because of limited resources, I did not use this method. I did, however, review my coding with executive search firms who were familiar with several of the events in question.

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2.5.3 Firm Performance

I use annual operating returns to the firm as a measure of firm performance. The annual operating return for a firm is defined as the ratio of operating income before depreciation and taxes to operating assets. Because operating income does not include discretionary adjustments such as taxes, royalty, dividends, or interest income received, nor any dividends paid to stockholders, it is considered a robust measure of changes in the operating performance of an organization (for a justification and review of this measure, see Smith, 1990). This measure is industry-adjusted by subtracting the mean value of the corresponding measure for the primary two-digit SIC industry in which the firm is active at the time of the succession. The two-digit SIC industry definition is used to identify firms with similar general characteristics. Support for the use of a two-digit industry definition to capture similarity among firms is provided by Clarke (1989) who found no significant differences in performance measures from 4-digit versus 2-digit industry adjustments.

2.6 Independent Measures

2.6.1 Director Composition

Register I and *Register II* are used to determine the composition of the board of directors. Directors who are current or former officers of the firm are classified as insiders. All other directors are classified as outsiders.

Based on this data I coded several measures of board composition. **Total Directors** is the numbers of persons on a firm's board. **Inside Board Members** are identified as current or former executives of the firm. **Proportion of Inside Directors** is measured as the proportion of inside directors divided by the total number of directors. **Board Interlocks** are measured as the total number of other boards in the sample any individual board members of the focus firm belong to.

2.6.2 Founder

I coded a dichotomous variable to indicate firms in which the CEO is also the founder of the company. Founder CEOs are identified from the Forbes' *Survey*.

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2.6.3 Separation of Chairman-CEO Position

I coded a dichotomous variable to indicate firms in which the CEO and chairman positions are held by separate individuals. This data was collected from the *Survey*, *Register I* and *Register II*, and firms' 10K and 10Q filings.

2.6.4 Year of Hire

The year in which the CEO was appointed to the position was collected from the *Survey*.

2.6.5 Tenure

The start of CEO tenure is measured as the year the individual at the firm under consideration took their position as CEO. Tenure was determined as the difference between the last year a CEO occupied the position from the start year plus one.

2.6.6 Mergers

Merger attempts on a firm are included in the analysis. This data was collected for all firms from the *Directory of Mergers and Acquisitions*.

2.6.7 Strategic Actions

Five broad types of strategic actions are measured as a proxy for changes in a firms strategies. The actions examined are downsizing, corporate restructuring, capital expenditures, research and development expenditures, and the ratio of debt to equity.

Downsizing

I follow Love (1996) in defining downsizing as any permanent layoff greater than 1% in a firms total work force in any given year; that is, the number laid-off divided by a firms average employment during the year. The 1% cut-off was chosen because it was found to be the threshold at which markets reacted to downsizing announcements (Love, 1996). The Lexis-Nexis database was searched to identify layoff announcements.

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Capital Expenditures and Research and Development Expenditures

Capital expenditure and research and development expenditure data was collected from COMPUSTAT. Both items are coded as a percent of total sales.

Capital Structure

Consistent with Jensen (1986), I define capital structure as the firms ratio of debt to equity. This measure was collected from COMPUSTAT.

Total Strategic Actions

To capture a firms total strategic activities, a composite variable was created from the various strategic actions. Each strategic action that exceeded a firms industry average was coded as 1. Those that were below the industry average were coded as 0. These actions were then summed into a single variable.

2.6.8 Analyzing the Quantitative Data

The pooled, cross-sectional nature of the sample allows for great flexibility in the types of techniques used to analyze the data. In this section, I want to provide a description of the main techniques used to explore each part of the CEO succession process. My purpose in providing these descriptions, however, is not to provide a primer on statistics. Rather, my purpose is to just introduce the major techniques I use to explore the causes, process, and consequences of CEO turnover. How I use these methods is discussed in greater detail in the relevant chapters.

The Determinants of Forced Versus Natural Turnover

The main statistical technique used for this analysis is event history analysis. Event history analysis is used to assess empirical change of discrete, qualitative events. The output of the analysis is a probability than an event will occur at a particular time to a particular subject, given that the subject is at risk at that time. With respect to the type of CEO turnover, this is the probability that a CEO will be fired given that the CEO is at risk for being fired. Similarly, we could just as easily generate a duration for the non-occurrence of an event during

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the time the CEO is at risk. The power of the analysis emerges from the ability to include both time-dependent and ascribed variables into the models to study their impact on the likelihood of an event occurring. Discussions on the mathematics underlying event history analysis and the uses of event history analysis to study change can be found in Blossfeld & Rohwer, 1995, Yamaguchi, 1991; Allison, 1988; and Tuma & Hannan, 1984.

Insider versus Outsider CEO Selection

The main statistical technique used for this analysis is logit analysis. Logit analysis is a commonly used method to model a discrete categorical variable as a function of a set of explanatory variables. Like its OLS parent, logit analysis provides test for the significance of a given predictor controlling for all other predictors in the model, as well as a test for the significance of a set of predictors, controlling for other effects. In my case, I use logit analysis to evaluate the effects of a certain set of independent variables on the likelihood that a firm will appoint an outsider versus insider CEO, given that a CEO succession has occurred. An introduction into logit analysis is provided by many statistical texts including Pindyck & Rubinfeld (1991), Kennedy (1993), and Demaris (1992). In addition to logit analysis, I also employ network analysis to generate certain measures about director characteristics. This analysis and the network measurements are discussed in Chapter 5.

The Consequences of CEO Turnover

I employ a variety of statistical methods in this section on the consequences of CEO turnover. First, I use traditional OLS analysis techniques on a panel data set. I also employ fixed effects and random effects models. Three techniques are used because the analysis of firm performance presents several theoretical and methodological challenges discussed in detail in Chapter 6. Moreover, employing the three different methods allows me to provide robust evidence for some counter-intuitive findings. Explanations of these various time-series analyses can be found in Greene (1993) and Kennedy (1993).

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2.7 Summary

The benefits of combined methods have been hypothesized by several researchers. This dissertation tests this hypothesis by developing a study that combines both field research and quantitative techniques to explore the topic of CEO succession.

Field research was conducted with executive search firms and directors of large, publicly held corporations. Field research provided data about the processes of CEO succession and selection that cannot be derived from either publicly available sources or statistical data. Consequently, despite the established limitations associated with field based research, with respect to understanding the CEO succession phenomenon, direct contacts with informants who have intimate knowledge about the CEO succession process has no substitute.

The research design followed the process of interweaving field observations with quantitative data analysis over the duration of the project. Both field and data analysis proceeded simultaneously with fieldwork being used to inform the statistical data collection and the quantitative analysis used to correct some of the bias and focus of the field research.

The field research is analyzed using iterative methods of thematic coding and returning to the field to clarify inconsistencies or anomalies. Statistical analyses is used to test the generalizability of the hypotheses and the field observations. The sample consists of 850 companies followed from 1980-1996. A variety of statistical methods congruent with the proposed theoretical statements are discussed in the subsequent chapters on the CEO succession process.

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Part I

CEO Turnover

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Chapter 3

Forced Versus Natural CEO Turnover

3.1 Introduction

The recent departures of the Chief Executive Officers (CEOs) at American Express, International Business Machine (IBM) and Kodak have focused public attention on the issue of forced CEO change. Following varying periods of poor performance, the boards at each of these firms dismissed its CEO. Because of the enormous impact a CEO can have on the fortunes of a firm, the decision to remove a CEO is among the most important actions a board of directors can take. Removing a poorly performing CEO can mean billions of dollars to the market value of a firm and, in some cases, significantly impact the survival of the firm. The purpose of this chapter is to present a theory and evidence about the factors that influence involuntary CEO turnover.

While a negative relation between firm performance and the likelihood of involuntary CEO turnover has been theoretically asserted, the empirical evidence is mixed. For example, some studies find that poor firm performance is a trigger for CEO turnover. McEachern (1977), in a study of the Fortune 500, found that executives had longer tenures in superior performing firms. He also found that four successive years of declining performance contributed to an increased rate of CEO turnover. Coughlan and Schmidt (1985) found a negative relationship between a firm's stock price performance and probability of CEO turnover. Warner, Watts,

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and Wruck (1988) also found a negative relation between stock price and turnover, but with an average lag of up to two years. Other studies, however, found fairly small effects (Weisbach, 1988) or no effects (Fizel, Louie, & Mentzer, 1990) of firm performance on CEO turnover. In sum, the evidence is inconclusive. Further, the fact that a great deal of variance exists in the timing between poor performance and CEO turnover, makes it difficult to conclusively establish a causal link.

A review of the research on CEO turnover suggests two reasons for these mixed findings. First, there is a wide gap between theory and empirical research on the factors that affect CEO turnover. Specifically, while a great deal of organizational theory and case research has suggested that CEO turnover is affected by a complex political dynamic between the board of directors (e.g. Mace, 1971; Vancil, 1988; Lorsch and MacIver, 1989) and the CEO, most large sample research has simplified the process to one that examines efficiency explanations of CEO turnover and ignores the richer, but more complex dynamic that underlies processes of corporate control. This gap between the qualitative evidence around CEO turnover and the efficiency motivated large sample research, in turn, suggests that researchers have had difficulty translating propositions about the dynamic character of power struggles into testable hypotheses (Ocasio, 1994), as well as testing those hypotheses using appropriate methods.

This chapter presents an argument that modifies significantly the performance-based explanations that dominate research on CEO turnover. Specifically, I suggest the utility of a perspective built on the notion that CEO turnover is at its root a political process and that the CEO and directors[1] are the firm's primary political actors (Ocasio, 1994; Davis & Thompson, 1994; Pfeffer, 1982; Pfeffer & Salancik, 1978). Using both previous research and my own field research on boards of directors, I argue that the interplay of this dynamic, within the context of firm performance, influences how open to competition the CEO position is and, therefore, impacts the likelihood of CEO turnover.

Using transition rate analyses to model the dynamic nature of CEO turnover, my findings in this chapter assert that mechanisms such as the institutionalization of a CEO's power, control over information and resources, whether the CEO is the founder of the company, and board configuration are the primary means by which CEOs close off their position from competition

[1] Including the director's networks.

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and the effects of firm performance. My findings in this chapter further suggest that the external market for corporate control and the cross-cutting ties between a firm's board of directors are the primary means by which CEO positions remain open to competition and contestation. In other words, these factors moderate a CEO's ability to close his or her position from the effects of competition from others for the position and of firm performance. Finally, my findings in this chapter present evidence supporting assertions by previous researchers that the shareholder-rights movement in the late 1980s and early 1990s has increased the overall rates of CEO turnover (Davis & Thompson, 1994).

I have divided this chapter into three sections. The first section presents the theory of how the distribution of power between a firm's CEO and board influences the openness or closure of the CEO position to dismissal. The second section presents both field and quantitative evidence to support the basic propositions of the theory. Finally, I summarize the results and discuss their implications.

3.1.1 Information Sources

This chapter relies on a range of existing research and primary research. I present a brief discussion of the primary sources here.

I combine both field and statistical analyses to study the phenomenon of CEO turnover. The benefits of field research to both develop and test theory and theoretical mechanisms for understanding organizational outcomes have been outlined in several texts (Strauss & Corbin, 1990; Yin, 1990). In the case of CEO turnover, the need for field research is particularly apparent. First, the existence of contradictory empirical evidence on the causes of CEO turnover highlights the need for a closer empirical examination of the phenomenon. Second, there is little multi-case comparative field research that has examined the process of CEO turnover (an exception is Vancil, 1987).

I first gathered field research data through personal interviews with 17 directors of large, publicly-held American companies. Interviewees were selected using the combined convenient and snowball sampling techniques described in Chapter 2.

In addition to the field data, archival data for a group 850 large firms was gathered. The purpose of this data was to validate hypotheses that emerged from the field study. The sample

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and a description of the basic variables for analysis is discussed in Chapter 2. The methods used for analyzing this data are discussed in more detail in the "Methods and Results" section of this chapter.

3.2 Theory

I argue that the relationship between firm performance and CEO turnover can be explained by differences in power between the firm's primary political actors–the CEO and the board. The interplay between these actors, I suggest, determines the degree the CEO position is open or closed to competition and contention. In this section, I first define in specific terms what is meant by open versus closed positions. Next, I introduce the different mechanisms that affect how open or closed the CEO position is and specify the conditions under which they are likely to arise. I then draw on my field research and discuss the operation of these mechanisms and how they affect forced CEO turnover.

3.2.1 A Political Perspective on CEO Turnover

The concepts of power and interests are fundamental to political theories of organization. In organizational theory, power has most often been defined in relation to interests. Specifically, power is the capacity of a particular social actor to control those resources, factors, or events that satisfy or further their interests (Coleman, 1990).

As an empirical concept, however, power has proven a difficult phenomenon to model. March (1962, 1966, 1988) has argued that inferring the operation of power in organizational situations is extremely tricky and that "power" is often used in a way conceptually similar to "needs" or "personality" to construct explanations for otherwise unexplained variance after the fact (Pfeffer, 1982 has made a similar argument). March suggests that to infer that power is operating in a particular decision situation, one should observe consistency in patterns of outcomes over time; otherwise the outcomes could have been produced by a random process instead of by power. Furthermore, March argues that the concept of power would be more useful to the extent that it could be explained by a theory of its sources. That is, the mechanisms used by a social actor to attain power and, thereby, further interests need to be precisely identified

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(Coleman, 1990). This lack of precision, in both the specification of a social actor's interest and the mechanisms used to advance these interests, is evident in much of the existing political research on CEO turnover.

While no single political perspective on CEO turnover exists, there are two general political theories that have been proposed to explain CEO turnover. These theories can be called the model of institutionalization of power and the model of circulation of power (Ocasio, 1994).

The model of institutionalization of power has been the dominant perspective in contemporary organizational theory (Pfeffer & Salancik, 1978; Pfeffer, 1981; Useem, 1984; Davis & Thompson, 1994). This perspective is consistent with managerialist perspectives that emerged from Berle & Means (1932) observations about the separation of ownership and control in large American business. Institutionalization of the CEO's power, in this model, is the establishment of relatively permanent structures and policies which favor the incumbent CEO. Researchers suggest that two important mechanisms through which CEOs successfully institutionalize their power and maintain their autonomy are board appointments (Useem, 1984; Richardson, 1987) and the selection of corporate underlings (Jensen and Meckling, 1976; Pfeffer & Salancik, 1978). Consequently, the institutionalization of power model suggests that a CEO's power increases over the period of his or her tenure as CEO and as a member of the board of directors.

A second approach is the circulation of power model which suggests that those in positions of power are vulnerable to dismissal, "with periods of stability being only temporary interruptions of an underlying pulling and tugging of contestants for power, position, and privilege" (Ocasio, 1994: p. 288). This model of power builds on theories of the circulation of elites by Pareto (1901, 1986ed). Discussing both economic and political elites, Pareto argues that societies and the sub-systems within them are characterized by ongoing processes in which elites replace each other. This means, above all, that the dominant actors in charge of economic or political resources change. Dramatic changes, such as the forced removal of the elite in power, come from two related sources. First, external events such as a decline in economic performance or an external attack create conditions for change. Second, the tendency of those in power to close off their positions from competition and "avoid open recruitment in its stratum" impair the abilities of the individuals in power to deal with these changes. The circulation of power, in sum, emphasizes the transient nature of power and competition for executive control over

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the corporation (Davis & Thompson, 1994; Palmer, Barber, Zhou & Soysal, 1995).

We have, then, two perspectives. One perspective is the dominant institutionalization of power view, which assumes that CEO's can close off their positions over time from competition and contestation and avoid dismissal despite poor performance. At the other end is the circulation view, which assumes that the insularity of leadership over time leads to a decline in its capabilities and that, therefore, external exigencies such as poor performance will lead to the CEO's removal.

The above two perspectives have usually been treated as competing theories about the ability of CEO's to hold on to their positions (Ocasio, 1994). However, I believe that posing these perspectives as competing theories is incorrect. Instead, I will argue that the circulation of power and the institutionalization of power perspectives represent two ends of a continuum.

Borrowing from a conceptual framework introduced by Weber (1947) and elaborated and specified by Sørensen (1974), I suggest that a CEO position can be thought of as varying along a continuum of being "open" versus "closed". How open or closed a CEO position is depends on the CEO's control over the decision to leave the job. To the extent that the CEO has full control over the decision to leave the job, we would consider that position as closed (Sørensen, 1974) and the likelihood of forced CEO turnover to be low. In the closed situation, the CEO effectively insulates himself or herself from the effects of competition and performance. On the other hand, to the extent that the CEO exercises no control on the decision to leave the job and, therefore, is unable to maintain control when their position is threatened, we would consider the position to be open (Sørensen, 1974) and the likelihood of forced CEO turnover to increase. When the CEO position is open, actors other than the CEO control the decision to vacate the position. Conceptually, factors leading to the openness of a CEO position are factors that constrain the CEO from closing off their position. Similarly, factors leading to closure are constraints to openness.

There are several advantages to treating the phenomenon of forced CEO turnover as a question of how open or closed the CEO position is. First, this approach explicitly recognizes that at its core, CEO turnover is a labor market phenomenon. Consequently, sociological models which have been used to understand the factors that influence turnover in other organizational positions can be used to understand the factors affecting CEO turnover. Second, this approach

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incorporates concepts from both economics and sociology (Sørensen, 1974: 1981; 1983). Consistent with previous economic views and my own research findings, I treat the CEO as an agent who has a strong interest to keep his or her job by closing off the position from competition.

The primary means through which closure is achieved, I argue, is a political process. Four mechanisms through which CEOs potentially close off their position are suggested: institutionalization of their power, founder status, control over information and rewards, and board size. At the same time, this approach also recognizes that CEOs are subject to both social and market forces that can constrain the degree to which they are able to close off their positions from the pressures of competition and performance. Two important constraints are a board of directors' cross-cutting ties and the external market for corporate control. I discuss the evidence for these mechanisms below.

3.3 Closing the CEO Position

3.3.1 Institutionalization of Power

Researchers have shown that in most organizational contexts, decisions are made in public (Meyer & Rowan, 1978; Cyert & March, 1963) and are arrived at through a negotiated consensus among competing organizational coalitions (Pfeffer & Salancik, 1978). These decisions are often explicit in terms of their expected consequences. Most organizational decision situations, therefore, are commitments.

While commitment to a specific course of action has been portrayed as a strength of formal organization (Chandler, 1977; Ghemawat, 1991), its benefits within the boardroom are debatable. Specifically, the commitment of a board to a specific course of action can lead directors to become bound to decisions regardless of their effectiveness and, in some cases, because of their ineffectiveness. These commitment processes make it difficult for directors to see, much less admit to, mistakes. Rather, evidence of poor performance is likely to be re-defined away from the CEO and, thus, result in a decoupling of CEO turnover from performance. Pfeffer (1981:297-298) describes this phenomenon as a consequence of the way organization's tend to define problems or challenges. He writes:

> Organizational difficulties tend to become defined as problems of implementation

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> and organizational control. The problem isn't that we have done the wrong thing; the problem is that we have been half-hearted about what we are doing; we haven't done it enough...

If organizational difficulties call forth escalation and increasing commitment and become defined in terms of support and enthusiasm for a specific course of action, then it is clear how a CEO can use this to their advantage to institutionalize their power and close off their position from the effects of firm performance. My field research is consistent with previous theory and research and suggests that CEOs do institutionalize their position over their tenure (Ocasio, 1994; Pfeffer, 1981). However, unlike the current literature, the field research suggests that the institutionalization process is not a linear process that monotonically increases with CEO tenure. Rather, it is a process that is characterized by an initial period of low vulnerability to being fired, followed by a period of escalating vulnerability, and then a third phase of declining vulnerability.

The first phase of a CEO's tenure is characterized by what some directors call a "honeymoon period." This period was suggested by directors to be "two to three years long" Here, the newly appointed CEO comes in with institutionalized power that arises from the fact that by simply selecting the particular CEO the board has initiated a commitment toward a specific course of action. "By simply selecting the CEO, the board has made the statement that it trusts the judgement of that individual", stated one prominent director and former CEO of an automobile company. "My selection as CEO" he continued, "was not arbitrary. The board gave serious thought to the current situation of the company, the facts of the situation...As a result, they at least owed me the benefit of doubt with respect to the decisions I was making." "Moreover," he added, because the "board is often involved in the major strategic decisions, at least with respect to ratifying them, they are often bound to them. It is difficult to criticize an action you approved of in the past."

A second contributing factor that leads to the honeymoon period for the CEO is the fact that for many organizational decisions there exists a lag time between the decision and its ultimate results. "The consequences of decisions", stated a director of a large manufacturing concern,

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do not often show up until 4 to 5 years after the decision...During my first two years as a director, the company lost $1.8 billion dollars. However, as a board member we are obligated to stand behind the decisions of the CEO and support him as best as we know possible. The reality is that declaring his failure is declaring our failure.

The performance consequences that subsequently emerge from decisions made early in the CEO's tenure initiates the second phase of institutionalization. This phase is suggested to begin three to four years after the CEO's start date. This phase, however, is not characterized by an increasing institutionalization of the CEO's power, but rather a period in which directors potentially exercise their own institutionalized power to represent the interests of shareholders. Since the new CEO has not developed a long track record or had an extended opportunity within which to consolidate their formal and informal power, the board has the opportunity to re-evaluate their choice of CEO. As one director from a prominent manufacturing company stated: "We used the three year mark to evaluate the performance of [Roger]. Since things had deteriorated significantly and it did not look like his initial plans had the impact we thought they would, we suggested that he resign from his position."

The notion that the CEO would become increasingly vulnerable to director evaluation has some theoretical support in the decision making literature. Gersick (1987), for example, finds that group decision making is not a progressive process. Rather, this process is characterized by punctuated periods during which re-evaluation of earlier decisions are made. These punctuations are initiated by preliminary feedback from earlier decisions. These punctuations are typically used to either continue with the existing course of action or choose a new course of action. With respect to CEO turnover, this period of re-evaluation creates an opportunity for forces opposed to the CEO to exercise their influence. The case of General Motors (GM) removing Robert Stempel only three years into his tenure is illustrative of this phenomenon. After three years of record-breaking losses, the GM board fired Stempel and replaced him with John Smith. Here, press accounts suggest that the selection of Stempel was originally a political compromise between the outgoing CEO who favored Stempel and a smaller group of directors who had originally favored Smith. Stempel's poor performance created an opportunity for this smaller coalition to re-open the case against Stempel's appointment.

The third phase of institutionalization is similar to the one characterized by previous re-

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searchers in corporate governance and managerialism (Lorsch & MacIver, 1989). Here, the CEO's position becomes taken for granted through the persistence of the same individual occupying the position. As institutional theorists have noted, the tendency for ways of doing things in the organization, patterns of authority, and standard operating procedures take on the status of objective social fact. Thus, instead of questioning the CEO's authority or dominance, despite poor performance, these aspects of the CEO's authority become defined as part of the organization's genetic makeup and are seen as essential to the organization's survival. Zucker (1977: p.726) summarizes this phenomenon:

> ...social knowledge once institutionalized exists as a fact, as part of objective reality, and can be transmitted directly on that basis. For highly institutionalized acts, it is sufficient for one person to simply tell another that this is how things are done. Each individual is motivated to comply because otherwise his actions and those of others in the system cannot be understood.

Board members articulate this institutionalization in a related manner. For example, one director, discussing why his board had not removed a poorly performing CEO, stated: "he had been CEO so long, the board had largely forgotten about succession." Another director, discussing a board's delay in acting in a firm that had shown three successive years of losses said: "Boards are made up of human beings. Human beings are afraid of talking about bad things and human beings are excellent at rationalizing. It was hard for us [the board] to imagine an alternative to [Steve]." The directors stated that the taken-for-granted nature of a CEO's power was particularly powerful when the CEO in place was charismatic. "The guy was charming. No doubt about it. He charmed an extra three years out of us as CEO." Consistent with Weber's (1947) discussion on the routinization of charisma, charismatic leaders seem to "inhibit the adoption of rationalized criteria for the problem of succession."

3.3.2 Founder

Another factor critical to whether a CEO can effectively close off their position is whether the CEO is the founder CEO. In founder led firms, the founder is the manager and under the assumption that individuals are unlikely to fire themselves, tenure would be relatively impervious

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to performance conditions. Founder CEOs also can rely on their symbolic association with the firm to assist them in closing off their positions from competition. Anecdotes of founders' ability to avoid dismissal and remove competitors from their position are legendary. One director offered the well-known executive of a large electronics company as an example.

> While he did not own a controlling portion of shares, I think a little less than 2%, the guy was the founder and had a cult of personality around him. He had basically been unsupervised for 35 years because the company would turn in phenomenal results year after year. Moreover, he had effectively established his leadership in the company and people literally worshipped the ground he walked on. These type of factors led to a delay in the board acting. Including me. We had all been so used to his running the company that we could not imagine it any other way.

3.3.3 Control over Information and Agenda

Most research on decisions begins with a set of alternatives and seeks to predict the decision among the alternatives. In the case of CEO turnover, this would arise with information about a firm's performance and the framing of this performance. Consequently those actors in the position to define and develop information about firm performance are left with enormous political power.

Directors suggested that control over information and agenda was cited as a critical mechanism through which CEOs close off their positions from competition and contention. The control over information arises primarily as a consequence of the fact that the CEO also occupies the position of chairman of the board and, thereby, controls not only the executive functions of the organization, but the executive functions of the governing board.

Closely related to the control of information is the control of a board meeting's agenda. As Bachrarch and Baratz (1962) noted that one of the best ways to exercise power is to prevent the decision issue from surfacing in the first place. They write:

> Of course power is exercised when A participates in the making of decisions that affect B. But power is also exercised when A devotes his energies to creating and reinforcing social and political values and institutional practices that limit the scope

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of the political process to public consideration of only those issues which are comparatively innocuous to A...to the extent that a person or group—consciously or unconsciously–creates or reinforces barriers to the public airing of policy conflict, that person or group has power.

The manner in which this control over information and agenda in the boardroom is exercised is summarized by a director who sits on the board of a major tool manufacturer:

> You have to understand, unless the CEO is willing, the board has a difficult time getting access to reliable and accurate information. The typical board meeting here was cooked. The presentations were cooked. The agenda was controlled. And the committees powerless. The entire compensation committee was staffed by friends of the CEO.

A director of a large hotel company stated:

> It is difficult to change things. The norms and signals are strong. How full the agenda is, how the long the meetings are, even the surroundings are all controlled by the Chairman-CEO. These are signals that influence board member behavior. Not talking about something is a decision in itself.

3.3.4 Board Size

Governance researchers suggest that smaller boards can operate more effectively and, thus, more efficiently than larger boards (Jensen, 1993). Reduced board size is expected to strengthen the relationship between firm performance and CEO turnover (Yermack, 1996). My field research is consistent with existing thinking on the relationship between board size and CEO turnover. The field research suggests that the size of the board impacts its effectiveness. Several directors suggest that large boards led to weaker governance because of the greater formality associated with the meetings and reduced constructive conflict. One director, discussing his experience on a board which had been enlarged by the CEO from 14 to 18 members, states: "The CEO had enlarged the board to the point that the entire meeting had to be scripted if we were to get through the agenda." Another director expresses a similar sentiment when comparing his experiences on a large board to those on a smaller board:

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> there is less formality in the smaller board. We can engage in more constructive and frank discussions with the CEO. Also, it is easier to develop a working relationship and team feeling with the other board members when the number of participants is smaller.

3.4 Factors Constraining Closure of the CEO Position

If the CEO position is open, there are no barriers to removing the CEO. Factors that lead to openness are constraints to closure. When a CEO position is open, shareholders and their appointed board representatives should be able to replace a poorly performing CEO with a more productive and effective individual. There are two forces that potentially constrain the CEO's ability to close the position from competition. One is the legally sanctioned force of corporate governance–specifically, the board of directors. The second is the external market for corporate control. I briefly discuss each in turn.

3.4.1 Composition of the Board of Directors

The interests of the board of directors are numerous, but two in particular have been identified in the literature as particularly relevant with respect to CEO turnover: wealth effects and reputation. Wealth effects are suggested to affect the incentives of directors to take action against poorly performing management. Specifically, directors with significant financial stakes in the firm have a greater incentive to undertake the burdensome task of removing existing management because their own personal interests in preserving their wealth will suffer if they do not take action. I did not find much qualitative support for this assertion. Many directors would concur with this director's statement:

> [L]ook there is not a lot of money being a director. The 30 or 40 thousand dollars I make being a director sounds like a lot of money, but it is not. I am a busy person. I make a good living and don't need the money. I do it for the exposure to other people and to help other companies with my experience as a CEO and knowledge about business.

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While I was skeptical about the altruistic motives of these individuals, I did not find much support for the incentive effects of director ownership. This finding is consistent with Core, Holthausen, and Larckers (1997: p.32) large sample study which found that "percentage ownership per outside director has little effect on the monitoring role of the board of directors." Their conclusion is that there is no empirical support for "recent conjectures suggesting that outside directors should be forced to hold a greater amount of the firms shares in order to ensure that they have a financial stake in the outcome of their monitoring" [p. 32].

Reputation, on the other hand, is thought to offer a particularly strong motivation for boards to remove a poorly performing CEO. Fama and Jensen (1983) argue that directors:

> will monitor the management that chooses them because directors have incentives to develop reputations as experts in decision control...The value of their human capital depends primarily on their performance as internal decision managers in other organizations. They use their directorships to signal the market for decision agents that (1) they are decision experts, (2) they understand the importance of diffuse and separate control, and (3) they can work effectively with such decision control systems.

Given the importance directors place on their reputations, board composition is suggested to affect the ability of the CEO to close off their position. Because one of the critical duties of the board of directors is to evaluate senior management of the corporation and replace managers if they fail, the composition of the board is likely to affect how closely a CEO will be monitored.

The task of monitoring is likely to fall mainly on the outside directors. Inside directors' careers are tied to the CEOs and hence, it is reasoned, they are unwilling to remove incumbent CEOs (Weisbach, 1988; Parrino, 1996). Outside directors, on the other hand, are thought to be concerned about their reputations and will act to remove a poorly performing CEO to the extent that their reputations suffer when they are known as directors of poorly performing companies. Thus, if there is a higher percentage of insiders on the board, the ability of the CEO to close off his or her position from competition and contestation is enhanced.

On the other hand, both political and human capital perspectives suggest that insider directors are much more likely to remove a poorly performing CEO. Inside directors have

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an incentive to remove a poorly performing CEO if the CEO's continual poor performance threatens the survival of the firm and their own career interests and investments in firm-specific skills. From a political perspective, inside directors are often potential future CEOs with an interest in occupying the top position (Vancil, 1987). These two views can only be reconciled through empirical testing.

With respect to the importance of reputation, I found support for Fama and Jensen's (1983) assertions in my interviews. Most directors are very protective of their reputations. For example, prior to scheduling the interviews, all of the directors insisted on total anonymity and disguising the names of the companies. One director I interviewed resigned from the board of a very prominent company after it adopted a re-organization policy that he thought would harm both shareholders and his reputation as a trustworthy director. He stated: "In order to maintain my credibility as a director and my peace of mind, I was prepared to walk." As a result of his resignation from the board, together with that of two other board members, the company subsequently dropped this particular re-organization plan. Incidentally, he was asked to join another board almost immediately following his resignation.

At the same time, it should be noted that not all outside directors are equal. I found that directors commonly believed there was a difference between outside directors who served at the pleasure of the CEO and professional directors who sit on more than one board. "Many so-called outside directors are not outsiders, but friends of the CEO." These "outsiders" usually "serve only on one board" as opposed to professional directors who sit on at least two.

Professional directors were said to belong to "a director community." Members of this community were perceived as being more objective and willing to take difficult actions. In situations of poor performance, one director said that the "outside director who plays golf with the CEO every weekend will have a harder time removing him than if you are a professional board member just flying in for a board meeting." "These professionals are the real independent board members", he continued. People who sit on multiple boards "get both pressure and ideas from other board members" to remove a poorly performing CEO. The professional directors have "their credibility at stake." These directors are suggested to act "before the situation gets out of hand in the media and the perceptions of the outside world is that we are just ornaments." One director at a consumer products firm told me how he was continually ribbed

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by directors from other boards he sat on for failing to remove a CEO at a firm that had been criticized by the media as having an unresponsive board that "had fallen asleep at the wheel."

While my field evidence suggests that interlocked directors are more likely to remove a poorly performing CEO, several researchers have argued that the relationship is not so clear-cut and could easily go the other way. For example, in a recent article Westphal and Zajac (1997), using a social exchange perspective, note that under certain conditions directors may discipline a poorly performing CEO and in other conditions directors may support a CEO, depending on the norms of the relevant group. Others have argued that directors who sit on many boards are too busy to effectively monitor and govern the CEO (Core, Holthausen, and Larcker, 1997). In other words, the directors espoused norms and values, uncovered from the field research, may be different from those exhibited in practice.

In summary, what the field research suggests is a relational perspective when considering the motivations of directors. Current conceptions of the role of corporate directors suggest that directors act with fiduciary concern to a faceless stock market and anonymous, dispersed shareholders. However, the reality is that those directors interlocked with other firms are often motivated to act (or not act) because of their loyalty to real people, not abstractions. Interlocked directors must constantly interact with other directors. As a result, as members of a larger community of directors, they feel greater peer pressure, guilt about not acting swiftly or appropriately, than those directors who are isolated and whose primary loyalty is to the CEO who appointed them.

In other words, the object of a director's loyalty is what often motivates directors to either act or not act. As sociologists we should not be surprised: relationships impact action. This idea begins as far back as studies on the American soldier which found that few soldiers during World War II fought for freedom or the American Way; motivation came not from these abstract ideals, but instead from loyalty to peers in the platoon and fear of embarrassment in front of them (Keegan, 1976). Consequently, isolated directors may be more willing to side with a CEO as opposed to a faceless, anonymous shareholder, whose needs are too distant to demand attention or concern. Those directors who are embedded in the interlocking directorate, on the other hand, are more likely to be motivated to act out of concern to maintain their reputations in the eyes of their peers and the legitimacy of the corporate governance system.

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On the other hand, academic researchers suggest that a norm toward supporting the CEO is more prevalent among directors (Jensen, 1990; Lorsch & MacIver, 1989). Consequently, in this case interlocks would constrain the removal of the CEO because such directors may be seen as "disloyal" or, worse yet, "CEO killers." This interpretation is bolstered by the fact that the majority of CEOs are CEOs or ex-CEOs themselves and, hence, subject to board monitoring themselves. Coleman (1989) in his discussion on norms in networked groups, notes the two-edged sword of norms, which may either constrain or facilitate effective actions. He writes: "norms that reward certain actions are in effect directing energy away from other activities. Effective norms in an area can reduce innovativeness in an area, not only deviant actions that harm others, but also deviant actions that can benefit everyone" (Coleman, 1989:105). The effect of interlocks on forced turnover, therefore, can only be ascertained through empirical testing.

3.4.2 Market for Corporate Control

While the board of directors is widely believed to be shareholders first line of defense against incompetent management, researchers have suggested that it sometimes fails as an effective monitor of executive performance (see Jensen, 1986). When it fails, the external market for corporate control can also act as a disciplining mechanism leading to the removal of entrenched management.

As Davis and Thompson (1994) note, the notion that takeovers could be used as a disciplinary action against poor managers was first espoused by Manne (1965). Manne argued that the stock market provides the only objective evaluation of management performance through the price it places on a firm's stock. If current management in a publicly held company is doing a poor job, the firm's share price will decline so as to create an incentive for more competent managers to take control and drive the firm's value back up. The worse the performance of a firm, the greater the incentive and potential reward to those who take control of the firm and run it more efficiently.

While the actual value eventually extracted from takeovers has been questioned (Palepu, Healy, & Ruback, 1991), what is of concern here is the claim that the external market for control is an important mechanism that constrains a CEO from closing his or her position from external

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competition. A director of a large publishing company relayed a story of how a takeover bid actually empowered an otherwise passive board. She stated:

> As a consequence of the takeover bid, the power shifted. Suddenly the board had overt legal responsibility to consider the company's shareholders, its recent performance, and the CEO. We were able to talk more frankly with the CEO and let him know that we thought he lacked the management experience to navigate the company in the new environment of publishing. We asked for his resignation and were able to put in someone with more depth and experience with both the financial side of the business and the new technological changes taking place in publishing.

3.5 Hypotheses

The above results from the field research and my descriptions of the mechanisms that lead to closure or constrain closure in a CEO position lead to a number hypotheses about the rate of forced CEO turnover. How these various mechanisms affect closure of the CEO position, however, can only be understood in the context of performance. Given the nature of political contestation and political coalitions in organizations (Pfeffer, 1992), it is only in the context of performance that CEO power and CEO control over a position can be understood–in particular, poor performance. Poor performance, as one director relayed it, "is when the relative power of the board and CEO becomes evident."

If the processes affecting forced CEO turnover conform to those suggested by the closed view, the institutionalization of the CEO's power should conform to the three phase patterned suggested earlier. We should see an overall pattern that conforms to a decline in the probability of CEO firing during the early tenure; a subsequent increase in vulnerability to firings; and, finally, a decline in the probability of being fired. To the extent that the CEO has effectively closed off the position, we should see a relatively weak link between performance and dismissal from the position. Further, we should find that founder status, holding both the Chairman and CEO title, and large boards decrease the likelihood of forced CEO turnover. The size and significance of these three effects in reducing the rate of CEO turnover should be particularly important during periods of declining performance.

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In contrast, if the CEO position is open, we should not expect any effect of CEO tenure on forced CEO turnover. Instead, we should expect that exigencies, such as poor performance or the threat of a hostile takeover, should trigger forced CEO turnover. We would also expect that in periods of poor performance, a higher percentage of outsiders on the board, takeover bids, and director interlocks increase the likelihood of forced CEO turnover.

In the next section I present a quantitative analysis of archival data support for the hypotheses suggested by the field research. My goal in this analysis is not to definitively support all the hypotheses drawn from the qualitative evidence, but to provide adequate support and evidence for the theory and mechanisms discussed above.

3.6 Methods and Results

3.6.1 Model

The logic of the theory assumes three possible outcomes for CEO changes: (1) CEOs who do not change their jobs; (2) CEOs who voluntarily move to another job or reach the retirement age; and (3) CEOs who involuntarily leave their positions. The different destination states for CEO transitions requires us to model these CEO events as competing risks:

$$T_{vt} = (T_{vt}*)\,[f_{vt}\,(r_{vt})]$$
$$T_{it} = (T_{it}*)\,[f_{it}\,(r_{it})]$$

where v and i refer to voluntary and involuntary turnover, and where each transition (T) is modeled conditional on the competing event not having occurred (Blossfeld & Rohwer, 1995). Each of these competing events involves a discrete change of state. These changes can occur at any point in time and our theoretical discussion suggests that there are both time-constant and time-varying factors influencing these events. For the purposes of this chapter, the event of interest is forced turnover. Consequently, I treat both no turnover and voluntary turnover as censored events.

The type of analysis used to model the competing events given both changing and constant independent variables is continuous-time transition rate analysis with time-varying co-variates. Effects on the transition rate are estimated by maximum likelihood procedures that model the

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probability that a CEO moves out of a job given a set of co-variates. In other words, transition rates are conditional probabilities for the occurrence of the discrete events of interest (the rates of voluntary and involuntary turnover). My main interest lies in CEO firings and how dependent these events are on the set of exogenous variables I have identified. Thus, while I estimate competing risk models for the event history analyses, I will only focus on the outcome of forced CEO turnover, not natural turnover. Since competing risk models assume that the competing outcomes are independent of each other, whether I estimate separate models for each outcome simultaneously, or estimate the outcomes as a dichotomous model and treat all other outcomes as censored, the results will be identical (Blossfeld & Rohwer, 1995: Chapter 4)

As Tuma & Hannan (1984) point out, a number of different continuous-time stochastic models can be specified for the transition equations specified above. I use the Log-logistic distribution to model the time dependence of the CEO transition process since this model explicitly models CEO changes in terms of waiting times. The choice of this model is based on two considerations. First, the closure argument I have specified suggests that the probability of involuntary turnover and voluntary turnover is an inverse of tenure in the position. Second, when I compared the maximized log-likelihoods assuming this model against those for the exponential, Weibull, and log-normal models, I found that the log-logistic model provided a better fit to the data (significant <.01) (see Figure 3-1). A visual and regression test of the parametric assumptions suggests that the log-logistic model provides the best linear transformation. A regression test of the parametric assumptions suggests no substantive difference between either the log-normal model or the log-likelihood. The fully specified model with its logarithmic time-dependence is specified as:

$$r_{jk}(t) = \frac{b_{jk}(a_{jk}t)^{b_{jk}-1}}{1+(a_{jk}t)^{b_{jk}}}$$
$$a_{jk} = \exp A^{(jk)}a^{(jk)}, b_{jk} = \exp B^{(jk)}b^{(jk)}$$

where r is the transition rate from origin state j to destination states k. The associated co-variates, $a_{(jk)}$and $b_{(jk)}$ are the model parameters to be estimated.

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Interactions

Many of my analyses require interaction effects involving cross-product terms to test the conditional effects of performance and other independent variables. I am therefore faced with a potential issue of multicollinearity. Problems of multicollinearity arise because predictors and their cross-products are highly correlated. To address the multicollinearity issue, the independent variables and their related interactions are centered. Centering a variable involves subtracting each mean from the cross-product variable. Rescaling by centering variables has no effects on the value of the regression coefficients for interaction terms (see Jackard, Turrisi, and Wan, 1990 for a more detailed discussion).

3.6.2 Results

Descriptive Statistics

Figure 3-2 presents simple statistics describing the firms in the sample. The descriptive statistics in this table are consistent with previous findings. For example, comparison of statistics for forced and natural turnovers reveals that firms in which forced turnover took place performed relatively more poorly than those in which voluntary turnovers took place. The relative differences and the differences in industry-adjusted performance are consistent with the notion advanced by Morck, Schleifer, and Vishny (1989) that directors consider performance relative to other industry firms when making turnover decisions. The results also show that founder-led firms, on average, performed better than other firms in the sample. This finding may occur for two reasons. First, founder-led firms are likely to be newer and, therefore, competition in a particular niche or industry may still be low. Second, founder-led firms may have lower agency costs and, therefore, outperform their industry counterparts.

Additionally, those firms that experience forced turnover are, on average, smaller than those that experience voluntary turnover. Smaller firms are likely to exhibit greater turbulence in both their product markets, takeover markets, and have higher levels of concentrated ownership. This suggests that studies focusing on the largest corporations are likely to underestimate the rate of forced turnover.

Figure 3-3 also shows that firms in which forced departures took place have a higher number

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of CEOs during the sample period. Further, the descriptive statistics for directors show a board in which approximately 24% of the directors are insiders. This percentage is consistent with Shivdasani (1993) and Bhagat and Black (1997).

Figure 3-4 presents a summary of the forced and natural turnovers in the sample. The table shows 1304 total CEO changes during the sample period of 1980-1996. Two-thirds of these departures are voluntary (836) and one-third (468) are forced turnovers. While the number of forced turnovers seems high, it is not surprising given the time period of the study. As several researchers have noted (Jensen, 1986; Davis & Thompson, 1994), the late 1980s and 1990s were a period of time during which there was both increasing pressure to remove poorly performing CEOs and increasing pressure on many CEOs to take early retirement. Many of these pressures originated from external forces including institutional investors (Useem, 1995), the media (Hirsch, 1986), and shareholder activists (Monks & Minnow, 1996).

Figure 3-3 examines changes in board composition over time. The results are consistent with anecdotal views that boards are becoming more outsider-dominated. There is a clear indication that the absolute number of insiders on the boards is decreasing. Also consistent with the anecdotal view, the median size of boards has declined since 1980, as has the percentage of insider directors. Finally, the median number of board interlocks per firm has declined slightly over time.

Duration Dependence

Figure 3-7 presents the estimated effects of the various independent variables on CEO dismissal for all the models[2]. The first column in Figure 3-7 presents the effects of performance and firm size on CEO dismissal without any specified time dependence using an exponential model. The results suggest that good performance significantly decreases the likelihood of forced CEO turnover. Firm size, however, is not significantly linked to forced turnover, though the direction of the coefficient suggests that larger firms are more likely to dismiss their CEOs. The distribution of tenure and the hazard rate of firings suggests support for the institutionalization model set forth earlier. A graph of the log-logistic model is provided in Figure 3-5. The early

[2]Because of the number of models run, the full results are only presented in Model 3-6. For purposes of clarity in presentation, the firm and CEO control variables are suppressed as are the period effects in the b-vector.

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tenure is characterized by a low risk of firing, followed by an increasing rise, and a subsequent decline. The log-logistic distribution is consistent with that obtained from a piece-wise model (not shown) which finds that shifts in the hazard rate are relatively flat until year 3 with a subsequent risk increase until the 6th year, followed by a decline.

Model 1 in Figure 3-7 presents the same results except it uses the log-logistic model. The coefficient of the b-vector coefficient is not statistically significant, but its size suggests support for the view that the overall CEO dismissal rate may be a negative function of tenure. A b-value of less than one suggests that following an initial rise, the likelihood of forced dismissal declines in subsequent years.

Model 2 clarifies this result by including the dummy variables for the period effects. We now see that the constant in the b-vector is significant. Because the signs of the period effects are in opposite directions, the effect on the b-coefficient was masked in Model 1. The significant b-vector is estimated to be less than one. This lends support to the field research which suggests that CEOs are able to close off their position over time through institutionalization of their power, thereby reducing their chances of dismissal as time passes.

Examining the estimated period effects in Model 2 more closely, we see strong support for the field research suggesting that the period during which a CEO was appointed affects the rate of dismissal. CEOs appointed after 1985 were more likely to be fired than their counterparts appointed in the period between 1980 and 1985 ($p<.01$). Those appointed prior to 1980 are less likely to be fired than those appointed between 1980 and 1985. These results indicate increasing rates of forced turnover for public corporations in recent periods. The results are also consistent with the following directors statement: "there is a lot more pressure on boards to govern today than there had been when I joined my first board in 1975. Today, I get letters from the Teamsters pension fund telling me my board is too lax and that performance is poor. Also, you never had articles about the Ten Worst Directors. Attitudes are different"

The period effects are also consistent with the other researchers findings. A recent study on the Fortune 200 from 1978-1993, for example, found an increasing number of CEO dismissal in more recent years (Khurana & Nohria, 1996). Westphal and Zajac (1997) suggest that the reason for greater board vigilance of CEO performance is a change in attitudes among board members. Other researchers suggest that changes in the market for corporate control have

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contributed to an increasing pressure on the board of directors to govern more closely than in earlier periods (Davis & Thompson, 1994). This finding can also account for findings reported by other researchers, that the average tenure of CEOs has decreased in recent times (Ocasio, 1994).

CEO Characteristics

Model 3 considers whether founder CEOs are less likely to experience dismissal. The results support the field research which found that directors claim that firing a founder is more difficult because there is "a difference in the power of a founder CEO when compared to a board-appointed CEO." Model 3 suggests that being a founder, independent of performance, reduces the likelihood of forced turnover ($p<.01$).

Model 4 considers the effect of the separation of the CEO and chairman positions. The model strongly supports ($p<.01$) directors contentions that separation of the positions significantly reduces the power of the CEO and, consequently, increases the likelihood of forced dismissal.

Board Characteristics

Model 5 in Figure 3-8 considers the effect of board configuration on forced turnover. The results show that the greater the percentage of insiders on the board the more likely a forced turnover. The results are counter to the current view among corporate governance reformers that outsiders are likely to exhibit greater independence from the CEO and, therefore, enhance the objectivity of the board. Model 5a, shows, the importance of including the interaction term. With the inclusion of the interaction term, the main effect now shows that a greater percentage of insiders decreases the likelihood of forced turnover. The interaction variable is statistically significant, indicating that at average levels of firm performance, insiders reduce forced turnover. At above-average performance, however, insiders reduce forced turnover drastically. And, at below-mean performance, insiders increase the rate of forced turnover. The direction and magnitude of the interaction between performance and percent insiders is illustrated in Figure 3-10. This finding is explored further in model 6.

Model 6 considers the impact of the absolute number of inside directors on forced CEO turnover. The main effect of number of insiders is not significant. This is surprising given

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that percent insiders and number of inside directors are positively correlated (.62). Model 6a considers the interaction between the number of insiders and performance. The main effect of the number of insiders shows that the greater the number of insiders, the less the likelihood of forced CEO turnover. The interaction, however, shows that as performance declines insiders board members can exert a positive effect on the likelihood of forced turnover. This result suggests further support for an emerging view that having a few insiders can counter the power of the CEO in times of poor performance (Core, Halthausen, and Larcker, 1997). For example, one director I interviewed suggested that having insiders on the board other than the CEO "provides alternative perspectives" on the challenges facing the firm. Insiders, another director argued, provide "an alternative to the CEO for information." In other words, inside board members can potentially constrain a CEO's power. Unlike outside directors, inside directors are privy to more specific knowledge about the company that can assist them in removing a CEO. Second, inside directors are more likely to have an accurate assessment of the skills of the individual who can best do the job and whether a poor situation can be improved with the replacement of the CEO. Inside directors also have a greater vested interest in removing a poorly performing CEO than outside directors if the CEOs continual poor performance threatens the survival of the company and their own career interests.

Model 7 considers the effect of board size. In the field study, directors argued that larger boards are usually "more formal", "less frank", and less able to develop into a "cohesive working group than smaller boards." The results, however, are contrary to the predictions suggested by the field research. Instead, we see that larger boards increase the likelihood of forced CEO turnover.

The effect of board size on increasing the likelihood of CEO firings is even more apparent when we consider its interaction with performance. Model 7a and Figure 3-11 illustrate that as increasing board size contributes to a higher rate of forced turnover in poorly performing firms. The interaction between board size and performance shows that smaller boards have a negative effect on the likelihood of forced CEO turnover in periods of declining performance. While the effects of board size are counter to the field research, this empirical finding is consistent with Ocasio's (1994) finding that larger boards decrease CEO tenure. Ocasio suggests that CEOs have a more difficult time controlling a larger board as opposed to a smaller board and this, in

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turn, increases the likelihood of dismissal.

Model 8 in Figure 3-9 considers the interlock characteristics of the board. The main effect of interlocks is not significant. When we consider the interaction between interlocks and performance, the results are consistent with the field research findings. Model 8a and Figure 3-12 both illustrate that in periods of performance decline, a high level of interlocks increases the likelihood of forced turnover. Low levels of interlocks, on the other hand, decrease the likelihood of forced turnover.

The field research suggests two reasons for this. First, board members who are interlocked have access to "better information" than those who are isolated. And, second, interlocked directors are more subject to "social pressures" related to maintaining reputation than those directors who are isolated. As a result, interlocked directors are more likely to have access to information and knowledge about how to undertake the complex and rare task of firing a CEO. Further, interlocked directors are more likely to act when subject to pressures from other directors to remove a poorly performing CEO. This normative pressure is particularly acute when the firm is a high profile firm (such firms tend to be highly interlocked) and the legitimacy and efficacy of the board is apt to be questioned by constituents, such as shareholders and the business media.

Market for Corporate Control

Model 9 considers the effect of the external market for corporate control on CEO firings. In this model, I consider the effects of unsolicited (but unconsummated) merger attempts on CEO dismissals. Firms in which takeover attempts are made are usually underperforming. The bidding firm undertakes a merger attempt when it believes it can extract greater value from a target firm than current management is able to obtain.

Takeover attempts usually trigger extensive corporate governance activity at the target firms. Davis (1991) notes the adoption of poison pills at firms that are threatened by a hostile takeover. Anecdotal evidence points to the re-organization of boards and the adoption of a variety of defensive measures such as golden parachutes, paying greenmail, or stock buy-backs. Unsolicited mergers also expose the weak position of existing management and force the board to reconsider the existing trajectory of the firm and the re-organization of the firms management.

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Model 9 shows that takeover attempts significantly increase the likelihood of CEO dismissal. Model 9a shows that the interaction effect with firm performance are significant. That is, when performance is poor a takeover attempt significantly increases the likelihood of forced turnover. Again, this is consistent with the field research in which directors argued that an external shock, like a hostile takeover bid, can energize and empower an otherwise passive board toward taking active steps to remove a poorly performing CEO.

3.7 Summary

This chapter points toward the dynamic character of corporate governance and the importance of power relationships and how they influence the decision to fire a CEO. Unlike efficiency-based explanations which rely on abstract notions of performance and markets reaching equilibrium, I have suggested that a more complex view of the dynamics between the actors involved in the CEO dismissal needs to be considered.

Unlike early organizational research which presumes relative autonomy of the CEO, I have advocated a behavioral perspective that specifies the interests of the actors and discusses the power dynamics between these actors. I argue that the distribution of control over the CEO position among a firms CEO and the board of directors determines how open or closed the CEO position is open to change. The interests and the power dynamics between the actors I have defined, it should be noted, have not been abstracted from economic theory, but refined and revised using field evidence obtained from extensive interviews with boards of directors and CEOs. The field evidence was then tested against a large sample consisting of over 11000 firm years.

Results show that the political dynamics of CEO dismissal are characterized by a process in which CEO positions are most open and vulnerable to forced change early in an incumbents tenure. The results also show that CEOs are able to close off their positions with increased tenure through institutionalization of their power. That is, the field and statistical research shows that CEOs do, in fact, get fired. The field and statistical research also show that a CEO's control over the position is weakest in the initial period of his or her tenure and then increases over time as the CEO consolidates his or her power base so as to close off the position.

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The study also shows that poor performance creates conditions under which the CEO's control over the position can be contested. The outcome of this contest depends on the relative power of the CEO and the board. Additionally, the empirical results show that the rate of dismissal is strongly mediated by a period effect during which the CEO was appointed. This period effect demonstrates the impact of changes in the larger context in which firms were operating, as well as is the first empirical research to confirm the often-perceived view that the risk of CEO firings is rising.

The results of this chapter point to the importance of considering the role of politics in CEO firings. The results question the previously untested assumption that boards dominated by outsiders will act more quickly than those dominated by insiders. My results suggest that insiders–who have vested career interests tied to the survival of the firm, access to more accurate information about the performance of the firm, and the ability to affect board dynamics are more likely to dismiss a poorly performing CEO than outsider dominated boards.

As well, the results also suggest that board interlocks play an important role in CEO dismissal. I found that heavily interlocked firms are more likely to have access to information on how to undertake the complex task of removing a poorly performing CEO and are subject to more pressure from outside constituents to act quickly in removing an underperforming CEO.

The managerial and social implications of my findings are discussed more fully in the conclusion of the dissertation. However, I want to introduce some issues to consider regarding the effectiveness of internal corporate governance systems. Jensen (1993) points out that with the effective shutdown of the capital markets as a mechanism for motivating change in organizations, firms are now again dependent on the internal corporate governance systems as a monitor on management. Mirvis (1991), for example, notes that several recent court decisions of the Delaware courts and Pennsylvania courts have returned much of the control over corporate decisions back to corporate directors and significantly weakened the market for corporate control. Consequently, firms are left to rely on the internal control systems of organizations to restrain managerial excess and maintain organizational effectiveness.

Since managerial control is both the main impediment and main facilitator of organizational change, it is important to highlight the processes by which change of control takes place. My field and empirical research point to the importance of power and interests of the main actors

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in explaining this process of change. More importantly, my results suggest that variance in the relative control boards and CEOs exercise over the CEO position can help account for differences across firms in forced CEO turnover, net of performance. The results also suggest re-examination of the theory that outsider boards are more effective in disciplining and removing the CEO than firms in which insiders are also present. Insiders, while facing different incentives than outsider boards, have access to more resources and information than do outside board members in pushing out a poorly performing incumbent CEO.

The field research suggests that a concern for reputation plays a strong role on board member behavior. That is, social considerations play an important role in influencing directors to undertake the difficult task of dismissing a poorly performing CEO and perhaps even in the selection of a successor CEO. This suggests that we pause and question the suggestions made in the media that board interlocks inhibit board members from disciplining CEOs. While a director who sits on too many boards is likely to be ineffective, my research does suggest that, under conditions of poor performance, multiple directorships hasten the removal of the incumbent CEO and, thus, improve board governance.

In sum, the results of this chapter point to the importance of power and politics in organizational decisions and outcomes. An understanding of the contest for corporate control lies not simply within the confines of efficiency based explanations set forth by organizational economists. Instead, it involves an explicit recognition that corporate actors such as CEOs and board members are involved in a complex political exchange where the currency is not simply dollars, but also interests and control.

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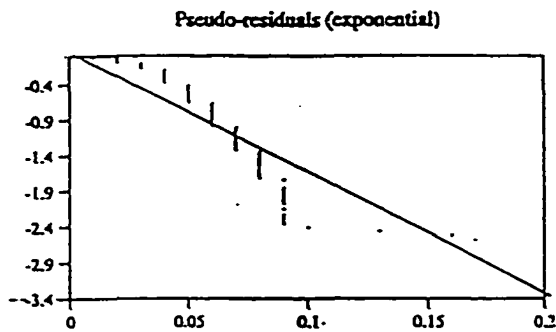
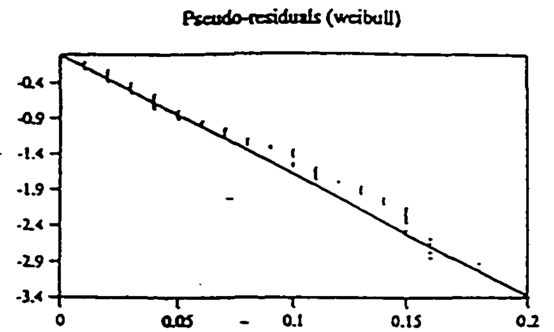
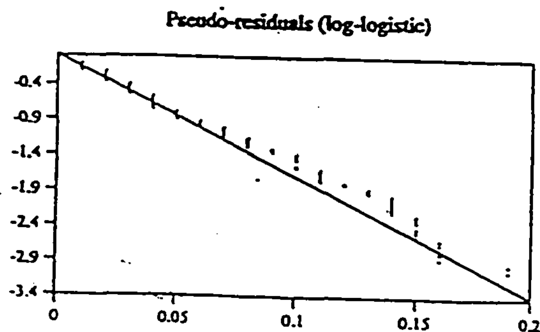
Figure 3-1: GRAPHICAL CHECK OF PSEUDORESIDUALS. Plots of logarithm of survivor functions (of residuals) vs. residuals.







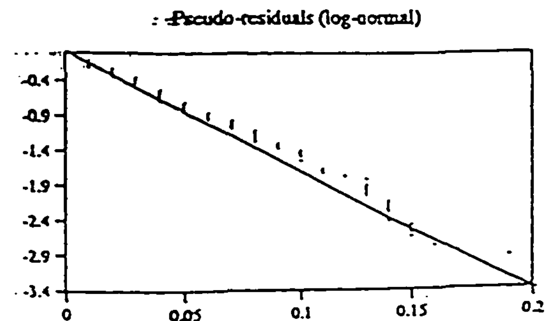


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Figure 3-2: Firm Characteristics for the Sample. CEOs who vacate their position prior to age 60 and who do not leave for other employment or for health reasons as identified in the New York Times, Wall Street Journal, or Businessweek are coded as forced.

	Median OI/TA (unadj)	Median OI/TA (adj)	Median Pct. Outsider on Board	Pct. of Firms w/Sep Chairman	Median Emps (000s)	Median Number of Board Interlocks	Average Number of CEOs	Average Tenure of CEOs
All firms	14.00%	0.00%	76.92%	14.89%	14.79	9	1.59	9.09
Founder-led	18.00%	1.00%	66.67%	1.40%	10.94	3	1.01	21.62
All turnovers	13.00%	-1.00%	77.76%	14.80%	17.90	11	1.52	10.02
Voluntary departure	13.00%	0.00%	77.76%	11.31%	20.01	12	1.45	11.87
Forced departure	11.00%	-3.00%	77.35%	21.56%	13.74	8	1.66	6.71

Figure 3-3: Board Characteristics for the Sample. Changes in board characteristics for the years 1980, 1985, and 1990. Outside directors are coded as individuals who have no current or prior executive management affiliation with the firm.

	1980			1985			1990		
	Median	Mean	Std. Dev.	Median	Mean	Std. Dev.	Median	Mean	Std. Dev
Inside Directors	4	4.2	2.2	3	3.7	2.2	3	3.2	1.9
Outside Directors	9	10.2	4.6	10	10.4	4.9	10	10.2	4.6
Entire Board	14	14.4	4.4	13	14.1	5.2	13	13.4	4.8
Board Interlock	11	12.0	11.5	10	10.9	11.2	9	11.1	9.9
% Inside Directors	.29	.31	.15	.25	.28	.16	.23	.26	.16

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Figure 3-4: CEO Turnover and Characteristics. Turnover events and CEO characteristics for the sample. Averages and medians are pooled for the years 1980 to 1996.

	Number of Events	CEO Characteristics			
		Average Age at Exit	Median Tenure as CEO	Median Tenure with Firm	Percent with Separate Chairman
Turnovers	1304	57.6	7	22.0	14.90%
Voluntary	836	65.3	10	28.3	11.31%
Forced	468	54.5	5	20.6	21.55%

Figure 3-5: LOG-LOGISTIC TRANSITION RATE. Figure displays distribution of log-logistic model which is best fitting model for the analysis. Estimated using TDA with rate=9. Distribution models an increased risk, followed by declining risk of firing over time.

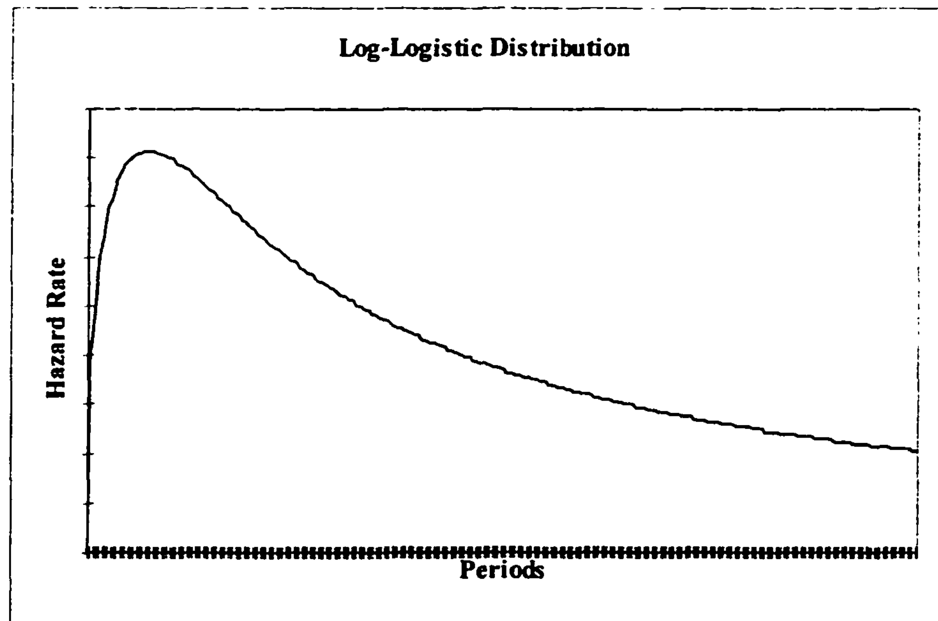

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Figure 3-6: Maximum Likelihood Estimation of Effects on Transition Rate Toward Forced CEO Turnover, Log-Logistic Model.

Coefficient	Exponential	Model 1**	Model 2**	Model 3**	Model 4**	Model 5**	Model 5a***	Model 6	Model 6a**	Model 7**	Model 7a**	Model 8*	Model 8a*	Model 9**	Model 9a**
a-vector															
Constant	-5.57***	-5.39***	-4.80***	-4.66***	-4.71***	-4.91***	-4.67***	-4.71***	-4.73***	-4.65***	-4.67***	-4.66***	-4.61***	-4.72***	-4.68***
	(.114)	(.153)	(.116)	(.112)	(.114)	(.136)	(.114)	(.120)	(.115)	(.134)	(.116)	(.120)	(.120)	(.114)	(.112)
Performance	-.831***	-.830***	-.615***	-.552***	-.564***	-.587***	-.380***	-.565***	-.529***	-.583***	-.492***	-.604***	-.319**	-.544***	-.433***
	(.162)	(.163)	(.127)	(.123)	(.123)	(.124)	(.130)	(.123)	(.127)	(.125)	(.120)	(.126)	(.137)	(.122)	(.125)
Employees (ln)	.018	.016	.024	.025	.028	.037	.039	.028	0.048	.031	.012	.041	.033	.012	.019
	(.039)	(.038)	(.030)	(.029)	(.029)	(.029)	(.030)	(.029)	(.029)	(.029)	(.030)	(.031)	(.032)	(.029)	(.029)
Founder				-.995***	-.967***	-.991***	-.921***	-.966***	-.891***	-.971***	-.963***	-1.00***	-.929***	-.983***	-.955***
				(.217)	(.216)	(.216)	(.208)	(.217)	(.209)	(.216)	(.216)	(.217)	(.215)	(.213)	(.201)
Separate Chairman					.327***	.300***	.240***	.328***	.257***	.325***	.337***	.311***	.278***	.326***	.326***
					(.092)	(.092)	(.091)	(.093)	(.094)	(.092)	(.092)	(.093)	(.091)	(.090)	(.090)
Pct Inside Directors						.578***	-.551**								
						(.193)	(.272)								
Pct. Insiders x Performance							-2.89***								
							(.394)								
Number of Insider Directors								-.0017	-.1206***						
								(.020)	(.029)						
Insider Directors x Perf.									-.266***						
									(.040)						
Board Size										-.006	.016*				
										(.007)	(.009)				
Board Size x Performance											.064***				
											(.017)				
Interlocks												-.049	.098**		
												(.036)	(.044)		
Interlocks x Performance													.454***		
													(.077)		
Target														.657***	.426***
														(.095)	(.113)
Target x Performance															-.986***
															(.217)
b-vector															
Constant		.045	.193***	.234***	.235***	.222***	.243***	.235***	.251***	.234***	.233***	.223***	.229***	.246***	.255***
		(.037)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)	(.045)
Cohort <1980			-.243***	-.248***	-.244***	-.243***	-.257***	-.245***	-.260***	-.246***	-.245***	-.245***	-.245***	-.245***	-.246***
			(.043)	(.043)	(.043)	(.043)	(.043)	(.043)	(.044)	(.043)	(.043)	(.043)	(.043)	(.044)	(.045)
Cohort >1985			.338***	.321***	.326***	.346***	.367***	.325***	.346***	.328***	.328***	.330***	.330***	.336***	.340***
			(.044)	(.044)	(.044)	(.045)	(.045)	-0.044	(.045)	(.044)	(.044)	(.044)	(.044)	(.044)	(.044)
Log-likelihood	2953.14	-2949.58	-2829.17	-2811.61	-2805.74	-2801.51	-2773.38	-2805.74	-2782.86	-2805.44	-2797.34	-2804.84	-2786.75	-2785.36	-2775.69

Figure 3-7: Maximum Likelihood Estimation of Effects on Transition Rate Toward Forced CEO Turnover, Log-Logistic Model. *p<.10,**p<.05,***p<.01

Coefficient	Exponential	Model 1**	Model 2**	Model 3**	Model 4**
a-vector					
Constant	-5.57***	-5.39***	-4.80***	-4.66***	-4.71***
	(.114)	(.153)	(.116)	(.112)	(.114)
Performance	-.831***	-.830***	-.615***	-.552***	-.564***
	(.162)	(.163)	(.127)	(.123)	(.123)
Employees (ln)	.018	.016	.024	.025	.028
	(.039)	(.038)	(.030)	(.029)	(.029)
Founder				-.995***	-.967***
				(.217)	(.216)
Sep Chmn					.327***
					(.092)
b-vector					
Constant		.045	.193***	.234***	.235***
		(.037)	(.045)	(.045)	(.045)
Cohort <1980			-.243***	-.248***	-.244***
			(.043)	(.043)	(.043)
Cohort >1985			.338***	.321***	.326***
			(.044)	(.044)	(.044)
Log-likelihood	2953.14	-2949.58	-2829.17	-2811.61	-2805.74

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Figure 3-8: Maximum Likelihood Estimation of Effects on Transition Rate Toward Forced CEO Turnover, Log-Logistic Model. *p<.10,**p<.05,***p<.01

Coefficient	Model 5**	Model 5a***	Model 6	Model 6a**	Model 7**	Model 7a**
a-vector						
Pct Inside Directors	.578***	-.551**				
	(.193)	(.272)				
Pct. Insiders x Performance		-2.89***				
		(.394)				
Number Inside			-.0017	-.1206***		
			(.020)	(.029)		
InsideDirector x Perf.				-.266***		
				(.040)		
Board Size					-.006	.016*
					(.007)	(.009)
Board Size x Performance						.064***
						(.017)
Log-likelihood	-2801.51	-2773.38	-2805.74	-2782.86	-2805.44	-2797.34

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Figure 3-9: Maximum Likelihood Estimation of Effects on Transition Rate Toward Forced CEO Turnover, Log-Logistic Model. *p<.10,**p<.05,***p<.01

Coefficient	Model 8*	Model 8a*	Model 9**	Model 9a**
a-vector				
Interlocks	-.049	.098**		
	(.036)	(.044)		
Interlocks x Performance		.454***		
		(.077)		
Target			.657***	.426***
			(.095)	(.113)
Target x Performance				-.986***
				(.217)
Log-likelihood	-2804.84	-2786.75	-2785.36	-2775.69

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Figure 3-10: INTERACTION EFFECT OF PERCENT INSIDERS AND PERFORMANCE ON RATE OF CEO FIRINGS. Model graphed using $\exp(b_1x_1+b_2x_2+b_3x_1x_2)$ holding all other independent values at their mean levels. High and low levels of performance are defined as one standard deviation above or below the mean value.

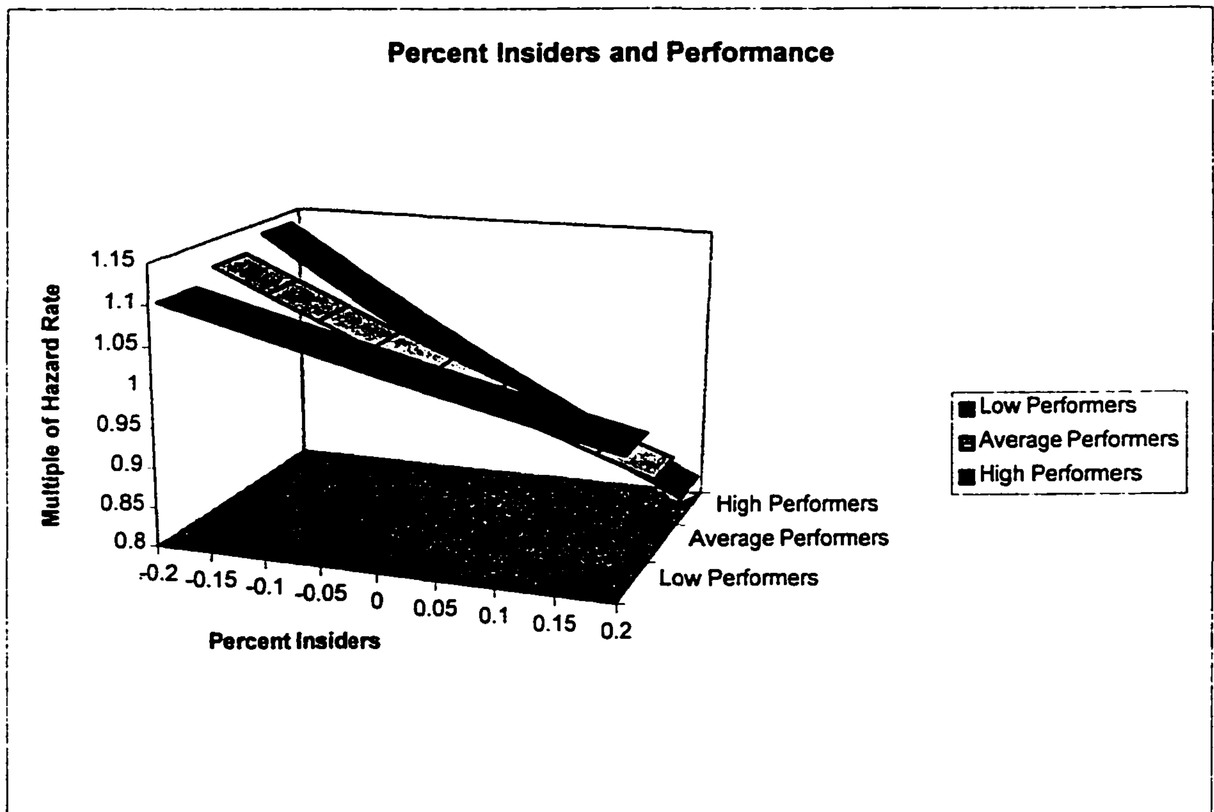

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Figure 3-11: INTERACTION EFFECT OF BOARD SIZE AND PERFORMANCE ON RATE OF CEO FIRINGS. Model graphed using $\exp(b_1x_1+b_2x_2+b_3x_1x_2)$ holding all other independent values at their mean levels. High and low levels of performance are defined as one standard deviation above or below the mean value.

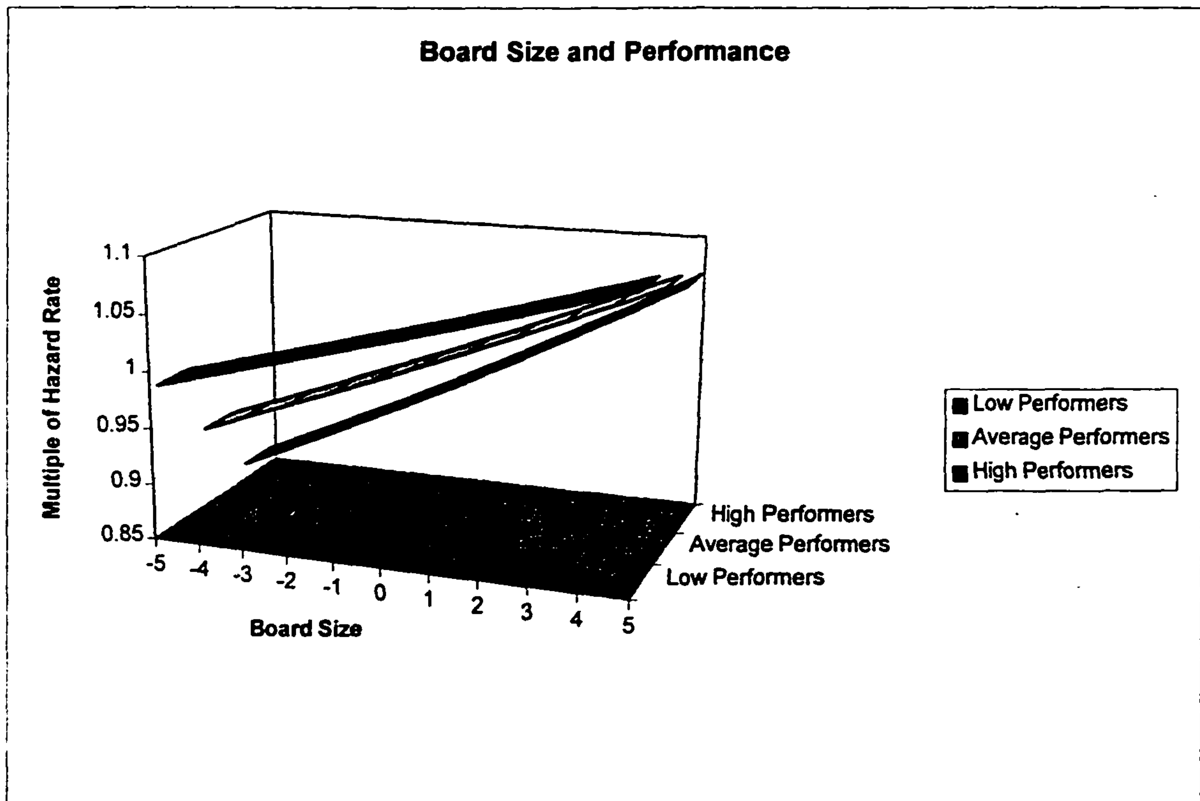

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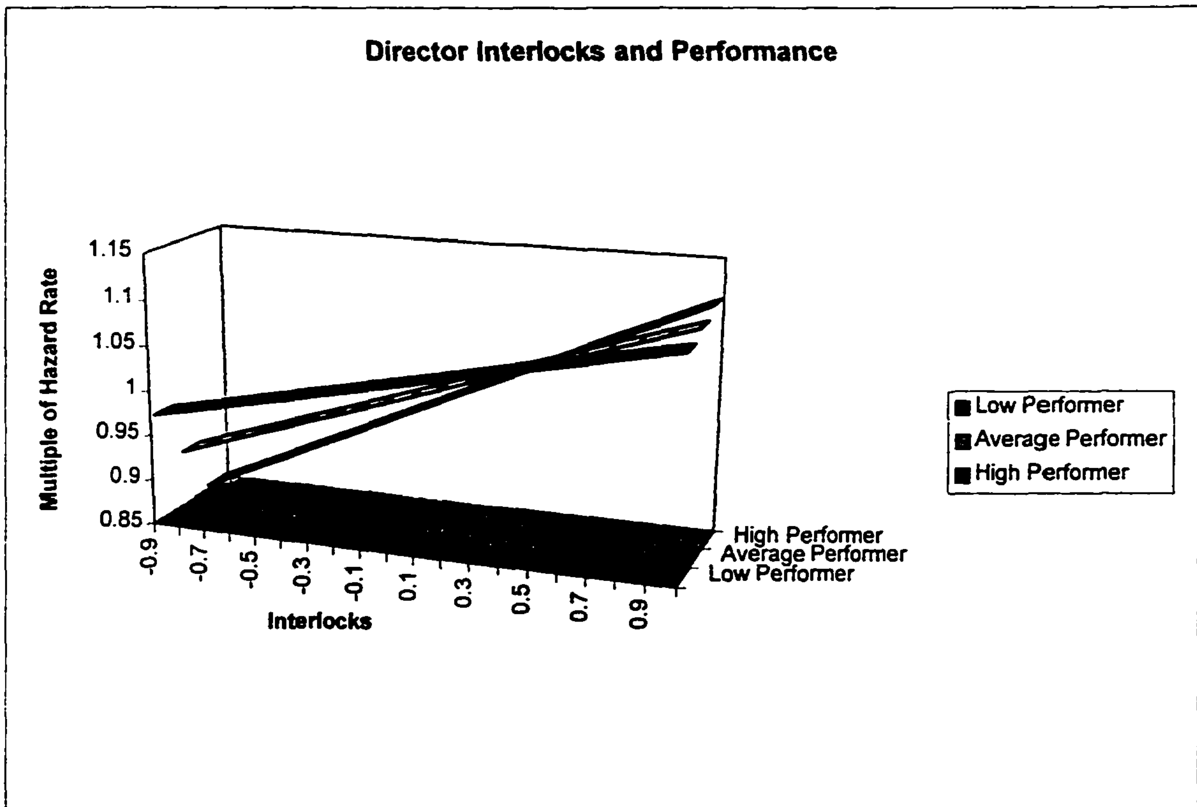
Figure 3-12: INTERACTION EFFECTS OF BOARD INTERLOCKS AND FIRM PERFORMANCE ON RATE OF CEO FIRINGS. Model graphed using $\exp(b_1x_1+b_2x_2+b_3x_1x_2)$ holding all other independent values at their mean levels. High and low levels of performance are defined as one standard deviation above or below the mean value.



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Part II

CEO Succession

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In Part I, I discussed the forces that affect forced versus natural CEO turnover. In Part II, I turn to the second act of this drama–the selection of a successor. Specifically, I focus on the factors affecting insider versus outsider CEO selection. I draw on both field research and statistical research to describe and understand the CEO selection process. My findings suggest that the insider versus outsider CEO recruitment processes are quite distinct from each other.

I have divided Part II into two chapters. Chapter 4 discusses the role of executive search firms in CEO search. Surprisingly, there is little scholarly work on this key actor in the executive labor market. Aside from a passing mention in other labor market studies (e.g. Granovetter, [1974] 1995), there is no empirical research on executive search firms. My aim in this chapter is to provide a description of the role of executive search firms in external CEO search. This description contrasts sharply with existing perceptions of the role of executive search firms in CEO search. In contrast to the view that the hiring of an executive search firm is akin to outsourcing the task of searching for candidates to a third party for economizing reasons, my findings reveal that the primary role of executive search firms in CEO search is managing a complex labor market exchange between candidates and firms. Additionally, Appendix A briefly summarizes the history and development of the executive search industry in the United States.

Chapter 5 focuses on the interaction between the board of directors of a firm searching for a CEO and an executive search firm. Combining field research findings from both executive search firms and directors, I highlight the critical role that interlocking directors play in affecting the CEO succession decision. I then test hypotheses that emerge from this discussion using the 850 firm sample described in Chapter 2.

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Chapter 4

Executive Search Firms and CEO Search

4.1 Introduction

The focus of this chapter is on the role of executive search firms (ESFs) in CEO search. For the purposes of this chapter, I focus only on the largest executive search firms; an analysis of the entire search industry, which now involves thousands of firms in the United States, would be unwieldy in length and inevitably inadequate and piecemeal in coverage.

I have two aims in this chapter. First, I argue that there are several characteristics unique to the position of CEO, the employment market for CEOs, and CEO candidates that necessitates the participation of an intermediary in external CEO search. While some characteristics of the CEO labor market I discuss below are shared by other top executive positions, my discussion focuses only on the CEO position. Moreover, I will contend that taken together, these characteristics distinguish the CEO labor market from other executive positions. For example, the high costs of an inappropriate match, the difficulty in discharging a poorly performing CEO, and the possibility of not getting the first choice candidate, make the choice of successor particularly risky from a board of directors' perspective. On the flip side, because the most desirable candidates are not "active job seekers", candidates are sensitive to the potential career damage that can result from premature disclosure about their considering other positions. Given these ambient factors, I show that ESFs play an important intermediary role in facilitating the

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interactions between candidates and firms in the external CEO search process.

My second aim is to describe in detail this intermediary role of ESFs in CEO search. I draw on my field research to suggest that this intermediary role consists of three particularly important functions.

The first function is as coordinators. As coordinators, ESFs assist a board in both developing candidate specifications and gathering general information about potential candidates, such as work history and educational background.

The second function is as mediators in a high stakes exchange process. This function involves managing the interests that both sides to the search have in ensuring the confidentiality of the process. More importantly, this intermediary function involves managing a gradual and synchronized commitment process during which both candidates and the search firm gain each others trust through exposure to equal levels of risk; that is, ESFs go to extraordinary lengths during the search process to ensure that no one side is more vulnerable than the other should the "date" fail to materialize into a "marriage". To this end, ESFs seek to minimize the contact between the candidates and the search firm. Direct contact between the candidate and the searching firm is held off for as long as possible because it would raise the commitment level on both sides which both want to avoid until a final deal is close to being negotiated.

Finally, ESFs also play a function in legitimizing the search process to an organization's constituents. The participation of an ESF signals to constituents that the CEO selection process was carried out both professionally and with their best interests in mind.

I have organized this chapter into three sections. The first section discusses why the CEO position is different from other positions in business organizations and why these differences lead to the need for an intermediary between candidates and the searching firm. The second section describes the role of ESFs in CEO search. The third section summarizes the findings and sets the foundation for Chapter 4 by arguing that while ESFs are necessary for external CEO search, their participation is not sufficient to ensure the selection of an outsider CEO candidate.

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4.2 What is unique about CEO search?

To paraphrase F. Scott Fitzgerald's comments about the rich in *The Great Gatsby*, CEOs are different from you and I. In particular, there are characteristics unique to the position of CEO, the labor market for CEOs, and CEO candidates themselves, which distinguish the way this position is filled from other positions in the labor market.

4.2.1 Characteristics of the Position

Choosing the CEO in a firm is an important organizational decision. The choice essentially determines who controls the organization and its resources, both human and capital (Pfeffer & Salancik, 1978; Kotter, 1988, Jensen & Meckling, 1976). As I indicated in the last chapter, the average tenure of an individual in the CEO position is almost 8 years. Consequently, once appointed, the individual in the CEO position exerts a great deal of influence on the strategic choices and direction of the organization. As one search consultant put it: "People are finally recognizing that the CEO position is the first place where shareholder value begins."

Recent anecdotal evidence of two high profile CEO appointments at AT&T and IBM illustrate the impact CEO choice has on shareholder value. AT&T, for example, suffered a 5% or four billion dollar decline in its market value the day they announced that John Walters would be the next CEO (*New York Times*, 1996). In contrast, IBM was rewarded with a two billion dollar increase in its market value on the day Louis Gerstner was announced as the new CEO (*Wall Street Journal*, 1993). More substantive research has established that even during a short tenure, a poor CEO can cost shareholders billions of dollars in real losses (Jensen, 1985; *Fortune*, 1993).

While it has been argued that the top management team as a whole is responsible for the performance of a company, researchers concede that it is much easier to fire most of the top management team than the CEO (Boeker, 1988). Despite recent increases in the level of shareholder activism, there exist many impediments to removing a poorly performing CEO. In addition to the political complexities discussed in the previous chapter, CEOs have several authorized advantages that make it costly to discharge a CEO once hired. Examples of these advantages include poison pills (Davis, 1991), board appointments (Westphal & Zajac, 1996),

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golden parachutes (Davis & Greve, 1997), employment contracts, and control over organizational resources (Pfeffer & Salancik, 1978). Several of these advantages are discussed in the principal-agent literature which highlights the potential for CEOs to act in ways divergent from shareholder interests (for a review, see Hawley & Williams, 1997 or Eisenhardt, 1992).

4.2.2 Characteristics of the Market

In the words of the managing partner of one of the worlds largest executive search firms, the CEO search process is a "job looking for a person, not a person looking for a job." Consequently, in addition to the motivations and interests of CEO candidates which I consider in the next section, understanding the search process requires paying explicit attention to the characteristics of the CEO labor market.

The neo-classical economic conception of recruitment in labor markets is of an auction market. Alfred Marshall (1930: p. 334), one of the founders of the neo-classical economic school, suggests that the labor market is no different from other markets in "which each participant behaves in accordance with his supply or demand schedule and reaches an equilibrium price upon which employment is initiated." Two key assumptions underlie this neoclassical view. First, that buyers and sellers are at least aware of the identities of all those they can potentially transact with. Second, buyers and sellers can freely communicate with each other about their intentions and reservation prices and that there are no reprecussions should a deal fail to be consumated. As Granovetter (1974) has shown, the first assumption is flawed and information about job opportunities is both problematic and differentially diffused. I will suggest that the second assumption is also problematic, especially in the CEO labor market where much of the communication between buyers and sellers passes through an intermediary.

Several characteristics of the CEO labor market are substantively different from recruitment to other positions and, therefore, make necessary the participation of an intermediary. For example, from the hiring firm's perspective it is not clear who is in the market. As one of the search consultants who specialized exclusively in CEO search put it: "Because the most desirable candidates are already employed in top level positions at other firms, potential candidates need to be contacted to find out if they would even seriously consider leaving their current position."

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A searching firm, however, he assured me, would never directly contact a potential candidate. Why? If a board member from the searching firm was to directly contact a candidate, it could seriously compromise the position of both the searching firm and the candidate. Another consultant, discussing a search he handled at a large computer company, stated that a searching board "wants to entertain the choice of more than one candidate and seeks to avoid premature commitment to any one candidate early on in the search process."

The candidate, the consultant explained, faces another risk. A candidate takes risk in even taking a direct call from a prospective employer. Why? Because most outsider candidates in CEO search are already gainfully employed in top executive positions, a premature disclosure that the candidate is "considering a job at another company (or even worse, a competitor) can result in irreversible damage to that individual's career."

The CEO search at American Express illustrates what happens when the confidentiality of a search is breached. Here, a news leak about a potential outsider replacement for departing CEO James Robinson led the most desirable candidates to publicly disavow any interest in the position (Harvard Business School Case). Moreover, the news leaks exposed publicly the various factions within the American Express board, each of whom backed a different candidate. As Lorsch & MacIver (1989) note, while boards may have internal disagreements, they go to extraordinary lengths to present a unified front to their constituents. Consequently, the entire process comes to be carefully orchestrated by a third party in order to insure the discretion and confidentiality required for an effective search.

Related to the confidentiality issue is the fact that information about a candidate's skills or capabilities cannot be obtained directly from his current employer or peers. As one consultant quipped: "You can't exactly go to the guys boss and let him know you are thinking of hiring his CEO." While general information about a candidate's educational background or work history can easily be collected through public sources, a searching firm usually relies on more private sources of information in order to collect specific knowledge about a candidate's capabilities, temperament, character, and skills. In the next chapter, I elaborate on how the directors of a searching firm rely on their interpersonal connections through director interlocks in order to gather this specific information.

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4.2.3 Characteristics of the Candidates

Because the CEO candidate under consideration is usually employed at another firm and because the job candidate is a passive job seeker, the relationship between the hiring firm and the candidate is fragile from the start. Hiring firms, for example, tend to perceive such candidates as having more leverage in negotiating the terms of employment than in the typical hiring situation. One consultant remarked: "The entire process from just approaching the candidate to consider the job, to then convincing him to quit his current job and take a new job is a complex task that requires understanding the candidate's motivations."

Conversely, the hiring firm can easily become frustrated with a candidate who seems to be taking too long to make a decision or is perceived as making extraordinary demands with respect to compensation, perquisites, or employment contracts. Much like international diplomacy, these complex negotiations usually require the active participation of a third party to resolve not only substantive issues such as compensation, but human issues that can potentially poison a working relationship between the board and the candidate such as frustration or anger that arise during intense negotiations. One consultant described his job as "part recruiter, part messenger, and mostly marriage counselor."

The benefits of third parties in negotiating complex transactions is well-researched in the negotiations literature. Researchers have noted the importance of third parties for strengthening commitments from of both sides to the negotiation (Lax & Sebenius, 1986 p. 229). With respect to CEO search, however, the primary benefit of a third party arises from its capacity to manage and limit the early commitments of the parties. A prospective candidate who responds to a call from a third party is much less committed to a job than is the candidate who responds directly to another employer. Responding to a third party call makes the candidate feel less like he or she is betraying her current employer. As one search consultant remarked: "Taking a call from a recruiter is not insidious. Since we also recruit for directors and are continually in the process of placing people at different firms, CEOs are always talking to recruiters."

Additionally, a third party can work actively with a candidate to identify the factors which would entice the candidate to take the job (e.g. need for a new challenge) and issues that could inhibit the candidate from accepting a potential job offer (e.g. geographic location or compensation requirements).

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4.3 The Role of Executive Search Firms

The above discussion on why CEO hiring is different from other hiring situations faced by firms sets the stage for a more in-depth discussion on the intermediary role of executive search firms in CEO search. Beginning with an overview of the process, I will show that a firm's decision to employ an ESF is not driven primarily by an efficiency or economizing logic; that is, the firm is not merely outsourcing a task that could otherwise be performed by the directors. While ESFs do assist a searching firm in gathering general information about a candidate, their more important role is as intermediaries between the searching firm and candidates. This role consists of three crucial functions: coordination, mediation, and legitimation.

I begin my discussion with a brief overview of the search process. I want to note that the search process I describe here refers to "genuine" searches. That is, it covers situations in which an insider candidate does not have a lock on the job, where the external search is a serious effort put forth by the board to identify external candidates and not simply a symbolic gesture. I discuss the symbolic employment of ESFs in CEO searches later in the chapter.

4.3.1 The Search Process

By the time an executive search firm is called in by a firm, two events may have already taken place. First, a CEO may have unexpectedly announced that he or she is leaving. Second, the board may have decided either that the current CEO needs to be replaced and an internal successor is not available or that its insider candidates should be benchmarked against outsider candidates. Generally, given the importance of the CEO position, there is a sense of urgency to fill the vacancy as quickly as possible. One search consultant remarks: "Wall Street, the directors, and the remaining company executives are nervous until they know who is going to be steering the ship." Because of this urgency, board's will often employ an executive search firm they have either previously used for otherexecutive appointments or were used in their own appointments[1].

[1]Boards will sometimes hold what is called a "shootout." Here, two sometimes three executive search firms will be invited to give presentations to discuss the strengths of their individual firms. Not surprisingly, unless there was a major problem with the search firm the company usually does business with, the firm involved with most current director placements and top executive searches will be awarded the CEO search.

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At the initial stage a specification is developed in joint discussions involving the executive search consultant in charge of the search and the board of directors. The ESF has two objectives in the specification phase. First, the ESF will work with a firm's board to draw up a mock resume of the ideal candidate. This usually involves a careful assessment of the firm's strategic and operational challenges. Second, the ESF will solicit from directors names of potential candidates who could fill the position. This second objective is of special importance if the board is seriously considering an outsider candidate.

This is a critical point: very few CEO searches start from scratch. In a BBC broadcast interview, the senior managing partner from the search firm of Russell Reynolds indicated that only very rarely has he had to start a CEO search from scratch. If the position is a general management appointment, it is very likely that the director's of the firm will have had direct experience and knowledge with executives both inside and outside the industry, and will be knowledgeable about senior executives who they can consider for the position or ask for recommendations.

To the extent that ESFs do search, their search is limited to a general level. As Figure 4-1 illustrates, the CEO search process involves two types of search: extensive search and intensive search. The first type, extensive search, involves defining candidate specifications, defining candidate pools, and gathering general information about potential candidates. Examples of general information include the educational backgrounds and work histories of the initial candidate pool. These tasks are typically divided between directors and the executive search firms.

The second type, intensive search, involves gathering particular information about candidates and reference checking. Much of this intensive search process is done by the directors. I elaborate on the role of directors in intensive search in the next chapter. But for the purposes of this chapter, it is sufficient to indicate that directors rely on their interpersonal contacts with other directors who have direct experience and knowledge about a candidate under consideration in order to collect the detailed, specific information about a candidate's capabilities.

The tasks involved in extensive search are divided between directors and the executive search firm. Figure 4-1 suggests that the primary value-added of the ESF in this phase is gathering general information about the candidates. Here, a searching firm is making an economizing decision to outsource the gathering of general information to a third party. Most of the consul-

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tants agreed with this consultant's view on this phase of search: "Our primary responsibility in the research phase is to get the factual, exact information on the preliminary list. Our responsibility is to make sure what is presented to the client with respect to the background and experience of the candidate is factual and verified." This information is often gathered from "our library or research group who collect general information on every major company and their executives."

While ESFs do have some economizing advantages over a hiring firm in CEO search, such as databases and research groups that track executives, such reasoning provides an incomplete (and potentially misleading) understanding of the role of an ESF in CEO search. Rather, the primary benefit of the ESF lies in its ability to serve as an intermediary between the searching firm and the potential candidates. As one consultant summarized: "Our key value-added is as a broker. If you look at this as some simple type of information gap that we fill, you are missing the big picture."

The broker or intermediary role emphasized by the various search consultants consists of three primary functions: (1) coordinating a searching firm's board activities to rapidly develop candidate specifications, a candidate pool, and make initial candidates to gauge the interests of candidates; (2) mediating the exchange between the searching firm and the candidates in order to manage a gradual commitment process during which both candidates and the searching firm are not unduly exposed to risk should a deal fail to materialize; (3) legitimizing the search process as a signal to constituents that the process was carried out both professionally and with the best interests of all participants in mind.

4.3.2 Coordinating

The ESFs coordinating role involves (1) bringing its previous experience in CEO search to facilitate a board's search process; (2) drawing on its own organizational resources to augment a preliminary candidate list and provide general background information about these candidates; and (3) approaching preliminary candidates to gauge their interests in considering another job.

While an individual firm is likely to have only limited experience with external CEO search, ESFs have a great deal more cumulative experience with CEO search. Consequently, the searching firm is able to take advantage of the ESFs knowledge about CEO search. One

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important aspect of this knowledge is coordinating and organizing the searching firm's board during the search process. As one search consultant stated:

> Outsider search is not typical for the average board. It usually means that something has gone wrong with respect to an insider or that the current CEO is being asked to leave. As a result, boards in these situations are usually fractured and need someone who can get them to work together to find a CEO. We have expertise in that. I can come in and get a board to appoint a committee, decide on what the main requirements of the candidate they are looking for, and decide on a time line for appointment in less than a days time. This, of course, is a result of having spent 20 years in the business.

A director from a firm that employed an ESF in a recent CEO search echoed this view. He stated: "They [the search firm] helped us coordinate and organize the search activities and make sure we weren't pulling in 14 different directions."

Another aspect of coordination is the ESFs experience in translating the requirements that the board has set out for the ideal candidate to a potential candidate list. As one search consultant put it: "We are skilled in working with the board to develop what starts out as fuzzy and firm specific descriptions of the ideal candidate that comes out of the specification process and turning that into an actual candidate list."

Most often, this candidate list emerges from the searching board itself. Much of the initial time a search consultant spends with individual directors involves soliciting names from them of specific people who could fill the position. A firm's directors are able to generate these candidates as a consequence of their experience and knowledge about an industry and their experiences and connections with other executives. While a search firm will add one or two names to the search list, most consultants agree that "the majority of the potential candidates are identified through the interviewing [of the directors]."

When I asked why a search firm relied on the references of directors as method of developing candidates for the CEO position, one search consultant summarized: "The CEO search largely involves using the board. The board knows the nature of the problem..." Moreover, he continued, "Many of the board members are former CEOs or top executives themselves and

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know directly or indirectly people who could effectively do the job."

The second component of coordination involves gathering general information on the preliminary candidate list. Executive search firms do maintain extensive information on several thousand "top executives." This usually enables them to quickly develop a background information sheet consisting of general information such as the work history and education of each candidate.

Executive search firms are able to quickly assemble this information because they are continually engaged in generating and replenishing their candidate lists. The average executive search firm in my sample interviews two thousand individual candidates a year. As a consequence, ESFs have a record "of a candidate's work history, personal information, and salary history." More importantly, the executive search firm is able to quickly cull the preliminary candidate list by identifying candidates who would be "too expensive," "are nearing retirement," or "are untouchable because we placed them in their current position within the last three years."

4.3.3 Mediating

In this section, I focus on a second function that ESFs play in the CEO search process: that of mediator. Focusing on the interactions between the ESF, client, and candidates, I argue that ESFs play a critical role as a buffer for relationships between high status actors who would otherwise not engage in the process of external CEO search.

Much of the current literature on social actors that bridge otherwise unconnected social actors focuses on information flow (Granovetter, 1974; Burt, 1992; DiMaggio, 1992). This focus on information, while important, has drawn attention away from an understanding of the specific interactions between the actors involved in a strategic situation. Consequently, much of the literature on the process by which unconnected actors are brought together by a third parties misses the rich and complex micro-interactions between the three actors as they seek to "make a deal" (Nohria, 1992). As the CEO of an ESF emphatically reminded me (after I had informally lectured him on the academic literature on brokers and structural holes), "We are not talking about relationships between positions, but relationships between people." He continued: " We are talking about real people here. People with egos, often fragile egos. People with career concerns. People whose greatest asset is their reputation."

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CEO search is risky for both the searching firm and the candidate and both parties have a strong interest in ensuring the confidentiality of the process. Firms want the process to remain confidential because they would like to avoid committing to a specific individual too early in the process and do not want to risk the embarrassment and difficulty of not getting their first choice candidate. Candidates want the process to remain confidential because their careers can be at risk if their interest in another firm is disclosed prematurely, or if they grow embarrassed at having been pursued, but not been offered a job. As one search consultant summarized:

> There are a lot of repercussions if the process comes out in the open. Those candidates who didn't get the job are seen as somehow defective to the outside world and disloyal in their own companies. Those directors who didn't get their first choice candidate are also seen as ineffective. The whole process is risky for all involved. You have to remember these are not your everyday people here. They are highly regarded people who are influential in their companies, government, and their communities. The risk to all parties involved is very high.

Much of the risk that the actors face arises by virtue of their high status positions as directors and CEOs at the top of the organizational hierarchies.

Because of the risk and potential threat to careers, reputations and status of the actors, ESFs are involved in ensuring that all parties to the exchange are serious with respect to their intentions. Consequently, once retained, ESFs are careful to probe directors about whether they are serious about hiring an external candidate.

If a board is not serious about external candidates the likelihood is that a particular insider will be hired, the ESF will usually conduct a superficial search. Here, one consultant remarked:

> We bring in a couple of young people that we might have our eye on just to see how they come across to a board. These are the people who are probably not ready for a CEO job just yet, but this is more of an exercise for the candidates...to see how they perform.

Likewise, when an external search is serious, the ESF is very diligent in ensuring that a candidate who shows interest is not simply trying to use a potential job offer as negotiation tactic against their current employer. Many of the consultants agreed with the view

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that getting at the intentions of the candidates is key. We ask probing questions about when they would be willing to start, what their expected compensation is, how they would feel about resigning from their current firm...and would they be willing to meet for an interview. The purpose is to make the job real to them...The candidates, too, are not stupid. They know if they screw around with this, we won't be calling them back. Reneging on an offer is a pretty bad move in a world where your word is taken as an oath.

Other researchers have also made note of the importance of identifying intentions of parties to a complex economic transaction. Geertz (1978: p. 229) calls this process of identifying genuine candidates to a transaction "clientelization." Clientelization consists of "partitioning... the crowd of [buyers] into those who are genuine candidates for his [the sellers] attention and those who are merely theoretically such..."

The potential threat to both status and careers that a searching board and external candidates face as a consequence of participating in external CEO search is reminiscent of Geertz's (1978) notion of "deep play." A "deep play" is a situation "in which the stakes are so high that it is, from [a] utilitarian standpoint", almost "irrational for men to engage in it at all." But as Geertz (1978) notes, individuals engage in deep plays of "status gambling" all the time. While the status gamble that Geertz (1978) describes could only happen through a game (a cockfight), the status gamble of CEO search can only take place through a mediator.

For the actors involved in CEO search, ESFs play this crucial role as mediators. Specifically, the ESF mediates the status gamble through a gradual and synchronized commitment process during which both candidates and the searching firm gain each others trust through an increasing exposure to similar levels of risk. ESFs go to extraordinary lengths during the search process to ensure that neither side is more vulnerable than the other should a deal fail to be "consummated."

One of the main ways that ESFs manage the status gamble is by limiting the direct contact that candidates and the searching firm have with each other. This limited contact strategy is apparent from the start. It is the ESF, not the searching firm, that approaches the prospective candidate to gauge their interest in the job. When I probed the search consultants about the reasoning behind this, he said: "It's obvious. It is the first step we take to protect our

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client's interests." He continued: "If the candidate is clearly not interested, he doesn't need to know the name of the firm...they remain anonymous. Similarly, the candidate is also protected because they didn't pursue the matter. Nobody is exposed."

The ESF mediates between candidates and clients through most of the search process. The ESF will continue to go back and forth between candidates and the client "identifying concerns, overcoming roadblocks, making sure each side is comfortable." At each point in a search, the ESF displays a sensitivity to the risk that each of the parties faces as their commitment escalates. As the process proceeds, what started as a list of "15 to 20 candidates will become whittled down as several candidates realize that they really aren't ready to leave their current job if an offer was made or [the firm ascertains] that the candidate is not the right type of person for the job." Eventually, through the process of "shuttling back and forth between candidates and client", a final candidate list of three to four candidates emerges. Then, and only then, will the ESF arrange a time and place for the candidates to interview with the searching firm. It is not uncommon, I was told, for the client and the candidate to meet only once before an offer is extended.

The idea that a searching firm's directors would interview candidates only once before making a decision seems quite surprising in light of the broad responsibilities of a CEO position. However, the executive search consultants made it clear that there was an important reason behind this. The face-to-face interview, consultants noted, "is a particularly intense exchange." The searching firm and the candidates are highly exposed to risk and vulnerable at this stage. During their interviews with the candidate, directors are usually "quite frank about the company's problems". Similarly, candidates are aware not only that "they are displaying disloyalty to their current employers by accepting an invitation to interview", but also that they face the possibility of rejection. Thus, what makes this play "deep" in the Geertzian sense is that all players are showing their hands. While the candidates could "technically refuse an offer, they are not likely to do so otherwise I would not have brought them in for the interview", observed one consultant.

The intensity and commitment of face-to-face interaction has been noted previously in the sociological literature. Simmel (1924) writes:

> Of the special sense-organs, the eye has a uniquely sociological function. The union

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and interaction of individuals is based upon mutual glances. This is perhaps the most direct and purest reciprocity which exists anywhere[T]he totality of social relations of human beings, their self-assertion and self-abnegation, their intimacies and estrangements, would be changed in unpredictable ways if there occurred no glance of eye to eye. This mutual glance between persons, in distinction from the simple sight or observation of the other, signifies a wholly new and unique union between them.

Goffman (1963), too, in his analysis of face engagements talks about the escalation of commitment that arises as a consequence of face-to-face interaction. He writes: Once a set of participants have avowedly opened themselves up to one another for an engagement...the participants turn their minds to the same subject matter, a shared definition of the situation comes to prevail. This includes agreement concerning perceptual relevancies and irrelevancies, and a working consensus, involving a degree of mutual considerateness" [p. 96].

Goffman also notes the peril of face-to-face engagements with respect to their effect on escalating commitment. By meeting face-to-face, he argues, "a kind of implicit contract or gentleman's agreement" arises [p.106]." All parties to the CEO exchange, I have argued throughout this section, seek to defer such an agreement until both sides are ready "commit to a marriage."

4.3.4 Legitimating

The legitimacy of an action "is determined by the amount of consensus within the relevant sector or field regarding the appropriateness of the means selected to achieve the desired ends" (p. 170, Scott, 1992). Because the directors and candidates involved in CEO search are deeply embedded in a community of overlapping business and social relationships, they are particularly sensitive to maintaining the appearance of propriety. The participation of the ESF in CEO search is a key means by which a searching firm can legitimately find a suitable person to fill its CEO position.

There is an unstated acceptance that a firm which uses an executive search firm to recruit from a competitor or customer has behaved appropriately. By employing a third party to search for the "best candidate", the searching firm distances itself from the social aspects of the market and, instead, appeals to the more normatively acceptable idea of a "free market."

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To paraphrase a director of a firm that had hired the CEO of one of its competitors: It is not us [the firm searching for a CEO] that is making an overture to a competitors CEO, but rather a third-party [the ESF] who is only trying to fulfill their contractual obligation to a client to find the "best candidate possible for the position."

Candidates, too, believe that taking a call from an executive search consultant is more acceptable than taking a call from a competitor about a job. One individual who had been placed in his current position by a search firm noted: "There is no harm done in taking a call from a search firm. You don't know who the company is and you are not giving away any company secrets. It is purely informational."

Finally, from a constituent perspective, the employment of an ESF during any CEO search is a signal of the legitimacy of what is otherwise an opaque process. Using an ESF signals to external stakeholders, such as stockholders, that a thorough and exhaustive process was employed in selecting the CEO. As one director put it: "These days, when institutional investors are monitoring your every move, it is very important that the process appear to be a fair process and not a political process." This pressure to demonstrate a fair process is so prevalent that ESFs are often employed even when a known insider is the best candidate to be a successor CEO.

4.4 Summary

The focus of this chapter has been on the roles of the executive search firm in selecting a successor CEO. I have argued that there are several characteristics unique to the position of CEO, the market for CEOs, and the individuals who are realistic CEO candidates that necessitate the participation of an intermediary in external CEO search. I then described the process by which a searching firm's board of directors uses an executive search firm in CEO search.

My field research findings suggest ESFs perform three functions in CEO searches as: coordinators, mediators, and legitimators. The role of coordinator is one in which an ESF draws on its experience to assist a searching firms board, which has more limited experience with CEO search. In the role of mediator, the ESF manages a gradual, synchronized and escalating com-

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mitment process during which both candidates and the searching firm gain each others trust through exposure to equal levels of risk. And, finally the ESFs involvement provides a sheen of professionalism that legitimizes what is, otherwise, an opaque and discreet process.

This chapter highlights the role of third parties in simultaneous buffering and bridging relationships between otherwise unconnected social actors. I demonstrated that unlike previous treatments of this bridging role, this is not an aseptic process. Rather, much of what is taken for as an instantaneous process in structural treatments of brokers or third parties is, in fact, an emergent property heavily reliant on the third party to help create a working relationship between the unconnected actors.

I have also argued in this chapter that the participation of an ESF is a necessary ingredient in external CEO search. I want to emphasize, however, that the participation of an ESF in external CEO search is by no means sufficient in and of itself to permit the selection of an outsider candidate.

Rather, as I describe in the next chapter, a firm's board of directors plays a critical role in the external CEO search process. An ESF facilitates the interactions between a firm's board and the candidates and provides general information about those candidates, but the hiring firm's board of directors plays a direct role in gathering and evaluating critical particular information about candidates capabilities and skills. This particular information, I show, is largely gathered through more private sources, specifically through a director's connections with other directors who have knowledge or experience with a candidate.

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Figure 4-1: Division of Roles Between Executive Search Firms and Directors in CEO Search

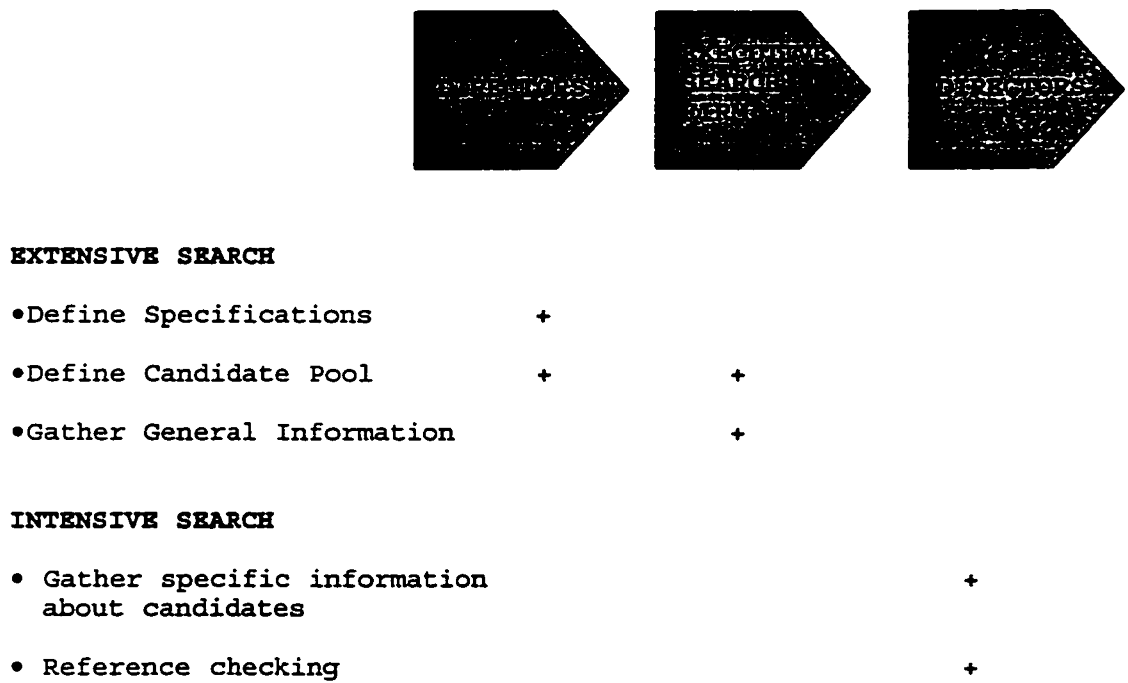

Figure 4-2:

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Chapter 5

Replacing the CEO: Insider versus Outsider Selection

5.1 Introduction

In the previous chapter, I established that the primary role of executive search firms, with respect to CEO search, was as intermediaries between the searching firm and the external CEO candidate. I presented field data suggesting that executive search firms are used in both internal and external CEO search. I argued that an important reason why firms employ executive search firms when conducting CEO searches is to increase the legitimacy of the search process. In situations where the board is not serious about external candidates and the likelihood is that a particular insider will be hired, my fieldwork suggested that an executive search firm will conduct a relatively superficial external search. In situations where the board is serious about identifying external candidates, executive search firms play an important intermediary role between the hiring firm and the external CEO candidate.

The fieldwork also revealed that executive search firms play a role in information transfer by providing general information about candidates, such as work history and educational background, to boards searching for a CEO. Particular information, however, such as the capabilities, style, and skills of the candidates, I asserted, is obtained from board members both within and external to the organization. In this chapter, I further develop and test this assertion within the context of a theory about outsider CEO selection.

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I have divided this chapter into three sections. The first section presents a theory informed by my field research about the factors that influence insider versus outsider CEO selection. The theory emphasizes the role of poor performance in triggering outsider CEO searches. The theory also emphasizes that while poor firm performance is often a necessary condition for triggering an outsider CEO search, it is not a sufficient condition for the eventual selection of an outsider CEO. Rather, as I discussed in earlier chapters, because of the importance of the CEO position and the difficulty in removing a CEO once appointed, boards require very detailed information when making the selection decision. An important source of this detailed information, I argue, are a board of directors' connections to other directors who are familiar with external CEO candidates. These connections to other directors are the primary mechanism through which particular information about external candidates is gathered.

In the second section of the chapter, I test propositions suggested by the above theory of how board characteristics and performance conditions affect insider versus outsider selection. These propositions are tested on the 850 company sample discussed in Chapter 2. Finally, I summarize the statistical findings and discuss their implications.

5.2 Theory

5.2.1 Insider versus Outsider CEO Selection

The decision to fire a poorly performing CEO does not benefit shareholders or the firm unless the board of directors appoints a more capable successor. Several studies suggest that CEOs who are appointed from outside the firm are more likely to change firm policies than are insiders. For instance, Helmich (1974) finds that while the rate of firm growth generally tends to increase after CEO succession, the increase is greater when an outsider is appointed CEO. Helmich and Brown (1972) find that the rate of organizational change, as proxied by management turnover, is also greater following an outsider CEO succession.

Evidence from studies of stock price reactions to top management turnover indicate that, on average, shareholders also benefit from the changes instituted by CEOs hired from outside the firm.[1] Nohria (1997) and Warner, Watts, and Wruck (1988) report significant positive

[1] A review of papers on stock price reaction to a CEO hiring is hard to interpet, however, because the firing

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abnormal stock market returns around outsider CEO announcements.

While the empirical evidence suggests that both shareholders and organizations can potentially benefit from outside CEO appointments, the selection of outsider executives has been theoretically and empirically problematic. The theoretical and empirical problems around external CEO succession emerge primarily from two sources. First, an under-specification in the literature of the role of directors in the external CEO selection decision. Second, a general neglect of the critical role that information plays in the CEO succession decision.

As I discussed in the chapter on CEO dismissals, much of the existing literature on CEO dismissal is informed by a managerialist perspective. The same is true for the literature on CEO selection. The managerialist perspective, rooted in the premise of "managerialism" that emerged from Berle & Means (1932) documentation of the separation of ownership and control in large American businesses, does not seriously even consider the possibility of outsider CEO selection. The managerialist argument is that because shareholding had become so diffuse, and the laws of proxies and charters so unfavorable to collective shareholder action, that control of the large corporation was de facto in the hands of managers and the board of directors these managers appointed. As a result, corporate control–the rights to determine the management of corporate resources, both human and financial–although legally the province of owners, rests in the hands of top managers, who dominate the board selection process and proxy machinery, and thereby ensure their continued rule (Herman, 1981).

A clear empirical implication of this perspective is that because board members are essentially "ornaments on the corporate Christmas tree" (Mace, 1971) and do not exercise control over internal management, board composition does not affect the CEO succession or selection process. Instead, the CEO succession decision is suggested to be driven primarily by internal selection processes. This view has influenced several theories about the CEO selection process, one example being the resource dependence perspective which focuses on the internal power dynamics of the organization and the regulation of these dynamics by environmental factors (Pfeffer & Salancik, 1978).

However, as Table 3.1 suggests, outsider CEO selection is not uncommon in large corpora-

announcement conveys information to the market both about the event (the hiring) and about how the firm performed under the predecessor CEO, but the preponderance of evidence is that investors believe that firings and outsider CEO succession increase firm value.

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tions. In fact, in my 850 company sample, an average of 18% of all the CEO successions are outsider appointments. While this fact alone may not be enough to refute the managerialist perspective, other empirical facts call into question its basic assumption that owners exercise little control over the activities of large corporations. The surge of large and hostile takeovers (Jensen, 1986), the adoption of takeover defenses (Davis, 1991) and the recent trends toward increasing institutional investor activism (Useem, 1993) suggests that owners (or would be owners) may, in fact, have more control than previously acknowledged by managerial theories.

5.2.2 Boards of Directors and CEO Selection

One consequence of the inability of managerial theories to account for the dramatic changes that have taken place in the arena of corporate governance has been the proliferation of agency theory accounts for corporate governance outcomes (Davis & Thompson, 1994; Useem, 1993; Jensen & Meckling, 1976). This perspective draws attention to the role of the board of directors in the CEO selection process. An important theoretical implication of this perspective is that board characteristics can affect the CEO selection decision.

Building on Berle and Means' thesis that the separation of ownership control now characterizes large corporations, agency theorists accept the premise that inside managers have interests that potentially diverge from those of shareholders. Consequently, with respect to the CEO succession decision, agency theorists predict that inside directors will usually oppose outside candidates. Because inside directors tend to be the leading internal candidates for the CEO position, they are more likely to promote their own candidacies rather than those of outsiders. Furthermore, inside directors who helped develop and implement their firm's policies may oppose the appointment of outsiders who are likely to alter those policies. Insider executives also resist outsider CEO appointments because of the potential threat to their own jobs. Helmich and Brown (1972) find, for example, that inside candidates are more likely to be replaced when an outsider CEO is appointed. Similarly, Boeker (1994) finds that non-CEO executives bear a disproportionate amount of the blame for poor firm performance.

In contrast to managerial theorists, however, agency theorists contend that a board can potentially exercise control over managers. Outsider dominated boards, in particular, are suggested to act more independently in making the CEO succession decision. For example, Fama

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& Jensen (1976) suggest that outside directors, who tend to be major decision makers at other organizations, have a self-interest in maintaining their reputation by acting in ways that are aligned with shareholder interests. Consequently, when a firm's performance threatens outsider directors' reputations, it is suggested that this situation would affect a board's CEO selection decision. While the number of empirical studies that have examined the relationship between board composition and CEO selection are few, some research does support this assertion and finds that a greater percentage of outside directors increases the likelihood of outsider CEO appointments (Borkovich, et. al, 1997).

Other studies, however, find weak effects or no effects relating board composition to CEO selection. For example, Bhagat and Black (1997) find no clear link between board composition and a variety of governance outcomes, including CEO selection. Vancil (1988), in his in-depth field examination of the CEO selection process, highlights that it is usually the incumbent CEO, not the board, that exercises the most influence in the CEO selection decision. Similarly Dalton and Kesner (1985) and Park and Rozeff (1994) report no effect and a weak effect, respectively, of director composition on the CEO selection decision.

These ambiguous findings suggest that the relationship between board composition and the CEO succession decision is not so clear-cut. In particular, no mechanism for why board member characteristics would affect organizational outcomes, such as external CEO selection has been clearly identified and articulated. One reason for this, I contend, is that both the agency and managerial literatures ignore a critical characteristic of board members. This characteristic is the nature of a board's interlocks to other boards, which I suggest, impacts a board's ability to gather information about external CEO candidates and, therefore, plays an important role in the outsider CEO selection decision.

5.2.3 Information, Performance and Outsider CEO Selection

Information is a necessary element for matching an individual to a job (Spence, 1972). Both sociologists and economists discuss the central role of information, from both the employers and employees perspectives, in labor markets (e.g. Granovetter, 1974; Doeringer & Piore, 1972; Williamson, 1976; Becker, 1962). A significant portion of the labor market literature, in fact, focuses on internal organizational procedures for matching workers to jobs. The focus here has

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been on the role of internal labor markets as a means for tracking and evaluating information about an employee's abilities for various positions in the organization. The performance review and promotion process are, in turn, the primary mechanisms by which employees are matched to jobs concomitant with their abilities. Because of the importance of the CEO position and the potential impact it can have on the performance of the firm, information about a candidate's abilities is particularly critical here.

A board of directors typically has the best information on internal or insider candidates. Directors typically have first-hand information about insider candidates either through board presentations or as insider directors (Bhagat & Black, 1997; Baysinger & Butler, 1985). As one director summarized:

> When evaluating an insider candidate, we have lots of data points. Insiders are evaluated on the bases of (1) observations of the individual's style and knowledge of the business through board presentations; (2) performance of the individual units they are coming from; (3) individual impressions these people make on board members through company functions; (4) formal reviews from their superior used to make compensation and stock option adjustments; and (5) an ongoing discussion within the board of a particular individual's qualities and the future needs of the business...In the case of an outsider candidate, we typically don't have these data points.

Yet, there are conditions under which an outsider CEO is preferred to an insider CEO. For example, when a firm is performing poorly, the appointment of an executive with firm specific skills will not necessarily improve firm performance if the new CEO is unwilling to take the necessary steps needed to improve performance. This is illustrated by one director's reasoning for undertaking an external CEO search at a large electronics company:

> The company had been performing poorly for several successive quarters. Moreover, the CEO kept telling us things were going to get better and they hadn't...Consequently, when we evaluated the succession decision we made a conscious decision to consider an outsider candidate, especially in light of the firm's poor performance and the dramatic changes that had affected the industry in recent years.

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Parrino (1996) writes that the difference between choosing an insider and outsider is the "choice between an executive who is better qualified to assume the responsibilities of the CEO position and another who is more willing to make necessary changes." A director of a poorly performing conglomerate echoes this view and suggests that an outsider CEO could redirect the energies of internal management in a way that was not possible by choosing an insider CEO. He stated:

> The board wanted the new leadership to shift the orientation of the company to a more market-driven company and to a brand orientation. The existing management had grown up in an engineering and manufacturing culture...The only way to do this strategically was to bring in an outsider to get away from the current culture.

Consequently, if the board does want to appoint an outsider, the question arises as to how the directors are able to gather the necessary information about a potential external candidate in order to ensure that the candidate is the right person for the job.

One important mechanism through which board members can gather information on external CEO candidates is through board interlocks.

5.2.4 Board Interlocks, Information, and Outsider CEO Selection

The view that interlocking board members can serve as an information source is not unique to this dissertation. Indeed, viewing the interlocking directorate as an information resource has largely replaced earlier sociological perspectives which took the existence of the interlocking directorate as evidence of a cohesive, united capitalist class (Mills, 1956) or as an instrument for reinforcing intercorporate exchanges (Pfeffer & Salancik, 1978).

The information approach to board interlocks suggests that the inner-circle of directors who sit on multiple boards should be viewed as a communication network that facilitate the exchange of information. These interlocked directors are suggested to be at the vanguard of advancing large businesses interests (Useem, 1984); coordinating political activity across firms (Mizruchi, 1992); and facilitating the spread of new business practices such as the adoption of poison pills (Davis, 1991), organizational structures (Palmer, Jennings, & Zhou, 1993), and acquisition activity (Haunschild, 1994). However, within this research stream what is unique

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about the interlocking directorate as a communication medium has largely been inferred, not documented (a notable exception is Useem, 1984). In particular, there is very little research about the content of the information that is transmitted across the interlocking directorate and why alternative or substitute mechanisms, including more formal associations or arrangements, for transferring this information are not utilized.

For example, all the research that I am aware of that discusses the kind of information that moves through the interlocking directorate assumes this information to be "*general*" or "generic." Useem's (1984: p. 56) work, for instance, suggests that the information that flows through the interlocking directorate is about "the practices and concerns of most large companies, companies that are operating in virtually all major sectors of the economy...[T]he information pursued is generic information about common business practices and the environment." Similarly, while Haunschild (1994) and Davis (1991) discuss the role of director contacts on clarifying a practice or innovation, the crux of their argument relies on the trust that is created as a consequence of the social relation, not the content of the information being transferred.

While trust does play an important role in interlock relations, it seems that a distinct advantage of using social ties would be to transfer private or *particular* information that is not easily gathered via alternative media such as the business press, consultants, or through intensive public search. Examples of this type of particular information in CEO search are the specific capabilities or skills of an external CEO candidate. Granovetter (1988: p. 239) hints at the particular character of information when he writes: "As one moves through a sequence of jobs, one acquires not only human capital but also...a series of co-workers who necessarily become aware of one's abilities and personality." He goes on to suggest that the existence of particularistic information about individuals is crucial to the employment process and consistent with the "often-documented fact that employers acquire a great deal of information about prospective employees from individuals known to both."

Thus, while previous research has stressed that "network norms discourage or prohibit the use of shared directorships...to collect private information" (Useem, 1984), this is not likely true for information intensive decisions such as CEO selection. Outsider boards without connections to other directors are likely to be at a disadvantage in selecting outsider CEOs. For example, suppose that outsider-dominated boards (1) are more likely to select outsider CEOs, but (2)

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know less about the capabilities of the external CEOs and, therefore (3) would not know whether they are choosing good or bad CEOs. Negative effects and positive effects would swamp each other and their would be no positive returns, on average, to outsider CEO selection. However, there is evidence that outsider CEO selection is associated with some performance improvement (Borkovich et. al., 1997; Denis & Denis, 1995). Consequently, given the agency risks associated with CEO succession and the importance of information in CEO selection, boards are more likely to hire outside CEOs when they possess detailed, particular information about such individual's capabilities and their abilities to prove firm performance. Interlocked directors, who have connections to other directors are more likely to possess this particular information about external candidates. One director of a large conglomerate stresses that it was precisely the availability of particular information on an external candidate was critical in the board's subsequent decision to appoint an outsider.

> We ended up appointing [David] as CEO. I had known about him from my background in the pulp and paper industry. I knew he had stepped up and been the interim CEO at [Paper Co] when the incumbent was quite ill. I had also done a lot of work with [Pharmaceutical Co] where [David] had previously worked and they had been a key customer of [Industrial Co, the firm I was CEO of]. Consequently, I knew directors from my own experiences who knew [David] and his work pretty well. Other members of our board had contacts and exposure as well. All of this, supplemented with the information of the search firm, allowed us to make the best decision possible.

A key point of this view is that within the context of CEO search, an interlocked board is potentially well suited to gather and transfer particular information about a potential candidate. Because CEO selection is both a particularistic and information intensive process, it has a high requirement for particular information in facilitating both search and selection. And, because CEO succession is an intensely board driven process, it is an ideal type of decision in which to study the effects of a firm's interlocking directorate on a business action. I examine the generalizability of this relationship in the next section.

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5.3 Data

Board of Directors and Outsider CEO Selection

Using the 850 firm sample from 1980-1996 discussed in Chapter 2, I define outside CEO appointment as one in which the new CEO has had no prior affiliation with the firm and assumes the CEO title within one year of the date he or she joins the firm. Figure 5-1 graphs the total number of outside successions and the mean board composition by year. Except for the upward trend beginning in 1994, the successions are evenly distributed over the sample time period, with an average of 80 successions per year. Outside successions average 15 per year and, like the full sample, are not obviously clustered in any sub-period.

For the 850 firm sample outside directors, on average, hold a voting majority in all years. Outside directors are defined as individuals who are not employees or former employees of the firm. The mean percentage of outside directors varies is 72.7%. The mean is consistent with Borkovich et. al. (1997) who found an average of 70.7% of outside directors between 1970 and 1980. The mean percentage of outside directors varies from 70.0% to 74.1% between 1980 and 1990. The noticeable upward trend in the percentage of outside directors over time is consistent with that reported by Hermalin and Weisbach (1988) and Parrino (1997). A test of the difference in the mean percentage of outside directors in 1980 versus 1990 rejects the hypothesis that these means are equal at the 1% level ($p<.01$).

As discussed earlier, agency perspectives suggest that outsider dominated boards are more likely to act in accordance with the interests of shareholders. Consequently, this would imply a positive relationship between the percentage of outsiders on a board and outsider CEO succession. The mean board composition values for the firms at which outsider successions take place during the indicated year are graphed in Figure 5-2. In this table, the total sample of 1286 successions has been graphed using the number of outsider successions against percentage of outside directors. The relationship suggests support for the agency assertion that outsider dominated boards are more structurally independent of internal management influence.

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Performance and Outsider CEO Succession

Firm performance is important to consider in outsider CEO succession because poor firm performance is one type of condition in which an outsider CEO is preferable to an insider CEO. Parrino (1996), Borkovich et al (1997) and Lubatkin et al (1995) all found a negative correlation between firm performance and outsider CEO succession. I use an accounting based measure, (2-digit industry adjusted Total Return on Assets, defined as annual earnings before income and taxes divided by the total book value of all assets), as a measure of firm performance. This is the same performance measure used by Parrino (1997) and Borkovich, et. al (1997) who find no significant differences in using accounting performance measures and stock return measures for predicting outsider CEO selection.

Figure 5-3 below suggests that industry-adjusted average and below average firm performance is associated with outsider succession. This finding suggests support for the view that outside successors are perceived as better equipped to improve performance than are insider CEOs. Additionally, the relationship between outsider succession and industry-adjusted firm performance suggests that corporate boards evaluate CEO performance relative to that of executives at other firms.

Board Interlocks and Outsider CEO Succession

Figure 5-4 graphs the distribution of board interlocks by percentage of outside directors. As expected, Figure 5-4 illustrates a definite pattern to board interlocks that varies along the proportion of outsiders on a firm's board of directors. This finding, while not surprising, is theoretically important because the pattern suggests that a critical difference between insiders and outsider directors is the structure of relationships within which they are embedded. Outsider directors are more embedded within the community of interlocking directors than are insider directors. To that end, all directors–insiders and outsiders–are not socially equivalent.

Figure ?? lends further support to the proposition that board interlock characteristics correspond to turnover type and succession decision. Table illustrates a positive relationship between board interlocks and the number of forced turnovers and the number of outsider successions for the sample.

Figure 5-6 models the relationship between firm and director characteristics on the likeli-

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hood of outsider CEO selection. The table reports logit model results for outside successions conditional on turnover having taken place. The dependent variable in the outside succession regressions equals 1 if the successor CEO is an outsider. The table presents evidence that the positive relationship between the percentage of outsiders on the board and outsider CEO succession is significant even after controlling for firm size and performance.

The natural log of employees is used in the logit models to control for firm size because previous research suggests that outside succession may be more frequent at small firms. These studies suggest that small firms may have less management depth than larger firms who often have numerous executives. This argument is also consistent with Reinganum's (1985) contention that larger firms have more complex control structures which makes it more difficult to exercise control in a large firm.

The positive coefficient estimates for the board composition variable suggests that an increasing proportion of outsiders on a firm's board increases the likelihood of outside succession Inside directors, as suggested earlier, are likely to oppose the appointment of outsiders who pose a threat both to past commitments and their individual careers.

Model 1 presents the effects of information centrality on outsider appointments, conditional on CEO turnover. Information centrality is operationalized using a Bonacich centrality measure. The method used to calculate this measure is discussed in Chapter 2. This measure captures the centrality of a firm's board by considering not only direct or adjacent ties of a firm's board, but also indirect paths involving intermediaries. Thus, the Bonacich measure captures the difference between a firm being connected to IBM (a computer firm with many ties to other firms) versus connected to Grand Union (a supermarket chain with only one tie to other firms). The Bonacich measure includes this possibility by incorporating a parameter that reflects the extent to which an actor's centrality is a function of the centrality of actors to whom the actor is tied. This measure has been used as an information indicator (Bonacich, 1987; Hansen, 1996) by prior researchers. The results suggest strong support for the role of the information centrality of the board in outsider CEO selection. Better information on external candidates is likely to be obtained from directors that are in contact with prominent or central directors that themselves are in contact with other directors. The coefficient for board centrality is the second strongest predictor of outsider selection after firm performance.

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Models 2 and 3 present alternative specifications of the information centrality effect on outsider CEO selection. Model 2 examines the effects of information centrality, conditional on a forced turnover. The is not unexpected since boards that force out a CEO are more receptive to considering an external CEO who is more likely to make changes when they are needed the most. More interesting, however, is that high information centrality still exerts a significantly large positive effect on outsider CEO selection when compared to Model 1, which is conditional on both natural and forced CEO turnovers. This finding is consistent with earlier described statements that particular information is an important requirement in making outsider CEO selection.

Model 3 examines the effects of information centrality, conditional on a natural turnover. Note that the results demonstrate very strong support for the view that information centrality is a key determinant of outsider CEO appointments. Even when the antecedent condition is a natural turnover, poor performance and high information centrality still strongly predict outsider CEO turnover. The insignificance of the control variable of percent insiders also suggests that the role of outside directors is not limited to the board room. In the situation of natural turnover, the power of outsider directors is exerted through their ability to access particular information rather than their relative strength in numbers inside the board room.

5.4 Summary

This chapter argues that the interlocking directorate is a critical source of information on outsider CEO candidates. Support for this argument is built on both fieldwork and statistical analyses.

The chapter demonstrates than an important function of interlock relations is to transfer information about outsider candidates. However, unlike previous research on information flow in director interlocks, I find that all information moving through the interlocking directorate is not generic. Instead, my findings suggest that it is critical to distinguish between general information, which can be gathered easily through alternative sources other than interlocks, versus particular information, which cannot be gathered without explicit ties to others in the interlocking directorate.

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The statistical research on CEO turnover is consistent with the outlined theoretical argument. The statistical results suggest that those firms that have connections to more central firms in the interlocking directorate are more likely to appoint an outsider CEO as a consequence of being able to access this particular information.

Unlike prior research, which specifies a board's connectedness as the number of interlocks a firm has with other firms in the interlocking directorate, I find it is important to specify the nature of these connections. Similar to Mizruchi and Bunting's findings (1981), the results suggest that while several measures of network centrality are correlated, these measures should not be used interchangeably. Rather selection of the appropriate measure affects the predictability of the model and, thus, needs to be driven by theoretical, not statistical, considerations. Consequently, my findings suggest that all relationships are not equal within the interlocking directorate. It is not how many connections or the range a firm has to other firms, but also who a firm is connected to. Those boards connected to more central boards have access to more particular information about potential candidates than those firms with peripheral connections.

My results also call into question the simple performance-CEO succession link that is typically used to examine CEO change and outsider succession. While agency theorists are correct to call attention to this linkage, it is not the full story. The results also extend and build upon the recent behavioral literature on managerial succession by introducing the importance of the larger social structure on corporate governance. In the spirit of Westphal & Zajac's (1995, 1996) research, the findings suggest that corporate governance researchers should explicitly consider the social character of board members when studying governance decisions. Both the field research and the statistical research suggest that a large aspect of the actions of directors in selecting an outsider CEO are motivated and constrained by their inter-organizational relationships.

In the next chapter of the dissertation, I turn to the consequences of CEO turnover. Focusing on consequences is important because there is presumably a hypothesized link between CEO turnover, selection, and firm outcomes.

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Figure 5-1: Proportion of Insiders versus Outsiders Appointed to CEO: 1980-1995. Outsider CEOs are defined as those who had been with the firm less than one year. Proportion is calculated for 850 largest manufacturing and various service firms as defined by Fortune magazine. Graph suggests no significant increase in outsider CEO succession during this period.

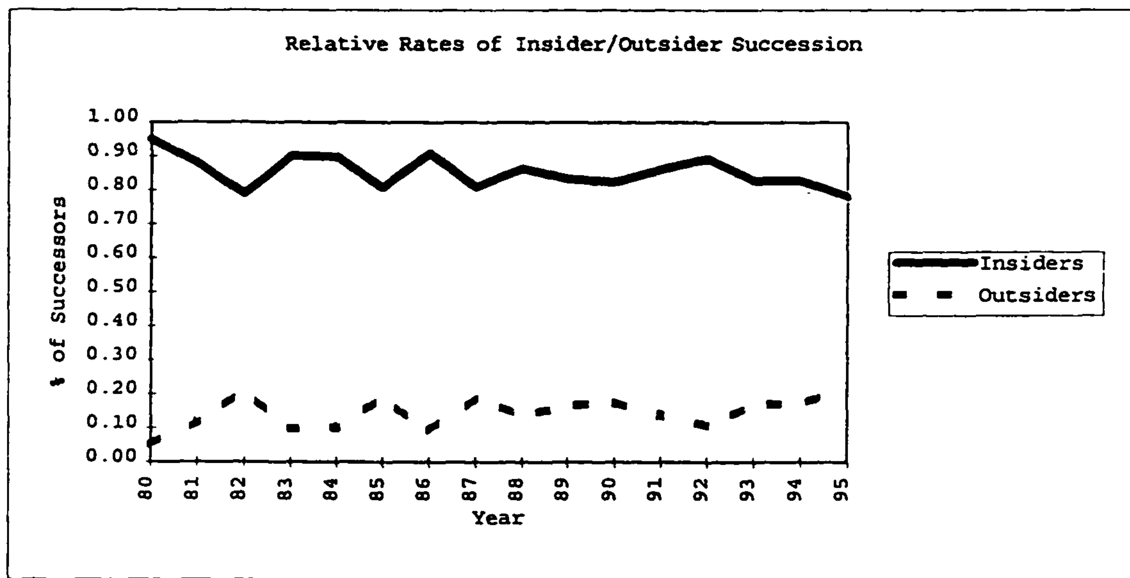

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Figure 5-2: BOARD COMPOSITION AND OUTSIDER CEO SUCCESSION. Graphs the number of outsider succession against board composition. Board composition is defined by the number of outsider directors divided by the total number of directors. Outside directors are those individuals who are neither current nor past executives of the firm. Graph suggests that a positive relationship between the proportion of outside directors and outsider CEO succession.

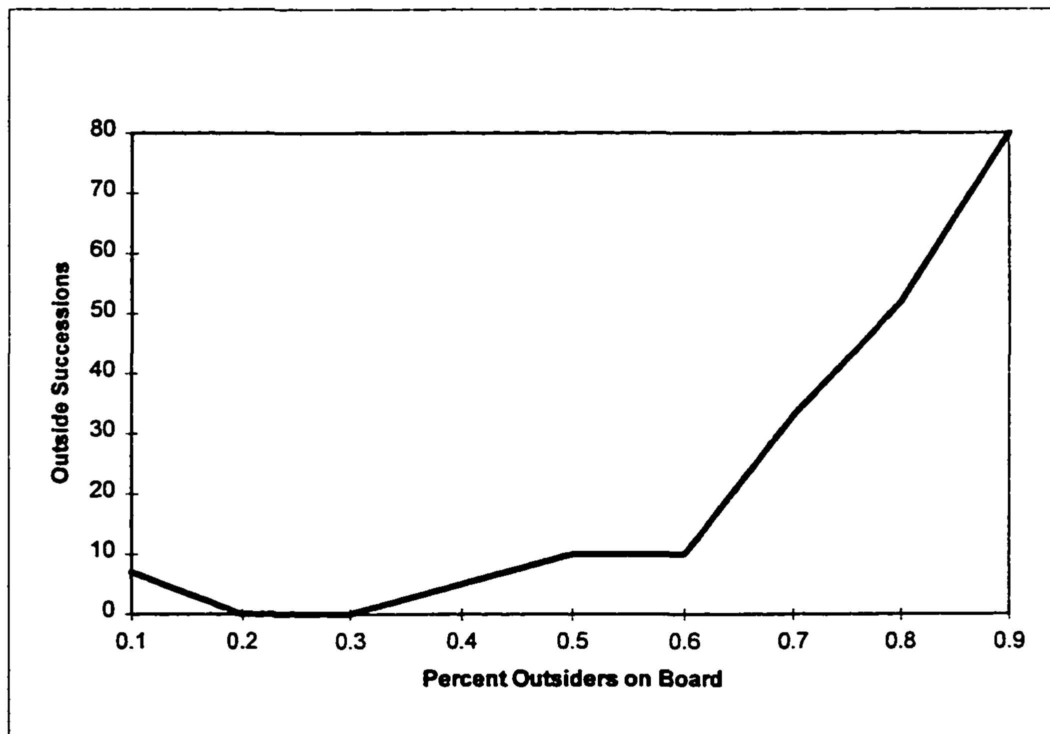

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Figure 5-3: PERFORMANCE AND OUTSIDER CEO SUCCESSION. Firm performance is defined as industry-adjusted total return on assets. It is calculated by net income before interest, depreciation, and taxes divided by the total book value of assets. Industry adjusted by subtracting the average two-digit SIC measure return on assets. Largest number of outsider CEO successions occur when industry-adjusted firm performance is at the mean level.

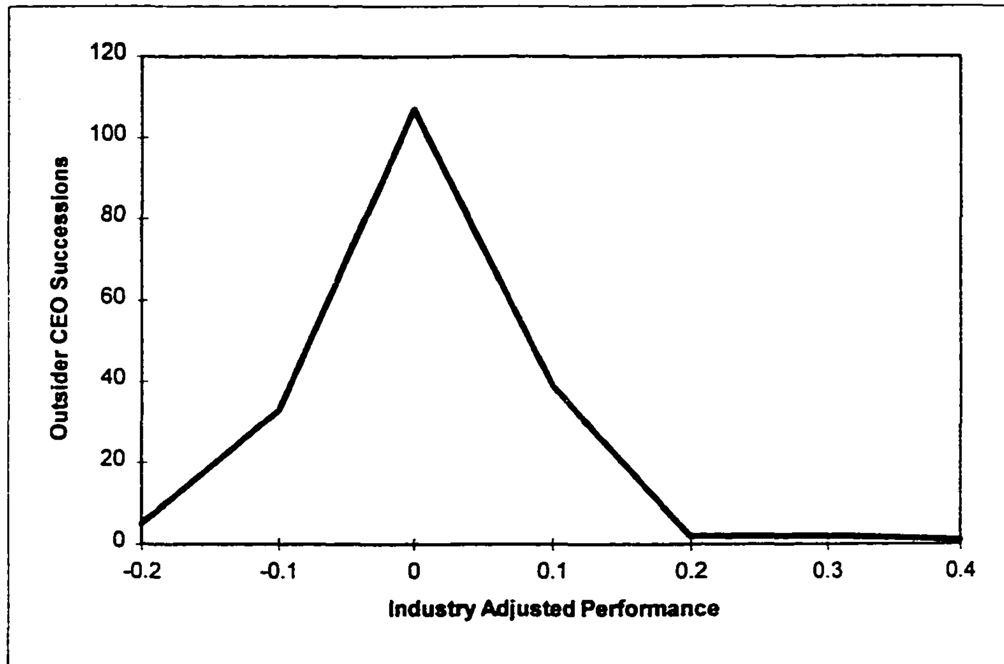

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Figure 5-4: INFORMATION CENTRALITY AND BOARD COMPOSITION. Information centrality is calculated using bonacich centrality. Bonacich centrality weighs interlocks by their prominence within the entire network. Outsider directors are defined as directors who are not current or previous employees of the firm. Suggests positive relationship between proportion of outside directors on a board and network centrality.

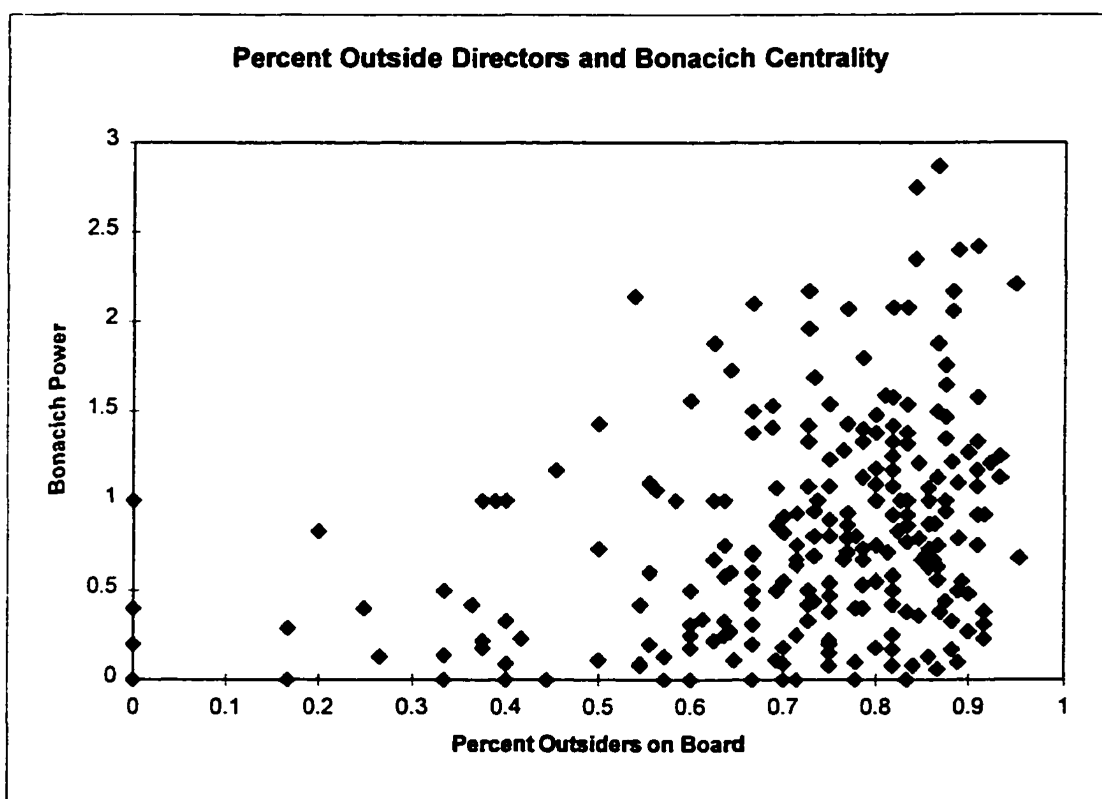

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Figure 5-5: SUMMARY STATISTICS OF CEO SUCCESSIONS AND BOARD COMPOSITION. Table presents the distribution of turnovers along the percentage of insiders on the board. Insiders are defined as former or current executives of the firm. Forced turnover is defined as CEOs who exit the firm prior to the age of 60 and do not leave for an equivalent position at another firm within one year of exit. All other turnovers are classified as natural. Outsider turnover is defined as individuals who have been with the company less than one year and had no prior affiliation with the firm. Sales are defined as annual revenues for the firm. Degree is calcuated as the number of interlocks of a firm's board minus any redundant ties.

	CEO Turnover and CEO Origin						
Percent Insiders on Board	Natural with Insider	Forced with Insider	Natural with Outsider	Forced with Outsider	Mean Bonacich Power	Mean Degree	Mean Sales
0-10&	42.45%	22.64%	15.09%	19.81%	1.02	14.18	5096.19
10-20%	56.26%	28.23%	10.34%	5.17%	0.92	14.23	5342.42
20-30%	61.18%	25.55%	8.35%	4.91%	0.78	11.13	5228.12
30-40%	65.26%	20.19%	7.51%	7.04%	0.66	9.09	5546.01
40-50%	72.58%	14.52%	5.65%	7.26%	0.49	6.34	5300.26
50-60%	82.35%	5.88%	11.76%	0.00%	0.37	4.36	1846.22
60-70%	47.17%	39.62%	1.89%	11.32%	0.25	2.74	2676.06
70-80%	40.74%	59.26%	0.00%	0.00%	0.13	0.84	2296.28
>80%	41.51%	45.28%	3.77%	9.43%	0.13	0.69	3594.45

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Figure 5-6: EFFECT OF INFORMATION CENTRALITY ON OUTSIDER CEO SUCCESSION. Coefficient estimates for logit models are estimated using data during the tenures 1286 CEOs for 850 firms between 1980 and 1996. All models have two outcomes, insider succession and outsider succession. Succession is classified as outsider if the successor CEO has been with the firm less than one year and had no prior affiliation with the firm. All other turnovers are classified as insider successions. Performance is measured as total return on assets calculated by earnings before taxes and depriciation divided by the total book value of assets, less the median value of that ratio for all firms in the same two-digit SIC industry. *p<.10, **p<.05,***p<.01

	Model 1	**Model 2**	**Model 3**
	Conditional on CEO Turnover n=1520	Conditional on Forced Turnover n=496	Conditional on Natural Turnover n=1024
Performance (Lag 1 Yr)	-5.02***	-3.82**	-5.57***
	(1.23)	(1.99)	(1.59)
Ln (Employees)	-.148**	.091	-.163*
	(.067)	(.117)	(.084)
Percent Insider Directors	-1.42***	-.824	-2.16***
	(.590)	(.828)	(.857)
Bonacich Centrality	1.47***	1.71***	1.21***
	(.333)	(.552)	(.417)
Constant	-.936***	-1.10***	.775**
	(.246)	(.383)	(.329)

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Part III

Consequences of CEO Turnover

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Chapter 6

Strategic and Performance Consequences

In the previous chapters, I discussed the processes that affect the CEO dismissal and CEO selection decisions. In this chapter, I examine the consequences of these decisions for the firm. Specifically, I look at the implications of different types of CEO turnover for firm strategies and firm performance.

Examining the consequences of CEO turnover is a natural conclusion for the CEO succession analyses undertaken thus far because it seeks to answer one of the burning questions in management: does a new CEO really make a difference? The increased control exercised over CEOs by board members and the significant organizational resources directed toward CEO selection outlined in the previous chapters presumes that CEOs can take actions to affect firm performance. This "common-sense" view, what I will refer to as the *substantive* perspective of CEO turnover, is diagrammed in Figure 6-1. This perspective is grounded in a rational view of organizations (Scott, 1992), and describes organizational actions as directed toward increasing efficiency.

The substantive perspective, however, has been challenged by some organization theorists who suggest that CEOs, in fact, have little influence on firm performance (Lieberson & O'Conner, 1972; Pfeffer & Salancik, 1978). According to this view, CEO turnover, at best, amounts to "ritual scapegoating" that appeases disgruntled shareholders but has little impact

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on firm performance (Gamson & Scotch, 1964). I call this second view, a *symbolic* perspective of CEO turnover. This perspective is grounded in a socially constructed view of organizations (Berger & Luckmann, 1967) and describes organizational actions as directed toward increasing legitimacy.

My aim in this chapter is not to propose a third perspective about the consequences of CEO turnover for the firm; that would be unproductive because the existing theories have not yet been adequately tested. As I noted in Chapter 1, the empirical evidence on the performance consequences of CEO turnover have fueled, rather than resolved, the theoretical debate between these two perspectives. There has been empirical research, for example, which examined the impact of coaching changes on team performance in sports. These studies provide compelling evidence for a scapegoating and symbolic interpretation managerial turnover in baseball (Gamson & Scotch, 1964), basketball (Allen, Panian, & Lotz, 1979), and football (Brown, 1982). However, similar studies on top management turnover in business firms have been inconclusive. Studies that examine changes in operating performance following CEO turnover and examine stock market reactions to CEO turnover have had mixed findings (for a review, see Furtado & Karan, 1990). Rather, using the substantive and symbolic perspectives as theoretical starting points, this chapter by way of empirical analyses addresses several limitations of prior studies and seeks to provide a thorough description of the strategic and performance consequences of CEO turnover.

There are three sections to this chapter. The first section places the substantive and symbolic perspectives within the larger context of general organizational theory and then focuses on two representative theories from these perspectives: agency theory and institutional theory. These two theories are, respectively, the clearest examples of the substantive and symbolic perspectives on CEO turnover because each builds on different conceptions of organizations, ascribes different roles to organizational leaders, and employs different approaches to analyze organizational behavior. I then generate testable propositions suggested by each of these theories. In the second section, I test these propositions using the Fortune 200 firms. Finally, I conclude with a summary of the findings and discuss their limitations and implications for current theory.

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6.1 Theoretical Perspectives

6.1.1 Substantive Perspective

The literature that focuses on the substantive effects of CEO turnover conceives of organizations as formal systems designed to enable their members to attain specified goals. In this view, the role of organizational leaders is to align organizational action toward desired outcomes, such as increasing the organization's profitability or survival prospects, through the appropriate structuring of strategies, procedures, and roles. Theorists in the substantive tradition suggest that the modern corporation is superior to earlier organizational forms because those at the top of the organization are best able to take actions that enhance the firms performance. Unlike leaders who derive their position largely from ownership, tradition, or charisma, the CEO who rises through the organizational ranks has the experience, training, and knowledge to take actions that enhance organizational performance (Weber, 1947; Chandler, 1977).

While agency theorists question whether executives are always motivated to act in the best interest of the firm (Berle & Means, 1932; Jensen & Meckling, 1976), they nevertheless share the view that executives in leadership positions can and do take actions that significantly affect organizational outcomes. Changes in organizational leadership are hence viewed as creating opportunities for the new leader to make strategic changes necessary to improve organizational performance.

What kinds of strategic changes can we expect following a turnover? Agency perspectives suggest that incumbent chief executives are likely to pursue self-serving actions such as making acquisitions that expand the size of the firm, but are not profitable, avoiding the financial discipline imposed by high leverage, and over-investing in areas such as research and development and capital expenditures. Chief executive turnover thus serves as an occasion to correct some of these agency problems.

Tough strategic changes such as restructuring a poorly performing firm, reducing investment in research and development and capital expenditures, and transferring risk from principals to agents through increased leverage, are especially likely if the turnover results from the forced dismissal of an incumbent, or if the successor is an outsider (Friedman & Singh, 1989). Clearly, a forced dismissal followed by the appointment of an outsider provides the strongest mandate

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for change whereas a natural turnover followed by an insider signals satisfaction with the status quo and a mandate for continuity. Theorists in the agency perspective have not made clear the ordering of the other two types of turnover (i.e. forced-insider, natural-outsider), but they are expected to fall somewhere in between, in terms of the extent of strategic changes they introduce.

Consistent with the agency perspective regarding the amount of strategic changes associated with different types of turnover are the performance consequences of these changes. Agency theorists, for example, clearly believe corrective strategic changes can enhance firm performance (Denis & Denis, 1995). One should therefore expect that those firms where the new CEOs are likely to introduce the most strategic changes will have the greatest performance improvements, whereas those firms in which the new CEO is not likely to introduce strategic changes to have the least performance change. Again, the ordering of the performance effects of the other two types of CEO turnover are not explicitly identified by agency theory, but are expected to fall between the other two types of turnover.

6.1.2 Symbolic Perspective

The symbolic tradition in organizational theory views organizational behavior as socially constructed. Some researches within this tradition go so far as to suggest that the only correct way to think of organizations is as systems of shared meanings, symbols, and beliefs (Berger & Luckmann, 1967; Pfeffer, 1997). The role and actions of organizational leaders are conceived of in terms of sense-making (Weick, 1979), rationalizing (Pfeffer, 1981) and, legitimizing (Meyer & Rowan, 1977).

From a symbolic standpoint, CEO turnover has often been seen as a scapegoating ritual. This view originates from Gamson and Scotch's (1964) classic study on the turnover of baseball team managers. The conclusion from this study is that because changes in management had no impact on team performance, changing organizational leaders was a form of symbolic scapegoating to both appease and regain legitimacy with organizational constitutents–in this case, the fans. Research by Lieberson & O'Conner (1972) provided more support for this perpsective. Their study sought to determine the relative impact of any leadership change for organizational performance when controlling for contextual factors. Their finding was that

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leadership changes had no effect on outcome measures, such as profits.

Although methodological criticisms have been raised about the empirical validity of studies in this genre (for a review and reassessment, see Thomas, 1988), this perspective has been cited by researchers and theorists as support for a symbolic view of organizational behavior–in particular, the new institutional theory of organizational behavior.

Beginning with the assumption that organizations operate within severe external constraints and power-dependence relationships, the new institutionalists proceed from the premise that external forces constrain and determine organizational actions (Fligstein, 1990). Managerial actions are not instrumental in this perspective because the link between behavior and performance outcomes is predicted to be loose. The loose coupling between behavior and performance occurs because organizational choices or actions are institutionally defined and shaped. That is, organizational actions are not made by autonomous organizational actors, single-mindedly pursuing maximum organizational performance, but instead are made by interdependent actors who "seek to behave in conventional ways...that will not cause us to stand out or be noticed as different" (Scott, 1983) from relevant others.

This interdependence, when coupled with uncertainty about what the efficacy of actions are, leads to a situation where organizations seek to resolve uncertainty by imitating or conforming to prevalent practice (DiMaggio & Powell, 1983). Thus, *organizational decisions or actions are not driven by the unique problems and opportunities facing their organization, rather they are driven by institutionalization processes that produce a common understanding about what is appropriate in a given situation.* Consequently, institutional analysis requires shifting focus from the individual actor in a decision making situation to the prevailing normative context within which the actor is operating. Institutional theory shifts the level of analysis from the autonomous organization in decision making to the role of external authorities and stresses the fact that organizational actions and processes largely serve to legitimate organizations rather than to advance efficiency (Scott, 1995).

Whether or not to fire the CEO and the choice of successor is largely driven by legitimacy considerations. During the period of the study, board members at poorly performing firms were increasingly pressured to fire their existing CEOs and bring in outsiders who were suggested to more likely undertake the necessary strategic actions to improve performance. Not firing

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a poorly performing CEO and the subsequent appointment was seen as a continuation of the status quo and often criticized by both the business media and financial analysts (see Business Week, 1/1/92: What is bad for General Motors on the appointment of Robert Stempel following the retirement of Roger Smith at GM). Firing a CEO and appointing an outsider was seen by both practitioners and organizational theorists as a way to introduce changes that entrenched management was reluctant to introduce (Weisbach, 1988; Business Week, 11/15/93: Kodak: Shoot the Works, a discussion the strategic changes Kodak needs to make, but that the incumbent CEO, Kay Whitmore, is unwilling to act on). In particular, forced turnover followed by an outsider was seen as a way of reversing poor prior strategic decisions, such as diversification and other expensive investment strategies that had once been heralded in the 1960s and 1970s and were now increasingly viewed as illegitimate and signs of poor management (Davis, 1994; Jensen, 1993; Schleifer & Vishny, 1994; Nohria, 1996). Again, the ordering of the other two types of changes is not explicitly identified, but expected to fall between the other two types of turnover.

In contrast to the agency perspective discussed in the previous section, however, the symbolic perspective suggests that the strategic actions taken by a CEO are loosely coupled with performance. The linkage between the strategic actions undertaken by a CEO and organizational performance, as diagrammed in Figure 1, is suggested to be tenuous since the new CEO's actions are driven by legitimacy rather than efficiency concerns. Evidence of the weak linkage between strategic actions and performance has been found in research that has examined the performance consequences of downsizing (Love, 1996), total quality management (Gulati & Westphal, 1997); and strategic realignment (Carroll, 1987). The symbolic perspective would suggest that any performance consequences of strategic actions, such as the ones discussed, should be randomly distributed across different types of turnover and, therefore, not significant.

6.2 Data and Methods

The starting point of the study is a selection of the Fortune 200 firms beginning in 1978 and followed through 1993. Collecting comprehensive strategic data for the entire 850 firm

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sample was prohibitively expensive. While the selection of the largest 200 companies limits the generalizability of the results, it was imperative to identify a sample of firms which are widely followed in the business media and hence offer more complete information on company events than is available for smaller firms. Where possible, I do test the generalizability of my results for the entire 850 firm sample.

As in the previous chapters, financial data for the firms was obtained from Standard and Poors COMPUSTAT database. The data for chief executive turnover and strategic actions was collected in the manner detailed in Chapter 2.

6.2.1 Dependent Variable

Annual operating returns are used as evidence of improvement in firm performance (Smith, 1990). The annual operating return for a firm is defined as the ratio of operating income before depreciation and taxes to operating assets. Because operating income does not include taxes, royalty, dividends, or interest income received, nor any dividends paid to stockholders, it is considered a robust measure of changes in the operating performance of an organization (Smith, 1990; Denis & Denis, 1995).

In order to control for industry-level effects, performance is industry-adjusted by taking the difference between a firms operating performance and the same year industry average (excluding the observed firm). The industry average includes all firms with the same 2-digit SIC code.

6.2.2 CEO Turnover

Consistent with the approach described in the last chapter, I identify distinguishing characteristics of forced resignations by comparing management changes for which the stated reasons are either forced resignation/conflict or poor performance to those turnovers for which the stated reason for the change is retirement or normal succession (Weisbach, 1988).

For the purpose of analysis, an aggregate dichotomous turnover category of "natural" (coded 0) and "forced" (coded 1) turnover was created. Forced turnover includes those cases in which the CEO retired before the age of 60 and did not take an equivalent position at another firm. Natural turnover consists of those cases in which the reasons for departure are retirement and other factors such as illness, death, or leaving for another position.

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Finally, successor chief executive officers are coded as insiders (coded 0) or outsiders (coded 1). Successors are coded as outsiders if they had been with the firm less than one year.

6.2.3 Strategic Actions

I examine five broad types of strategic actions and measure these actions over a three year period. Gabarro (1987) found that three years is the typical period over which new executives introduce major changes to their organization. The actions examined are downsizing, corporate restructuring, capital expenditures, research and development expenditures, and the ratio of debt to equity. Taken together, these actions capture a broad spectrum of changes that might be expected following a major organizational event (Khanna & Poulsen, 1995; Kose, Lang, & Netter, 1992). One may think of these actions as a proxy for changes to: strategy (restructuring); structure (downsizing); operations (capital and research and development expenditures); and financing (debt to equity).

Because there is heterogeneity in the types of strategies individual firms pursue which depend on their individual situations, a cumulative measure to approximate total levels of strategic change was also created. I created this measure by looking at whether the five individual changes examined for each firm exceeded their industry average. Those changes that exceeded the industry level were coded as (1) and those that are below were coded as (0). The total number of changes were then summed and used to create a limited continuous measure of change that varied from 0 to 5. Admittedly, this is a crude measure, but it has been used in previous research to measure strategic changes before and after significant organizational events (see Zajac, 1995 as an example).

6.2.4 Methods

Because the data consists of multi-firm data over a multi-year period, both cross sectional and time-series techniques are used to test the propositions about the consequences of different types of CEO turnover for firms. To test the predictions related to the strategic and performance consequences of CEO turnover, I used three different analyses. My choice of analyses was driven by the various components of the theoretical models suggested by the substantive and symbolic perspectives of CEO turnover discussed earlier.

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The first analysis examines the effects of the various CEO turnover outcomes on firm performance. This effect is estimated using three types of time-series methods; OLS model, fixed-effects model, and a random-effects model. I test a similar specification using the three different methods of analyses. I discuss the strengths and weaknesses of each of the methods and argue that the consistency of the results across the various methods, using a specification, illustrates the robustness of the findings.

The second analysis pools firms strategies before and after the CEO turnover. The advantage of pooling the data for this analysis is that I can examine the individual strategic changes that take place within the first few years of the tenure of a new CEO. This allows me to formally incorporate into the model previous empirical findings that new CEOs institute strategic changes over a 2 to 3 year period rather than instantaneously (Gabarro, 1987).

Finally, I examine the individual effects of the strategic changes and the different types of turnover on performance. Here, I again estimate an OLS model, a fixed-effects model, and a random effects model to take advantage of the time-series nature of the data

Descriptive Statistics

Table 6-1 presents the correlation matrix for the analysis. The correlations suggest consistency with the larger sample (and, consequently with previous research). For example, the negative correlation between forced turnover and performance is similar in magnitude to that found in the 850 firm sample discussed in Chapter 2.

Figure 6-2 presents simple descriptive statistics for firm characteristics for each of the turnovers and the entire sample. Mean values are reported in Table 2 (median results are similar). A comparison of the statistics for the forced and natural turnovers reveals that firms in which forced turnover took place performed relatively more poorly than those firms in which voluntary turnover took place. The relative differences and the differences in industry-adjusted performance are consistent with the notion advanced by Morck, Shleifer, and Vishny (1989) that performance relative to other industry firms is considered by directors when they make turnover decisions.

Figure 6-3 presents a summary of the various types of turnover. In the sample of 200 firms followed from 1978 to 1993, 222 turnovers are identified. Of these turnovers, 46 are coded as

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forced (20.7%). This percentage of forced turnovers is less than the 35.8% found in the larger sample of 850 firms, but the differences can be attributed to the fact that the sub-population consists of the 200 largest corporations where rates of forced turnover are lower (see Chapter 3) and that the analysis period ends in 1993 not 1996.

Insider appointments represent 85.1% of the total appointments. This is slightly greater than the 83% insider appointments found in the larger sample. The higher proportion of insiders is not surprising given that the sub-sample consists of the 200 largest firms which are more likely to have a larger pool of internal candidates to choose from (Osterman, 1984).

CEO Turnover and Performance

The data allow us to distinguish between four succession outcomes based on the type of turnover and the impact of these turnovers on firm performance. Figure 6-4 shows both the industry-adjusted and unadjusted mean differences in operating performance in comparison to the year prior to the turnover. Differences are presented as the change in performance in years 1, 2 and 3 after the turnover subtracted from performance the year prior to the turnover.

Panel A of Table 4 looks at the different types of turnover and successors. Panel B examines the different types of turnover in combination with the successors. Both panels A and B suggest that the performance consequences of different types of CEO turnover vary significantly. I focus my discussion on Panel B.

The third column in panel B shows no significant difference in performance when natural turnover is followed by an insider successor. Natural turnover followed by an outsider, however, results in a 4.9% ($p<.05$) decline in performance relative to the year prior to the turnover. There also seems to be no significant change in performance when forced turnover is followed by an insider. Finally, when forced turnover is followed by an outsider there is significant performance improvement. The average performance increase is 4.2% ($p<.05$). Thus, contrary to the performance effects suggested by the symbolic perspective, CEO turnover does affect firm performance. The effect, however, is not in the order suggested by the substantive perspective. Instead, while forced turnover followed by an outsider results in the greatest performance improvement, the predictions for forced turnover followed by an insider and natural turnover followed by an outsider are contrary to predictions. Forced turnover followed by an insider has

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no significant affect on performance. Natural turnover followed by an outsider, on the other hand, has a significant negative affect on performance.

While the average differences in performance across the different types of turnover are inconsistent with the performance predictions of the substantive perspective, caution should be exercised from a simple comparative analysis of performance data. While previous researchers (Khanna & Poulsen, 1995; Denis & Denis, 1995) do draw conclusions on the relationship between CEO turnover and firm performance using this type of difference analysis, this approach ignores several estimation problems associated with this type of analysis. Two problems, in particular, render this type of analysis suspect: regression to the mean and sample selection bias.

Regression to the Mean

Regression to the mean is a serious issue that confounds the statistical analysis of performance (and change, in general). Regression to the mean involves changes in performance not due to the specification of my model, but instead is the result of high or low performing firms reverting toward the average level of performance. Coleman (1968: p. 438) describes the source of this problem as the result of positive and negative feedback associated with the fact that most phenomena "are parts of equilibrating processes, so that once far from the mean, they tend to return." Regression to the mean in this analysis on performance arises from the fact that an endogenously determined variable, CEO turnover, is included in the model. In other words, the independent variable CEO turnover is itself determined to some extent by a firm's reaction to poor performance (see Chapter 2). Figure 6-5 presents coefficient estimates for the logit turnover model lending support to this assertion.

Model 1 in Figure 6-5 looks at all CEO turnovers. Model 2 looks at forced versus natural turnover. The coefficients highlight the sensitivity of turnover and forced turnover, respectively, to the level of industry-adjusted firm performance in the year prior to the turnover. The likelihood that a CEO turnover will take place is negatively related to firm performance ($p<.05$), that is consistent with the findings in Chapter 2 poor performance increases the likelihood of CEO turnover. Model 2 shows that the same relationship, only magnified, exists for forced turnover ($p<.01$)[1].

[1]On the other hand, it is possible that while the CEO turnover was itself caused by the firm's poor performance

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Thus, the results of Figure 6-5 suggest that there is a problem of reverse causation; that is, firm performance is related to firing the CEO since poorly performing firms are more likely to force out their CEO. Regression toward the mean comes in because firms that were having really poor performance are likely to improve in performance in subsequent years for reasons that have nothing to do with the CEO. This will lead one to overestimate the impact of CEO change on performance. One way to address this problem is by incorporating a lagged performance measure into the time series model to avoid overestimating the effects of the other independent variables in the model[2].

Sample Selection Bias

A second problem facing the analysis is that of sample selection bias. Sample selection bias arises from the fact that several firms drop out of the sample during the fifteen years of the study. Because I do not believe that firms drop out of the sample randomly, the sample selection problem potentially creates a correlation problem between the error term and the independent variables (see Winship & Mare, 1992 for a detailed discussion). In this case, firms that drop out of the Fortune 200 for reasons such as bankruptcy, hostile takeover, or merger are likely to do so because of poor performance. Consequently, without correcting for those firms that drop out of the sample, it is likely that the value of the dependent variable will be restricted and, thus, bias the estimates.

Given this reasoning, the best way to deal with the sample selection problem is to incorporate

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and that the subsequent changes introduced by the new CEO are the real source of improving performance. That is, the CEO change is one of the mechanisms producing the observed improvements in performance. In this case, the estimated lagged model would "over-correct" for the regression toward the mean effect and result in us underestimating the effects of the various CEO turnovers.

[2]Inclusion of a lagged performance variable, however presents a potential estimation problem due to autocorrelation. The problem is associated with the correlated errors between the lagged performance variable and the error term. Whenever a lagged version of the dependent variable is included as an independent variable and one has correlated errors over time, this biases coefficient estimates even when estimated by Generalized Least Squares (GLS) or any of its variants. The only way to get unbiased estimates is using instrumental variables.

Because I do not have a good instrument for this analysis, I cannot use this technique. Fortunately, prior research on firm performance estimation suggests that it is not unreasonable to assume that the errors are not strongly correlated over time, thus making it possible to estimate our model without instrumental variables. After controlling for the the lagged dependent variable, I did not find significant residual autocorrelation (at the .10 level). The reason for the reduced autocorrelation, Sørensen points out, is that with a 200 firm sample, over a smaller number of time periods, there is much more cross sectional variation than longitudinal variation, thus, reducing the amount of error correlation between time periods. Additonally, any bias that does arise from autocorrelation is mostly associated with the lagged performance variable whose precise estimate is not critical for this analysis.

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the selection process into the substantive model. I do this using an approach suggested by Kang (1996) that estimates a hazard rate or probability that a firm is likely to drop out of the sample. Kang's approach adapts the Heckman (1976) two-stage estimation procedure, which was originally used for cross-sectional data, for use on a panel data set. Because I coded firm exit from the sample on annual basis, I can use discrete-time event history analysis to calculate the hazard rate for a firm dropping out of the sample from the following equation (Allison, 1986):

$$\ln(\frac{\lambda(t_i;p)}{\lambda(t_i;1-p)}) = a_i + b_1x_1 + b_2x_2 + b_3x_3 \qquad (1)$$

where:

$\ln(\frac{\lambda(t_i;p)}{\lambda(t_i;1-p)})$ is the estimated probability for whether a firm dropped out of the sample at time t_i

x_1 is whether a firm had a hostile takeover attempt in the previous two years

x_2 is whether a firm filed for Chapter 11 bankruptcy in the preceding two years

x_3 is industry adjusted firm performance

The specification of the model is based on the reasoning that for the Fortune 200 sample, the reasons for exit are either merger, acquisition, or liquidation following bankruptcy. The predicted values from equation (1) are included in the lagged model as an independent variable to generate the estimates for a firm dropping out of the sample.

6.3 Model and Results

6.3.1 Lagged OLS Model

For this model:

$$Y_{it} = a + bx_{1it} + bx_{2it} + bY_{it-1} + e_{it} \qquad (2)$$

where:

Y_{it} is the change in performance for the ith firm in the tth time period

x_{1it} is the type of CEO turnover coded as a dummy variable with the base case of no turnover

x_{2it} is the estimated probability of dropping out of the sample derived form equation (1)

Y_{it-1} is firm performance lagged one year

The specified model allows us to examine the effects of CEO turnover alone on performance.

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One can compare the different types of CEO turnover to the baseline condition of no turnover to capture the individual effects of each type of turnover on performance. The results of the model along the four types of CEO turnover are presented in Table 6-2.

Model 1 shows that there is a small .8% performance improvement associated with CEO turnover ($p<.05$). The positive effect following CEO turnover is consistent with prior research findings that CEO turnover is often followed by a performance improvement (Worrell, Davidson, & Glascock, 1993).

Model 2 looks at the effect of forced turnover versus natural turnover on performance. The model shows that natural turnover is followed by a positive 1% performance change ($p<.01$) whereas forced turnover has a small positive (.003), but insignificant ($p<.25$) effect on performance change. This finding is consistent with Worrell, Davidson, & Glascock (1993).

Model 3 looks at the effect of insider versus outsider successors. Insiders have a positive impact on performance of 1% ($p<.01$) whereas outsider succession exerts no significant affect on performance. These results are consistent with the notion that insider appointments, which are the majority of appointments, are usually found in conditions where firm performance is stable and, or, slightly improving.

Model 4 presents the full model of all four turnover conditions against the baseline condition of no turnover. Forced turnover followed by an insider and natural turnover followed by an insider do not significantly impact performance. On the other hand, in those firms where there is a forced turnover followed by an outsider, performance improves by 3.6% ($p<.05$) when compared to the year prior to the turnover. Natural turnover followed by an outsider, however, results in a performance decline of 5.9% ($p<.05$).

6.3.2 Fixed Effects Model

$Y_{it} = a + bx_{1it} + bx_{2it} + bY_{it-1} + bw_{1it} + e_{it}$

where:

Y_{it} is the change in performance for the ith firm in the tth time period

x_{1it} are dummy variables of the various types of CEO turnovers

x_{2it} is the estimated probability of dropping out of the sample derived from equation (1)

Y_{it-1} is firm performance lagged one year

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w_{1it} is 1 for ith firm, 0 otherwise

The purpose of the dummy variable coefficients,x_{1it} , is that they will measure the change in the cross-section of firms in the sample. By using dummy variable coefficients, there is an explicit recognition that the possibility of omitted variables may lead to changing cross-section intercepts. Fixed effects analysis involves the addition of dummy variables to the model to allow for changing intercepts. While it appears that the addition of dummy variables would use up a substantial number of degrees of freedom, the formal fixed effects model implement in statistical packages, like STATA, is able to control for this heterogeneity through a formula to correct for biased standard errors due to changing cross-sectional intercepts without the addition of dummy variables (see Greene, 1991: section 16.4.2). The major downside of using fixed effects modeling are (1) they do not theoretically identify the omitted variable; (2) the assumption is that the effects are constant across firms and over time; and (3) the interpretation of the results is constrained to the sample under study and should not be generalized to the larger population of firms.

Model 5 in Table 6-2 shows the results of the fixed effects model with the lagged performance variable across all four types of turnover. The results are very consistent with the findings from the lagged OLS model.

6.3.3 Random Effects Model

Just as the fixed effects model is a way of using dummy variables to reflect ignorance or missing variables, some researchers have suggested that this type of ignorance should be treated in a fashion similar to the general ignorance represented by the error term and have proposed using a random effects model (Kennedy, 1992).

Here, there is an overall intercept and an error term with two components:

$Y_{it} = a + bx_{1it} + bx_{2it} + bY_{it-1} + bw_{1it} + e_{it} + m_{it}$

The difference between this model and the fixed effect model is in the modeling of the error term. Here, e_{it} is the systematic error and m_{it} is the error term associated with the coefficients of the independent variables. As a result, the random error is suggested to occur in the value of the independent coefficients, not the intercept.

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Which one is better, fixed effects or random effects? Model 6 in Table 6-2 shows similar results. Kennedy (1992) suggests that if the data exhaust the population, then the fixed effects approach, which produces results conditional on the units in the data set, is reasonable. However, if the data is drawn from a larger population, the random effects model is better. The drawback of the random effects model, however, is the assumption that the random error associated with each cross section unit is uncorrelated with the other regressors. If this assumption does not hold, it can bias the estimates. This problem is no different than when a researcher uses OLS regression with a misspecified model. Thus, since there is no theoretical reason to believe that the unmeasured variables are constant over time and because I want to generalize the findings to the larger population of firms, random effects represents the best approach.

In sum, while the size of the coefficients across the different models varies, I find no support for the symbolic perspective regarding the impact of CEO turnover on firm performance and only partial support for the substantive perspective with some confounding results regarding natural turnover followed by an outsider resulting in a severe decline in firm performance.

6.3.4 Strategic Changes Before and After CEO Turnover

Figure 6-6 shows both the industry-adjusted mean differences in strategic changes before and after CEO turnover. All the results are based on a seven-year event window around the turnover and exclude changes that take place the year of the turnover, as it was not possible to accurately attribute all the changes in the turnover year to either the predecessor chief executive or successor chief executive. The results in Figure 6-6 show that along the five strategic changes examined, unadjusted changes are consistent in both direction and magnitude with the industry-adjusted changes suggesting no systematic industry-level effects on the results. I focus the discussion on the industry-adjusted results.

While the previous discussion on relying on comparative differences between firms across turnovers focused on the problem of regression to the mean when examining performance, here regression to the mean is not a problem. Recalling that problems with regression to the mean are associated with the view that extremely high or low values are likely to revert to the average level, the question emerges as to whether strategic changes or choices are subject to these equilibrating forces. With respect to strategic changes, however, it is not likely, particularly in

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the short-term, that these changes are subject to equilibrating forces that tend extreme values toward the average level. Empirical research has shown that strategic differences across firms, even those within the same industry, endure over many years (Nanda, 1996).

The first column of Figure 6-6 shows that there were significant changes in most of the strategy measures after CEO turnover. Following any kind of CEO turnover, firm employment declined an average 8.9% ($p<.01$). There is also a significant increase in restructuring activities following a CEO turnover; on average, firms engaged in 2.8 ($p<.05$) more acquisitions in the three years following turnover compared to the previous three years. There is also a significant increase in the firms leverage ratio of 7.8% ($p<.10$) following CEO turnover. This is consistent with the secular trend of rising debt levels during the period of the study. The only strategic change that did not show a significant change following turnover is capital expenditures (-.9%). Overall, the findings suggest that CEO turnover is associated with several strategic changes in subsequent years.

In sum, there is a surprisingly strong similarity in the types of strategic changes that followed CEO turnover regardless of its type. These findings are inconsistent with both the substantive and symbolic perspectives which both suggested that forced turnover followed by an outsider would result in the most changes and natural turnover followed by an insider would result in a continuation of the predecessors strategies. Both substantive and symbolic perspectives would predict greater variance in the direction and magnitude of the strategy changes depending on the type of turnover. Agency theory, as one example of the substantive perspective, would suggest that at least forced turnover should result in very different types of strategic changes and even a reversal in direction for many of the types of changes considered. Instead, the findings lend support to the perspective that the kinds of strategic changes that a new CEO can make are constrained. These constraints may arise because of resource dependencies (Pfeffer & Salancik, 1978) or institutional factors (Powell & Dimaggio, 1983).

6.3.5 Performance Consequences of CEO Turnover and Strategic Changes

This model looks at the combined effects of CEO turnover and strategic changes on firm performance. Again, a lagged OLS model, a fixed-effects model, and a random effects model are all examined. The model is specified as:

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$$Y_{it} = a + bx_{1it} + bx_{2it} + bY_{it-1} + bw_{1it} + e_{it} \qquad (3)$$

where:

Y_{it} is the change in performance for the ith firm in the tth time period

x_{1it} are dummy variables of the various types of CEO turnovers and cumulative strategic change

x_{2it} is the estimated probability of dropping out of the sample derived from equation (1)

Y_{it-1} is firm performance lagged one year

W_{1it} is 1 for ith firm, 0 otherwise (only included in the fixed-effects model)

Table 6-3 presents the results from the three models. The results are consistent across the models. I will focus the discussion on the random-effects model since it allows us to generalize the sample estimates to the larger population of firms.

The results from the first model show the effect of the total strategic changes made by the firm and the CEO turnover on firm performance. The second model examines the effect of the total strategic changes and forced versus natural turnover on firm performance. The third model examines the effect of the total strategic changes and insider-versus outsider successors. In the fourth model the combined effects of different types of turnover and total strategic changes on firm performance are presented.

The results of the random-effects model both complement and are consistent with the previous analyses. Models 1 through 4 on Table 8 show that the strategic changes undertaken by a firm following CEO turnover have a positive effect, independent of the type of turnover, on firm performance (.4%, $p<.01$). This finding is consistent with the substantive perspective that CEO turnover serves as an opportunity for a firm to take different strategic actions that can have a positive impact on firm performance. However, the small size of the effect suggests that strategic effects account for only a small proportion of the total performance change. Additionally, the fact that the value of the strategic change coefficients is consistent across the four models suggests that these differences are constant across the different types of turnover and, therefore, do not support the expectation for variance in the types of strategic changes following different types of CEO turnover predicted by either the substantive or symbolic perspectives.

Models 2, 3 and 4 show the impact of different types of turnover on performance. The results indicate that when controlling for strategic changes, the type of turnover has significant

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consequences for firm performance.

Model 2 shows that forced turnover leads to a positive, but not a significant improvement to firm performance (.3%, p<.32). Natural turnover leads to a small positive and significant improvement in performance of 1% (p<.10).

Model 3 examines the consequences of insider-versus-outsider successors for firm performance. Insiders have a small positive and significant effect on performance of 1% (p<.10). Outsiders seem to have no effect (.1%, p<.92).

Model 4 compares all four turnover conditions to the baseline of no turnover. The results are consistent with the previous analyses in that they clearly show that despite the similar amount of strategic change across the turnover, the performance outcomes are quite varied. Forced turnover followed by an insider and natural turnover followed by an insider do not significantly impact performance, thus weakening the support for the substantive perspective which suggests that forced turnover is likely to result in some performance improvement. In those firms where forced turnover is followed by an outsider, there is significant performance improvement of 3.4% (p<.01). But in those cases where natural turnover is followed by an outsider, there is significant performance decline of 6.0% (p<.05). Again, these values are not significantly different from the results of either the fixed effects or lagged OLS models.

In sum, the results are highly consistent across the various analyses. These results neither support the substantive or symbolic perspectives of CEO turnover completely. The theoretical and research implications of these findings are discussed in the next section.

6.4 Discussion

This chapter examined the consequences of CEO turnover in large corporations. The results, which are consistent and robust across several models, do not completely support the dominant substantive or symbolic perspectives on CEO turnover. There is little empirical support for the symbolic perspective which asserts that CEO turnover will not affect firm performance. Rather, there is strong support showing that different types of CEO turnover does lead to differential effects on firm performance. However, contrary to the substantive perspective which does predict a linkage between CEO turnover and firm performance, these changes cannot be

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accounted for by differences in the types of strategic actions new CEOs introduce. Moreover, the performance consequences are not in the predicted direction or order suggested by the substantive perspective. What is left is a paradox: even though the strategic changes that results from different types of CEO turnover are similar, the performance consequences of these events varies significantly and in ways not predicted by the existing perspectives.

Because these findings are contrary to current theoretical expectations, it is important to discuss limitations of the study and to consider alternative explanations. After that, I will return to a discussion of the broader theoretical implications of the study.

The first limitation of the study is that in contrast to the earlier chapters, I rely on purely quantitative analyses and somewhat coarse measures for strategic changes. While the employed measures capture the magnitude and type of strategic changes that follow CEO turnover, they do not capture the qualitative aspects of these changes. Examples of these qualitative aspects include whether the strategic changes are appropriate and to what extent that they depart from the firms existing strategic trajectory. It is possible to argue, for instance, that what really matters is not whether a firm divests itself of a business unit or not, but which business unit is divested. Such considerations are important. One could reasonably expect that outsiders, for example, are more likely to make superior changes because they bring a fresh or new perspective to the firm and can break the frame that traps insiders. If this were the case, however, one would expect that in all turnover conditions, bringing in an outsider should improve firm performance relative to insiders. The results do not support this expectation because not all outsiders do equally well. While outsiders do well if they succeed a fired CEO, they do poorly if they are brought in after a natural turnover.

A second potential limitation of the study is that the substantive effects considered in the form of the strategic changes, are incomplete. One could argue that critical strategic changes that could account for the observed differences in performance have been omitted. On the other hand, the comprehensive set of strategic changes that are considered are commonly described in research as critical to affecting firm performance (see Denis & Denis, 1995 as one example of such a comprehensive study). If performance is significantly affected by strategic changes not considered here, this suggests that much of the empirical literature on CEO turnover, because it has focused on the wrong strategic variables, should be reconsidered.

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Another alternative explanation for the results might be that small or marginal differences in the magnitude of strategic changes have significant performance consequences. Another alternative explanation for the results may be that small or marginal differences in the magnitude of strategic changes have significant performance consequences. It could be argued, for instance, that while a 15% reduction in workforce may not be statistically significant from a 10% reduction, the impact of the additional 5% reduction of the workforce may be quite significant because performance differences lie at the margin. Again, although plausible, this alternative explanation does not square well with the findings. Some of the strategic changes that are examined suggest that the magnitude of change introduced by an outsider following a natural turnover exceed the amount of strategic change introduced by an outsider following a forced turnover. With respect to downsizing as Figure 6-6 shows, natural turnover followed by an outsider results in a 26% reduction in employment whereas a forced turnover followed by an outsider results in an average 17% reduction. These two employment reductions are much greater than those initiated by insiders. These marginal differences might lead us to expect that all outsiders improve performance than insiders and that an outsider following a natural turnover could do even better than outsider following a forced turnover. The results, however, don't support the predictions that follow from this alternative explanation.

Finally, one can argue that the findings are a consequence of sample selection bias. That is, the sample of the Fortune firms represents a unique population distinct from other organizations. While this may be the case, a recent paper by Borkhovich, Parrino, and Trapani (1996) found strikingly similar results with a sample of 588 large firms with 969 turnovers. These researchers found that, on average, shareholders benefit from outside appointments following forced turnover, but are harmed when an outsider replaces a retiring CEO. Further evidence that the results are not attributable to sample selection bias or drawing on a small sample is presented in Figure 6-7. The figure presents the full 850 large corporations and presents the effects of different types of CEO turnover on subsequent firm performance. While it would be prohibitively expensive to collect data for the strategic actions of 850 companies, the results for the 850 companies are consistent with the findings across all turnovers.

In summary, while there are limitations to the empirical design of this chapter, the robustness of my findings suggest performance results consistent with substantive perspectives and

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strategic consequences consistent with symbolic theories. Such findings indicate the need for further empirical study which I outline in the concluding chapter.

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Figure 6-1: Substantive Model of CEO Change

	1	2	3	4	5	6	7	8	9	10	11	12
1. Forced Insider	1											
2. Forced Outsider	-.0067	1										
3. Natural Outsider	-.0065	-.0046	1									
4. Natural Insider	-.0206	-.0144	-.0140	1								
5. Total Strategic Changes	.0189	.0247	-.0094	.0976*	1							
6. Employment changes	-.0259	-.0033	-.0194	-.0137	-.0252	1						
7. Research & Development	.0135	.0244	-.0212	.0078	.0295	.0423*	1					
8. Capital Expenditures	.0116	.0154	-.0017	.009	.0327*	.0420*	.1416*	1				
9. Restructuring Activities	.0782*	.0227	-.0415	.028	.1485*	-.0414	-.1291*	.0736*	1			
10. Debt to Equity Ratio	.0098	.0861*	.0123	-.0111	-.0018	.0018	-.0235	.0085	.0603*	1		
11. Operating Performance	-.0396	-.0147	-.0290*	.0399*	-.0179	.0637*	-.0197	.1050*	.0606*	-.0728*	1	
12. Hazard Rate Correction	.1051*	.0239	-.0019	-.0185	-.0092	-.1544	.0328	-.1143*	.0264	.0847*	-.5986	1

Table 6.1: Correlation Table

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Figure 6-2: Firm Characteristics for the Fortune 200 from 1978-1993. CEOs who vacate the position prior to age 60 and who do not leave for other employment or for health reasons who are reported by the Wall Street Journal or New York Times or Business Week to have been forced from their positions are classified as having been forced out. CEOs who join the firm within one year of succession are classified as outsiders. ROA is the ratio of annual earnings before interest and taxes to total assets.

	Firm Characteristics		
	Median ROA year prior to turnover	Median percentage of outside directors	Median sales in the year of turnover (millions)
All firms	+.017%	72.22%	4109.14
All turnovers	+.025	71.01%	5783.85
Voluntary departures	+.028	72.47%	5659.15
with insiders	+.030	71.43%	5263.39
with outsiders	+.001	75.00%	8701.59
Forced departures	+.022	64.29%	7597.62
with insiders	+.008	62.50%	7859.37
with outsiders	+.001	68.75%	7109.70

Figure 6-3: CEO Turnovers. CEO turnovers are classified as forced if the stated reasons for the change are forced by the board or poor performance. Turnovers are classified as natural if the stated reasons are retirement or departure for another position. CEO successors are classified as outsiders if they had been with the firmless than one year.

		Context	
		Forced	Natural
Successor	Insider	29	159
	Outsider	17	16

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Figure 6-4: Changes in Operating Performance Surrounding CEO Turnover. Operating performance is measured as the ratio of operating income before depreciation and taxes to total assets (OIBD/TA). The data below presents the industry-adjusted changes for 222 CEO changes between 1978-1993. Significance of mean differences from zero measured using standardized two-tailed tests.

Panel A

Year	n=46 Forced	n=176 Natural	n=189 Insider	n=33 Outsider
-3 to -1	+.022**	-.003	-.001	+.020**
-2 to -1	+.009**	-.002	-.005	-.006
-1 to 0	-.010	-.003	-.003	-.012
-1 to +1	.007	+.001	+.002	-.022
-1 to +2	+.013	+.004	+.006	+.005
-1 to +3	+.013	+.004	+.006	+.005

Panel B

Year	n=29 Forced Insider	n=17 Forced Outsider	n=159 Natural Insider	n=16 Natural Outsider
-3 to -1	+.018**	+.028	-.005	+.011**
-2 to -1	+.008**	+.011	-.002	+.002
-1 to 0	-.013	-.005	-.002	-.020
-1 to +1	-.003	-.016	+.002	-.028**
-1 to +2	+.001	+.042**	+.007	-.049**
-1 to +3	+.001	+.042**	+.007	-.049**

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Figure 6-5: Multinomial Logit CEO Turnover Models. The models are estimated using data from the Fortune 200 sample of turnovers between 1978-1993. The results with respect tot he independent variables and the p-value for a two-tailed test of the null hypothesis test that the model coefficient equals zero are reported in the parentheses. CEOs who vacate the position prior to the age of 60 and who do not leave for other employment, health, or death reasons are coded as forced. Two outcomes: (1) turnover and (2) forced. Number of observations=1598. Model chi-square=20.52 (pvalue=.001).

	Intercept	%Institution Holdings	Log of Sales	Performance year-1	Performance year-2	Performance year-3
(1) Turnover	-3.336 (.001)	+.000 (.038)	+.142 ('.178)	-5.158 (.032)	+4.032 (.200)	+.776 (.300)
(2) Forced	-5.842 (.003)	-.019 (.124)	+.317 (.112)	-15.240 (.000)	+8.641 (.132)	+3.513 (.682)

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	Lagged OLS	Lagged OLS	Lagged OLS	Lagged OLS	Fixed Effects	Random Effects
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Constant	+.014***	+.014**	+.014**	+.014**	+026***	.013***
	(.005)	(.005)	(.005)	(.005)	(.005)	(.005)
Turnover	+.009**					
	(.004)					
Forced		0.003				
		(.010)				
Natural		+.010**				
		(.005)				
Insider			+.010*			
			(.005)			
Outsider			-0.001			
			(.001)			
Forced-Insider				-0.016	-0.014	-0.016
				(.012)	(.001)	(.012)
Forced-Outsider				+.036**	+.037***	+.036**
				(.016)	(.015)	(.016)
Natural-Insider				+.015***	0.011	+.015**
				(.005)	(.005)	(.005)
Natural-Outsider				-.061***	-.047***	-.059***
				(.005)	(.018)	(.020)
Prior Performance	+.692***	+.692***	+.692***	+.692***	+.270***	+.660***
	(.029)	(.029)	(.029)	(.029)	(.033)	(.029)
Hazard Rate	-.045*	-.046*	-.044*	-.045*	-0.035	-0.038
	(.027)	(.027)	(.027)	(.027)	(.026)	(.026)
R-square	0.46	0.46	0.46	0.46	0.46	0.47

Table 6.2: CEO Turnover and Firm Performance

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Figure 6-6: Strategic Changes Surrounding CEO Turnover. Reports characteristics of strategic changes before and after CEO turnover. Significance of changes ismeasured using a two-tailed means differences test. Scheffe's test is a pairwise comparison of differences in group means that allows us to compare whether differnces across the types of turnover are significant. Scheffe's test penalizes comparisons of differences from the same sample so as not to overestimate signficiances (p<.05).

Type of Turnover	Turnover Alone	(1) Forced-Insider	(2) Forced-Outsider	(3) Natural-Insider	(4) Natural-Outsider	Scheffe's Test
A. Employment Level Changes						
Industry-Adjusted	-.071***	-.030	-.171*	-.063**	-.264*	(4,1)
Unadjusted	-.089***	-.002	-.175**	-.091***	-.230**	(4,2)
						(4,3)
B. Research & Development/Sales						
Industry-Adjusted	+.004**	+.005	-.000	+.004**	+.002	None
Unadjusted	+.006***	+.008	+.002	+.006**	+.001	
C. Capital Expenditures/Sales						
Industry-Adjusted	-.004	-.011	-.021	-.001	-.008	None
Unadjusted	-.009*	-.025	-.035	-.004	-.019	
D. Corporate Restructuring						
Industry-Adjusted	+2.77**	+3.70	+1.67	+2.80**	+3.00	None
Unadjusted	+1.99**	+2.40	+1.00	+1.96**	+2.30	
E. Debt/Equity						
Industry-Adjusted	+.776*	+1.38	+3.32	+.511	-.029	None
Unadjusted	+.913**	+1.42	+3.29	+.693	.166	

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	Random Effects	Random Effects	Random Effects	Random Effects	OLS Lagged	Fixed Effects
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Constant	+.006	+.006	+.006	+.006	+.006	.020**
	(.006)	(.006)	(.006)	(.006)	(.005)	(.005)
Turnover	.007					
	(.005)					
Forced		+.003				
		(.010)				
Natural		+.009				
		(.005)				
Insider			+.009**			
			(.005)			
Outsider			-.001			
			(.013)			
Forced/Insider				-.015	-.014	-.013
				(.012)	(.012)	(.011)
Forced/Outsider				+.034**	+.034**	+.036**
				(.016)	(.015)	(.015)
Natural/Insider				+.014**	+.014**	.013**
				(.005)	(.005)	(.005)
Natural/Outsider				-.060***	-.061**	-.059**
				(.020)	(.020)	(.020)
Prior Performance	+.640***	+.641***	+.640***	+.659***	+.700**	.272**
	(.030)	(.030)	(.030)	(.029)	(.027)	(.033)
Hazard Rate	-.039	-.046*	-.044*	-.045*	-.045*	-.045*
	(.027)	(.027)	(.027)	(.027)	(.027)	(.027)
Strategic Actions	+.004***	+.004***	+.004***	+.004***	+.004**	+.003*
	(.001)	(.001)	(.001)	(.001)	(.001)	(.001)
R-square	.46	.46	.46	.46	.48	.46
n	1598	1598	1598	1598	1598	1598

Table 6.3: CEO Turnover, Strategy and Performance

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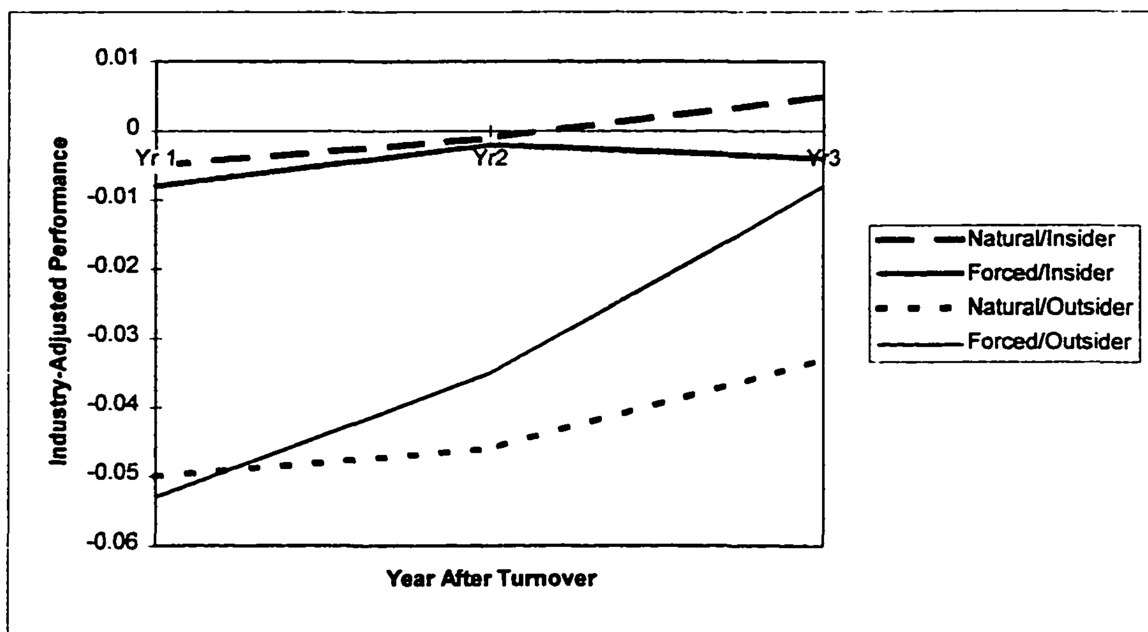
Figure 6-7: PERFORMANCE CHANGES FOLLOWING TURNOVER. Industry-adjusted performance, measured as operating returns, for the 850 firm sample. Performance results are measured for one year, two years, and three years after the turnover.



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Chapter 7

Conclusion and Implications for Research

I have argued throughout this dissertation that as a universal organizational process, the event of leadership succession and the problems surrounding it can be analyzed using sociological theory and tools. As Grusky (1960: p.115) notes: "The vital problem of organizing and interrelating the general variables relevant to administrative succession...still-remains as one of the fundamental necessities of a fruitful approach to the study of formal organizations." The wave of CEO changes during the 1980s and early 1990s and the inability of sociological theory to explain–let alone predict–these events highlights the need for sustained research on this topic.

My purpose in this dissertation was to make a contribution to research on administrative succession by examining CEO changes in large, publicly held corporations during the period of 1980-1996. I conceptualize CEO change as consisting of three phases. First, the factors that lead to forced versus natural turnover. Second, the factors leading to insider versus outsider succession. And, finally, the effects of turnover and succession on a firm's strategies and performance. At the most general level, my findings suggest that the two leading theoretical schools that potentially inform our understanding of CEO succession–managerial theory and agency theory–conflict on many points, but share a similar direction of theorizing that understates the importance of several key actors in the CEO succession process. By examining the roles of directors, director interlocks, executive search firms, and top managers in the CEO succes-

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sion process and by combining both field data and quantitative analyses, this study sought to contribute to a more informed debate about CEO change.

Below, I summarize my findings and implications for future research concerning turnover, succession and its consequences for firms.

7.1 Summary of Findings

7.1.1 Forced versus Natural CEO Turnover

My research on dismissals reveals the intensely political nature of CEO firings. I developed a model to examine the main factors which affect the CEO firing process. My findings demonstrated that while performance is linked to CEO dismissal, this relationship is mediated through both internal and external corporate disciplinary mechanisms. These disciplinary mechanisms affect the distribution of power among the primary actors in the CEO firing process–the CEO, the board, and shareholders.

Results show that as CEOs institutionalize their power, their risk of dismissal declines. I found that while the risk of CEO firings increases during the early part of tenure, this risk declines significantly over time. Other factors that reduce the rate of CEO dismissal are when the CEO is also chairman of the board and is the founder of the company.

A CEO's power, however, cannot be assumed to remain unchallenged. I found that poor performance can create conditions under which CEOs are at an increased risk for being fired. The relationship between poor performance and CEO firing, however, is not direct. Rather, it is mediated by both internal governance mechanisms, such as board composition, and external governance mechanisms, such as the takeover market. For example, I find that it is not simply the proportion of outside directors which increases the risk of CEO firing, but the proportion of professional outside directors. Professional outside directors are those directors who sit on more than one board. Because professional directors are independent of any one CEO for board membership and are more sensitive to the reputational consequences of their actions, they are more likely to take dismiss a poorly performing CEO.

My findings also suggest that the relationship between insider director-managers is more complex than suggested by current theories. While inside directors are likely to be loyal to

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an incumbent CEO, this loyalty is likely weakened when poor CEO performance threatens the career interests of the inside managers. I find that as performance declines, insider directors can exert a positive effect on the likelihood of CEO dismissal. This finding is also important since it suggests that the internal competition among managers for scarce managerial positions is a critical, but often neglected governance mechanism.

Finally, my findings also point to the importance of the capital markets in stimulating boards to take actions against poorly performing CEOs. I find that the overall rate of CEO dismissal rose with the increased takeover activity of the 1980s. My research suggests that an active market for corporate control can trigger the latent legal power that a board has over a CEO. This suggests that the capital markets create an important disciplinary mechanism against poorly performing CEOs. Unlike product markets, where the success of a product or strategic initiative is measured over a period years and involves dynamic interplay with a defined group of competitors in the industry, capital markets are swift and immediate in their reaction to firm performance.

7.1.2 Insider versus Outsider Selection

In Part II of the dissertation, I focused on the factors affecting insider versus outsider CEO selection. I first examined the role of executive search firms (ESFs) in the external CEO selection process. I then examined the role of directors in the external versus internal selection process. My research suggests that the ability of a board to collect information on potential external candidates and an ESF's ability to coordinate between a searching firm and potential candidates is key to understanding the insider versus outsider selection process.

Information is a key component necessary to match any CEO candidate–internal or external–to a job. Typically, directors have the best information on insider candidates. Information about external candidates is often sparse and cannot easily be collected through traditional sources, such as observation or internal human resource systems. Contrary to the popular belief that executive search firms collect and provide detailed information about external candidates to boards, my findings reveal that it is the directors searching for a CEO that collect most of the information about external candidates. Directors rely on their contacts with other board members to collect information about potential candidates. These connections, created through

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interlocking directorships, allow directors to get detailed information from other directors who have had direct experience or contact with a potential candidate. Consequently, I find that controlling for factors such as performance and board composition, those firm's boards which are at the center of intercorporate director networks are most likely to appoint an outsider CEO.

My findings suggest that the major role of ESFs in the CEO search is as intermediaries to a complex labor market exchange. This intermediary role arises as a consequence of the special nature of the CEO labor market and the relationships between CEO candidates, ESFs, and the firm searching for a CEO.

The intermediary role of ESFs consists of three important functions: coordinator, mediator, and legitimator. The role of coordinator is one in which an ESF draws on its experience to assist a searching firm's board, which has more limited experience with CEO search. In the role of mediator, the ESF manages a gradual, synchronized, and escalating commitment process during which both candidates and the searching firm gain each others trust through exposure to equal levels of risk. And, finally, the ESFs involvement provides a sheen of professionalism that legitimizes what is, otherwise, an opaque and discrete process.

7.1.3 Strategic and Performance Consequences of CEO Turnover

The final section of the dissertation examined the impact of CEO turnover on subsequent changes to a firm's strategy and performance. I suggest that existing theoretical approaches concerning the consequences of CEO turnover can be broadly classified as either substantive or symbolic in their orientation. Substantive theories, such as agency theory, suggest a tight coupling between changes in firm performance, CEO turnover, subsequent strategic choices and subsequent performance. Symbolic theories, such as new institutionalism, suggest that while CEO turnover and strategic choice may be motivated by changes in firm performance, their real effects for subsequent performance are negligible.

My findings suggest that neither perspective adequately accounts for the types of strategic and performance changes we see following different types of CEO turnover. I found that strategic changes, across any type of turnover, are similar in direction and magnitude. These changes, however, do not account for the variance in performance we find across different types

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of turnover. Specifically, I find that while forced turnover followed by an outsider results in an average performance improvement for the firm, natural turnover followed by an outsider results in an average performance decline. I find no significant change in performance for either natural turnover followed by an insider or forced turnover followed by an insider.

I conclude that these empirical findings are theoretically problematic. First, substantive theories, such as agency theory, would predict greater variance in the types of firm strategies pursued following different turnover conditions. Second, symbolic theories, such as new institutional theories, would predict no performance changes following any of the CEO turnovers. Third, neither theory would suggest that whether a CEO was fired or retired would effect outsider CEO's effectiveness.

I discuss the research implications of the above findings in the next section.

7.2 Implications for Future Research

While all three parts of this dissertation contribute to the CEO succession literature in their respective areas, they also point to many additional areas for further research.

Part I of the dissertation explored and extended the most developed area in the CEO succession literature–the determinants of forced CEO turnover. While this area has been well developed, my findings reveal the resources that CEOs have at their disposal to insulate themselves from the effects of firm performance. One finding that was particularly intriguing was the countervailing power of interlocked directors against entrenched CEOs. I found that shared directorships provided autonomy for directors from any one CEO and are also a mechanism through which pressure from other directors can be exerted to affect director behavior. However, there are also other sources of social influence that have not been studied that can affect CEO firings.

One source of social influence potentially impacting the CEO dismissal decision are securities analysts. Zuckerman (1997) argues that analysts exert a great deal of influence on the activities of corporations. Specifically, because of their unique position between buyers of securities (e.g. stockholders and institutional investors) and sellers of securities (e.g. corporate firms), they exert a great deal of influence on the perceived quality of a firm's management

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and its future prospects. Recent research in the area of capital markets finds that the release of analyst reports has significant implications for a range of organizational behaviors, such as the buying and selling of a company's shares, movement of stock price, reduction of shares held by individuals, divestitures of unrelated businesses, the market advantage of institutional investors over individual investors because of earlier access to analyst reports, and, increasingly, the decisions made by a firm's competitors and its own management. Consequently, it is likely that financial analysts are likely to exert influence in one of the most crucial areas of corporate behavior–CEO dismissal. The nature of this influence, however, remains to be theoretically specified and tested.

A second possible source of social influence that can impact corporate behaviors is the business media. There is little question that the media and business are important elements in U.S. society. Researchers in both mass communication and organizational sociology suggest that there likely exists a strong relationship between these two areas. The nature of this relationship remains to be theoretically specified (one attempt is Hirsch, 1986). For example, research in mass communication suggests that the role of the media in the United States has changed dramatically. In the 1960s the media was largely a public informant and today it is seen as a crucial mechanism for creating public opinion. As a consequence, one can hypothesize that the business media now exerts a great deal of social influence on organizational actors and participants. With respect to CEO dismissal, the focus of the media spotlight on a particular firm's performance, management, or board may significantly shape the types of actions that are taken by organizational actors such as directors or managers.[1]

In Part II of the dissertation, I examined a little explored area of CEO succession–the factors affecting insider versus outsider CEO succession and the role of executive search firms in external CEO search. My findings point to the critical role that information plays in the CEO selection process and the conditions that lead to the participation of intermediaries in markets.

My findings about executive search firms as intermediaries in the labor market for executive talent opens up a vast area for future research. It has been assumed that intermediation

[1]Since my research on firings suggests that the currency in the market for directors is reputation, the impact of the media on creating and diffusing reputational capital is another area worthy of exploration.

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can be treated like any other economic activity. In contrast, I suggest that specific market conditions in the labor market for CEOs creates the need for the participation of a third party intermediary. The presence of an intermediary in this labor market suggests that many preconceptions that one might have on the basis of standard microeconomic theory are wrong. For example, the Walrasian theory of perfect competition, upon which most labor market economics is predicated, is based on assumptions that eliminate the very need for private intermediation between employers and potential employees. Instead, one of the main theoretical implications of this section is that markets may require a good deal of organization. That is, just as producing goods and services consumes resources, so does the establishment and operation of markets to allocate those goods and services. This too runs counter to the view implicit in much of the economic literature, which is that markets are largely self-organizing.

My description of the process by which external CEOs are identified and selected suggests the need for future research on what we mean by the term "market." Clearly, the market for CEOs is not like the market for, say, oranges. My research suggests that the term market is often used indiscriminately and that there are in fact numerous types of "markets" that do not conform to the traditional economic definition. For example, in the CEO search process institutional forces play an important role in defining both the boundaries of exchange and the appropriate behaviors among the individual participants to the exchange. As such, future research needs to develop more refined categories for the array of exchange arrangements that exist in society and how these arrangements either conform or deviate from the economic definition of markets.

The presence of intermediaries in the executive labor market also has significant implications in the arena of economic sociology. In classical economic models, there is a puzzling absence of a mechanism through which wages adjust to clear markets. Instead, firms simply react to wages. But in practice it seems that companies and intermediaries have at least some power over wage setting due to a variety of factors not usually discussed in labor market research. Examples of such factors include: the number of participants in a market, the costs of reversing a decision, and the cost to participate in a market transaction. As a consequence, a focus on intermediaries and the contexts within which they arise can help shed light on the different kinds of institutional arrangements we see in labor markets.

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The research on the process for identifying CEO candidates also sheds light on previously ambiguous theory about who is searching for a job and who is "in the market for a job." My findings raise questions about whether employment, labor force, and job vacancy statistics for white collar management, as we currently construct them, map to the reality of how individuals and firms connect with each other. This also opens up a whole new research area with respect to examining transitions among various states of labor force mobility.

Finally, the research in this section opens up an avenue of research related to stratification and the equality of opportunity. Few dispute the proposition that equal opportunity in most economies has not been achieved. There remains substantial inequality by race, gender, and ethnicity, particularly in the upper echelons of corporate management. My field data suggests this inequality may be related to the structure of executive labor markets which creates aspects of what Max Weber referred to as "closure of economic relationships." Some aspects contributing to closure in the executive labor market, but requiring further study include: the demographic similarity of the participants in the executive labor market–executive search consultants, executives, and directors; the process by which executive search firms sort and create candidate lists for various positions; the availability of particular information about candidates in the executive labor market; and the difficulty of signaling quality in the executive labor market through traditional mechanisms, such as education.

In Part III of the dissertation, I examined the strategic and performance consequences of CEO turnover. My empirical findings highlight the need to reconceptualize existing theory to explain the consequences of CEO turnover. While my results are consistent with those theorists who argue that a more active market for top management will lead to improved performance, the findings suggest that the underlying mechanism for how chief executive turnover affects firm performance goes beyond differences in the type of strategic actions employed.

Future research on this topic should consider the possibility that CEO turnover impacts organizations in a more subtle way than simply changes to a firm's measurable strategies. In addition to changes to strategy, a CEO successor may also disrupt the existing political coalitions within an organization by either strategically replacing subordinates or changing the number of formal executive positions reporting to the CEO. For example, a hypothesis to test in future research is that forced outsider succession will result in a greater amount of

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top management team change than does a forced outsider succession. In this instance the replacement of persons in the top management team may enable the outsider CEO to (1) get rid of those old executives who are loyal to the predecessor; (2) subdue those on the executive team who might oppose the new CEO's policies; and (3) bring in new individuals who are loyal to the new CEO.

Another area related to the consequences of CEO turnover that remains to be examined is the relationship between the personal characteristics of a new CEO and the characteristics of the organization. A new CEO's effectiveness will likely depend on how well their are equipped to deal with the contingencies and problems faced by the organization. Consequently, if succession is related to organizational contingencies, the question of the effect of succession on organizational success can be investigated using a contingency theory.

7.3 Implications for Practice

The dramatic changes in the corporate landscape of the last few years are reshaping the face of corporate America; the new corporate lexicon is EVA, takeovers, globalization, and, of course, the mantra of the last decade, shareholder value. As a consequence the performance standards for CEOs have gone up substantially in this new era, and the performance standards for directors must too–not just for legal reasons–but because director passivity in today's world can threaten the survival of the corporation. As evidenced by the dismissal of CEOs at once managerially autonomous corporations like IBM, GM, and Kodak, it is clear that a transition is underway in the relationship between the board and the CEO. Making this transition, however, is formidable. The managerial autonomy that characterized the last fifty years created an environment where directors were largely pawns–to use the words of Jay Lorsch and Elizabeth MacIver (1989). However, I believe my research does suggest some prescriptions toward the objective of making boards more diligent and autonomous from CEOs. I want to discuss the most obvious and easily implementable here–structural changes in board appointments.

There is a well-intentioned movement underway among institutional investors and academics which recommends that board members should serve on as few boards as possible, preferably one or two (Institutional Shareholder Services, 1995 p. 3.11). The recommendation is based

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on the theory that because director time is scarce and the governance of organizations time intensive, directors who serve on fewer boards will be more effective than those directors who sit on many boards. Consequently, it is hypothesized that such directors will more effectively monitor a firm's performance and a firm's management. My findings suggest that such reasoning can, in fact, lead to weaker corporate governance.

While there are obviously diminishing–or even negative–returns for directors sitting on too many boards, my research points to the fact that multiple directorships can provide many benefits that have previously been overlooked but are critical to effective corporate governance. Multiple directorships are a source of independence. Directors who sit on only one or two boards are more beholden to a single CEO for their status as board members. Consequently, multiple board memberships give directors autonomy from any single CEO and, therefore, provide directors with a way to take disciplinary actions against a poorly performing CEO without fear of losing their status as board members within the larger community of directors.

A second practice that firms can easily implement is the appointment of at least one or two non-CEO inside directors to the board. Again, this practice goes against current recommendations. Institutional investors, such as Calpers, suggest that the CEO should be the only inside board member. My research points out that such a board structure creates an impediment for outside directors to have access to timely and relevant information about a firm's performance. Because in most American boards the CEO and chairman are the same person, they have enormous power in controlling the type of information that directors have access to. By putting other insider executives on the board, alternative communication and information channels into the firm are automatically created within the boardroom. Additionally, putting insider board members relates directly to the process of CEO succession. The presence of insider directors reveals the management depth of the company to outside directors.

Placing more active outside directors on the board along with inside directors is not without its challenges. Putting active and professional outside directors can add complexity to an arena which has traditionally been under absolute control of the CEO. First, there is likely to be more conflict and disagreement within the boardroom. Professional directors will likely insist on non-executive board meetings, independent search committees, and more timely access to firm data. Such demands can create an uncomfortable situation for a CEO who is not used to

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having their authority challenged.

The presence of inside directors, who are effectively competitors for the CEO's position, can also create problems inside the boardroom. The discussions during board meetings may become less about addressing the firm's issues or problems and closer to becoming status contests among the CEO and those vying for his or her position. Because there are winners and losers in such competitions, and losers suffer status losses and negative emotions, such a situation can lead to unhealthy conflict in the boardroom.

While the above recommendations have their implementation challenges, my research suggests that these challenges can be overcome. Both directors and CEOs are becoming increasingly receptive to change within the board room. Almost every director and CEO I met with during my field research was hungry for suggestions about governance practices that could improve their board's effectiveness and send a positive signal to the capital markets. As my research suggests, changing the structure and operation of the board–particularly through the presence of activist outsider and insider directors–can enhance the ability of these firms to respond to the managerial challenge of CEO succession.

* * *

No society can be better than the quality of its leadership. Almost every aspect of a society's quality of life depends on how good its leaders are. That is never more true than today. The end of the Cold War has ushered in a new era in which private corporations have become the most important institutions in society. As a consequence, we cannot afford to ignore the processes governing the selection and succession of the individuals who sit on top of these institutions. There is too much at stake. Private corporations now interpenetrate almost every sphere of modern life. We depend on such organizations for much of our welfare and livelihood. As a consequence, the study of organizations and the process by which those who run them are selected is an important subject. It not only contributes to academic knowledge, but has broader social value as well. My goal in this dissertation was to take a step toward explicating this subject. But as my list of implications for future research indicates, this dissertation is merely the beginning of a journey.

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Appendix A

Research Setting and Strategy

While the role of executive search firms, sometimes called "headhunters", in placing people in jobs has been widely acknowledged in the business press, very little has been written about this type of organization in the academic literature. A noted exception is Martinez's (1976) excellent, but dated, description of employment firms. However, even in this exceptional work, Martinez pays no attention to executive level search.

A.0.1 Executive Search Firms

Executive search firms are defined as professional service firms whose primary mission is assisting organizations in the search and recruitment of executive management. Globally, executive search is a $3.5 billion dollar industry. Close to half that revenue is generated in the USA, where search firms are used about four times more often than in Europe (Jenn, 1995). While it is difficult to obtain exact numbers on how many positions are filled by recruiters, the recent National Organizations survey reported that between 13 and 20 percent of all establishments "frequently" use agencies (Kalleberg et. al, 1996) .

The largest executive search firms (ESFs), a subset of the broader recruiter category and the focus of this section, are most significantly differentiated by their geographic reach, private sector focus, multiple industry experience, and specialization in the recruitment of senior management and boards of directors (see Table 2). These firms are distinct from the contingency headhunters which usually fill mid- and lower-level managerial jobs, as well as professional, technical, and office-support jobs (Cole, 1985; Lucht 1988).

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The core task of executive search firms is well defined and similar both within and across these large firms (see Table 2). Executive search consultants are motivated to complete an assignment successfully in order to maintain a continuing relationship with clients with whom they depend on for their retainer and additional fees . This similarity in goals and payment structure facilitates comparative research, since firm differences are not confounded by differences in tasks.

A.0.2 Analytic Strategy

Archival, interview, and observational data were collected over a two year period (1995-1997). I rely on archival data to document the historical and institutional foundations of the industry. Examples of this data include industry newsletters (e.g. Executive Recruiter News), company brochures, industry directories, materials from industry conferences, and newspaper articles discussing the industry. Additionally, I use the few available popular texts on executive search firms as reference material for historical and news items that discuss the industry.

For the discussion of the specific role of executive search firms in CEO succession, I rely on interview data that I gathered, as well as on my reading of multiple case studies provided by the executive search firms. These data were collected from three separate search firms over a two year period. The firms studied are the largest executive search firms; together, they fill close to 75% of all the executive assignments in the Fortune 500 . I collected over 100 hours of in-depth interview data. Interviewees were those search consultants who focused on CEO and board level recruitment. Additionally, I spent 50 hours conducting field observations of several CEO and director searches. The field observations involved watching several consultants do their work, sitting in waiting rooms, reading transcribed speeches given by the search consultants at various industry conferences, leafing through documents in the research libraries, and observing the interactions between candidates and consultants in the waiting rooms of the search firm. In both the interview and field settings, I took extensive notes.

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A.1 Early History of a New Industry

The executive search industry emerged out of the post World War II economic boom. With the European economy in ruin, American industry found itself confronted with an unprecedented demand for its goods and services. This massive demand, in turn, fueled a demand for a large number of new executives to accommodate large corporations requirements for general mangers to run the booming factories of the United States (Chandler, 1977). As well, increased executive demand came from the powerful global financial industry which had completely shifted its center of activities from London to New York, and the emerging service sectors of transportation, communications, and retail.

While many of these companies had traditionally prided themselves on training and nurturing their own people to fill positions within the firm, the growth pressures on U.S. industry forced firms to turn to other firms for their best people. This emphasis on the demand by companies for executives, as opposed to a demand from would-be executives for jobs, is a critical difference of executive search firms from traditional employment services. In other words, these are not people looking for jobs, but rather jobs looking for people.

The earliest executive search firms, such as Boyden Inc. and Handy Inc., did not emerge overnight. Rather, their roots lay in another postwar phenomenon–management consulting. In the industry's early days, Booz, Allen & Hamilton and McKinsey & Co. dominated the management consulting business, which by the 1940s was advising top executives on corporate strategies . As management consulting continued to gain legitimacy within corporate America, the question often arose who would actually implement the necessary strategies which these consulting firms recommended.

This led to the initial phase of the emergence of the externally facilitated search, as management consultants developed in-house capabilities to deliver executive search functions. Independent search firms soon followed. Handy, for example, set up his executive search firm in 1945 after several years with McKinsey & Co. Similarly, Boyden left Booz, Allen & Hamilton's executive recruitment division to found his company in 1946.

While both Boyden Inc. and Handy Inc. were successful in building legitimacy for externally conducted executive searches among corporate chieftains, both remained relatively small firms confining their searches to geographic localities and charging on a contingency fee basis. For

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the next fifteen years, the executive search industry as a whole was fragmented and business was largely generated as a consequence of the founders connections. Most of these firms did not survive beyond the retirement of their founders . As a result, given the low barriers to entry into the business, there are, even today, literally thousands of search firms in the United States . It was not until the second phase of executive search in the 1960s that some rationalization of the business became evident.

This second phase was marked by the formation of the large executive search firms. Emerging out of the thousands of local search firms, there are today four dominant domestic players in the executive search business: Heidrick & Struggles, Spencer Stuart, Russell Reynolds, and Korn/Ferry. Three of these firms can trace their beginnings to the search departments of the major management consulting firms. Heidrick & Struggles and Spencer Stuart emerged out of Booz, Allen & Hamilton and Korn/Ferry from Peat Marwick. The fourth, Russell Reynolds, emerged out of the investment banking industry.

Three institutional factors influenced the dramatic growth of the Big Four companies. First, out of a concern for issues related to conflict of interest and maintenance of professional objectivity, management consulting firms exited the search business . The demand for executives, however, did not decline. Rather, corporate Americas demand for executive search was now filled by firms focused only on executive search. The firms at a distinct advantage to serve large, lucrative, reliable, geographically dispersed clients were those which (a) emerged out of consultancies in which prior relationships with clients had been established; (b) were organized as partnerships rather than sole proprietorships, thus, enabling them to create a career path for search consultants ; and (c) had developed branch offices around the country .

The second institutional factor which fueled the growth of the Big Four companies was the dramatic diffusion of the formal personnel function across large corporations. As Baron, Dobbins, & Jennings (1986) note, there was a dramatic increase in personnel departments across the corporate landscapes in the postwar period. What these researchers fail to make explicit, however, is that while the personnel function was becoming more complex, most personnel officers were viewed by their firms as ancillary and marginal to the strategic mission of the company.

While personnel departments could effectively recruit junior employees and managers, de-

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sign salary grades, and write job descriptions, they were not instrumental in promotion or selection decisions related to senior executives. The personnel function was [and continues to be] peripheral to the executive team and did not often have board status . Consequently, when personnel departments were being asked to search and select executives to positions considerably higher in both formal and informal authority than theirs, most lacked the ability to make effective decisions. Further, personnel departments facing new, complex government regulations on recruitment made personnel work more complex and managerial recruitment more difficult. Out of a concern for both maintaining privacy and preventing discrimination, there were many personal questions that could no longer be posed to a prospective employee, a problem that could now be partially overcome by employing a search consultant as an intermediary.

The third institutional factor was the dramatic rise of the MBA as a professional credential. The notion that the MBA education created a "general manager" altered assumptions that all executives had to be home-grown talent. The new "general managers" being produced by business schools were increasingly seen as interchangeable even across different types of industries . As a result, the corporate landscape was characterized by a new class of mobile managers willing to move for a promotion and a few thousand dollars. This group was distinctly different from the loyal corporate executive described in William Whyte's (1956) classic text, *The Organization Man.*

At the same time, it is important to note that the CEO position with only a few notable exceptions, remained sacrosanct. The idea of an outsider coming into the organization as CEO without at least a few years in senior executive ranks was close to heresy . The appointment of an outsider was seen as suspect and a failure on behalf of a company's board and executive management to develop competent executives. For example, Wall Street analysts jeered at the 1978 appointment of an outsider CEO at International Paper. Commenting on the fall of the stock after the announcement, one analyst stated that the outsider appointment "is the wrong decision for a company which has visibly underperformed in the paper market. They need a competent guy...who has experience in the forest products industry...IP hasn't had a chief executive who knew one end of a paper machine from the other" (WSJ, 1978). This attitude and Wall Streets reaction to firms appointing outsider CEOs was soon to change in the 1980s.

Today, we are left with a rather unique industry. Unlike most professional service industries,

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in search firms, there is no regulatory body which has the power to enforce qualifications on practitioners and standards of behavior. There are no educational barriers for search consultants. Legal barriers are non-existent. Cost barriers too are unlikely to arise since the industry is not characterized by asset specificity. The requisite physical facilities–desks, telephones, computers–are all widely available for relatively low cost compared to capital investments in other industries. Further, the human capital assets of the consultants are widely applicable to numerous industries as evidenced by their varied educational and career backgrounds. Essentially anyone with a telephone and a corporate directory of executives could enter the search firm industry. Consequently, customers are often left to rely only on the general reputation of the firm. It is here that we begin to see the distinct advantages of the larger established firms.

A.1.1 Geographic Reach

Those executive search firms that opened branch offices prior to the exit of management consulting firms from executive search were at a distinct advantage from their more locally focused competitors. By the time McKinsey & Co. and Booz, Allen & Hamilton exited the search business, the Big Four had set up offices in at least three major cities around the United States. This gave them the distinct advantage of having a wide reaching domestic network through which to identify candidates and a strong marketing advantage over regionally constrained competitors . These firms were able to market themselves as being able to find the best candidate possible . By the late 1960s, with the spread of multinational corporations around the globe, these firms had well-established offices in the major capitals of the world. The Big Four firms were able to effectively meet the demand of large multinationals for both expatriates and local executives to staff their growing international operations.

A.1.2 Loyal Customers

On average, almost 85% of the executive search business comes from repeat business . Once a search firm has placed a senior executive at a company, that search firm is at a particular advantage in getting additional business from a client. Consequently, each of the search firms I interviewed emphasized "the annuity value of placing a senior executive." The phenomenon of repeated business highlights two aspects of the business. First, the norm of reciprocity exists

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in strong form between placed executives and the search firms . One consultant remarked: "of course there is an expectation that the next time this individual has a search to do he will call us." The payoff is particularly large when an outsider CEO is brought in since this usually involves subsequently replacing much of the senior management team (Sibbald, 1996). As a result, most search firms offer a broad array of search services that cover the full range of executive functions, from the board of directors, to chief financial officers, to chief information officers and the host of specialized vice-presidents at the division level.

Second, the repeat nature of the business highlights the relationship-oriented nature of the work. Unlike more traditional services in which objective criteria exist to measure the quality of the service being performed, in the search industry clients rely more on atypical, "embedded" sources of information, such as personal recommendations, reputation, and past experience with the search firms. Because there is great deal of uncertainty in the quality of a potential CEO, boards searching for a successor CEO adopt a more social orientation in selecting a search firm they have worked with. In particular, given the high uncertainty involved in the outsider CEO selection process, most boards will select the search firms they have transacted with in the past .

A.1.3 Service Organization

The largest executive search firms are sophisticated service organizations whose resources extend well beyond the earlier intimate sole-proprietorships run by Boyden and others. These earlier entrepreneur-centric firms needed only a telephone, a convincing salesman, and a carefully collected rolodex. Today's large search firms are extensively computerized and professionally managed. Consultants are highly leveraged with each handling up to five or six searches simultaneously. Additionally, these large firms make extensive use of expensive computer directories, *Who's Who*, and research staffs mapping the latest changes in large company organization charts.

Table 1: The World's Top 4 Executive Search Firms

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	Worldwide Revenue	U.S. Revenue	% Total
Korn/Ferry	152.0	80.8	53.0
Heidrick & Struggles	109.5	73.4	67.0
Russell Reynolds and Associates	108.0	75.0	69.4
Spencer Stuart	102.1	68.0	66.6

Source: Executive Recruiter News, July 1994

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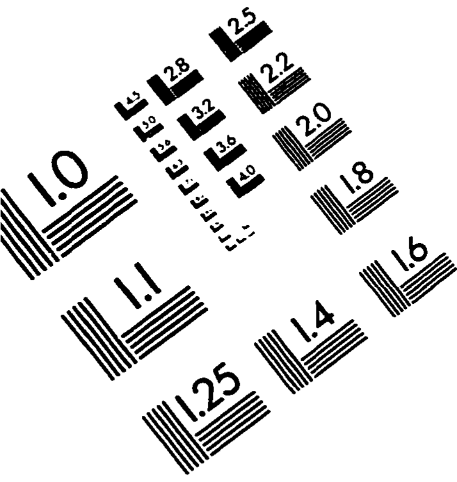
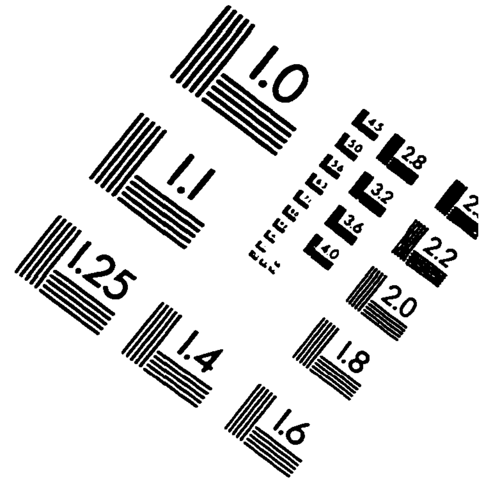
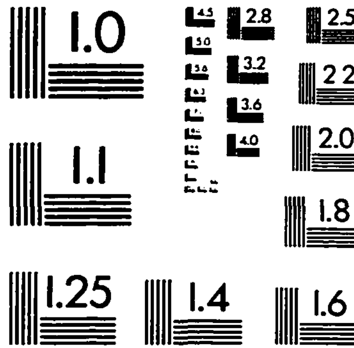
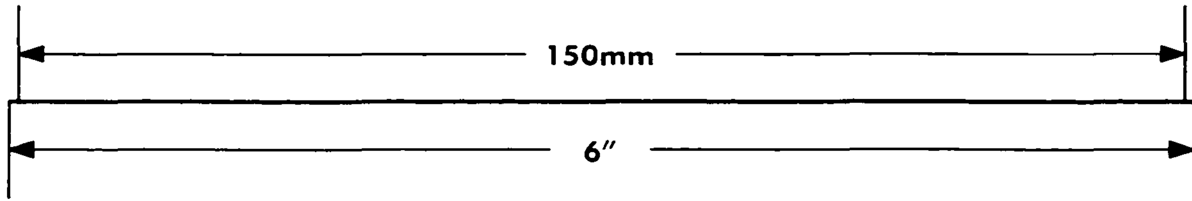
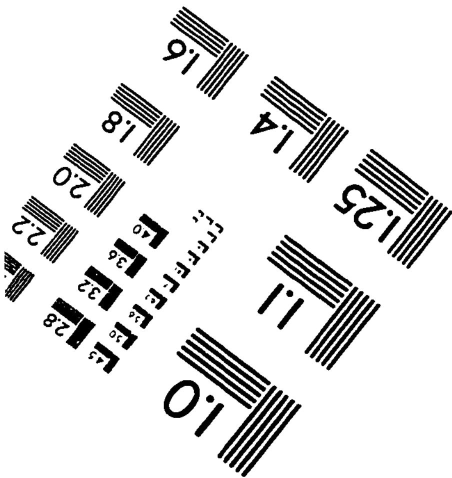
IMAGE EVALUATION TEST TARGET (QA-3)



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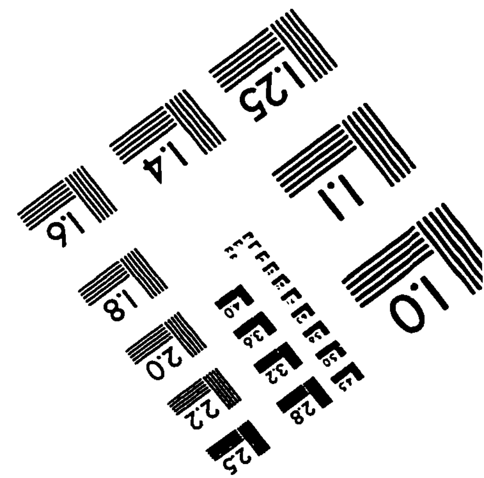

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