РАЗДЕЛ 2
ОРГАНИЗАЦИЯ РАБОТЫ СОВЕТОВ ДИРЕКТОРОВ

SECTION 2
BOARD PRACTICES

CORPORATE GOVERNANCE AND THE NEW CHIEF EXECUTIVE: HOW INSTITUTIONALIZED POWER AFFECTS THE AGENCY CONTRACT

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Abstract

This research examines one explanation for why replacing the chief executive officer does not seem to improve firm performance despite its positive effect on financial markets: some new chief executive officers (CEOs) are able to negotiate favorable agency contracts, and therefore protect their positions, at the expense of performance that would benefit shareholders. In a longitudinal study of 150 publicly-traded firms in the United States, we found that the governance systems that align the CEO's and owners' interests, the mechanisms by which compliance with the agency contract is monitored, and the firm's strategies and performance differed as a function of ownership concentration. In firms with dispersed ownership, new CEOs initiated changes favorable to them in the composition of the board of directors and in the level of and risk associated with their compensation. We also explore reasons for the differing patterns of institutionalized power resulting from the agency contract.

Keywords: corporate governance, Chief Executive Officer, agency contracts

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Introduction

Except for deaths, voluntary terminations, and retirements, poor firm financial performance is the best-documented reason for CEO turnover (Furtado and Karan, 1990). It is reasonably clear that replacing a CEO for poor firm performance has positive consequences for financial markets, especially when the CEO is from outside the firm (e.g., Davidson, Worrell, and Cheng, 1990; Reinganum, 1985), because of the expectation that the new chief executive will effect positive change in the organization. The results of CEO succession on firms' financial performance, however, are not so clear as the effects on

financial markets. Studies show that rather than having a strong positive effect on performance, CEO succession has often had very little or no effect on financial performance (Fizel, Louie, and Mentzer, 1990; Fredrickson, Hambrick, and Baumrin, 1988).

The literature to date has offered few plausible explanations for why the performance effects of CEO succession so often fail to meet expectations. The practice of scapegoating, where executives are dismissed in order to atone for inadequate firm performance (Boeker, 1992), for example, explains why an executive may be dismissed but fails to explain why some CEOs are dismissed but others remain relatively unscathed. This research takes up where scapegoating leaves off and examines this problem by focusing on the new CEOs' actions to protect themselves from the possible consequences of poor firm performance. Replacing the CEO when the firm is performing poorly creates a paradox for equity holders. On one hand, there is evidence to support their expectations that new CEOs, whether coming from inside or outside the firm, are likely to be given significant decision latitude by the board of directors, leading to both organization-level change and strategic change (Greiner and Bhambri, 1989; Goodstein and Boeker, 1991). Evidence shows that new CEOs, especially those appointed from outside the firm, were better able to implement structural and strategic change in their firms (Greiner and Bhambri, 1989; Helmich & Brown, 1972). On the other hand, since the effects of succession on firm performance are equivocal, and the structural and strategic changes initiated by new CEOs may not lead to improved financial performance that would benefit equity holders, the objective of these changes might well be to create organizational structures and select strategies that are likely to institutionalize their positions in the organization (Pfeffer, 1981). Further, new CEOs unable to produce financial results are in a vulnerable and tenuous position during their first ten years (Ocasio, 1994), and it would be perfectly rational for them to strive to fortify their place after being appointed, whether their predecessor left voluntarily or was dismissed. A new chief executive has special incentive to solidify his or her position in that new CEOs are likely to be contested by insiders on the board of directors when economic performance remains weak after succession (Ocasio, 1994). As a result, a new CEO has both the incentive and the opportunity to negotiate a favorable agency contract at the time of succession.

The agency contract specifies the "rules of the game" between the CEO and board of directors, specifically (1) the system for monitoring the management's actions and (2) the reward structure, which includes the degree to which managerial incentives are aligned with the interests of the owners (Jensen, 1983), and (3) the role that the top managers are to play in strategic decision making. Since it is impossible to know all of the contingencies, and there are the well-known problems of adverse selection and moral hazard, perfectly fashioned complete contracts are not feasible, and the result is a "relational contract" that has both explicit and implicit elements (Milgrom and Roberts, 1992). A relational contract outlines the parameters of the relationship by focusing on (1) goals and objectives instead of specific actions, (2) on the general nature of the relationship, (3) the criteria to be used in decision making, (4) who has the power to act and the boundaries of that action, and (5) mechanisms for resolving differences between the parties. This is the sort of contract that is reflected in corporate charters, specifying "such matters as the procedures for selecting directors and officers and, in very broad terms, their powers and the range of decisions that they may make without consulting the stockholders, but they do not go into further detail" (Milgrom and Roberts, 1992: 132).

The generality and ambiguity of the relational contract result in some obvious problems that are particularly relevant to how CEOs might develop a post-succession self-defense strategy. For instance, there is the possibility of opportunistic behavior throughout the contracting process that arises because of private information, adverse selection, and moral hazard. A new CEO could, for example, negotiate very favorable terms by virtue of information known only to him or her. Another possibility is post-contractual opportunism, which permits CEOs to take advantage of the loopholes in the relational contract, which exist because all contingencies cannot be known before hand, and this is particularly true when the CEO is not subject to monitoring by a strong board of directors.

These arguments suggest that modeling how the incentive structure, monitoring, and governance choices differ after succession, especially under different conditions of power balance between equity holders and CEOs, may be a useful way to comprehend what the contract permits the CEO to do to strengthen his or her position. That is, when there are some equity holders with large enough blocks of stock to influence what goes on in the firm, it is likely that the contract will be more restrictive in giving the CEO latitude to construct a strong self-defense strategy. This would result in lower levels of institutionalized influence as characterized by (1) stronger incentive alignment, (2) a board of directors that is likely to monitor the CEO more actively, and, ultimately, higher firm performance. To understand the contractual "rules of the game", we study how these two facets of the agency contract differ following the hiring of a new chief executive, as a function of the differences in the relative influence of the equity holders, as represented by the board of directors, and the CEO.

Theory and hypotheses

In agency theory applied to organizations, firms are seen as a nexus of explicit and implicit contracts among the various participants. Owners (principals)

contract with managers (agents) to perform on their behalf, delegating to management the right to use resources and make decisions. Because both the principal and agent are rational self-maximizers, the principal faces the problem of controlling the agent. This control is sought through the contract that provides for monitoring, gathering information about the agent's efforts or outcomes, and/or risk sharing, and can also be achieved by aligning the incentives of the managers with the owners. If successful, monitoring and incentive alignment lead to strategic choices that will benefit the principal.

As equity has become more dispersed, however, individual shareholders in most firms lack the expertise or the incentive, due to the small relative fraction of ownership, to adequately monitor managers or provide effective management incentives. This difficulty in creating incentive alignment or effective monitoring occurs when the owners, through the board of directors, are unable to negotiate a contract with effective monitoring and incentive alignment. This is most likely when equity is so widely dispersed among stockholders that it is difficult, if not impossible, to exercise any serious influence on the management of the firm (Berle and Means, 1932). As a result a manager in a firm may draw excessive compensation or take non-pecuniary perquisites (because these costs are borne by the firm's owners and not by the manager), modify the monitoring system, and engage in strategies that do not accrue to the optimal benefit of the owner (Jensen and Meckling, 1976; Fama and Jensen, 1983).

A vast literature on managerial capitalism argues that as a result of the dispersion of equity in modern corporations, individual owners are unable to achieve the degree of communication and action necessary to effectively monitor the firm's managers (Marris, 1964). Those firms that have such widely dispersed equity concentrations that they permit managers to subordinate shareholder interests to their own are called management-controlled firms.

When there are strong equity holders, the firm is called owner-controlled. We can therefore say, as a general proposition, that the relational contract for CEOs in management-controlled firms will have been negotiated with the owners in a relatively weak bargaining position, providing CEOs with opportunities to strengthen their position after appointment. This results in a contract for CEOs with (1) the power to defeat incentive-alignment agreements, (2) the ability to alter monitoring arrangements, and (3) discretion to the governance structure in order to enhance their own position.

Negotiating the incentive alignment structure

We expect that the new CEO will seek a contract with higher pay and lower compensation risk than the previous office holder (Harris and Raviv, 1979), and this is most likely to be the case in management-controlled firms. The evidence shows that total pay of executives of management-controlled firms is higher than for those in owner-controlled firms, even when controlling for size and firm performance (Gomez-Mejia, Tosi and Hinkin, 1987). Further, the research shows that pay is sensitive to different factors in these types of firms: In owner-controlled firms, changes in pay are related to changes in financial performance; in management-controlled firms, changes in pay are related to changes in the size of the firm (Lambert, Larcker and Weigelt, 1993). This occurs because of the different influence patterns between management-controlled and owner-controlled firms in that the dispersion of ownership in manager-controlled firms makes communication and concerted action on the part of owners much more difficult. As a result, compared with owner-controlled firms, in management-controlled firms there is weaker monitoring of the CEO compensation-setting process, the CEO is more influential than major stockholders or the board in the pay-setting process, and CEOs bear less pay risk (Tosi and Gomez-Mejia, 1989).

The communication and control difficulties that stem from the dispersion of corporate ownership, in addition to the reduced incentives for monitoring by individual owners under these conditions, might allow a new CEO to negotiate a more favorable agency contract. We think that it is likely that both the compensation premiums that CEOs receive and their lower pay risk is negotiated as part of the agreement with the board upon succession. Further, this kind of contract is possible because of the relative weakness of the board in relation to the level of power that has been institutionalized in the CEO position itself, permitting a candidate to strike a very favorable personal compensation bargain. Therefore,

H1a: The level of CEO compensation after succession will be greater in management-controlled firms than in owner-controlled firms.

H1b: The CEO's compensation risk after succession will be smaller in management-controlled firms than in owner-controlled firms.

Negotiating the monitoring arrangements

Since the board of directors is the conventional mechanism for monitoring the CEO, we expect that new CEOs will seek authority to modify its composition in ways that consolidate their own influence. First, they may actively encourage existing directors to leave the board, replacing them with more sympathetic directors who are more similar to themselves. Directors appointed by a CEO are likely to act to protect the CEO's interest because, in many ways, it is in their own interest to do so (Main, O'Reilly and Wade, 1995). This notion is supported by studies of the age and demographic similarity of board members (Main, O'Reilly and Wade, 1995; Westphal and Zajac, 1995b) that reported that CEO compensation was higher when the CEO was more similar to the board members socially and in age.

Second, after succession, CEOs are likely to increase the proportion of outside directors on the board, especially when the firm has weak equity holders.

Outside directors must rely on the firm's managers (especially the CEO) for information about the firm's performance, and as a result, they may be subject to manipulation by the CEO (Baysinger and Hoskisson, 1990).

There is some evidence that outside board members are more sympathetic than insiders to the agendas of CEOs, in that executive pay is higher in firms with a greater proportion of outside board members, and this relationship holds when controlling for firm size and performance (O'Reilly, Main and Crystal, 1988; Main, O'Reilly and Wade, 1995; Westphal and Zajac, 1995b).

Further, though this argument runs counter to classical theoretical expositions of agency theory (e.g., Fama and Jensen, 1983; Walsh and Seward, 1990), inside directors may have more to gain by ousting an incumbent CEO. The reason, according to tournament theory (Lazear and Rosen, 1981; Ocasio, 1994), is that, as senior managers, inside directors may actively compete for the chief executive's position. Ocasio (1994) showed that inside directors may be more intense monitors of CEO performance than outsiders, in that a poorly performing CEO was more likely to be dismissed when the firm had a high concentration of inside directors. Several other authors have found that inside directors were more effective monitors of the CEO. Main, O'Reilly and Wade (1995), for example, reported that outside directors were more subject than insiders to influence by the CEO and that this added influence resulted in higher pay for the chief executive than would be predicted by firm performance. Similarly, Fizel and Louie (1990) and Baysinger, Kosnik, and Turk (1991) found that greater concentrations of outside directors resulted in lower CEO accountability. Thus, although outside directors may ostensibly be appointed to represent owners and limit CEO power, it appears that these board members may augment the chief executive's influence over activities, including composition of the board, within the firm (Ocasio, 1994). These arguments lead to the following hypotheses:

H2a: The post-succession ratio of outside directors to inside directors will be greater in management-controlled firms than in owner-controlled firms.

H2b: The post-succession turnover of directors will be greater in management-controlled firms than in owner-controlled firms.

Although there is sound theoretical and empirical reason to argue that inside board members are a more effective solution to the agency problem than are outside board members, the empirical evidence linking board composition to firm-level outcomes is decidedly mixed (Dalton, Daily, Ellstrand, & Johnson, 1998). As a result, the question of board composition may provide insufficient evidence to draw conclusions about which board members are most likely to act in the shareholders interest. Rather than examining the agency contract solely from the narrow perspective of board structure, it may be useful to consider other characteristics of the members of the board of directors that could explain why these directors might be more inclined to act in the interest of the shareholder. One such characteristic involves the compensation that outside directors receive from their full-time (often executive) positions in their own firms.

It appears that new CEOs can also seek to protect their positions by appointing outside directors who are highly compensated by their own firms. Several studies show that CEO pay is higher when their boards are composed of outside directors who are highly compensated in their own firm (O'Reilly, Main and Crystal, 1988; Kosnik, 1990; Main, O'Reilly and Wade, 1995). O'Reilly and his colleagues (1988) attribute this phenomenon to norms of reciprocity that would lead these directors to be more likely to approve of high levels of compensation for the new CEO. Therefore, not only might powerful CEOs attempt to stack their boards with outsiders, they would search for highly paid outsiders. This argument leads to the following hypothesis:

H2c: The level of external compensation received by outside directors after succession will be greater in management-controlled firms than in owner-controlled firms. The traditional monitoring mechanism as cited by agency theorists is the board of directors (Milgrom & Roberts, 1992), which is charged with ensuring that the CEO acts in the shareholders' interests. We have discussed three ways in which that monitoring might be compromised: stacking the board with outsiders who are dependent on the CEO for information, removing certain board members or failing to renew their terms, and seeking highly compensated outside board members who may be more inclined to approve of higher executive compensation. There is a fourth means, that of holding both the CEO and board chair positions simultaneously, that a new CEO could use to create a monitoring system that is advantageous to him or her. Though CEO duality offers a chief executive an avenue to effect positive change in the firm, the additional influence that results from holding both the CEO and board chair positions may result in less effective monitoring of the CEO's activities (Dalton & Kesner, 1985). As a result, we expect that new CEOs in management controlled firms, where the board is presumed to exert relatively less influence over the CEO, would be more likely to hold both the CEO and board chair positions.

H2d: Duality among new CEO's will be more prevalent in management-controlled firms than in owner-controlled firms.

Succession and firm performance

Perhaps the most effective defensive strategy for new CEOs is to improve firm performance, thereby

reducing the sort of vulnerability to insiders and boards as suggested by Ocasio (1994). Because it is likely, however, that high performance risk remains after a succession event precipitated by poor performance under the previous CEO, it may be difficult for new CEOs to improve the firm's performance. We nevertheless expect that new CEOs in management-controlled firms will be able to negotiate contracts that provide strong defensive mechanisms, but that this will have a detrimental effect on firm performance. A number of studies have demonstrated that several strategies more common in management-controlled firms, such as increasing unrelated diversification and de-coupling CEO pay from firm performance, are associated with decreased financial performance (Rumelt, 1982; Amit and Livnat, 1988; Hill and Snell, 1988; Tosi and Gomez-Mejia, 1994). Thus, new CEOs in management-controlled firms would face fewer decision constraints than CEOs in owner-controlled firms and be better able to modify the incentive structure, implement changes to the board of directors, and select firm strategies that reduce their employment risk. As a result, financial performance may suffer in these firms. Therefore,

H3: Levels of financial performance will be higher in owner-controlled firms than in management-controlled firms after succession.

Method

Data for this research were collected from archival sources, including the COMPUSTAT and Compact Disclosure electronic data bases, *the Wall Street Journal, Dun and Bradstreet's Reference Book of Corporate Managements*, and proxy statements from each of the firms. We identified a sample of 150 publicly held firms that experienced a single succession event during the period 1988 to 1991. The succession event window had to be large enough so that a large enough number of succession events occurred to provide sufficient statistical power to detect moderate to small effects. At the same time, we wanted to keep the succession-event window short enough so that the effects studied could be attributed to the new CEO and not to exogenous events. We did not include firms that had experienced multiple succession events during the succession-event window, or firms that had experienced succession in the four years immediately preceding the succession-event window, or in the three years following the event period. It was our intuition that these circumstances would have confounded the analysis, as there would have been multiple contracts negotiated that would make it difficult to draw strong conclusions about our hypotheses. Ultimately we were able to use 143 firms across the ten years. The data included the years from 1985 to 1994 in a pooled cross-section and the variables are, where necessary, adjusted to 1988 dollars through the use of the GDP deflator.

The hypotheses were tested with a fixed-effects specification, in which each year in the cross section is represented by a dummy variable. The fixed effects approach allows the model to capture variance unique to a given year that is not captured in the other explanatory variables while being fairly simple to operationalize. Each OLS specification was tested for nonconstant variance of the disturbance terms with the Goldfeld-Quandt (1965) test. When the test indicated that the variance was nonconstant, we applied a two-stage generalized least squares (GLS) procedure. In addition, each specification was tested against a first-order autoregressive scheme (AR1) with the pooled Durbin-Watson test (Sayrs, 1989), and the AR1 process was incorporated when indicated.

Dependent variables

To test the hypotheses about how the post-succession agency contract differed as a function of the type of control, the dependent variables were tested in the theoretical classes described in the previous sections. Though selecting the explanatory variables involved a relatively straightforward application of agency theory and managerial capitalism, the choice of variables to represent the contract proved more challenging. The dependent variables must capture the kinds of contractual provisions likely to be preferred by a CEO and those that are likely to change as a result of the influence processes that are developed in manager-controlled and owner-controlled firms.

Although we do not have formal contracts that can be analyzed, we can observe the outcomes of contractual activity in the firm's compensation and monitoring arrangements, as well as in the pattern of strategic decisions. Indeed, in the absence of complete principal-agent contracts, Hart (1995) argues that the firm's governance structure becomes critical in resolving the agency problem. As a result, we selected variables that are thought to characterize the monitoring, decision latitude, and incentive alignment features of the agency contract (Hart, 1995; Milgrom & Roberts, 1992). The dependent variables are necessarily proxies that offer a reasonable, though imperfect, assessment of the hidden provisions of the negotiated agency contract.

CEO Compensation. The absolute level of CEO cash pay was determined from proxy statements for each of the years in the pool and a log transformation was used to avoid heteroscedasticity problems (Baker, Jensen, & Murphy, 1988). Previous research has found that total cash remuneration of the CEO is highly correlated with total compensation ($r = .75$), suggesting that it is a suitable proxy for total compensation (Gomez-Mejia, Tosi and Hinkin, 1987; O'Reilly, Main and Crystal, 1988), which often includes deferred pay as well as stock options and grants. Although cash compensation (salary plus bonus) is an imperfect measure of total pay, it avoids some of the serious estimation difficulties associated

with the Black-Scholes approach (Kroll, Wright, Toombs, & Leavell, 1997).

CEO compensation risk. CEO compensation risk was calculated by computing the proportion of total cash pay that was contingent on performance (i.e., a bonus). This information, derived form the proxy statements for the sample firms, is often used as a proxy for pay risk (Werner and Tosi, 1995).

CEO/Chair duality. The CEO/Chair variable indicates whether the CEO also holds the board chair position (Dalton and Kesner, 1985). It was coded one for the successor CEO, if within 12 months of taking the chief executive post he or she was also made board chair, and zero otherwise.

Outsider ratio. The outsider ratio represents the number of outside directors on the firm's board divided by the total number of board members.

Director turnover. Director turnover is the percentage of directors who leave the board in each year. The variable is computed by dividing the number of exiting directors by the total number of directors in each year.

Outside director compensation. The measure of outside director compensation is the cash pay received by outside directors in their positions as executives at their own firms (O'Reilly, Main & Crystal, 1988). Similar to the total pay measure for sample CEOs, we used a log transformation of the outside director pay.

Performance. The performance measure is an index constructed from several measures of performance, including return on equity, return on assets, return on investment, and the market-to-book ratio. A principal components factor analysis of the standardized values of the four measures revealed that a single factor, representing firm performance, was appropriate (Tosi and Gomez-Mejia, 1994). This factor accounted for 71 percent of the variance in the four variables, and the factor loadings for ROA, ROE, ROI, and market-to-book value were .92, .80, .89, and .71, respectively. The individual performance index for each firm was then industry-adjusted, as follows. First, we created an industry-average performance index, for each of the 90 industries represented in the sample, from the industry population averages as reported in COMPUSTAT. We then computed an annual firm-minus-industry deviation score using the difference of the firm-specific and industry-average performance indices (Hoskisson, Johnson, & Moesel, 1994). Hence when a firm's performance is better than the industry average, the deviation score is positive, and the score is negative when the firm performed worse than industry average. These deviation scores control for industry effects (Hoskisson, Johnson, & Moesel, 1994).

Independent and control variables

The main question of this research is how the dependent variables, reflecting the state of the agency contract, are affected by whether the firm is owner-controlled or management-controlled. Effective control of the corporation by a CEO, however it is achieved, should result in different kinds of agency contracts than in firms where owner's interests prevail. Although there is general agreement that the balance of power between the CEO and the board is important to a number of outcomes in the firm (Finkelstein & Hambrick, 1989; Pfeffer, 1982), there is less consensus as to how this notion of effective control should be operationalized. In order to solve this problem, we selected an ownership concentration measure, after McEachern (1975), that has seen extensive use in the agency literature and that provides three important advantages. The first advantage of the measure is its simplicity: the data can be acquired with relative ease and reliability. The second advantage is theoretical consistency. The measure has its roots in managerial capitalism (Berle & Means, 1932; Marris, 1964), which describes the control problems associated with the dispersion of corporate ownership. Essentially the dispersion of ownership allows monitoring by owners to deteriorate, as each owner's proportionate stake and interest in the firm declines, until managers effectively control the firm. The agency problem, where owner's interests differ from manager's, results in part from the dispersion of ownership and as such the measure of ownership concentration suggested here provides measurement in a manner consistent with theory. Third, due to the wide use of the 5% owner as a proxy for control, its use in this study improves the comparability of our results. There are, though, other factors that might affect the contract, such as firm size, the origin of the new CEO, and the reason that the previous CEO left the firm. These are treated as control variables.

Control. Ownership concentration, the proxy for effective control of the firm, was operationalized by the presence of an external owner holding at least 5 per cent of the outstanding equity (Hunt, 1986; McEachern, 1975; O'Reilly, Main & Crystal, 1988). Thus, firms in which at least one external owner held a 5-percent or greater equity stake were classified as owner-controlled (N=760). If no single individual, institution, or group held at least 5 percent of the outstanding shares, the firm was classified as management-controlled (N=610). In sixty cases, internal managers held at least a 5-percent equity stake. Since it has been shown that these firms act like owner-controlled firms (McEachern, 1975), they were included in the owner-controlled sub-sample. The control structure is a dummy variable, with management-controlled firms coded as one and owner-controlled firms coded as zero. Although control of the firm can be conceived of in a variety of ways, the ownership concentration proxy has the advantage of theoretical consistency with managerial capitalism (Berle & Means, 1932; Marris, 1964) and much previous research has found evidence that ownership concentrations of around five percent of outstanding equity can prevent inappropriate managerial behav-

ior (Hudson, Jahera & Lloyd, 1992; Hunt, 1986; O'Reilly, Main & Crystal, 1988; Ware, 1975; Tosi & Gomez-Mejia, 1989; 1994).

Corporate strategy. Wood (1971) proposed two measures of diversification strategy that have demonstrated appropriate validity in separate studies (Lubatkin, Merchant, and Srinivasan, 1993; Hoskisson, Hitt, Johnson and Moesel, 1993). One measure assesses related diversification and the other unrelated diversification. These variables were assessed as an unweighted count of the SIC codes of a firm's business, as reported in COMPUSTAT. The number of product markets, as indicated by an SIC code that matched the third and fourth digits of the firm's primary business code, were counted as related business units. The value of the related diversification variable was simply the number of these units. Similarly, we counted the number of product markets that did not match the first two digits of the code for the firm's primary line of business as unrelated business activities.

Size. Firm size is a composite index constructed from the standardized number of employees, assets, and sales (with assets and sales scaled in constant 1988 dollars) and subjected to a principal components factor analysis (Gomez-Mejia, Tosi and Hinkin, 1987). The factor accounted for 80 percent of the variance in the three variables. The factor loadings of assets, sales, and number of employees were .89, .94, and .84, respectively.

Pooled panel year. Because the data were collected to cover a ten-year period, we used a control variable (nine separate dummy variables) to ensure that variance associated with a particular year was accounted for in the regression.

CEO origin. We controlled for the new chief executive's origin, defined by the last job held prior to becoming the CEO at the focal firm (Dalton & Kesner, 1985). If that position was outside the focal firm, successor origin was coded as one; and if the successor CEO was promoted from within the firm, successor origin was coded as zero.

Disposition. We controlled for the circumstances of the succession by assessing the predecessor's disposition: the circumstances under which the previous CEO left that position. If it could be determined from text sources (the proxy statements or the *Wall Street Journal*) that the predecessor had retired, died, or had voluntarily taken another position, or if no determination could be made about the predecessor's disposition, this variable was coded as zero. If the text sources suggested that the predecessor was forced to resign or retire, this variable was coded as one. For example, when Robert Schoellhorn was dismissed from Abbot Laboratories, his departure was announced in the Wall Street Journal as a "firing by Abbot's board."

Table 1. Means, standard deviations and intercorrelations of study variables

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12
1. Log of Total Pay	13.08	12.71												
2. Pay Risk	.22	.54	.59**											
3. Outsider Ratio	.71	.18	.13**	-.19*										
4. Director Turnover	1.28	1.81	.16**	.04	.08*									
5. Dual CEO	.60	.41	.38**	-.09*	.25**	.00								
6. Director Pay	12.01	11.55	.51**	.19**	.24**	.04	.10*							
7. Related Diversification	.67	.84	-.05*	.04	.12**	-.09*	.05	.06						
8. Unrelated Diversificat.	2.00	2.50	.20**	.39**	.20**	.01	.04	.10*	.13*					
9. Performance	14.73	43.46	.12**	-.07*	-.01	-.04	-.03	.11*	.06*	.02				
10. Control	.43	.56	.10*	-.15*	.11*	-.07*	.04	-.03	-.14*	.01	-.09*			
11. Size	55.09	9.21	.55**	.60**	.20**	.17**	-.02	.39**	.03	.33**	.00	.08*		
12. Origin	.66	.47	.26**	.20**	-.16*	.07	-.06	.20**	-.05	.18**	-.08*	.13*	.12*	
13. Disposition	.17	.38	.11*	.16*	.15*	.05	.12*	.06	-.09*	-.25*	.02	.07*	-.03	-.31*

** (p .01), *(p<.05)

Analysis

Pooled regression analysis was used to test the relationship between the independent and control variables and each of the dependent variables. All beta coefficients reported in the tables are standardized for comparability.

Results

Descriptive statistics and correlations for the study variables are reported in Table 1. The hypotheses were tested in separate regressions as described previously.

The Negotiated Incentive Alignment. The results of the regression on the level of CEO compensation are reported in Table 2. Hypothesis 1a, which predicted that the level of CEO pay would be greater in firms controlled by managers, was supported and the model fit the data well. Higher levels of CEO compensation were also associated with the involuntary disposition of the predecessor and with dual chief executives. Unrelated diversification was also associated with higher levels of total pay while related diversification was associated with lower levels of total pay.

The results of the regression on compensation risk are also reported in Table 2. Hypothesis 1b, which predicted that the level of CEO compensation risk would be lower in management-controlled firms, was supported. In addition, pay risk was lower when the successor CEO also assumed the board chair position. It was higher when the predecessor CEO was forced out of the firm.

Table 2. Incentive alignment regressions

	Total Cash Pay		Pay Risk	
	Std. Beta	Std. Error	Std. Beta	Std. Error
Control	.308**	.041	-.262**	.038
Origin	-.060	.026	.012	.023
CEO/Chair	.162*	.033	-.472**	.027
Disposition	.258**	.037	.183*	.032
Firm Size	.508**	.002	-.121	.001
Total Cash Pay			.458**	.001
Pay Risk	.277**	.096		
Outsider Ratio	.031	.060	.004	.055
Board Turnover	-.014	.010	.090	.005
Director Pay	.274**	.001	-.119	.001
Unrelated Diversification	.183*	.013	-.058	.008
Related Diversification	-.242**	.021	.165	.025
Firm Performance	.044	.001	.072	.001
R square	.80		.67	
Adjusted R square	.78		.64	
F value	39.91		20.35	

(*p .05, **p .01)

Table 3. Monitoring arrangement regressions

	Outside Ratio		Director Turnover	
	Std. Beta	Std. Error	Std. Beta	Std. Error
Control	.646**	.049	.083	.067
Origin	.155	.032	.268*	.065
CEO/Chair	.335**	.040	-.016	.048
Disposition	.611**	.040	-.163	.051
Firm Size	.002	.001	.312**	.001
Total Cash Pay	.074	.001	-.048	.001
Pay Risk	.006	.108	.189	.131
Outsider Ratio			.323**	.075
Board Turnover	.217*	.007		
Director Pay	.148	.001	-.149	.001
Unrelated Diversification	.138	.010	-.109	.038
Related Diversification	.180	.035	-.014	.054
Firm Performance	-.016	.001	-.010	.003
R square	.54		.31	
Adjusted R square	.49		.24	
F value	11.58		4.52	

(*p .05, **p .01)

Negotiated monitoring Arrangements. The results of the test of the ratio of outside directors is reported in Table 3. Hypothesis 2a, which predicted that the ratio of outside directors would be higher in management-controlled firms than in owner-controlled firms, was supported. These results also suggest that factors other than ownership influence may be associated with differences in the outsider

ratio. Indeed, in addition to the significant effect of ownership concentration, the CEO/chair position was associated with more outsiders, as was dismissal of the previous CEO.

The regression on the rate of director turnover is also reported in Table 3. Hypothesis 2b, which predicted that director turnover would be higher in management-controlled firms than in owner-controlled firms, was not supported, though the data fit the board turnover model reasonably well. Though ownership control is evidently not directly associated with the rate of director turnover, the results show that an outside origin of the successor CEO and more outsiders on the board were associated with greater levels of director turnover

The regression for outside director compensation, reported in Table 4, was significant but hypothesis 2c, which predicted that the level of external pay for outside directors would be higher in management-controlled firms than in owner-controlled firms, was not supported. Several variables were associated with higher levels of director pay, including predecessor dismissal and outside origin of the successor. The test of hypothesis 2d, which predicted that dual CEOs would be more common among new chief executives in management-controlled firms, was not supported, though dual CEOs were more common in firms when the predecessor was dismissed or when the successor originated from outside the firm. These results are presented in Table 4.

Table 4. Monitoring arrangement regressions

	Director Pay		CEO/Chair	
	Std. Beta	Std. Error	Std. Beta	Std. Error
Control	.092	.349	-.116	.079
Origin	.225**	.253	.401**	.052
CEO/Chair	.146	.336		
Disposition	.130	.288	.599**	.068
Firm Size	-.156	.005	-.008	.001
Total Cash Pay	.571**	.310	.206*	.001
Pay Risk	.167*	.282	-.262**	.187
Outsider Ratio	.145	.475	-.181*	.142
Board Turnover	.129	.253	-.006	.013
Director Pay			-.137	.001
Unrelated Diversification	-.097	.273	.056	.021
Related Diversification	.125	.496	.112	.066
Firm Performance	-.011	.007	-.089	.001
R square	.55		.74	
Adjusted R square	.50		.71	
F value	11.97		29.40	

(*p .05, **p .01)

Table 5. Performance regression

	Firm Performance	
	Std. Beta	Std. Error
Control	-.331**	.123
Origin	-.301**	.068
CEO/Chair	-.185	.378
Disposition	-.286*	.035
Firm Size	.140	.001
Total Cash Pay	.178	.013
Pay Risk	.179	.304
Outsider Ratio	-.028	.428
Board Turnover	-.002	.286
Director Pay	-.020	.001
Unrelated Diversification	-.083	.125
Related Diversification	.050	.351
R square	.60	
Adjusted R square	.55	
F value	12.28	

(*p .05, **p .01)

Performance effects

Table 5 reports results of the regression on firm performance. Hypothesis 3, which predicted that management-controlled firms would experience lower levels of performance after succession, was supported, and the data fit the model well, explaining 55 percent of the variance. Financial performance of the firms also suffered when the successor CEO origi-

nated from outside the firm or when the predecessor CEO had been removed from office. Firm financial performance was better as the level of related diversification increased.

Discussion

This paper provides evidence about the nature of the agency contract that is negotiated with new CEOs as it is reflected in the years immediately following succession. The consistent theme is that new CEOs who are in more favorable positions, relative to those charged with monitoring managerial decision making, are able to negotiate agency contracts with more generous terms. This appears to be the case whether the favorable position of the CEO stems from a lack of ownership control or from other sources, such as CEO duality. The ability to receive a more favorable contract, which permits less employment and compensation risk, is important to new CEOs given that in their early years as chief executive they are particularly vulnerable to political threats from their internal colleagues serving on the board of directors (Ocasio, 1994).

In general we found that there is no common pattern of contracts for new CEOs, but that they vary as a function of different circumstances surrounding the succession events. For example, contracts appear to provide different ways to reduce employment risk depending on whether (1) the firm is owner-controlled or management-controlled, (2) the previous CEO was fired, (3) the new CEO is from outside the firm, and (4) the new CEO also holds the position of board chair. The interesting thing is that, with the exception of holding both the CEO and board chair positions, these same factors are associated with lower levels of firm performance after the succession has occurred, suggesting that it is wise for CEOs who face such circumstances to attempt to reduce their own risk.

The effects of ownership concentration

Mechanisms through which the institutionalization of power occurs in management-controlled firms differ from those in owner-controlled firms. CEOs in management-controlled firms were able to negotiate contracts that permitted them to more actively reduce their employment risk by manipulating the incentive-alignment structure, the monitoring arrangements, and to a lesser extent the governance structure. These factors may account in large part for the finding that these management-controlled firms do not perform as well as the owner-controlled firms in our study, a result consistent with other work that shows that owner-controlled firms outperform management-controlled firms in most contexts (Hudson, Jahera & Lloyd, 1992; Hunt, 1986; McEachern, 1975; Ware, 1975).

One important aspect of the agency contract involves CEO pay, which is the principal mechanism available for incentive alignment. CEOs in management-controlled firms negotiate compensation contracts that have higher pay levels than their predecessors and less pay risk, while pay risk is higher for CEO successors in owner-controlled firms. Thus, compensation that is already high because CEOs are in management-controlled firms (McEachern, 1975; Gomez-Mejia, Tosi and Hinkin, 1987), is not likely to suffer much from the poorer performance of the firms. These results are consistent with previous findings that CEOs in management-controlled firms have more influence over board members with respect to their pay levels and pay risk than those in owner-controlled firms (Tosi and Gomez-Mejia, 1989).

In addition to successor CEOs in management-controlled firms, successor CEOs who are also board chairs are more likely to have a greater fixed-pay component (i.e., have less compensation risk) than those who do not hold this dual role. The general conclusion from these two findings with respect to CEO pay and pay risk is consistent with theory and previous research but also suggest that executive pay remains a critical and unresolved element of incentive alignment in publicly-held firms.

Another aspect of the negotiated agency contract in management-controlled firms, consistent with this more favorable compensation package, is that after succession the proportion of external board members is higher than in owner-controlled firms. Consistent with previous research on the board's monitoring arrangements (Main, O'Reilly & Wade, 1995; O'Reilly, Main & Crystal, 1988), the greater proportion of outside board members, especially those who are highly compensated by their own firms, appears to lead to more generous compensation packages for new CEOs.

Ultimately the negotiated agency contract appears to impact the firm's financial performance. In manager-controlled firms, where we have argued that the new CEO will be in a relatively stronger bargaining position vis a vis the board of directors, firm performance is lower than in the owner-controlled firms. The pattern of results reported here suggests that the relatively greater power of the CEO in management-controlled firms, as reflected in the terms of the agency contract that is negotiated after succession, is one reason that owner-controlled firms out-perform management controlled firms.

Other influences on the agency contract

Though ownership concentration affects the relational agency-contract between the board of directors and the successor CEO, suggesting that when a firm is manager-controlled the new CEO has a stronger bargaining position, several other factors at the time of succession are important as well. The disposition of the previous CEO appears to have the broadest effect on the negotiation of the agency contract. New CEOs who succeeded one that was fired received a

higher level of pay than previous incumbents but also had a greater level of pay risk, which shifts more of the firm's future performance risk to the new CEOs and thus acts as an incentive alignment device. The higher pay and higher pay risk represent a rational response by firms that have found it necessary to dismiss their chief executive, because by increasing the CEO's pay level, the job is more attractive to prospective executives but there is also a strong signal of the firm's demand for better future performance.

When new CEOs were more powerful because they also held the position of chair of the board, they were able to negotiate a contract with lower rather than higher pay risk than their predecessors, in addition to higher total pay levels. One explanation suggested by the theory of human capital (Becker, 1964; Finkelstein and Hambrick, 1989) is that this lower level of pay risk and greater total pay represent legitimate recompense for the additional skills required to discharge the duties of the CEO and board chair positions effectively. Because we also found that the CEO/chair will increase the proportion of outsiders on the boards of directors, however, we think a better explanation is the power of the incumbency. Outsiders are likely to be more forthcoming in the future with respect to CEO compensation (Westphal and Zajac, 1995a; Ocasio, 1994; O'Reilly, Main and Crystal, 1988) as well as be more accommodating in permitting changes to the structure of the board of directors, through turnover of existing directors, that would favor the CEO.

CEOs who come from outside the firm use a similar strategy to solidify their position. They are more active in restructuring the board in that there is more director turnover, likely replacing both inside and outside members when their terms expire. This permits them to reduce the threat from inside board members because it will take some time for the newly appointed insiders to establish a power base that can effectively imperil the CEO. At the same time, by appointing new outsiders the CEOs can establish alliances that will strengthen their position because reciprocity norms are likely to develop between the new outside directors and the CEOs who appointed them (O'Reilly, Main and Crystal, 1988). Thus, new outsider CEOs structure boards that are less threatening and more closely aligned with their own interests and strategies than had the old board members remained.

These results are especially interesting in light of the positive stock market announcement effects reported for outside successors (Davidson, Worrell, and Cheng, 1990; Reinganum, 1985). While the evidence shows that equity markets expect more from an outside successor - a notion that is consistent with outside successors having more power - the results shown here suggest that longer-term post-succession performance is worse, rather than better, under an outside successor. This result, and the finding that firm performance was worse when the successor CEO followed a dismissal, suggests that the practice of dismissal and the subsequent recruitment of an outside successor does not have the desired impact on the firm's financial performance, a notion that is consistent with the research on executive scapegoating (Boeker, 1992).

Ultimately, however, the terms and conditions of the relational agency-contract appear to depend on how easily power can be institutionalized in the firm. This institutionalization is more difficult when owners control the firm. When managers control the firm, however, the evidence suggests that the preferences of shareholders may be marginalized in favor of managerial preferences through shifts in the firm's governance structure initiated by the new CEO.

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