РАЗДЕЛ 2
СОВЕТ ДИРЕКТОРОВ

SECTION 2
CORPORATE BOARD

IS THE „BOTTOM LINE" THE BOTTOM LINE ? THE DETERMINANTS OF CEO FORCED EXIT

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Abstract

The linkage between poor firm performance and CEO dismissal has not been consistently demonstrated in prior research, leading to calls to explore factors that moderate this relationship. In an industry-matched sample of firms from the Business Week 1000 that dismiss their CEO and those that don't, we examine the relationship between different measures of firm performance and dismissal, as well as the power of the CEO, board and shareholders to moderate this relationship. We find that CEO succession is related to stock returns, changes in profitability, and debt downgrading, but not to earnings expectations. Further, CEOs use their power to resist exit under all circumstances, while boards and institutional investors exercise their power to force out the CEO only when performance is poor.

Keywords: bottom line, board, stakeholder power, CEO

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1. Introduction

Sparked by Lieberson and O'Connor's (1972) article, numerous studies have sought to establish the link between poor corporate performance and CEO exit. While the majority have found such a link (e.g. Schwartz & Menon, 1985), curiously some have not been able to establish such a connection (e.g. Fizel & Louie, 1990). In other words, it seems that the question remains as to whether the bottom line in terms of firm financial performance is the bottom line, or determining factor, for CEO dismissals.

In order to explain this variance in results, researchers have turned to examine power as a moderator to this performance exit relationship. In this paper we seek firstly to examine the performance-exit relationship in more detail, and then control for performance and look at power as the distinguishing factor between firms of similar performance, but with different outcomes for the CEO.

While the "common-sense" notion that poor performance causes succession is generally supported in the literature (Giambatista, Rowe, & Riaz, 2005), there are many factors that contribute to performance and indeed, the very definition of performance is more ambiguous than it might appear at first glance (Meyer & Gupta, 1994). The purpose of the first part of this paper is to systematically investigate the relationship between company performance and CEO forced exit.[1] CEO forced exit

[1] [1] We define forced exit in the same manner as Fredrickson, Hambrick and Baumrin (1988): a case where the CEO is removed from the office by the board before he intended to leave. These cases need not always be publicly announced as a forced exit but may be presented as non-forced resignations or retirements for face saving reasons.

is of fundamental importance because it represents a means for organizational change in the face of poor performance (Huson, Malatesta, & Parrino, 2004; Bertrand & Schoar, 2003; Boeker, 1992). Yet, whether or not poor performance actually leads to forced exit is subject to debate. Authors have found a relationship between some measures of performance and forced exit but not others (e.g. Huson, Parrino, & Starks, 2001; Daily & Dalton, 1995; Puffer & Weintrop, 1991; James & Soref, 1981; Morck, Shleifer & Vishney, 1989). In addition, performance is found to account for a modest amount of variance in forced exit (Fredrickson, Hambrick & Baumrin, 1988). While some studies have looked at performance and the power of CEOs and boards in relation to CEO succession (Ocasio, 1994; Zajac & Westphal, 1996; Cannella & Shen, 2001), very few studies of forced exit as a phenomenon independent of other forms of exit have been completed (Boeker, 1992). In agency theory terms, one of the board's primary functions is to monitor management on behalf of the shareholders and replace the management if shareholder interests are not maximized. So, the goal here is to shed slight on how, and indeed if, this monitoring and discipline mechanism functions.

2. Causes of Succession Events

The two primary causes of succession events that are alluded to in the literature are performance and power. Both these primary causes take on various forms, and while performance has generally been found to be the primary motivator for forced exits, this relationship may be moderated considerably by power considerations amongst the three major actors in the governance process: the CEO, the board, and shareholders.

Performance and Forced Exit

A central problem with studies that focus on the relationship between performance and forced exit is that they all use different measures of performance. The reasons that findings concerning this relationship are inconclusive may be that some measures of performance related more closely to forced exit than do others. Meyer and Gupta (1994) note that measures of performance tend to be correlated within categories but not between categories. Because these categories are not correlated, it is important to consider multiple performance measures that are uncorrelated with one another to adequately test which performance measures are relevant to the particular situation. Testing the relationship between succession and several different categories of performance measures allows us to consider the possibility that the succession may be related to some types of performance but not others. Indeed, given the lack of correlation between categories of performance measures, it would be surprising if exit were related to all types of performance. Testing against multiple measures allows us to ascertain which types of firm performance are presumably considered by the board as important when assessing CEO performance.

Profit margin (return on sales) is a commonly used performance measure that has been found to be related to succession in past studies. Board members may measure performance based on the information provided to them in company financial statements, making profit margin a readily available measure of performance. In addition, profit margin is a measure that is easily compared with competitors in the same industry and therefore may be used by a board as a primary indicator when comparing their firm's performance with others in the industry. In their work on the effects of leadership on performance, Lieberson and O'Connor (1972) studied the effects of leaders on sales, profits and profit margin. They found that industry and company had a large effect on sales and profits but that leaders have the greatest effect on profit margin. Assuming that the board will use a measure performance that they deem to be within the realm of CEO control, the relationship between profit margin and forced exit should be tested as such a measure.

Hypothesis 1: Firms that have had a decline in profitability (income before tax as a percentage of sales) are more likely to oust their CEO than firms that suffer no such decline.

Moving beyond those studies that examine internally generated measures of performance, Fredrickson, Hambrick and Baumrin (1988) develop a theoretical model of CEO dismissal in which they contend that although an organization's performance affects CEO dismissal, this relationship is not a direct one, but is mediated by four constructs: 1) the board's expectations and attributions, 2) the board's allegiances and values, 3) the availability of alternative candidates for the CEO position, and 4) the power (both personal and structural/ownership) of the incumbent CEO.

Puffer and Weintrop (1991) extend Fredrickson, Hambrick and Baumrin's first construct, arguing that it is not the absolute level of performance that matters, but rather how that performance matches up to, or falls short of, the expectations of the board of directors. They found that actual earnings per share which fell below the expectations of the board was a predictor of turnover, whereas traditional mechanical algorithms of abnormal security returns and historical accounting ratios were not.

Hypothesis 2: Firms that have unmet performance expectations (EPS/Expected EPS) are more likely to oust their CEO than firms that meet expectations.

It is possible that directors are not able to adequately assess a performance shortfall. Given confusion over the large number of performance

indices available, directors may not be able to determine when company performance is so poor as to warrant the dismissal of the CEO, so, they turn to outside sources in order to assess performance. Klein and Rosenfeld (1988) found a positive relationship between top management turnover and the payment of greenmail. It appears that the board sees the payment of greenmail as a signal of management's poor performance and use this signal as an indicator that they need to bring in new management. Another outside signal of performance decline is a downgrading of publicly rated debt as reported by Standard & Poor's or Moody's rating services. When a company's debt rating is downgraded, it is a sure signal of a long-term decline in performance. It is also a public signal of the firm's failure. Therefore, one would expect that the downgrading of a company's debt should be associated with CEO succession.

Hypothesis 3: Firms that have received outside signals that performance is declining (reduction in bond ratings) are more likely to oust their CEO than firms that receive no such signals.

Under the efficient market hypothesis, each individual performance measure should be encompassed in the price of a firm's stock. So while each board of directors will use its own measure of performance to assess the CEO's performance, stock price should be related to succession regardless of which measure they choose. In addition, stock price should encompass subjective information concerning the quality of management. Finally, a decline in stock price is a signal that investors are unhappy with firm performance. Morck, Shleifer and Vishney (1989) found a relationship between cumulative abnormal returns and forced exit. Given these factors, one would expect that stock price should be related to succession.

Hypothesis 4: Firms that oust their CEOs will have lower market adjusted stock price performance than firms that retain their CEOs.

Despite these hypothesized linkages between performance and CEO exit, prior studies have found only a minimal amount of variance in forced exit explained by prior performance (Fredrickson, Hambrick & Baumrin, 1988). Other variables, particularly in respect to the power of the CEO to resist exit independent of performance, are likely to intervene to moderate this relationship (Boeker, 1992). Forced exits are of interest because they serve as a signal of the power structure of the firm. However, empirical investigation of the role of power and the form of its relationship to forced exit has been limited (Boeker, 1992).

Thus, while performance has been linked to the forced exit of CEOs, the variability and inconsistency in findings in establishing this link would indicate that there is a need to focus on the power dynamics which may moderate the performance-exit link.

Stakeholder Power and Forced Exit

With the shortfall in explanatory power of performance, scholars have begun to explore the various facets of stakeholder power. The three primary stakeholders in the governance process are owners (shareholders), the board, and the CEO. From an agency theory perspective (Jensen & Meckling, 1976), the board is an alignment mechanism whose primary responsibility is to monitor the actions of the CEO to ensure that he is pursuing the goals of shareholders rather than his own goals. Tying compensation to firm performance is one means by which the board may control the behavior of the CEO. The board also has the authority to remove the CEO from office if he is not maximizing shareholder value.

However, agency theory does not address the fact that the board may not be willing or able to remove the CEO from office. The board may be impeded from performing its monitoring duties for a number of reasons. Agency theory assumes that the board is both willing and able to perform its fiduciary duty to shareholders. In other words, the alignment of board and shareholder interests is generally assumed to exist, and the balance of power in the relationship between the board and the CEO is assumed to be tilted squarely in favor of the board. However, this may not always be the case in reality.

Legally, the board has the power to remove the CEO from office. So it seems that power should always rest with the board. However, while the board possesses this legal authority, they do not often use it. In fact, some contend that the boardroom is often controlled by the CEO (Mace, 1971; Lorsch & MacIver, 1989). It is obvious that factors beyond the legal mandate influence the power dynamics between the board and the CEO.

The disruption of the fine balance of power within an organization, and particularly between the CEO and the board of directors, has been shown to have a significant bearing on the decision to oust a CEO (Ocasio, 1994). Prior studies have used multiple measures of power and also examined how that power is exercised within the organization. For example, Boeker (1992) took an unusual slant on the power and performance influences on managerial dismissal. Taking a scapegoating perspective, he hypothesized and found support for the notion that powerful CEOs are less likely to be dismissed than less powerful CEOs in periods of poor performance. They remain in power by placating the board and other stakeholders, placing the blame for the poor performance onto their subordinates. These subordinate "scapegoats" are replaced while the CEO remains.

Boeker (1992) used various measures of power which influence the likelihood of CEO dismissal or scapegoating of senior managers, including measures

of board power (percent of insiders and board loyalty), measures of CEO power (ownership stake) and measures of shareholder power (ownership dispersion). He found that these power factors influenced dismissals, showing that CEOs use their power to avoid dismissal when threatened with such an event due to poor performance. What was interesting, however, was that these factors only had an effect in poorly performing firms.

The balance of power and political maneuvering between the board and the CEO, explored by Boeker (1992), is key to the decision to oust the CEO independent of the existence of tangible performance causes. Pearce and Zahra (1991) found a positive relationship between board power relative to CEO power and firm performance. This evidence supports the conjecture that boards do play an important role in corporations. Of the measures of power that Boeker (1992) used, the measure most often used in other studies of the balance of power is the ratio of outside directors to total board members. Methodologically, researchers often use current employment with the firm in question as a means of discriminating between insiders and outsiders. However, a more conservative approach is to consider any director who has ever been employed by the firm or is related to the CEO to be an insider as these directors are more likely to be influenced by the CEO. The assumption that we wish to test is that board members who have a connection to the firm or to the CEO will be less likely to push for his dismissal.

Hypothesis 5: The percent of independent directors on the board will be positively related to forced exit, particularly in poorly performing firms.

The ability of the CEO to remain in his position in the face of declining performance also needs to be considered. It is possible that CEOs who have a high degree of power relative to their boards will be able to hold on to their positions despite poor performance. Power of the CEO can be measured in a number of ways. In addition to stock ownership, which is often minimal in proportion to the total outstanding stock in large public companies, CEO tenure is another proxy for power (Allgood & Farrell, 2003; Drazin & Rao, 1999; Fredrickson, Hambrick & Baumrin, 1988). When a board hires a CEO they are likely to choose someone, whether from outside or inside the company, who espouses a strategy consistent with that held by the board. The newly hired CEO is consequently likely to be aware of his obligation to the board and of their power to hire and fire the CEO, and unlikely to adopt a strategy or take actions contrary to that espoused by the board. This is especially true for an outsider who, when hired, has less knowledge of the company and the issues facing the company than the board. However, as time elapses, the CEO becomes more established in his position, gains more knowledge of the company and controls the information flow to the directors, and thus feels less aware of the power of the board and more secure in his position. Also, as turnover occurs within the board, the CEO gains more board experience than other members and also influences, if not making an outright choice, of new directors, who in turn, feel an obligation to the CEO.

Thus, given that *prima face* the power of the CEO should increase over his tenure with the company, due to the increasing influence over the board and particularly new board appointments and increasing knowledge of the company, we hypothesize that the tenure of the CEO will be negatively related to forced exit.

Hypothesis 6: The tenure of the CEO will be negatively related to forced exit, particularly in poorly performing firms.

Having addressed the balance of power between the board and the CEO, we turn our attention to the influence of owners. Owners of the company are the third party to the governance process. Owners who are unhappy with company performance may encourage the board to remove the CEO. However, the ability of owners to influence the board of directors is limited. Only shareholders who own or control a large portion of stock will be able to influence the board (hence the recent interest by the popular business press in institutional investors).

Salancik and Pfeffer (1980) examined the effect of ownership on the relationship between power and managerial tenure in a stratified random sample of 84 US corporations. Salancik and Pfeffer, following McEachern (1975), split their sample into three ownership categories: owner managed firms, externally controlled firms, and management controlled firms. Based on their analysis, they concluded that capital markets impose discipline on management controlled firms, causing a relationship between tenure and the firm's share price performance. In externally controlled firms, owners seem to discipline managers as tenure was related to the profit performance of the firm. In owner managed firms, where power resides with the management, there was no positive relationship between performance and tenure, and even slight evidence for a negative relationship, which Salancik and Pfeffer suggests implies little discipline or consequences of poor performance in such firms. However, an alternative interpretation of their result might be that owner managed firms have different goals or measures of success than other firms. For many entrepreneurs or owner-managers, the entire purpose of being independent is to escape the constraints of the short term perspective of capital markets; often the entrepreneurs measure performance in non-monetary ways, such as new products, market share, growth, or even ephemeral terms such as 'making a difference,' employee well-being or impact on the community. While few owner controlled firms exist among the largest U.S. public corporations as studied in this sample, a new breed

of owners has acquired a significant ownership stake, institutional investors. The media has highlighted the role which large institutional investors have played in the recent ousting of several high profile CEOs. Frequently, institutions that own a large portion of a company's stock may not be able to sell their stock over a short period of time without unduly decreasing the price of the stock, thus removing the option to sell the stock (Hirschman, 1970). This encourages a more active participation in the governance of the company in order to protect the institution's investment. While several authors have argued that institutional investors are only interested in short-term performance, Hansen and Hill (1991) found a positive association between R&D spending and institutional investment. This evidence would support the notion that institutional investors do care about factors that influence the long-term performance of the firm. Even though an individual institution may not own enough stock to influence the board, institutional investors acting as a group may have the power to persuade the board to oust the CEO. Anecdotally, there have been numerous reports in the media that activist institutional shareholders such as CalPERS and LENS have prompted board member's concerns regarding corporate performance resulting in CEO ouster. Institutional investors make their views known through both direct and indirect contacts with the board, through letters to boards, open letters or comments in the media, or shareholder proposals. Even the general perception of a rise in institutional shareholder activism should make board members more aware of the performance concerns of these investors and make the boards more prone to pull the trigger early when things start to go wrong, for fear of later spotlighting by the institutions, or worse, law suits. Therefore, one would expect that the percentage of institutional ownership of a corporation should be related to the likelihood of succession.

Hypothesis 7: The percentage of shares held by institutional investors will be positively related to forced exit, particularly in poorly performing firms.

This first part of the study deals with the relationship of performance to exit and the moderating impact of the power of the three players in this game, the CEO, the board, and owners, have in the relationship between performance and exit. Yet, as we stated at the outset, the interesting cases are not those where the CEO is ousted in the face of poor performance, but rather when performance is poor and the CEO is able to remain, and where performance is good and yet the CEO is ousted regardless of the company's solid performance.

3. Beyond performance

In the first part of the study then, we seek to firmly establish the important role of performance in CEO exit. However, it is apparent that there are cases where the company is performing equally as poorly as a company that changes CEO, yet does not take such an action. Equally, there are cases where the organization is performing well, and yet the CEO is nevertheless ousted.

In order to address these situations in which performance is equally poor and yet no action is taken, we need to include such firms in our sample. Thus while the preceding hypotheses will be tested using a matched pair sample based on similar sized companies within industry groups, and examining performance differences, the following hypotheses will be made in the context of a sample where performance is equalized in order to examine other differences.

Types of Exit

While performance may be a major cause of forced exit for CEOs, it is by no means the only cause to trigger such an event. Indeed, Ward, Sonnenfeld & Kimberly (1994) in a study of the career consequences for the ousted CEOs, identified seven distinct causes of exit. From an agency theory perspective, owners, and as a consequence, boards, will only be concerned with replacing the CEO when their investment is threatened or performing poorly, and so will only exert their power under such circumstances. However, we can reasonably assume that the CEO will always seek to retain his position in the face of some threat or motion to oust him. Thus, while the CEO's use of his available power will be uniform in the presence of causes that might trigger exit, the owner's and their board's use of power is likely to be variable for differing exit circumstances.

Ownership itself is the very basis of power for the investor, and the board is in place to protect the interests of the shareholder. Indeed, often board members directly represent large shareholdings either personally or on behalf of a major shareholder. However, when the CEO himself is a primary shareholder, and especially if the CEO has ownership power relative to the board, the board's basis for power is somewhat undermined in this dimension and they may be less willing to act even in the face of poor performance.

An early study in the use of ownership structure as a surrogate measure for the degree of influence considered the power of managers to resist pressure for their dismissal based on their stock ownership (Allen & Panian, 1982). Managerial power, defined as belonging to a controlling family, was directly related to both managerial tenure and longevity, even controlling for the effects of corporate performance, thus demonstrating the influence of a CEO's power on retaining his position despite poor performance.

For large, public firms, the CEO's personal stockholdings in the company, even if relatively

large in dollar terms, are likely to represent a relatively small amount of the company's outstanding equity, and thus absolute managerial power through ownership control is relatively rare amongst large corporations. However, in governance terms, given that in most cases there is no single majority owner of a large company's stock, what is conceivably the measure of influence is the relative holding of the CEO to the holdings represented by the board. If the CEO has a stock holding that is large relative to that of the board, even given that in absolute terms the CEO's holding is small relative to the total outstanding capital, his ownership stake will give him power within the board and thus reduce the likelihood of ouster.

Hypothesis 8: The stock ownership of the CEO relative to board ownership will be negatively related to forced exit, when performance is controlled.

In addition to stock ownership, board tenure and experience is another source of power at the board level (Fredrickson, Hambrick & Baumrin, 1988). The experience of a CEO relative to his board is of importance for two major reasons. First, experience counts in and of itself. More experienced members of the board will be looked up to and regarded with respect, and are likely to exert influence over less experienced members. Second, and more importantly in regards to the relationship and relative power between the CEO and the board, board members who have been recruited to the board under the tenure of the current CEO are likely to feel an obligation to the CEO for their seat on the board.

Hypothesis 9: The proportion of board members with tenure less than that of the CEO will be negatively related to the occurrence of forced exit, when performance is controlled.

Structural vs. Non-structural Influences

Thus far in the paper, and in the literature in general, the hypotheses have centered around structural factors of the governance process, mainly board composition and ownership structure. However, while we are testing the impact of these factors, and indeed, previous studies have already validated the impact of such structural components (Boeker, 1992), we contend that there are other factors that intervene between poor performance and the board's response to performance. These factors are less structural in nature and are contingent on the group dynamics inside the boardroom and the power and independence of individual players.

Group Dynamics of the Board

The crux of the issue addressed in this paper is why some boards fail to oust their CEO in situations where it is seemingly the obvious course of action due to the poor performance of the firm. The group nature of the decision may provide some insight into this conundrum. One of the unique facets of the CEO's position in the organization is that a group rather than an individual is responsible for the decision to fire the CEO. The literature on groups suggests that even if it is obvious to individual board members that the CEO should be replaced, the group may never reach this decision, or more likely, may never even broach the issue. It is the initial broaching of the issue within the board which enables a positive decision to be made, in the sense of the board making a considered decision to retain or replace the CEO rather than a decision by default of not explicitly considering the issue.

Specifically at issue here is what Janis (1972) labeled groupthink. By studying major policy decision fiascoes at the federal government level, Janis discovered several symptoms of tightly-knit groups that result from in-group pressures to seek consensus and in so doing, suppresses alternative solutions. These symptoms include the development of rationalizations for defective policies; the formation and reliance upon stereotypes of the out-group which discredits information coming from outside the group; the suppression of individuals doubts and reservations about a decision; the illusory belief that the group is unanimous in its decision when many in fact have doubts and reservations; the overt calling upon those who do express criticism to suppress that criticism out of loyalty to the group or its leader; and to sometimes appoint what Janis calls a "mindguard" who is in charge of suppressing dissent.

It is very possible that a number of these symptoms of groupthink are present in boards who do not take action to broach the subject of reviewing the CEO's position even in the face of poor performance. As outlined above, the board relies heavily on the CEO for information regarding the organization and its prospects. They are however, at least cursorily involved with approving major strategic shifts in the organization and therefore subject to constructing rationalizations for the poor performance of the organization, and susceptible to conforming to the CEO's rationalizations for performance and the future improvement of such. Similarly, they may be inclined to discredit outside indicators of poor performance, such as a debt downgrading or downgrading of the stock by analysts, stereotyping those outsiders as having a short-term perspective and limited knowledge of the inside view of the firm. While these outside signals may elicit doubts in the minds of some, or even all, board members, in the absence of anyone voicing these doubts in a convincing manner, each individual may believe that he is the only one holding such doubts and that the rest of the board is unanimous in its confidence in the CEO. In such circumstances each board member will likely suppress their own individual doubts about the CEO's ability to improve

performance. Finally, particularly when the organization is performing poorly, the CEO may act in the "mindguard" role, attempting to suppress any hint of dissent by individual board members and provide reassurance that things are on the brink of improvement.

While Janis (1972) deals with the steps a leader can take to avoid groupthink, we might surmise that in this case it is precisely the leader, the CEO, who wishes to promote groupthink. However, the principles still apply and it is up to the board then to ensure that group think does not occur. The board must act as boundary spanners, constantly open to, and seeking out, information both internal and external to the firm. It is also important for at least one member of the board to voice his opinion to release the concealed opinions of others, and to break the assumed unanimity of the group.

The impact of such a lone dissenter (Asch, 1956) can be powerful. A lone dissenter gives credence to the contrary opinion and frees each individual in the group to express his own opinion. Asch found that this occurs even if the dissenter's view is not the same as the subject in his experiments, but merely different from the majority or assumed viewpoint. The social influence for conformity therefore is not merely a matter of majority rule, but relies on unanimity. This is especially critical when the assumed majority opinion is not in fact the majority viewpoint but a conspiracy of silence.

However, while the presence of a lone dissenter is often enough to spark the question of CEO replacement, the question remains of who is willing to "step up to the plate" and break the silence. We might expect that some board members have more incentive to initiate a departure of the CEO or assurance in their position and may be willing to make such a move, while others may feel more obligation or loyalty to the CEO and consequently unwilling to rock the boat.

There are several types of board member who might be more willing to put forward a motion against the CEO and several structural variables which might facilitate such a motion or improve its chances for success. First, a former CEO of the company who remains on the board, especially one who left office reluctantly, or who having left, misses the power and trappings of office, might be eager to undermine his successor and take any failing of his successor as an opportunity to regain power (Sonnenfeld, 1988). Similarly, a former CEO of another company, who has recently left that organization may see the opportunity to wrest power from a CEO in trouble. Additionally, a founder or member of the founding family may be eager to protect the legacy of the founder and push for a change of CEO at early warnings of poor performance, especially if the CEO is a non-family member. Those board members who sit on a number of boards, and who consequently have a smaller portion of their career identity tied up in the organization and feel less of a direct tie to the CEO may also be willing to propose or support a notion for change. This is particularly salient if the person has been on a board where a CEO ouster has previously occurred. Finally, a director that directly represents a large shareholding, be it on his own account or as the representative of an institution is also likely to be less tolerant of poor performance and likely to push for a change if performance slips.

On the other hand, inside directors, and those directors who have been recently appointed to the board, or even appointed to the board during the tenure of the CEO, may feel a high degree of loyalty to the CEO for their positions on the board and consequently are unlikely to propose or openly support a motion to oust the CEO.

We would therefore expect that:

Hypothesis 10: The presence of directors who owe less loyalty to the CEO will increase the likelihood that the CEO will be ousted.

CEO control over information

One reason many governance scholars feel that CEOs control boards is that CEOs often control the information supplied to the board. Particularly in cases where the CEO chairs the board (duality) or board committees, the CEO will control the agenda of the board as well as information provided on corporate strategy and performance. When the CEO controls the board's access to information, he may be able to hide poor performance from the board. Even if he can't hide poor performance, he may be able to influence the board's opinion concerning the cause of poor performance, shifting the blame from himself to other employees or factors external to the firm (Boeker, 1992).

Hypothesis 11: When the CEO controls the board's access to information, through chairing the board and control of board committees, the likelihood of the board ousting the CEO is reduced.

Another way that the CEO controls the information provided to the board is by controlling the issues addressed by the board. There is no set standard concerning the issues on which the CEO should consider board input. The generally acknowledged duty of the board is to oversee the strategy of the firm (Mace, 1971; Vance). This general guideline gives the CEO considerable leeway to determine which decisions or actions should be discussed with the board.

When the board is broken down into committees, board members are able to address a greater number of issues which constraints of time would not allow the full board to consider. So, the committee structure of the board will influence the issues addressed by the board, and the monitoring capability of the board. Likewise, the number of

times the full board meets during the year will regulate the number of issues the board addresses. While law requires that every public company have a board of directors, there is no regulation concerning the number of meetings a board must hold. A board which meets more often will be better able to monitor CEO behavior.[2]

Hypothesis 12: The greater the structural monitoring ability of the board, the higher the likelihood that the board will act to remove the CEO.

4. Methods

Sample

The population of succession events was derived from the Business Week listing of the Corporate Elite -- the Chief Executive Officers (CEO) of the largest 1000 publicly traded corporations in the US, from 1988 to 1992. Any company where the CEO changed between the annual listings of the Corporate Elite was coded as a succession event. Over the five year period examined, this produced a total of 456 succession events. Each event was then categorized into one of the following causes of succession: death of the CEO, retirement (planned exit, with no subsequent seat on the board), retired as CEO, but remained on the board of directors, left to accept another position, resigned (without moving immediately to another position), and forced exit. This categorization was based on extensive research and coding of reports of succession events from The Wall Street Journal, The New York Times, regional newspapers (e.g., Los Angeles Times, Chicago Tribune, Washington Post, etc.), national business magazines, and stock analysts' research reports. Finally, the classifications were verified by a prominent executive search firm with intimate first-hand knowledge of many of the events surrounding the successions.

From the above categorization, successions coded as 'resigned without moving immediately to another company' and 'forced exit' were classified as 'non-voluntary exits'. This provided a sample of 70 non-voluntary exits. This categorization provides a conservative estimation of the total number of non-voluntary exits in the population as it is quite probable that a number of those exits coded as retired but that remained on the board of directors may have been as a result of board pressure to step down as CEO. It is not an infrequent occurrence that a CEO remains on the board for a short period after stepping down in order for the board and CEO to disguise the internal disputes that surrounded the succession event. This common form of face-saving behavior, engaged in to give the illusion of a smooth transition, benefits the company and also serves to save the ego and reputation of the departing CEO. The 70 exits in this sample however, are ones that have been reported in the media as being unambiguously non-voluntary exits, and therefore expect that they would provide the clearest and least confounded test of the hypotheses proposed here.

To develop a control group for the initial hypotheses on the performance-exit relationship, companies with a non-voluntary exit were matched with a comparable company within the Business Week 1000 where a succession event did not occur during the entire period of study. Where this was not possible, companies were considered where there was a clear routine departure, usually a retirement, but not in the same year or in the year prior to the exit to which it was paired. Companies were matched based on SIC code, and sales (as a proxy for size). Four digit SIC codes were used where possible. In cases where a four digit match was not available, or where four digit matches were vastly different in size, we resorted to three or two digit matches (sixty-four percent were based on four-digit matches).

Matches were made based first on industry and then on sales three years prior to the succession event as a proxy for size. A three-year time-window was used because the primary hypothesis of this study is the effect of prior performance on the likelihood of succession. If it is indeed the case, as Puffer and Weintrop (1991) suggest, that boards base their decision to force the CEO to exit based on perceived performance, it is likely that they use similar companies as one basis for forming their perception. They are more likely to compare their relative performance with a company that at some point in the recent past was comparable rather than to one that they now find themselves similar to, given that a drastic decline in performance may have changed their peer group.

Once the performance-exit relationship had been tested, the sample of forced exits was then rematched to a sample of firms where performance was equal, yet the CEO was not ousted in order to look at differences between such firms. Again matches were made based first on industry, but then on return on equity (ROE) as a measure of corporate performance.

Variables

Profit performance was measured using change in income before taxes/sales three years prior to the succession to the year-end prior to succession. This measure was taken as of the last year-end prior to succession in order to prevent confounding due to the succession event. Data were collected from annual company findings summarized by Standard and Poor's and Moody's. Performance expectations were measured by comparing the consensus of stock analysts' expected earnings six months prior to the year end preceding succession to the actual earning reported. Earnings estimates were reported by Vicker's. Outside signals of performance change

were measured as a debt downgrading by Moody's in the year prior to succession. Stock price performance was measured using cumulative abnormal returns as recorded on CRSP tapes. Returns were measured for the two year period prior to the announcement of the succession event ending one month prior to the announcement date in order to eliminate any confounding returns due to the announcement itself.

The power of owners was operationalized using percentage of shares outstanding held by institutional investors as reported by CDA Spectrum at the year-end prior to succession. Power of the board was measured by the percentage of outside directors on the board. Power of the CEO was measured as tenure in years of the CEO in his position. The dichotomous dependent variable, exit, was coded 1 when a forced exit occurred and 0 otherwise.

Power generated by stock ownership was measured using three ratios: the CEO's holding to the total shares held or controlled by the board, the total shares held or controlled by the board to the total outstanding share capital, and the CEO's holding to the total outstanding share capital. Director loyalty to the CEO was measured by the proportion of directors who were ex-CEOs of the company, ex-CEOs of another company, or founding family members. Board freedom from CEO control of information was measured by the number of committees of the board that the CEO did not chair. Structural monitoring ability of the board was measured by the number of committees of the board and the number of full board meetings per year.

Analysis

The analysis was run using a logit model, due to the dichotomous dependent variable, with the succession event as the dependent variable. Descriptive statistics of the first sample are included below.

Table 1. Descriptive Statistics

		Mean	S.D.	1	2	3	4	5	6	7	8
1	Oust	0.50	0.50	-	-0.24	-0.08	0.07	0.16	0.12	-0.22	-0.11
2	CEO Tenure	8.44	8.61	-	-	-0.01	0.04	-0.16	-0.18	0.15	0.04
3	EPS Margin	0.54	1.57	-	-	-	0.13	-0.13	-0.05	0.35	0.17
4	Institutional Ownership (%)	0.48	0.19	-	-	-	-	-0.12	-0.02	-0.12	0.11
5	Debt Downgrading	0.15	0.35	-	-	-	-	-	0.05	-0.19	0.03
6	Independent Directors (%)	0.67	0.18	-	-	-	-	-	-	-0.32	0.01
7	Stock Market Returns	-0.06	0.43	-	-	-	-	-	-	-	0.25
8	Change in Profit Margin	0.01	10.20	-	-	-	-	-	-	-	-

A separate set of models was run for each of the four performance measures (Tables 1.1-1.4). The first model includes the performance measure as well as the three power measures. The second model includes the performance measures, CEO power and the interaction term. The third model includes the performance measures, board power and its interaction term. The final model includes performance, institutional investment and the interaction term.

5. Results and Discussion

Support was found for the relationship between performance and forced exit (hypotheses 1-4). Hypothesis 1 predicted a relationship between profitability and forced exit. A negative relationship was found between profitability and forced exit as predicted ($p<.05$). Hypothesis 2, concerning the relationship between debt downgrading and forced exit was also supported ($p<.10$). Debt downgrading is positively related to a subsequent forced exit. This is a conservative test given that many of the companies in the sample do not have publicly traded debt, and were thus coded with a zero (not a downgrade). So the data is strongly biased towards finding no results and findings may actually be stronger than they appear. No relationship was found between earnings expectations and forced exit, so Hypothesis 3 was not supported. Finally, Hypothesis 4 that predicted a relationship between abnormal stock returns and forced exit, was also supported ($p<.10$). A negative relationship between cumulative abnormal returns and forced exit was found.

Table 1.1. Return on Sales

Model	1	2	3	4
Intercept	-.29	.91***	-.88	-.02
Performance -- Return on Sales	-.40***	-.35**	-.18	-.24
CEO Power	-.06**	-.09**		
CEO Power x Performance		.02		
Board Power	1.15		.87	
Board Power x Performance			1.13**	
Investor Power	.65			.82
Investor Power x Performance				1.06
-2 Log Likelihood	16.39***	17.22**	13.31***	9.21**

Table 1.2. Expected Earnings

Model	1	2	3	4
Intercept	-1.28	.73**	-.74	-.66
Performance -- Actual/Expected Earnings	-.13	-.10	-.05	-.08
CEO Power	-.07**	-.09**		
CEO Power x Performance		.04		
Board Power	1.31		.49	
Board Power x Performance			1.42**	
Investor Power	2.33**			.65
Investor Power x Performance				1.96**
-2 Log Likelihood	12.46**	8.65**	8.89**	9.25**

Table 1.3. Debt Downgrading

Model	1	2	3	4
Intercept	-1.22	.43	-.88	-.61
Performance -- Debt Downgrading	98*	.71	.85	1.06**
CEO Power	-.05**	-.09**		
CEO Power x Performance		.05		
Board Power	1.18		.35	
Board Power x Performance			1.37***	
Investor Power	1.31			.03
Investor Power x Performance				1.47**
-2 Log Likelihood	12.41**	12.14***	12.27***	9.89**

Table 1.4. Cumulative Abnormal Stock Returns

Model	1	2	3	4
Intercept	-.21	.53*	-.39	-.15
Performance -- Cumulative Abnormal Returns	-.88*	-.95*	-.90*	-.85*
CEO Power	-.05*	-.09**		
CEO Power x Performance		.06		
Board Power	.40		-.06	
Board Power x Performance			1.16**	
Investor Power	.70			-.37
Investor Power x Performance				1.37*
-2 Log Likelihood	8.76*	12.27***	9.73**	7.57*

* p<.1, **p<.05, ***p<.01.

It is interesting that these findings are directly opposite of Puffer and Weintrop (1991), who found a relationship between earnings expectations and forced exit but found no relationship with stock returns or accounting measures of performance. These results support Meyer and Gupta's (1994) assertion that performance can be measured in a number of uncorrelated ways and firms switch performance measure choice as over time the deviation in a particular performance measure declines. In particular, the sample of firms used may have an important effect on the meaningfulness of a particular performance measure. In this case, problems arise with the EPS/Estimated EPS measure. In the sample used in this study, there were a large number of firms that were barely profitable or indeed were incurring a loss. In such cases, there are two major problems. The first occurs when the estimate is very close to zero, and therefore any small deviation from the estimate produces large fluctuation in the ratio. The second, and more difficult problem is when either the estimate or actual EPS is negative, and the ratio is essentially meaningless.

In order to try to address these problems in the sample used here, the analysis was re-run separating the two components of the variables, and also by using a simple dichotomous variable valued 1 if the actual earnings were below estimate, and 0 otherwise. These still did not produce a significant result in support of the hypothesis.

While the fact that a relatively large number of firms in this sample had low or negative earnings would possibly explain the reason that our findings differ from Puffer and Weintrop (1991) in terms of earnings expectations, it is curious that the findings here are also contrary to the findings by Puffer and Weintrop on stock return and accounting measures. This may arise from the fact that in this study longer term measures of performance were used. Puffer and Weintrop measured stock returns and change in accounting measures of performance over the relatively short period of one year, as opposed to three years here[2]. The contrary findings support the notion that boards give the CEO the opportunity to reverse performance decline rather than immediately taking action to remove the CEO, and will only resort to the drastic action of removing the CEO if the performance decline is sustained over a longer period. If this argument is correct then performance measures that consider performance over a period of time rather than immediate performance should be used when examining forced exit. In the study reported here, all of the measures found to be related to forced exit were measures over a period of time.

However, Puffer and Weintrop's (1991) concept of unmet expectations as the real driver of CEO forced succession rather than actual performance remains very intuitively appealing. What is not so clear is why analysts' forecasts accurately reflect the board's expectations. Puffer and Weintrop argue that this linkage is as much causal as anything else -- that the board's expectations are at least partially set by the analyst's forecasts. However, when one considers that analysts are more distant from the organization, boards should have more access to inside information enabling them to create their own expectations. Also, there is considerable difference in the goals for the organization, and time perspective valued -- the short term, quarterly results perspective of analysts, versus the supposed long term institution building perspective of boards. So, expectations may be considerably different for both groups.

Hypotheses 5, 6 and 7 addressed the relationship between power, performance and forced exit. Hypothesis 5, concerning the relationship of CEO power to forced exit was strongly supported. CEO power was negatively and significantly related to forced exit in every performance model. However, no interaction effect was found between CEO power and performance measures. So, CEO power is negatively associated with forced exit, regardless of firm performance.

A relationship between board power and forced exit was found as well, supporting Hypothesis 6. However, similar to the findings of Boeker (1992), no direct relationship between board power and forced exit appeared. An interaction was found between director power and poor performance in all models tested. So, the power of directors only influences forced exit when considering poorly performing firms. This finding is logical as the board will be more concerned with removing a CEO when the company is performing poorly.

Support is also found for Hypothesis 7. A relationship between institutional ownership and forced exit is found, but as above, an interaction rather than a direct effect is found, except for one case where a direct effect was found. The interaction effect is present when performance is measured as debt downgrading, earnings expectations and cumulative abnormal returns but not when measured as profitability. So, institutional holdings are related to forced exit, but only in poorly performing firms.

[2] Puffer and Weintrop (1991) also test 5 year average performance measures and while they do not report the results, the authors state that they support other findings. We would note however, that 5 year average results do not capture the decline in performance that we are able to capture by using change in performance over 3 years rather than using averages which may dilute the severity of the decline in performance.

This finding is not surprising. Institutional investors will most likely be interested in having the CEO dismissed if the firm is performing poorly, and they are concerned only with the measures that directly affect them as investors; the market measures of performance rather than accounting measures.

Overall, then, it appears that the power of stakeholders plays any important role in forced exit. The power of the CEO is important regardless of the performance of the firm. This fact is not surprising. The CEO will attempt to use his power to withstand dismissal regardless of firm performance. On the other hand, power of the board and investors are only related to forced exit in poorly performing firms. These findings are likewise not surprising. The board and investors will be most concerned with removing the CEO when the firm is performing poorly.

Partial support was found for Hypothesis 8 concerning stock holdings of the CEO and board (Table 2.1). While the size of the CEO's holding relative to the board and the board's holdings relative to the total shares outstanding were not significant, the CEO's holding relative to the total outstanding shares was significant ($p<.1$). Thus it would appear that it is the absolute ownership power of the CEO which is important rather than the direct representation of large shareholders on the board, and the board is less likely to dismiss CEO's with substantial holdings.

Table 2.1. Stock ownership

Variable	DF	Parameter EstimateError	Standard Chi-Square	Wald Chi-Square	Pr >
Intercept	1	0.2705	0.2157	1.5730	0.2098
CEO / Board holding	1	0.00330	0.0386	0.0073	0.9318
Board / Total Shares	1	2.1202	2.3210	0.8345	0.3610
CEO / Total Shares	1	-18.4858	10.1290	3.3307	0.0680

No support was found for Hypotheses 9 (Table 2.2), or 10 (Table 2.3). These hypotheses are an attempt to empiricize a component of loyalty that the board member may have to the CEO. It may be that these measures do not really get at the construct that we are trying to measure. While board members with less tenure than the CEO will have been appointed while the CEO is in office, loyalty and to some extent, inertia, generated by this fact is likely to be reduced over time as the board member establishes him- or herself in the position and becomes more knowledgeable about the company and the issues facing it. Similarly, while from anecdotal evidence it would appear that it is necessary for one director to initiate the motion for dismissal, and further that these directors frequently have some underlying motive or hidden agenda for doing so (Sonnenfeld, 1988), we may need to take a more fine grained approach to discover empirical evidence for such a phenomenon. Indeed, these things may happen so differently on a case by case basis that it is unlikely to be supported empirically even if it occurs. Thus, somehow, we need to be able to combine different indicators of loyalty to effectively measure loyalty as a construct.

Table 2.2. CEO / Board relative tenure

Variable	DF	Parameter EstimateError	Standard Chi-Square	Wald Chi-Square	Pr >
Intercept	1	-0.2560	0.3416	0.5615	0.4537
Tenure > CEO / Size	1	0.7745	0.5975	1.6806	0.1948

Table 2.3. Director Loyalty

Variable	DF	Parameter EstimateError	Standard Chi-Square	Wald Chi-Square	Pr >
Intercept	1	-0.2953	0.3598	0.6736	0.4118
Tenure>CEO / Size	1	0.6262	0.6225	1.0120	0.3144
"Less loyal" type	1	1.1253	1.5884	0.5019	0.4787
Presence of large block holder of stock	1	-0.0633	0.4241	0.0222	0.8814

No evidence was found for the CEO's ability to restrict the monitoring activities of the board through control of information or structural control of the board and committees (Hypotheses 11-12, Tables 2.4, 2.5). These results provide some evidence that boards still adequately perform their fiduciary duty even in the face of structural constraints. The fact that having a CEO who is also board chairman and chair of major committees, and even the number or frequency of meetings does not deter an ouster shows the potential for effective governance in the face of such constraints.

Table 2.4. CEO control of information

Variable	DF	Parameter EstimateError	Standard Chi-Square	Wald Chi-Square	Pr >
Intercept	1	0.7550	0.6302	1.4356	0.2309
Duality	1	-0.3136	0.6978	0.2020	0.6531
Committees where CEO not chair	1	-0.1128	0.1887	0.3575	0.5499

Table 2.5. Structural monitoring ability of the board

Variable	DF	Parameter EstimateError	Standard Chi-Square	Wald Chi-Square	Pr >
Intercept	1	-0.8094	0.5932	1.8620	0.1724
# of committees	1	0.0881	0.1148	0.5891	0.4428
# of board meetings	1	0.0604	0.0558	1.1709	0.2792

6. Conclusions

The use of multiple performance measures used in this study improves our understanding of the nature of the relationship between performance and succession. In addition to profitability and stock returns, nontraditional measures of performance including debt ratings and analysts' earnings expectations are used. While there is a confirmed relationship between performance and forced CEO succession, there are a variety of other reasons for exit not directly tied to performance (although directors may be concerned about their possible impact on future performance). Therefore we cannot expect the pure statistical relationship between performance and forced succession to be overwhelming. However, the overall findings of a link between performance and exit and even the common perception of the existence of such a link may have pervasive influence on the outcomes for the ousted CEO.

The findings in this study support a negative relationship between performance changes and forced succession. However, this relationship is dependent upon how performance is measured. In this sample, succession is related to stock returns, changes in profitability and debt downgrading. Forced succession was not found to be related to earnings expectations.

These findings suggest that one must take care to choose a performance measure that is related to the phenomenon under study. The logical conclusion from the results found here is that performance should be measured over a long period of time and controlled for industry effects when studying forced exit. The results also suggest that external measures of performance should be considered in addition to internally generated financial ratios.

The fact that involuntary succession is related to, and possibly triggered by, certain performance shortfalls and not others suggests a promising line of research beyond the scope of this study. Findings on the relationship between performance measures and succession help us to understand the board's decision making process. The measures of performance that are most salient to the board should be those related to succession as the board has ultimate responsibility to dismiss the CEO.

While performance is one major cause of exit, power is also a major consideration. In this first part of the study, we have explored the relationship between the power of owners; their agents, the board; and the CEO, and the impact the balance of power has on exit. The disruption of the fine balance of power within an organization, and particularly between the CEO and the board of directors, has been shown to have a significant bearing on the decision to oust a CEO (Kimberly & Zajac, 1989). While we have suggested above that the common perception of the link between performance and exit may have a substantial impact on the outcomes for the ousted CEO, the causes and machinations of power struggles, although equally real,

are often less visible to the outside world and so it remains a question to be explored whether or not power related exits have the same impact on the ousted CEO.

Another valuable extension from this study, given its current prominence in the media, the relationship between institutional ownership and succession deserves further future attention. Given the increasing involvement of institutions in governance activity, a relationship between institutional investment and succession is predicted and found. While the popular press has touted the increasing power of institutional investors, few studies have considered the effect of these owners on the governance process. This study finds a relationship between institutional investment and forced exit in poorly performing firms. The institutional investor is at the nexus of the power and performance variables in the exit equation. While the institutions have power by their large holdings of stock, they themselves have holdings spread across numerous companies and so only tend to exert their potential power when performance is an issue. So, future studies of forced exit as well as other mechanisms of the governance process should not ignore the increasing influence of institutional investors, and indeed, should explore this relationship further.

The most interesting conclusions from this study are that although we found strong results for the performance - exit relationship and the moderating impact of stakeholder power on this relationship, once we controlled for performance by re-matching the sample on a performance measure, virtually none of the variables about how the board was structured had any impact. We used structural measures such as board members stock holdings, tenure of the board member relative to the CEO, CEO duality, number of board committees and number of board meetings, all of which have been touted by shareholder activists and proponents of governance metrics as being key to good governance, but none of which made a difference to the likelihood of dismissing the CEO in our sample. This would lend support to the view that governance is not about regulated board structures, but is dependent on the individuals involved (Sonnenfeld, 2002). As long as the board had sufficient independence in terms of the percentage of outside directors, further structural factors didn't matter. Thus, while despite the fact that our course-grained examination of group dynamics did not yield results in this study, future research might turn its focus from structural concerns to a more fine-grained examination of cultural norms and individual level attributes that may affect the board's willingness to act in the face of poor performance.

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