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The Influence of the Board Chairman on CEO Dismissals and Replacements

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Abstract

Based on a sample of large, publicly traded German companies, we study performance implications of CEO duality for executive succession events. We find that CEO dismissals are more frequent at low levels of pre-succession market-based performance and CEO duality. Post-succession sales growth and operating earnings are higher for firms with CEO dismissals and CEO duality. Our results provide partial support to stewardship theory and no support to agency theory.

Keywords: Executive Succession, CEO Duality, Stewardship Theory, Agency Theory

INTRODUCTION

Since the 1980s, the executives and boards of poorly performing firms face increasing market pressures, such as buyout threats, and institutional investor and shareholder activism (Jensen, 1993; Martin & McConnell, 1991). These pressures led to the institution of more stringent corporate governance mechanisms, such as outsider dominated boards and stock incentive plans, with the objective of committing managers to the pursuit of shareholder value enhancing strategies. The heightened concern for effective corporate governance prompted research on executive succession events that, specifically, focused on the question of whether underperforming firms dismiss their CEOs (e.g., Denis & Denis, 1995; Denis & Kruse, 2000; Wiersema, 2002; Bresser et al., 2005).

Most CEO dismissal research has been conducted in the U.S. but, typically, this research has paid little attention to the role of the chairman of the board in a firm's dismissal process. We address the general question of whether the board chairman plays a performance-enhancing role in CEO dismissal events. Specifically, we investigate this question for a sample of German corporations, and thus for a setting where, just like in the U.S., more stringent governance mechanisms were adopted recently (Tuschke & Sanders, 2003; Fiss & Zajac, 2004). However, CEO dismissal research is scarce in Germany, and research on the board's influence on dismissals is virtually absent.

CEO DUALITY IN THE U.S. AND GERMANY

In the U.S., CEO duality exists when the same person holds both the CEO and the board chairperson positions in a corporation (Rechner & Dalton, 1991). *In Germany*, this situation is legally proscribed. However, *a similar form of duality does exist: Frequently, a German board chairperson has been the former CEO of his or her firm*.

The corporate governance debates in the U.S. and Germany have criticized and rejected CEO duality because it promotes CEO entrenchment and opportunistic, inefficient behaviour (e.g., Finkelstein & D'Aveni, 1994). In Germany, this criticism has led to widespread calls for proscribing duality (Malik, 2002; Oechsler, 2003), even by law (Fockenbrock, 2004; Löwer, 2005).

However, this criticism is motivated by an agency theoretical logic, and isolated, well-publicized cases of mismanagement. A different view emerges when considering stewardship theory.

CEO DUALITY IN LIGHT OF AGENCY AND STEWARDSHIP THEORIES

The *agency theoretical* perspective focuses on CEO entrenchment and opportunism (Fama & Jensen, 1983; Finkelstein & D'Aveni, 1994). Duality increases the likelihood that executives will take actions that deviate from the interests of their principals because it is an impediment to effective control processes. To avoid opportunistic executive behaviour (Eisenhardt, 1989), agency theory asserts that vigilant boards would tend to favour non-duality because such structures facilitate monitoring and control. Within the German context, this view would support a proscription of structural arrangements that allow a departing CEO to assume the role of the board chairman.

Stewardship theory suggests that executives can act as stewards, and are motivated to act in the best interest of the firm and its stakeholders (Donaldson & Davis, 1991; Davis & Schoorman, 1997). Given a choice between self-serving and pro-organizational behavior, executives would not depart from the interests of their organization. Thus, for CEOs who are stewards, their pro-organizational actions are best facilitated by governance structures that give them high authority and discretion (Donaldson & Davis, 1991), i.e., structures that are based on CEO duality.

Interestingly, when disregarding the moderating effects of firm performance, lower CEO dismissal rates can be expected from both an agency and a stewardship perspective under conditions of CEO duality. Agency theory would suggest that (German) CEO duality decreases dismissals because chairmen do not wish to disrupt their power network. Stewardship theory suggests that CEO dismissals are less likely because chairmen will have used the intimate knowledge of their firms to hire highly qualified CEOs that act in the best interest of stakeholders and, therefore, do not need to be dismissed. What follows is[1]:

Hypothesis 1: Firms with CEO duality will dismiss the CEO less frequently than firms with non-duality.

PRE-SUCCESSION PERFORMANCE, CEO DISMISSALS, AND CEO DUALITY

Several studies provide evidence that CEO dismissals are preceded by poor firm financial and/or stock price performance (Denis & Denis, 1995; Goodstein & Boeker, 1991; Westphal & Fredrickson, 2001; Zajac & Westphal, 1996; Wiersema, 2002; Leker & Salomo, 1998; Salomo, 2001; Bresser et al., 2005). But what is the role of the board chairman, and specifically CEO duality in such dismissal events? Agency and stewardship theories would suggest alternative scenarios.

Agency theory would predict self-serving behavior of the chairman. In the German context, duality would be expected to prevent the dismissal of a poorly performing CEO because the CEO is likely to be a part of the chairman's good-old-boy-network and instrumental to his/her power. In contrast, with a stewardship perspective it can be argued that CEO duality will lead to dismissals as necessary, because stewards will not hesitate to fire a poorly performing CEO if this measure is in the best interests of their firms. These ideas lead to two alternative hypotheses:

Hypothesis 2a: CEO dismissals will be less frequent for firms with poor pre-succession performance and CEO duality. (Agency theory)

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[1] Note that all our hypotheses define CEO duality in the German sense, i.e., the board chairman being a former CEO of his/her firm.

Hypothesis 2b: CEO dismissals will be more frequent for firms with poor pre-succession performance and CEO duality. (Stewardship theory)

POST-SUCCESSION PERFORMANCE, CEO DISMISSALS, AND CEO DUALITY

A corporate governance system that encourages the dismissal of poorly performing CEOs can be considered effective if it leads to the appointment of replacement CEOs who will improve the performance of their firms. If such improvements do not obtain, the system is flawed. While several studies support this proposition, the evidence is somewhat inconclusive (Weisbach, 1988; Denis & Denis, 1995; Gerpott, 1993; Jahn, 1996; Salomo, 2001). For example, both Wiersema (2002) and Bresser et al. (2005) find that firms with CEO dismissals do not experience significant improvements in either accounting or market performance.

Again, what is the chairman's and CEO duality's role in selecting a replacement CEO who manages to turn things around? According to agency theory, the selection of less qualified successors can be expected. The chairman wants a successor who does not disrupt his/her influence and power, i.e., who doesn't 'rock the boat', but these individuals may not be highly qualified to mastermind and implement a turnaround. With a stewardship theoretical perspective, concern for the successor's qualifications will be paramount. Powerful stewards (i.e., chairmen who are former CEOs) will actively seek for the successor who appears to be best qualified for managing a successful turnaround. What follows are alternative predictions:

Hypothesis 3a: Performance in the post-succession period will be lower for firms with CEO dismissals and CEO duality. (Agency theory)

Hypothesis 3b: Performance in the post-succession period will be higher for firms with CEO dismissals and CEO duality. (Stewardship theory)

METHODS

Sample

Data on succession events on all large German stock companies (DAX 100) for the years 1997 – 2003 were collected based on the firms' annual reports and the *Hoppenstedt* database. During this seven-year period, 111 CEO succession events were identified. After distinguishing between dismissals and routine successions (procedure described below), the final sample consisted of n = 107 succession events.

Measures and Analysis

Succession Type. To verify the type of succession, we content analyzed all press articles on each succession event that were included in the *Lexis/Nexis* database. Two authors reviewed each article and classified each succession event independently as either a dismissal or a routine succession. Only those events were classified as dismissals where disagreement between the CEO and the board was given as the reason for a CEO's departure. Routine succession events comprised causes such as retirements (including health-related early retirements), voluntary departures due to personal reasons, and replacements due to the death of an incumbent. 94.4% of the independent classifications were in agreement, corresponding to a Cohen's kappa of .88 ($p < .001$). Succession events that had been classified differently were discussed and either resolved or excluded from the data set. This procedure led to an identification of 36 dismissals and 71 routine successions. Succession type is a dummy variable with scores of 1 for dismissals and 0 for routine succession events.

CEO duality. The measure is a dummy with information ascertained at the time of a CEO succession event. A score of 1 is used for a board chairman who has been a former CEO of his/her firm; scores of 0 are assigned to chairmen who were not former CEOs of their firms.

Performance measures. Three accounting measures of performance and one market measure are utilized: operating earnings to total assets (*EBIT/TA*), return on assets (*ROA*), sales growth

(*SG*), and total return to the firm's shareholders (*RTS*). All four variables were calculated as industry adjusted performance measures by taking the unadjusted measure and subtracting the industry average. For example, an industry adjusted ROA was obtained by subtracting the Industry ROA from the firm ROA. The industry averages were calculated on the basis of all firms with the same aggregate SIC code as the sample firm.

All performance measures were also calculated in terms of change rates: To test for *H3a* and *H3b*, it is sensible to consider relative in addition to absolute changes.

All performance measures were calculated for both a pre-succession and a post-succession period. The year of the succession event was excluded from the calculation of pre- and post-succession performance because both the outgoing and the incoming CEO have considerable discretion to manipulate the short term financials of the firm. Thus it would be difficult to attribute the performance of the succession year to either CEO. A firm's pre-succession period (performance) is the average of a performance measure of the two years preceding the succession event, and the post-succession period (performance) is the average of the two years following a succession event.[2]

Analysis. The test of *H1* is based on frequency distributions and a χ^2-test. *H2a* and *H2b* are tested by means of logistic regression analysis, and *H3a* and *H3b* are tested using multivariate regression analysis. All regression models (base and full) and runs included time/year dummies.

PRELIMINARY RESULTS AND DISCUSSION

H1 is supported: CEOs are dismissed less frequently under conditions of duality, i.e., when the board chairman is a former CEO, than non-duality ($\chi^2 = 8{,}927$, $p = .003$).

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[2] Since consolidated performance data were only available through 2002 at the time of data collection, tests pertaining to post-succession effects (*H3a* and *H3b*) are based on succession events during the period of 1997 to 2000. Thus, a reduced sample of n=64 (24 dismissals and 40 routine successions) is used.

Logistic regression analysis was used to test *H2a* and *H2b* about the joint effects of CEO duality and performance on succession type. The logistic model was individually tested for all four measures of pre-succession performance (RTS, EBIT/TA, ROA, and SG). All base models indicate that CEO duality is a significant predictor of succession type ($p<.01$) as *H1* suggests: CEOs are dismissed less frequently under conditions of duality.[3] With the exception of ROA, poor firm performance is not by itself a significant predictor of succession type. ROA, however, shows a significant ($p<.05$) main effect, i.e., dismissals are more likely with a low ROA. The full models indicate that the interaction of RTS and CEO duality moderates the probability of dismissal ($p=.034$). The plots of the respective interaction term shows that CEO dismissals are more frequent at low levels of market based performance and CEO duality. This result supports *H2b*, i.e., the stewardship theoretical prediction. In the full models involving the three accounting-based performance measures no significant interaction effect obtains.

Thus, the overall logistic regression results provide partial support for *H2b* that dismissals will be more likely for firms with CEO duality and poor pre-succession performance. The insignificant interaction effects in the models using accounting-based performance measures suggest that CEO duality when paired with accounting performance does neither increase nor decrease the frequency of CEO dismissals.

Multivariate regression analysis was used to test *H3a* and *H3b* about the joint effects of succession type and CEO duality on post-succession performance. Eight regression analyses were performed, four with absolute values of the post-succession performance measures, and four that use the relative changes of the post-succession performance measures as dependent variables. The base models indicate that succession type is not by itself a significant predictor of post-succession firm performance. Similarly, with two exceptions, CEO duality is not by itself a significant predictor of post-succession performance. The exceptions concern sales growth, where positive main effects ($p<.05$) obtain for the models using the absolute and the relative

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[3] Due to space constraints, tables containing numerical regression results are omitted.

values of the performance measure: CEO duality leads to the appointment of successors that manage to increase sales growth significantly during the two-year post-succession period.

In two (of eight) cases, the full models reveal significant interaction effects. The relative increases in sales growth (p=.008) and EBIT/TA (p=.016) are higher for firms with CEO dismissals and CEO duality. The plots of the interaction terms indicate that the relationships are in the direction predicted by *H3b*. Thus, multivariate regression results also provide partial support for stewardship theory.

Our study on the influence of CEO duality on executive succession decisions, specifically CEO dismissals, provides partial support to stewardship theory and no support to agency theory. The results suggests that a chairman who has been a former CEO of his/her firm exerts either a positive influence on succession decisions or an influence that is not different from chairmen who did not previously assume the role of CEO. These findings suggest that the criticism of CEO duality in Germany (e.g., Malik, 2002; Fockenbrock, 2004) is not substantiated, and appears to be a politically motivated strawman debate based on nothing but anecdotal evidence. Rather than proscribing CEO duality by law, efforts should be directed towards exploiting the expertise of former CEOs, and on incentives that will encourage them to perform as effective stewards once they assume the role of chairman of the board.

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