INFORMATION ASYMMETRY AND THE DISMISSAL OF NEWLY APPOINTED CEOS: AN EMPIRICAL INVESTIGATION

YAN ZHANG

Jesse H. Jones Graduate School of Management

Rice University

6100 Main Street

Houston, Texas 77005

Phone: (713) 348-2462

Fax: (713) 348-6296

yanzh@rice.edu

Forthcoming at *Strategic Management Journal*

October 2007

The author acknowledges the helpful comments and suggestions provided by Haiyang Li, Nandini Rajagopalan, Wei Shen, and Margarethe Wiersema. Suggestions and comments provided by SMJ editor Edward Zajac and two anonymous SMJ reviewers have significantly improved this article.

INFORMATION ASYMMETRY AND THE DISMISSAL OF NEWLY APPOINTED CEOS: AN EMPIRICAL INVESTIGATION

ABSTRACT

Why are some newly appointed CEOs (i.e., with tenure of three years or less) dismissed while others are not? Drawing upon Zajac's (1990) argument on information asymmetry and adverse selection in CEO selection, I argue that the board of directors may make a poor CEO selection at the succession time and as a result the board needs to dismiss the CEO after succession, when better information about the CEO is obtained. Therefore, the level of information asymmetry at the succession time increases the likelihood of the dismissal of the newly appointed CEO. With data on 204 newly appointed CEOs, the results of this study support the argument. After controlling for alternative explanations of CEO dismissal (e.g., firm performance and political factors), the results show that the likelihood of the dismissal of the newly appointed CEO is higher in an outside succession and/or if the succession is following the dismissal of the predecessor CEO. Further, if at the succession time, the firm's board has a nominating committee that is independent and/or in which outside directors have few external directorships, the likelihood of the dismissal is lower. Contributions to the CEO dismissal/succession literature are discussed.

Key words: New CEO dismissal, information asymmetry, board committees.

Selecting a new CEO is a top-priority task for a board of directors (Lorsch and Khurana, 1999; Zald, 1969). The board is expected to select a new CEO who can lead the firm to success. However, in many cases CEO successions become failures in which the newly appointed CEOs get dismissed with a short tenure (i.e., three years or less) and boards have often been criticized for not having the necessary skills and assurance to guide the CEO succession process (Gabarro, 1987; Khurana, 2001; Wiersema, 2002). Recently the dismissal of CEOs with short tenures has become a global trend as the rate of CEO dismissals increases and the mean CEO tenure declines (Khurana, 2001; Lucier, Schuyt, and Tse, 2005; Wiersema, 2002).[1] As Lucier and colleagues (2005: 3) claimed, "early departure of chief executives is the 'new normal' for corporations, the age of the ephemeral CEO is here."

The dismissal of a newly appointed CEO can result in organizational disruption that can lead to lost opportunities (Khurana, 2001). Also, the dismissal of a newly appointed CEO often makes a firm bypass a normal succession process and forces the firm to select another new CEO in an unplanned manner, which may lead to a vicious cycle in the firm's successions (Wiersema, 2002). As Shen (2003: 469) noted, "dismissing new CEOs before they can fully demonstrate their leadership potentials is not only a waste of executive talent but very disruptive to the firm, because it hinders the establishment of reliable and predictable routines that are highly regarded by inside and outside stakeholders (Hannan and Freeman, 1984)."

What factors can cause the dismissal of newly appointed CEOs? Previous studies have provided some explanations, including the weak power of the new CEOs (Shen and Cannella, 2002b), the bad actions new managers take in a rush (Gabarro, 1987), the obsolescence of the CEOs' competence (Ocasio, 1994), and the emphasis the board places on the candidates' celebrity status (Khurana, 2001). In this study, I propose that the dismissal of a newly appointed

[1] According to a recent study of the world's largest 2,500 publicly traded corporations conducted by Booz Allen & Hamilton, the rate of CEO dismissals has escalated to where they represented nearly a third of all CEO turnovers in 2004, which was a 300 percent increase over 1995—the earliest year benchmarked (Lucier, et al., 2005). Meanwhile, the mean tenure of departing CEOs has declined from 11.4 years in 1995 to 8.8 years in 2004 in North America, and from 8.8 years in 1995 to 6.6 years in 2004 globally (Lucier, et al., 2005: 8).

CEO is an outcome of the information asymmetry and adverse selection problem at the succession time. Because of information asymmetry between boards of directors and potential CEO candidates (Zajac, 1990), boards may make poor CEO selections (i.e., adverse selection) at the succession time. The updated information provided in the early years of a new CEO's tenure can enable the board to better evaluate the new CEO's true competencies and as a result the board may dismiss the new CEO.

Following this proposition, I argue that the origin of the new CEO, the board of directors (as the selection decision maker) and the context in which the selection is made (i.e., the disposition of the predecessor CEO) may affect the level of the information asymmetry at the succession time and thus they may affect the likelihood that the newly appointed CEO is dismissed. Empirically, I will examine the impact of these factors on the likelihood that a newly appointed CEO is dismissed within three years after the succession. A three-year window is used in order to be consistent with previous studies, which have typically referred to the three years after succession as the post-succession time period and have examined how successions influence organizational outcomes during this time period (e.g., Shen and Cannella, 2002a; Zhang and Rajagopalan, 2004). Indeed, Finkelstein and Hambrick (1996: 193) have explicitly suggested the use of three years after succession to examine executives' early survival prospects.

THEORY AND HYPOTHESIS DEVELOPMENT

Information Asymmetry and the Dismissal of Newly Appointed CEOs

CEO dismissal, in which a CEO leaves office against his or her will, has attracted a lot of research attention. The existing literature on CEO dismissal has suggested that poor firm performance and political reasons are two major factors for CEO dismissals (e.g., Fredrickson, Hambrick, and Baumrin, 1988; Ocasio, 1994; Shen & Cannella, 2002b).

Some studies have further shown that compared to long-tenured CEOs, newly appointed CEOs face a higher risk of dismissal. For example, focusing on a sample of large, publicly traded companies in the 1988–1997 time period, Shen and Cannella (2002b) found that the likelihood of CEO dismissal is higher in the earlier years than in the later years in office. Similarly, Ocasio

(1994) found that the risk of CEO turnover increases in the early years of their tenures and then declines in the later years of their tenures. Further, Gabarro (1987), in his field study, observed that many CEOs lose their jobs within less than three years. Khurana (2001) also provided anecdotal evidence suggesting that many new CEOs are dismissed after a brief tenure.

In this study, I focus on newly appointed CEOs and investigate why some of them are dismissed while others are not. I argue that the dismissal of a newly appointed CEO is an outcome of information asymmetry and adverse selection at the succession time. Using the information asymmetry and adverse selection argument of agency theory in the CEO succession context[2], Zajac (1990) argued that there exists information asymmetry between the board of directors and the potential CEO candidates. The candidates typically possess more information about their true competencies than the board, and thus, they may misrepresent such competencies, which makes the board incapable of selecting a new CEO whose competencies fit the firm's task contingencies (Zajac, 1990). Further, while a candidate's generic human capital can be transferred between industries and firms, his or her industry-specific human capital is hard to transfer between industries, and firm-specific human capital is hard to transfer between firms (Harris and Helfat, 1997). Even inside candidates may not necessarily be able to carry out the CEO task because the CEO position differs significantly from other senior executive positions (Zhang and Rajagopalan, 2004). For these reasons, the track record of the new CEO is no guarantee that he or she will continue to be successful in the new job (Shen, 2003). Therefore, the board may make a poor CEO selection decision.

Agency theory suggests that the principal can learn about the agent's ability over time and that the updating of the ability estimate becomes more informative with each successive period (Holmstrom, 1982). According to this argument, the board can update its ability estimate of the

[2] Agency problems emerge from principal-agent relationships because of two fundamental conditions: goal incongruence and information asymmetry. Goal incongruence is an assumed condition of principal-agent relationships, suggesting that agents, e.g,. CEOs, seek to maximize their own interests, which may not be consistent with the best interests of the principal, e.g., shareholders (Zajac, 1990). Consistent with Zajac (1990), in this study, I take goal incongruence between the board of directors and the newly appointed CEO as an assumed condition (i.e., the newly appointed CEO wants to get the job although his/her competencies may not fit the job) and investigate the adverse selection problem of information asymmetry in new CEO selections.

new CEO after the succession, as it observes and evaluates how the new CEO applies his or her existing knowledge and skills to the new position and develops new task knowledge and skills required by the position. As noted by Vancil (1987), new CEOs are watched closely by their boards and stakeholders because they have yet to prove themselves in the new position. Based upon the updated information after the succession, a board of directors may dismiss the newly appointed CEO.[3] In other words, a CEO succession process does not end when a new CEO is appointed. It can be a continuous evaluation process that may last for a few years after the succession. Following this logic, I argue that the level of information asymmetry at the succession time can increase the likelihood that a newly appointed CEO is dismissed[4]. In the following sections, I will develop specific hypotheses to test this theoretical argument.

The Impact of the Origin of the New CEO

New CEO origins have been typically divided into two categories: (1) inside CEOs who are hired from within the firm, and (2) outside CEOs who are hired from outside the firm. Zajac (1990) argued that the insider versus outsider distinction is important in the board of directors' ability to distinguish the characteristics of a CEO. Relative to an outside succession, in an inside succession, because the board members and the inside candidate have joint work experience, the board has greater opportunities to update its ability estimates of the candidate more accurately over time (Zajac, 1990). This argument is based upon Holmstrom's (1982) formal modeling, which suggests that the principal can learn about the agent's ability over time, and the updating of the ability estimate becomes more informative each successive period. Thus, relative to an inside succession, an outside succession is characterized by a higher level of information

[3] This argument is unique to the dismissal of newly appointed CEOs. The dismissal of CEOs who have been in office for many years is unlikely to be an outcome of the information asymmetry problem at the succession time because the boards of directors should have updated their information regarding the CEOs in the early years of the CEOs' tenure.

[4] What a new CEO does (or fails to do) after taking office can also affect the dismissal of the CEO (Gabarro, 1987). In the information economics literature, this has been labeled formally as the *moral hazard* problem, which is different from the *adverse selection* problem examined here. Zajac (1990: 220) noted that the literature on agency problems between owners and managers has typically discussed the moral hazard problem and he argued that the adverse selection problem is also a major factor in the CEO/board agency relationship. This study specifically examines the *adverse selection* problem by focusing on the information asymmetry conditions at the succession time rather than after the new CEO takes office.

asymmetry between the board and the new CEO (Zajac, 1990). As a result, the board tends to make a worse CEO selection decision in an outside succession than in an inside succession (Zajac, 1990). Previous studies have mainly used this information asymmetry argument of new CEO selection to predict post-succession firm performance and found that appointment of outside new CEOs often leads to inferior firm performance relative to inside new CEOs (e.g., Shen and Cannella, 2002a; Zajac, 1990). In this study, I extend this argument to the dismissal of newly appointed CEOs. I argue that because the board tends to make a worse CEO selection decision in an outside succession than in an inside succession, the new CEO in an outside succession is more likely to be dismissed after succession than the new CEO in an inside succession. This prediction is consistent with Gabarro's (1987) observation from his field study that a disproportionate number of the outside CEOs he studied failed within the first three years. Therefore, I propose,

Hypothesis 1: New CEOs appointed from outside the firm have a higher likelihood of dismissal than those appointed from inside the firm.

The Impact of the Board of Directors

Boards of directors play a central role in CEO successions. Zald (1969: 107) argued that the hiring and firing of CEOs represent crucial "strategic decision points when board power is most likely to be asserted." Lorsch and Khurana (1999) argued that boards are exerting a stronger hand in the oversight of the CEO succession process. While most extant research has focused on the board-at-large, some researchers have called for examination of board committees (e.g., Daily, *et al.*, 1998; Finkelstein and Hambrick, 1996). A board typically has a number of committees that are charged with particular duties and important decisions typically are made by the committees and then reported to the board-at-large. Several studies have shown the importance of board committees as significant components of corporate governance (Abbott, Park, and Parker, 2000; Daily, et al., 1998). In the context of CEO succession, the most important board committee arguably is a nominating committee. Specifically, Knepper and Bailey (2004: 12), in *Liability of Corporate Officers and Directors*, state that:

> This committee should have responsibility for recommending nominees to fill board vacancies and for bringing to the full board recommendations for the membership of board committees. *When a vacancy occurs in the office of chief executive, this committee should recommend a successor*" (italics added).

It is possible that even if a board does not have a nominating committee, a search committee may be formed as the need to select a new CEO arises. However, a nominating committee, even if its main responsibility is to recommend nominees to fill board vacancies, can contribute to a successful CEO succession process. In the process of identifying potential candidates for board vacancies, the committee can get to know managerial talents whose competencies fit the needs of the firm. Further, in the process of filling board vacancies, the committee can develop and institutionalize a procedure of how to work with executive search firms and how to identify and evaluate potential candidates, etc. The information gathered and procedures developed by the committee can be used in the new CEO selection process as the need arises. In contrast, lack of a nominating committee on the board may limit the board's role in a CEO succession process and leave the predecessor CEO to dominate the process (*Economist*, 2003).

Because of the important role of a nominating committee, the independence of the committee is crucial. The independence of a committee refers to the relative representation of outside directors on the committee (Abbott, et al., 2000; Daily, et al., 1998). A non-independent nominating committee, which is mainly composed of insider directors, may be biased in the new CEO selection decision. Previous studies have suggested that inside directors often compete with one another for the CEO position because of the material benefits and prestige associated with it (Ocasio, 1994; Shen and Cannella, 2002b; Zhang and Rajagopalan, 2003). Hence, a non-independent nominating committee is less likely to make an objective judgment in the new CEO selection decision.

In contrast, outside directors are not employees of the firm and they can lend a nominating committee a degree of independence. Empirical evidence has supported the importance of the independence of a board committee. For example, Abbott *et al.* (2000) found that firms with independent audit committees are less likely to be sanctioned for fraudulent or misleading reporting. In a nominating committee, outside directors can bring objectivity to the CEO

selection decision because their incentives are not aligned with those of the predecessor CEO and they are more neutral on the role conflicts relative to the inside directors. As a result, an independent nominating committee is more likely to broadly consider potential CEO candidates, available both within and outside the firm, and objectively evaluate what CEO competencies the firm needs and which candidate's competencies best fit the firm's task contingencies. A broad search and objective evaluation can reduce the information asymmetry and adverse selection problem and enable an independent nominating committee to make a better CEO selection. Therefore, relative to firms that either do not have a nominating committee on the board or have a non-independent nominating committee, firms having an independent nominating committee on the board are less likely to dismiss the new CEO. Therefore, I propose,

Hypothesis 2: The presence of an independent nominating committee on the board at the succession time decreases the likelihood that a newly appointed CEO is dismissed.

Hypothesis 2 focuses on the relative representation of outside directors on a nominating committee. These outside directors may differ in their external directorships. Previous studies have argued that directors' external directorships serve as important information sources to keep the firm up to date on other firms' practices and procedures (Davis, 1991; Haunschild, 1993). In CEO successions, directors with extensive external directorships may use their contacts to help the company recruit new top managers (e.g., Barry *et al.,* 1990). For example, Khurana (2002) found that directors' external directorships represent an important mechanism for the board to identify outside CEO candidates. Directors can also access private information on fine-grained details such as the working style and cultural values of an outside candidate through their external directorships (Khurana, 2001). Therefore, a nominating committee on which outside directors have a larger number of external directorships should have more and better information on a larger number of potential candidates for the CEO position, which can reduce the information asymmetry problem of new CEO selection. Such a committee is likely to make a better CEO selection decision, and as a result, firms with such a committee are less likely to dismiss the new CEO.

One may argue that if outside directors on the nominating committee have a larger number of external directorships, these external directorships will compete for these outside directors' time. As a result, these outside directors will spend less time in managing the focal firm's CEO succession process, which can worsen the information asymmetry problem in new CEO selection. With this possibility in mind, at this stage, I follow previous studies' suggestions on the information benefits of directors' external directorships (e.g., Barry *et al.*, 1990; Khurana, 2001, 2002) and propose the following hypothesis.

Hypothesis 3: The presence at the time of succession of a nominating committee on which outside directors have a large number of external directorships decreases the likelihood that a newly appointed CEO is dismissed.

The Impact of the Disposition of the Predecessor CEO

The disposition of the predecessor CEO—i.e., dismissal versus voluntary turnover—represents an important context of CEO succession (Cannella and Lubatkin, 1993). The existing literature has largely treated dismissing a predecessor CEO (particularly under conditions of poor firm performance) as evidence that the board is executing its due diligence (e.g., Finkelstein and Hambrick, 1996). However, recent studies suggest that the dismissal of the predecessor CEO may adversely affect a firm. For example, in her study of 83 CEO successions in the 500 largest public companies in the U.S. during 1997 and 1998, Wiersema (2002) found that most companies perform no better (and may even perform worse) after they dismiss their CEOs than they did in the years leading up to the dismissal. These companies also do worse than companies that replace their CEOs in a routine succession process.

The dismissal of the predecessor CEO may also adversely affect the subsequent CEO succession process and increase the likelihood that the newly appointed CEO is dismissed. Note that a successful CEO succession usually requires that the board of directors spends a long time grooming inside CEO candidates and/or conducting a comprehensive external search (Friedman and Olk, 1995; Zhang and Rajagopalan, 2004). The dismissal of the predecessor CEO, however, often leads to the bypassing of a normal succession process because the board feels pressure to

choose a successor within a short time period after dismissing the predecessor (Wiersema, 2002). Under such conditions, the board does not have the time to groom internal candidates and/or comprehensively search for external candidates. Nor does the board have the time and information to investigate the true competencies of the potential candidates. In addition, dismissing a predecessor CEO usually occurs under pressure from shareholders. As a result, the subsequent succession process is driven by the desire to quickly restore investor confidence rather than by a careful consideration of the CEO competencies the firm really needs (Wiersema, 2002). This rush to select a new CEO can worsen the information asymmetry problem and very likely lead to a less-than-optimal selection. Therefore, following dismissal of the predecessor CEO, the board is likely to make a worse CEO selection at the succession time and dismiss the CEO after succession. Consistent with this expectation, in their conceptual work, Fredrickson *et al.* (1988) proposed that predecessor CEO dismissal represents an important factor contributing to a new CEO's early vulnerability. Thus,

Hypothesis 4: The dismissal of the predecessor CEO increases the likelihood that a newly appointed CEO is dismissed.

Methods

Sample

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

Measures

Dependent variable: New CEO dismissal. New CEO dismissal refers to a situation in which a newly appointed CEO is dismissed within three years after taking office. Two research assistants collected all news reports on each of the newly appointed CEOs during a four-year period, from the year of succession to three years after the succession, from the *Dow Jones* databases. We relied upon these news reports to identify the dates when the new CEOs assumed office and we used the news reports and annual corporate proxy statements to check whether the CEOs were still in office three years after succession. For those who were no longer in office, we used the news reports to identify the dates when they left office.

Overall, 55 CEOs left office within three years after succession. For those CEOs, we relied upon the news reports to identify the circumstances under which they left office (dismissal versus voluntary turnover), using an approach adapted from the one used by Shen and Cannella (2002b: 1198–1199). There were 4 cases in which the CEOs left office but kept another position in the firm (e.g., chairman or vice chairman), 1 case in which the CEO left office due to health issues, 11 cases in which the CEOs retired, 5 cases in which there were mergers or acquisitions, and 8 cases in which the CEOs accepted a similar position at another firm, all which were identified as voluntary turnovers. There were 5 cases in which the CEO was directly reported as having been fired or ousted, 20 cases in which the CEOs were reported as having resigned unexpectedly or immediately due to poor performance or for undisclosed personal reasons, and 1 case in which the CEO was reported as having taken early retirement and there were discussions of performance problems; all of these were coded as dismissals of the CEOs. Overall, we identified 26 new CEO dismissals on the basis of the news report analysis.

Another widely used approach to identifying CEO dismissals relies on CEO age and continuity as a board member at the time of succession. A succession is considered as a dismissal if the CEO terminates his or her service as both CEO and board member before the age of 64 for reasons other than death, health problems, acceptance of a similar position at another firm, or the occurrence of a merger or acquisition (Shen and Cannella, 2002b). All the 26 “dismissed” new CEOs identified above were all younger than 60 years of age and that none of them continued to

serve on the firm's board of directors after leaving office. Thus, the operationalization of new CEO dismissal based on news report analysis is also consistent with this approach.

A time-varying dichotomous outcome measure—***new CEO dismissal***—was coded 1 in a year in which a new CEO was dismissed and 0 otherwise. Twenty-nine new CEOs who voluntarily left office within three years after taking office were treated as "censored" cases and were included in the sample (Hosmer and Lemeshow, 1999). As was appropriate for the modeling strategy, a newly appointed CEO was dropped from the sample after leaving office (voluntary turnover or dismissal) because he or she was no longer at the risk of dismissal. One hundred and forty-nine new CEOs remained in office three years after succession, and they were treated as "censored" observations. Overall, there were a total of 571 CEO-years for data analyses.

Independent variables. ***Outside new CEO*** was coded 1 for new CEOs who had firm tenure of less than 2 years when assuming office and 0 otherwise (Cannella and Lubatkin, 1993; Harris and Helfat, 1997). The primary data sources for new CEO origin were the *Dun & Bradstreet Reference Book of Corporate Management,* annual corporate proxy statements, and news reports.

From the corporate proxy statements in the year prior to succession, I checked whether there was a nominating committee on a firm's board. For firms with a nominating committee, I counted the number of outside directors and inside directors on the committee. Firms then were divided into three categories: firms with an independent nominating committee on which the number of outside directors was larger than that of inside directors, firms with a non-independent nominating committee on which the number of outside directors was equal to or less than the number of inside directors, and firms with no nominating committee. I then created two dummy variables: ***independent nominating committee*** and ***non-independent nominating committee.*** Coefficients for these two dummies in models represent the comparisons of these two groups of firms with firms with no nominating committee.

I also counted the number of external boards (other than the focal firm's board) on which each of the outside directors on the nominating committee was serving. ***Nominating committee with more external directorships*** was coded 1 if the firm had a nominating committee on which

the average number of external directorships of the outside directors was larger than the sample median (1.75, excluding the focal firm's board) and 0 otherwise. ***Nominating committee with fewer external directorships*** was coded 1 if the firm had a nominating committee on which the average number of external directorships of the outside directors was equal to or smaller than the sample median and 0 otherwise. Coefficients for these two dummies in models represent the comparisons of these two groups of firms with firms with no nominating committee.

Following a similar procedure that has been used to identity new CEO dismissals, I identified the circumstance in which the predecessor CEO left office. ***Predecessor dismissal*** was coded 1 if the predecessor CEO was dismissed and 0 otherwise.

Control Variables. This study controlled for alternative explanations for new CEO dismissal. Poor firm performance has been found to be the most important reason for CEO dismissal (Fredrickson *et al.*, 1988). This study controlled for both concurrent and pre-succession firm performance. ***Concurrent performance*** was operationalized as industry-adjusted return on assets (ROA), in which firm ROA was adjusted for industry differences by subtracting the industry median ROA (excluding the focal firm) (Huson, Malatesta, and Parrino, 2004). This variable was updated yearly and lagged the dependent variable by one year. ***Pre-succession performance*** was operationalized as the average of the industry-adjusted ROA for the three years prior to succession. I also controlled for a lagged measure of ***firm size***, operationalized as the natural logarithm of firm sales for each year a firm was in the sample. These data were collected from COMPUSTAT and CRSP.

Political factors can also affect the likelihood of CEO dismissal (Ocasio, 1994; Shen & Cannella, 2002b), and thus were controlled for in this study. CEO duality, in which a CEO also has the title of the chairman of the board of directors, may decrease the likelihood of CEO dismissal because it can enable the CEO to build strong, unambiguous leadership in the firm and decrease the board's monitoring role (Finkelstein and D'Aveni, 1994). ***New CEO duality*** was coded 1 if a new CEO also had the title of the chairman of the board of directors in a year and 0 otherwise. ***New CEO shareholding*** was measured by the proportion of a firm's outstanding

shares owned by the newly appointed CEO. In addition, Ocasio (1994) and Shen and Cannella (2002b) suggested that inside directors on the board can influence CEO turnover/dismissal, so I controlled for the ***proportion of inside directors*** on the board of directors. Further, I controlled for ***prior CEO experience,*** coded 1 if the new CEO had been a CEO of another firm and 0 otherwise. As Khurana (2001) noted, new CEOs who have been a CEO in another firm have a track record and may point to an understanding of a CEO job, so that they may have a lower risk of dismissal. I also controlled for ***new CEO age,*** operationalized as the years since the new CEO was born in a year. These data were collected from the *Dun & Bradstreet Reference Book of Corporate Management*, annual corporate proxy statements, and news reports.

The survival prospects of CEOs may be time-dependent (Ocasio, 1994). Following Allison's suggestion (1984), I created two year dummy variables: ***year 2*** was coded 1 for a new CEO's second year in office and 0 otherwise, and ***year 3*** was coded 1 for a new CEO's third year in office and 0 otherwise. Coefficients for these two dummies in models represent the comparisons of new CEOs' second and third years with their first year in office.

Data Analysis

The data were analyzed using discrete-time event history techniques that estimate logit models of dichotomous outcomes for pooled time-series data in which the same units are observed at multiple intervals (Allison, 1984; Yamaguchi, 1991). Covariates were allowed, but not required, to vary between time intervals. Because one newly appointed CEO may be observed in multiple intervals and these observations are not independent, a robust variance estimator for cluster data was used to correct for the non-independence (Fischer and Pollock, 2004). This approach essentially treats each cluster (i.e., all observations associated with one newly appointed CEO) as a super-observation that contributes to the variance estimate and thus generates robust estimates.

Using discrete-time event history models offered several advantages in this study. First, given that I had right-censoring in the data, the probabilities of a CEO dismissal occurring may change as a function of time since the CEO assumed office. The use of the discrete-time

approach enabled us to capture the potential effects of time (Allison, 1984). Second, some new CEOs in the sample voluntarily left office during our period of study, and once they left office they were no longer at risk of dismissal. The use of the discrete-time approach allowed me to keep these new CEOs in the sample until they voluntarily left office, thereby providing more rigorous analyses of the antecedents of new CEO dismissal (Allison, 1984). Third, the use of the discrete-time approach also allowed me to control for time-varying control variables such as firm concurrent performance in the analyses (Fischer and Pollock, 2004).

RESULTS

Table 1 presents the means, standard deviations, and correlations of variables in the study. Table 2 summarizes the results of the discrete-time analyses predicting the likelihood that a newly appointed CEO is dismissed. Hypothesis 1 suggests that outside new CEOs are more likely to be dismissed than inside ones. This hypothesis is strongly supported because the coefficient for outside new CEO is positive and significant ($b = 2.11$, $p < 0.001$ in model 2 and $b = 2.05$, $p < 0.001$ in model 3).

Hypothesis 2 suggests that the presence of an independent nominating committee at the succession time decreases the likelihood of new CEO dismissal. The result shows that the coefficient for independent nominating committee is negative and significant ($b = -0.90$, $p < 0.05$ in model 2) and that for non-independent nominating committee is not significant ($b = -0.03$, n.s. in model 2). In additional analyses, I dropped the variable of non-independent nominating committee, and the coefficient for independent nominating committee remained negative and significant ($b = -0.90$, $p < 0.05$). These results suggest that the likelihood of new CEO dismissal is lower in firms with an independent nominating committee than in firms without a nominating committee or firms with a non-independent nominating committee. Hypothesis 2 thus is supported.

Hypothesis 3 suggests that the presence of a nominating committee on which outside directors have a large number of external directorships decreases the likelihood of new CEO dismissal. The result shows that the coefficient for nominating committee with more external

directorships is not significant (b = -0.20, n.s. in model 3). Hence, Hypothesis 3 is not supported. However, the coefficient for nominating committee with fewer external directorships is negative and significant (b = -1.36, $p < 0.05$ in model 3). In additional analyses, I dropped the variable of nominating committee with more external directorships, and the coefficient for nominating committee with fewer external directorships remained negative and significant (b = -1.32, $p < 0.05$). These results suggest that the likelihood of new CEO dismissal is lower in firms with a nominating committee on which outside directors have a small number of external directorships than in firms without a nominating committee or firms with a nominating committee on which outside directors have a larger number of external directorships.

Hypothesis 4 suggests that the dismissal of the predecessor CEO increases the likelihood of new CEO dismissal. This hypothesis is supported because the coefficient of predecessor dismissal is positive and significant (b = 1.00, $p < 0.05$ in model 2 and b = 1.10, $p < 0.05$ in model 3).

[Insert Tables 1 and 2 about here]

Among the controls, firm concurrent performance is negatively and significantly related to the likelihood of new CEO dismissal in model 1. However, this significant relationship disappears in models where the predictor variables are added. There is some evidence suggesting that firm size increases and new CEO duality decreases the likelihood of new CEO dismissal. In addition, the coefficients for the two year dummy variables (year 2 and year 3) are positive and significant.

DISCUSSION AND CONCLUSION

Information Asymmetry and the Dismissal of Newly Appointed CEOs

In this study I focus on dismissals of newly appointed CEOs and systematically examine why some of them are dismissed while others are not. I propose that the dismissal of a newly appointed CEO is an outcome of information asymmetry and adverse selection at the succession time and thus the level of information asymmetry at the succession time increases the likelihood

of the dismissal of a newly appointed CEO. Empirical results of this study have generally supported this theoretical argument.

As expected, I find that outside new CEOs are more likely to be dismissed with a short tenure than inside ones. While previous studies have found that outside CEOs are more likely to be dismissed than inside ones in general (e.g., Shen and Cannella, 2002b), I extend this line of research into the specific context of newly appointed CEOs. This finding supports the theoretical argument that relative to inside CEO successions, outside successions are characterized by a higher level of information asymmetry between the board and potential candidates (Zajac, 199).

Findings of this study suggest that the composition of a nominating committee on a board of directors has significant impact on the dismissal of newly appointed CEOs. As expected, I find that the likelihood of new CEO dismissal is lower in firms with an independent nominating committee at the succession time than in firms that do not have a nominating committee or firms that have a non-independent nominating committee. It appears that an independent nominating committee can provide objectivity in the CEO succession process and thus will have the necessary assurance to guide the process. These results are consistent with other studies of the independence of board committees (e.g., Abbott *et al.,* 2000). The results also provide empirical support for the recent regulation on the independence of board committees. For example, the *American Law Institute's Principles of Corporate Governance* recommended that "at least a majority of the members of a (nominating) committee in a publicly held corporation [should] be outside directors who have no significant relationship with the company's senior executives" (Knepper and Bailey, 2004: 13). The New York Stock Exchange recently instituted a similar requirement (*NYSE: 303A.00 Corporate Governance Standards*).

As hypothesized, I find that the dismissal of the predecessor increases the likelihood that a newly appointed CEO is dismissed. This finding suggests that the dismissal of the predecessor CEO can adversely affect the subsequent CEO succession process, which provides further support to Wiersema's (2002) notion that dismissing a CEO is not a "silver bullet" to solve a firm's problems.

In contrary to Hypothesis 3, I find that the likelihood that a newly appointed CEO is dismissed is lower in firms with a nominating committee on which outside directors have few external directorships (no more than 1.75 on average, excluding the focal firm's board) than in firms that do not have a nominating committee or firms that have a nominating committee on which outside directors have a large number of external directorships (more than 1.75 on average, excluding the focal firm's board). This finding does not support the argument that more external directorships can provide a board of directors with more information to guide a succession process (e.g., Barry *et al*., 1990; Khurana, 2001, 2002). Instead, this finding suggests that a larger number of external directorships of outside directors can worsen the information asymmetry problem in the CEO selection. Note that outside directors of large companies as sampled here are either executives of their own firms or professionals. These people experience great day-to-day pressures and constant scrutiny in carrying out their own jobs. If they have too many external directorships, they may become stretched too thinly and be unable to devote sufficient time and energy to the focal firm's succession process. This is particularly true considering that the demands on the time of a director have dramatically increased (*Economist*, 2003). Therefore, firms with a nominating committee containing overly committed outside directors are not much different from firms without a nominating committee at all.

Other Explanations of the Dismissal of Newly Appointed CEOs

Results of this study show that while firm concurrent performance is negatively and significantly related to the likelihood of new CEO dismissal, this significant relationship disappears when the predictor variables of this study are taken into account. These findings are different from past research that has consistently found that poor firm performance is the most important predictor of CEO dismissal (e.g., Finkelstein and Hambrick, 1996; Fredrickson et al., 1988; Kesner and Sebora, 1994). A possible reason for the difference is that this study focuses on the dismissals of newly appointed CEOs whereas previous studies have typically examined the dismissals of CEOs regardless of their tenures in office. As Hambrick and Fukutomi (1991) noted, CEOs at different tenure stages face different attributions. For example, considering that a

newly appointed CEO may not have sufficient time to greatly impact firm performance, the performance explanation of the prior research may not be applied to dismissals of CEOs with a short tenure. Also, the theoretical argument of this study, which focuses on the information asymmetry problem *at the succession time,* may not be applied to dismissals of CEO with a long tenure in office.

There is some evidence suggesting that new CEO duality can reduce the likelihood of new CEO dismissal. This is consistent with prior research suggesting that CEOs who are also the board chairman are more powerful than those who are not (Finkelstein and D'Aveni, 1994; Finkelstein and Hambrick, 1996) and thus can better protect their positions. In contrast, when there is a separate board chairman, the newly appointed CEO's power will be undermined and the firm has an alternative choice for leadership, both of which contribute to a higher likelihood that the newly appointed CEO is dismissed. This finding thus shows that power plays a role in dismissals of newly appointed CEOs.

Further, the results of this study show that the likelihood that a newly appointed CEO is dismissed is the lowest in the first year in office, followed by the second year, and the highest in the third year in office. It appears that new CEOs may have a short "honeymoon" right after the succession, especially in the first year of their tenure. During the "honeymoon" period, the new CEOs are allowed to develop and demonstrate their leadership potentials while their jobs are protected. The boards of directors also use this "honeymoon" period to update their information of the new CEOs.

Contributions and Conclusions

This study makes important theoretical and practical contributions to the literature on CEO dismissal and succession. First, this study focuses on newly appointed CEOs, and it proposes and empirically tests a new theoretical argument. This argument suggests that the dismissal of a newly appointed CEO is an outcome of information asymmetry and adverse selection at the succession time. This new argument broadens our understanding of the determinants of CEO dismissal. It highlights the theoretical linkage between the succession context (e.g., the origin

from which the new CEO is selected, the characteristics of the selection decision makers, and the condition under which the selection is made) and CEO dismissal, which is relevant and unique in the context of the dismissal of newly appointed CEOs but has largely been ignored in the literature.

Second, findings of this study suggest that the dismissal of newly appointed CEOs and that of CEOs with longer tenure indeed are driven by different factors. While past research has consistently found that poor firm performance is the most important predictor of CEO dismissal (e.g., Finkelstein and Hambrick, 1996; Fredrickson et al., 1988; Kesner and Sebora, 1994), this study finds that firm performance – both concurrent and pre-succession performance – is not a significant predictor of dismissal of a newly appointed CEO. Thus, by focusing on CEOs at different tenure stages, we can draw a better picture of driving forces of CEO dismissal.

Third, this study contributes to the literature by examining factors that have not been studied in the prior research on CEO dismissal (or succession)—i.e., the composition and external directorships of the nominating committee on the board and the disposition of the predecessor CEO. The significant findings of these novel variables broaden our understanding of what factors drive CEO dismissal and can stimulate future research to investigate the impact of these novel variables on other organizational outcomes of CEO successions. In addition, the significant results regarding board nominating committees also contribute to the emerging research stream that targets the role of board committees (e.g., Abbott *et al.*, 2000; Daily *et al.*, 1998). It appears that a fruitful direction for future studies on corporate governance would be to examine board committees.

Findings of this study also have important practical implications. The dismissal of a newly appointed CEO is often considered the failure of a firm's CEO succession process and the board of directors is usually blamed for that (Khurana, 2001; Wiersema, 2002). Results of this study can inform boards how to better manage the CEO succession process. First, findings of this study highlight the importance of having an effective nominating committee on the board – one that is independent and/or has focused outside directors (i.e., with few external directorships). Second,

the finding that the dismissal of the predecessor CEO can increase the likelihood of new CEO dismissal is practically important. While I have no intention of suggesting that boards should not fire underperforming CEOs, this finding cautions managers that the turmoil resulting from dismissal of predecessors can leave companies with a vicious cycle of CEO succession. Third, the finding on new CEO origin offers a caution with regard to the tendency of firms to look outside for their new CEOs. Also fourth, findings of this study suggest that firms should limit the number of external directorships on which their senior executives and board members can serve. This is consistent with a recent observation that "companies are now reluctant to allow their senior executives to sit on more than one other corporate board" (*Economist*, 2003: 61).

I would like to acknowledge some limitations of this study that, in turn, suggest interesting avenues for future research. First, like most research on CEO succession, this study relied on archival data rather than direct observations of the succession process. Future research that uses field studies may provide better understanding of how a board of directors and a nominating committee on the board make decisions on hiring and firing a new CEO. Second, while this study represents a first research effort to examine factors that can affect the likelihood of new CEO dismissals, future studies can examine other possible antecedents. For example, how do environmental factors and the turnover of senior executive teams affect the likelihood of dismissing a newly appointed CEO? As noted in footnote 4, what a new CEO does (or fails to do) after taking office can also affect the dismissal of the CEO. Third, this study has used a sample of new CEOs in non-diversified firms during the time period 1993–1998. How the results can be generalized to other contexts (e.g., diversified firms) may be an issue. Future research should verify these findings using different samples of new CEOs in order to build a more generalizable theory.

To the best of my knowledge, this is the first study that has systematically examined what factors influence the dismissal of newly appointed CEOs. I hope that these findings can contribute to our knowledge on early departures of CEOs and inspire future studies to address this new phenomenon that is becoming increasingly prominent in today's business world.

REFERENCES

Abbott LJ, Park Y, Parker S. 2000. The effects of audit committee activity and independence on corporate fraud. *Managerial Finance* **26**: 55–67.

Allison PD. 1984. *Event History Analysis: Regression for Longitudinal Event Data*. Sage: Newbury Park, CA.

Barry CB, Muscarella CJ, Peavy JW III, Vetsuypens MR. 1990. The role of venture capital in the creation of public companies. *Journal of Financial Economics* **27**: 447–471.

Cannella AA Jr., Lubatkin M. 1993. Succession as a sociopolitical process: internal impediments to outsider selection. *Academy of Management Journal* **36**: 763–793.

Daily CM, Johnson JL, Ellstrand AE, Dalton DR. 1998. Compensation committee composition as a determinant of CEO compensation. *Academy of Management Journal* **41**: 209–220.

Davis GF. 1991. Agents without principles? The spread of the poison pill through the intercorporate network. *Administrative Science Quarterly* **36**: 583–613.

Economist, 2003. The way we govern now. January 11: 59–61.

Finkelstein S, D'Aveni RA. 1994. CEO duality as a double-edged sword: how boards of directors balance entrenchment avoidance and unity of command. *Academy of Management Journal* **37**: 1079-1108.

Finkelstein S, Hambrick DC. 1996. *Strategic Leadership: Top Executives and Their Effects on Organizations*. West Publishing Company: Los Angeles.

Fischer HM, Pollock TG. 2004. Effects of social capital and power on surviving transformational change: the case of initial public offerings. *Academy of Management Journal* **47**: 463–481.

Fredrickson JM, Hambrick DC, Baumrin S. 1988. A model of CEO dismissal. *Academy of Management Review* **13**: 255–270.

Friedman SD, Olk P. 1995. Four ways to choose a CEO: crown heir, horse race, coup d'etat, and comprehensive search. *Human Resource Management* **34**: 141–164.

Gabarro JJ. 1987. *The Dynamics of Taking Charge*. Harvard Business School Press: Boston.

Hambrick DC, Fukutomi GDS. 1991. The seasons of a CEO's tenure. *Academy of Management Review* **16**: 719–742.

Hannan MT, Freeman JH. 1984. Structural inertia and organizational change. *American Sociological Review* **29**: 149–164.

Harris D, Helfat C. 1997. Specificity of CEO human capital and compensation. *Strategic Management Journal* **18**: 895–920.

Haunschild P. 1993. Interorganizational imitation: The impact of interlocks on corporate acquisition. *Administrative Science Quarterly* **38**: 564–592.

Holmstrom B. 1982. Managerial incentive problems—a dynamic perspective. In *Essays in Economics and Management in Honor of Lars Wahlbeck* 209–230. Swedish School of Economics: Helsinki, Finland.

Hosmer S, Lemeshow D. 1999. *Applied Survival Analysis: Regression Modeling of Time to Event Data.* Wiley: New York.

Huson MR, Malatesta PH, Parrino R. 2004. Managerial succession and firm performance. *Journal of Financial Economics* **74**: 237–276.

Kesner IF, Sebora TC. 1994. Executive succession: past, present and future. *Journal of Management* **20**: 327–372.

Khurana R. 2001. Finding the right CEO: why boards often make poor choices. *Sloan Management Review* **43**(1): 91–95.

Khurana R. 2002. *Search for a Corporate Savior: The Irrational Quest for Charismatic CEOs*. Princeton University Press: Princeton, NJ.

Knepper WE, Bailey DA. 2004. *Liability of Corporate Officers and Directors* (6th ed). Aspen Publishers, Inc.: New York.

Lorsch JW, Khurana R. 1999. Changing leaders: the board's role in CEO succession. *Harvard Business Review*, May–June: 96–105.

Lucier C, Schuyt R, Tse E. 2005. CEO succession 2004: the worlds' most prominent temp workers. *www.strategy-business.com/press/article/05204*.

New York Stock Exchange: NYSE 303A.00 Corporate Governance Standards. *http://www.nyse.com/about/listed/1101074746736.html*, updated November 3, 2004.

Ocasio W. 1994. Political dynamics and the circulation of power: CEO succession in U.S. industrial corporations, 1960–1990. *Administrative Science Quarterly* **39**: 285–312.

Shen W. 2003. The dynamics of the CEO-board relationship: an evolution perspective. *Academy of Management Review* **28**: 466–476.

Shen W, Cannella AA. 2002a. Revisiting the performance consequences of CEO succession: the impact of successor type, postsuccession senior executive turnover, and departing CEO tenure. *Academy of Management Journal* **4**5: 717–733.

Shen W, Cannella AA. 2002b. Power dynamics within top management and their impacts on CEO dismissal followed by inside succession. *Academy of Management Journal* **45**: 1195–1206.

Vancil R. 1987. *Passing the Baton*. Harvard University Press: Boston.

Wiersema M. 2002. Holes at the top: why CEO firings backfire. *Harvard Business Review* **80**(12): 70-75.

Yamaguchi K. 1991. *Event History Analysis*. Sage: Newbury Park, CA.

Zajac EJ. 1990. CEO selection, succession, compensation, and firm performance: a theoretical integration and empirical evidence. *Strategic Management Journal* **11**: 217–230.

Zald MN. 1969. The power and functions of boards of directors. *American Journal of Sociology* **5**: 97–111.

Zhang, Y. Rajagopalan, N. 2003. Explaining New CEO Origin: Firm Versus Industry Antecedents, *Academy of Management Journal*, **46**: 327-338.

Zhang Y, Rajagopalan N. 2004. When the known devil is better than an unknown god: an empirical study of the antecedents and consequences of relay CEO successions. *Academy of Management Journal* **47**: 483–500.

Table 1. Means, Standard Deviations, and Correlations[abc]

Variables	Means	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. New CEO dismissal	0.05	0.21	-															
2. Outside new CEO	0.35	0.47	.17	-														
3. Independent NC	0.46	0.50	-.09	.03	-													
4. Non-independent NC	0.07	0.26	-.03	-.16	-.26	-												
5. NC with more external directorships	0.26	0.44	-.04	-.07	.50	.09	-											
6. NC with fewer external directorships	0.27	0.45	-.08	.01	.46	.19	-.36	-										
7. Predecessor dismissal	0.18	0.38	.12	.22	-.09	.01	-.15	.05	-									
8. Concurrent performance	-0.02	0.11	-.11	-.29	.07	.02	.12	-.03	-.21	-								
9. Pre-succession performance	-0.01	0.07	-.05	-.16	.00	.05	.12	-.09	-.20	.48	-							
10. Firm size	7.08	1.26	.00	.07	.22	-.16	.33	-.18	-.19	.18	.17	-						
11. New CEO duality	0.46	0.50	-.05	-.02	.04	-.09	.13	-.14	.06	.08	.03	.21	-					
12. New CEO shareholding	0.03	0.07	.03	-.19	-.24	.03	-.15	-.11	-.12	.02	.06	-.25	.10	-				
13. Proportion of inside directors	0.25	0.13	.03	.44	-.22	.09	-.15	-.05	-.04	.05	.12	-.16	-.11	.20	-			
14. Prior CEO experience	0.14	0.34	.01	-.13	-.01	-.05	-.01	-.03	.06	-.11	-.22	-.05	.22	-.02	-.24	-		
15. New CEO age	5.75	6.26	-.03	.01	.22	-.09	.14	.06	-.02	.02	-.02	.18	.14	-.20	-.16	-.01	-	
16. Year 2	0.35	0.48	.04	-.04	-.01	.01	.01	-.01	.00	.02	.00	.00	.03	.02	.00	.00	.01	-
17. Year 3	0.30	0.46	.08		.02	-.02	-.01	.02	-.02	.11	.01	.04	.14	-.03	-.01	-.01	.11	-.47

[a] N = 571. [b] NC refers to nominating committee.
[c] Correlations larger than 0.08 are significant at the level of $p < 0.05$, and those larger than 0.11are significant at the level of $p < 0.01$.

Table 2. Results of Discrete-Time Analyses Predicting New CEO Dismissal [ab]

Variables	Model 1	Model 2	Model 3
Controls			
Concurrent performance	-3.79*	-2.89	-3.06
	(1.67)	(2.36)	(2.48)
Pre-succession performance	0.11	2.38	2.28
	(3.07)	(2.94)	(3.02)
Firm size	0.16	0.37*	0.29
	(0.14)	(0.18)	(0.18)
New CEO duality	-0.71	-0.94†	-1.07†
	(0.48)	(0.56)	(0.58)
New CEO shareholding	1.77	2.16	2.01
	(2.32)	(3.00)	(3.05)
Proportion of insider directors	1.16	2.24	2.44
	(1.72)	(1.78)	(1.89)
Prior CEO experience	0.31	-0.57	-0.56
	(0.67)	(0.71)	(0.71)
New CEO age	-0.02	0.03	0.03
	(0.02)	(0.04)	(0.04)
Year 2	1.69*	1.77**	1.79**
	(0.69)	(0.67)	(0.69)
Year 3	2.16**	2.32***	2.37***
	(0.70)	(0.68)	(0.69)
Predictors			
Outside new CEO		2.11***	2.05***
		(0.54)	(0.52)
Independent NC[c]		-0.90*	
		(0.52)	
Non-independent NC[c]		-0.03	
		(1.09)	
NC[c] with more external directorships			-0.20
			(0.66)
NC[c] with fewer external directorships			-1.36*
			(0.68)
Predecessor dismissal		1.00*	1.10*
		(0.55)	(0.58)
Constant	-4.77**	-10.32***	-9.51***
	(1.81)	(2.64)	(2.55)
Wald Chi-Square	24.21**	58.83***	52.56***
Pseudo R^2	0.09	0.22	0.23

[a] N = 571.
[b] Robust standard errors are reported in parentheses.
[c] NC refers to nominating committee.
† $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$ (one-tail test for predictors and two-tail test for controls).