

Why outsider CEOs bring less change: A relational perspective

Purpose

Extant research on Chief Executive Officer (CEO) succession has long questioned whether the appointment of a new CEO is beneficial, or detrimental, for firms facing conditions of financial distress (Finkelstein, Hambrick & Cannella, 2009). Our paper attends to answer this question by adopting a relational perspective to study the link between new CEO succession origin and strategic change in turnaround conditions. Specifically, we argue, that the degree to which outside CEO succession associates with strategic change depends on the relational network the outsider CEO has established with key incumbent board members prior to succession.

Theoretical background and research gap

Organizational turnaround literature studies how organizations with a threatening decline can adapt strategies in order to alter the organization's status quo (Barker & Duhaime, 1997; Hofer, 1980; Schendel, Patton & Riggs, 1976; Schweizer & Nienhaus, 2017). Prior literature has mainly focused on a company's managerial responses and strategic actions towards decline, and their effects on turnaround outcomes (Trahms, Ndofor & Sirmon, 2013); CEO replacement has been considered as an integral part of the turnaround strategy (Bibeault, 1982; Hofer, 1980; Schweizer & Nienhaus, 2017). Empirical evidence shows that CEO turnover rate is higher in turnaround situations (Bibeault, 1982: 42; Chen & Hambrick, 2012) and that firms tend to replace corporate leadership with the ultimate aim to shake things up, and respond to the crisis facing them via alternation to the strategic status quo of the organization. Yet, while the inclination of replacing organizational upper echelons in crisis conditions is clear, extant research provides mixed results as to whether the appointment of a new CEO in crisis conditions is the right path to swiftly realize strategic change when it is needed for recovery (Chen & Hambrick, 2012).

Some scholars advocate that changing the leadership, especially the CEO, of the firm is crucial for a turnaround to be successful (Bibeault, 1982; Hofer, 1980; Kanter, 2003). They claim that the decline indicates an ineffective and incompetent management which requires strategic and organizational changes (Bibeault, 1982: 35; Chen & Hambrick, 2012; Schweizer & Nienhaus, 2017). Under turnaround conditions, new CEOs are therefore expected to pay attention to the existing problems (Kanter, 2003), as well as to make changes with their fresh

perspectives to turn around the performance of the firm (Hofer, 1980). In this regard, empirical evidence advocates a positive effect of CEO replacement on levels of strategic change, measured by the number of strategic actions taken by the new CEO (Barker & Duhaime, 1997). As a result, shareholders react positively to CEO replacement in turnaround situations (Davidson, Worrell & Dutia, 1993), because they expect new CEOs to bring effective and favorable changes to the company.

In direct contrast, however, another stream of research challenges the substantial effect of CEO replacement in turnaround situations – stressing that replacing corporate leadership can often lead to organizational disruption, and thereby slower change to the strategic status quo of the company (Finkelstein et al., 2009: 205; Karaevli & Zajac, 2013; Zhang & Rajagopalan, 2004). In this regard, some scholars argue that ‘changing the CEO for the sake of change’ will have limited substantial effect (Chen & Hambrick, 2012). Empirical evidence also shows that a CEO replacement per se does not help the troubled companies to recover (Chen & Hambrick, 2012; Daily & Dalton, 1995). It is the background and characteristics of the new CEO that differentiate him or her from the incumbent, and allow him or her to make different decisions and bring changes to the firm (Finkelstein et al., 2009: 211).

Along these lines, research on the effects of CEO replacement has therefore taken new CEO characteristics into consideration (Schweizer & Nienhaus, 2017; Trahms et al., 2013). Upper echelons scholars have emphasized the key role of CEO succession origin – defined as whether the CEO is hired from inside versus outside the firm – as an important determinant of corporate strategic change (Karaevli & Zajac, 2013; Zhang & Rajagopalan, 2010). The predominant assumption is that appointing an outsider CEO associates with bolder alterations to the corporate strategic status quo, as it promotes the transfer of new knowledge outside of corporate boundaries and shows the firm alternatives to pre-established corporate processes (Shen & Cannella, 2002). Since outsider CEOs are generally less committed to the existing strategy of the organization, they are expected to promote swift strategic changes in the years after their appointment – and thereby to more effectively respond to their hiring mandate for change in turnaround conditions (Finkelstein et al., 2009). Yet, a number of scholars have recently stressed that appointing a CEO from outside the firm associates with a number of corporate challenges – particularly with regard to the lack of internal knowledge and understanding of how the organization operates (Karaevli & Zajac, 2013). Since outsider CEOs lack an internal understanding of the firm, they require time to bring about change – and thereby to adequately respond to the internal and external imperatives surrounding the organization via strategic renewal (Georgakakis & Ruigrok, 2017). The unreconciled debate continues and

raises question on whether outside versus inside CEO succession has substantial effects on turnaround and how such effect is realized.

Research approach

In resolving this debate, we suggest that relational characteristics of the new CEO, in terms of the social capital and network relations new CEOs may share with incumbent board members, should be taken into consideration. This aspect is notable because board of directors plays a key role in CEO succession (Berns & Klarner, 2017) and tends to be more active in monitoring the management when facing a decline (Trahms et al., 2013); thus relations between board members and new CEO get crucial for post-succession strategic change. Introducing a new CEO allows the board to realign the leadership credentials with its mandate (Hambrick & Mason, 1984; Westphal & Fredrickson, 2001), and a corporate decline highlights the need of mandate renewal with a suitable leader (Chen & Hambrick, 2012; Westphal & Fredrickson, 2001). Social network relations with the new CEO prior the succession enable the board to evaluate his or her suitability with enhanced understanding and trust (Berns & Klarner, 2017; Carpenter Li & Jiang, 2012; Uzzi, 1997). Moreover, social ties facilitate smooth communication, cooperation and interaction between the new CEO and other board members, which allows each individual to contribute to the turnaround with his or her expertise and improves collective cognition, strategic consensus and board effectiveness (Bromiley & Rau, 2016; Hambrick, 2007; Hambrick & Mason, 1984; Pettigrew, 1992; Simsek, Veiga, Lubatkin & Dino, 2005; Trahms et al., 2013). A new CEO sharing more social network relations with the board, therefore, tend to be more capable to decide a proper turnaround strategy and lead an effective implementation (Westphal & Fredrickson, 2001).

Based on these premises, we research the effect of new CEO outsidership and intra-board networks on post-succession strategic change. We propose a theoretical framework, which focuses on CEO replacement in turnaround firms and suggests that the degree to which outside CEO succession associates with strategic change depends on the new CEO's relational network with key incumbent board members prior to succession. We hypothesize that new CEO outsidership, as a continuum of new CEO origin, has a negative effect on post-succession strategic change. Adopting a longitudinal perspective, we explore how new CEO tenure, defined as the number of years the new CEO is in his or her position from the time of appointment, impacts strategic change. Given that outsider CEOs require time to become familiar with the firm's internal context prior to promoting renewal via their external knowledge, we predict that new CEO's tenure will play a key role in the relationship between

CEO succession origin and strategic change. Further on, we investigate how the new CEO–board relational networks prior to the new leader’s appointment mediate the predicted relationship.

Methodology

We conduct a quantitative empirical research on a sample of companies with new CEOs in turnaround situations between 1993 and 2015. We identify a turnaround situation by observing an abrupt operating loss (i.e., negative operating income) after at least two years of satisfactory performance, defined by an operating return before extraordinary items on equity (ROE) higher than the cost of equity (COE) (Chen & Hambrick, 2012), as such situation brings great pressure to the board and requires strategic actions to restore investors’ confidence. We identify 108 CEO replacement cases occurring within three years after the abrupt loss, excluding the interim CEOs. In consistency with the previous literature (Datta, Rajagopalan & Zhang, 2003; Finkelstein & Hambrick, 1990; Karaevli, 2007; Karaevli & Zajac, 2013; Zhang & Rajagopalan, 2010), we adopt a measure of strategic change composed of six key indicators: 1) advertising intensity, 2) R&D intensity, 3) plant and equipment newness, 4) nonproduction overhead, 5) inventory level, and 6) financial leverage. Besides, we measure new CEO outsidership as an index variable, considering the new CEO’s pre-succession experiences both in the firm and the industry (Karaevli, 2007; Karaevli & Zajac, 2013), and new CEO–board networks as the degree centrality of the new CEO in the board at the year of nomination, adjusted by dividing the maximum number of degrees (Freeman, 1978; Li, 2013).

We adopt a multiyear approach and observe the post-succession strategic change of the sample companies with new CEOs for up to 4 years after the decline, because strategic change through new CEOs may unfold over time (Chen & Hambrick, 2012; Karaevli, 2007; Karaevli & Zajac, 2013; Shen & Cannella, 2002). We conduct a random-effect generalized least squares (GLS) regression on our panel data of 250 observations, where new CEOs at different companies constitute the cross-sectional index and the time of observation constitute the time index, with controlling for relevant new CEO- and company-related variables.

Main findings

From the results of regression models as shown in Table 1 and 2 in the Appendix, we find that new CEO outsidership has a negative effect on post-succession strategic change, meaning that new CEOs with higher outsidership bring a lesser degree of post-succession strategic change. Secondly, we find a moderating effect of new CEO tenure on the relationship,

so that new CEOs with higher outsidership bring a higher degree of strategic change in their later tenure than their earlier tenure. This implies that new outsider CEOs may experience a learning process, which enables him or her to bring strategic change with increased familiarity with the company and accumulated network resources over time. Thirdly, we find that a lack of social ties with the incumbent board members hinders new CEO's post-succession strategic change, and empirical results show that outside successors have fewer intra-board connections than insiders.

Contributions and links to the sub-theme

We participate in the discussion of the sub-theme on boards' interactions and decision-making by exploring how social relations between a new CEO and other board members contribute to strategic change for recovery in turnaround situations; in particular, our study indicates that such relations facilitate communication and interaction within the board and leads to higher degree of strategic change.

The findings provide an affirmative answer to the question of the substantial effect of CEO replacement in turnaround situations with strong empirical evidence. We respond to Trahms, Ndofor and Sirmon (2013)'s call for considering the successor's attributes and experiences when studying CEO replacement. Our paper also indicates the necessity of a more complete research framework on turnaround processes where the interaction of various strategic actions are studied in more detail. We also contribute to this area of enquiry by connecting new CEO origin and strategic change, as called for by Chen and Hambrick (2012), and by highlighting the key role of CEO-board interface, as called for by Berns and Klarner (2017). To this end, our work highlights the importance of adopting a relational perspective in resolving the various debates in the CEO succession literature.

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Appendix

Table 1: Effects of new CEO outsidersness on post-succession strategic change

	Model 1	Model 2	Model 3
Constant	-0.07 (0.41)	0.75 (0.51)	1.21* (0.55)
<i>Control variables</i>			
Firm decline severity	-0.07 (0.13)	-0.06 (0.13)	-0.07 (0.12)
Firm prior-year performance	-0.82*** (0.21)	-0.80*** (0.21)	-0.78*** (0.21)
Firm size	-0.09** (0.03)	-0.11*** (0.03)	-0.12*** (0.03)
CEO age	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
CEO gender	0.04 (0.23)	-0.05 (0.22)	-0.06 (0.22)
CEO duality	0.02 (0.09)	0.06 (0.09)	0.07 (0.09)
CEO compensation structure	0.09 (0.11)	0.12 (0.11)	0.14 (0.11)
TMT change	-0.09 (0.13)	-0.07 (0.13)	-0.09 (0.13)
<i>Independent variables</i>			
New CEO outsidersness		-0.57** (0.22)	-1.10** (0.34)
New CEO tenure			-0.24* (0.12)
<i>Moderating effect</i>			
New CEO outsidersness × new CEO tenure			0.29* (0.14)
N	250	250	250
Overall R-squared	0.13	0.16	0.17
Wald chi-square	36.30***	44.61***	49.58***
Note: Standard errors in parentheses. +p<0.10, *p<0.05, **p<0.01, ***p<0.001.			

Table 2: Effects of new CEO intra-board network on post-succession strategic change

	Model 1	Model 2	Model 3
Constant	0.69 (0.67)	-0.45 (0.56)	0.50 (0.69)
<i>Control variables</i>			
Firm decline severity	-0.25 (0.26)	-0.10 (0.27)	-0.18 (0.26)
Firm prior-year performance	-0.55 (0.42)	-0.66 (0.44)	-0.63 (0.43)
Firm size	-0.14** (0.04)	-0.10* (0.04)	-0.14** (0.04)
CEO age	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
CEO gender	-0.02 (0.28)	0.10 (0.28)	0.01 (0.28)
CEO duality	0.28* (0.14)	0.18 (0.14)	0.25+ (0.14)
CEO compensation structure	0.38+ (0.21)	0.44 (0.23)	0.49* (0.23)
TMT change	0.26 (0.31)	0.40 (0.33)	0.35 (0.32)
New CEO network size		-0.08+ (0.04)	-0.05 (0.04)
<i>Independent variables</i>			
New CEO outsidersness	-0.86** (0.29)		-0.69* (0.31)
New CEO intra-board network		0.41* (0.18)	0.28 (0.19)
N	83	83	83
Overall R-squared	0.26	0.23	0.29
F-statistic	2.82**	2.16*	2.53**

Note: Standard errors in parentheses. +p<0.10, *p<0.05, **p<0.01, ***p<0.001.