

STRATEGIC MANAGEMENT SERIES

STRATEGIC LEADERSHIP

THEORY AND RESEARCH
ON
EXECUTIVES, TOP MANAGEMENT
TEAMS, AND BOARDS

SYDNEY FINKELSTEIN
DONALD C. HAMBRICK
ALBERT A. CANNELLA JR.

Strategic Leadership

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Top Management Teams, and Boards

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We dedicate this book to our families.

Preface

It has been thirteen years since the first version of *Strategic Leadership* was published. In that time, there has been a veritable explosion of research on CEOs, top management teams, boards of directors, executive compensation, and related topics. In fact, the study of the top-most figures in organizations—the upper echelons of business enterprises—has been one of the most robust areas of inquiry in strategy and organization science for over two decades now. The field of strategy is about general management, and general management is about the intersection of major decisions and the people who make those decisions and otherwise define what an organization is and aspires to be—what we and others have called strategic leadership. While research on executives, top management teams, and boards has proceeded at breakneck speed—involving not only scholars in strategy and organization theory, but also in organizational behavior, psychology, sociology, economics, finance, and accounting—it seems an opportune time to take stock of where we have been and where we may be going. The purpose of this book is to do precisely that—to review and synthesize existing research, and to offer an agenda for further inquiry on this most central of topics in the field of strategy and organizations.

We hope that this book, like its predecessor, will bring scholars important benefits. First, it is meant to be a reference book of the most consequential research in each of the topic areas that make up the domain of strategic leadership. As in our earlier version, we have not attempted to include every article or monograph in our review, as such an undertaking would be both unwieldy and unfocused. Instead, our goal has been to synthesize the key theoretical ideas and empirical findings in the literature without exhausting the reader with every possible citation. Of course, no doubt we have overlooked works that some might find helpful, but overall we have sought to identify and discuss each research topic in sufficient detail to provide readers with a reasonably complete understanding of the relevant literature.

Second, we hope researchers will turn to this book not only for a meaningful review of past work, but for our interpretation of how this past work fits together as well. Our editorial views on the research record will be evident throughout, and while not all will agree with everything we suggest, compilation without comment is inevitably of only limited value. Indeed, true synthesis requires it.

Third, we bring our point of view to bear especially in our suggestions for future work. We have organized each chapter by subtopics or major research questions, punctuated by propositions to spur further inquiry. While we have by no means set out to identify an exhaustive set of ideas for research, the propositions we have included represent important, and unanswered, research opportunities.

Finally, we believe that there is value in bringing together a wide set of studies in one place, and thus offering scholars insights that might not be as forthcoming without such an anthology. Certainly the body of work in this book represents the most extensive consolidation of work on strategic leadership yet. Very often, when a researcher focuses on a specific research question, say on some aspect of executive compensation, it is not easy to see how it fits with the bigger picture; therefore, it is useful for all of us to step back at times to see how a narrow research question fits into the broader research base and conceptual themes of the domain of strategic leadership.

This book would not have been possible without the support and encouragement of numerous people. Our editors at Oxford, Mike Hitt, Duane Ireland, and Bob Hoskisson, have been fans of this project from the start, and have stood by us as we waded through remarkably dense research literatures to try to deliver a crisp yet authoritative account of the field. Oxford University Press also deserves thanks for their support of this book, and their belief that the community of strategy and organization scholars would embrace our efforts.

We are grateful to Deans Paul Danos at the Tuck School, Judy Olian and Jim Thomas at the Smeal College of Penn State, and Bob Mittelstaedt at Arizona State for creating the intellectual climate that supported this project, as well as for providing the time and resources needed for its completion. Our colleagues in each of our schools have been helpful throughout as well, and they deserve our deep thanks: Rich D’Aveni, Bill Joyce, Len Greenhalgh, Vijay Govindarajan, Connie Helfat, Aviad Pe’er, Margie Peteraf, Alva Taylor, and Judith White at Tuck; Arijit Chatterjee, Guoli Chen, Craig Crossland, Denny Gioia, Dave Harrison, Rajiv Nag, Tim Pollock, Linda Treviño, and Wenpin Tsai at Penn State; and Blake Ashforth, Amy Hillman, Carla Jones, Christine Shropshire, Anne Tsui, and Bob Hoskisson at Arizona State.

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Strategic Leadership

1

The Study of Top Executives

One does not need to look very far to find ample evidence that the trajectories and fortunes of companies are often traceable to the actions (or inaction) of their top executives. Think of all the business founders who have built companies in their likeness, as direct reflections of their distinctive philosophies and aspirations—such as Ingvar Kamprad at IKEA, Herb Kelleher at Southwest Airlines, and Richard Branson at Virgin. Think of the executives who have brought new life and direction to mature companies—for example, Louis Gerstner at IBM, Jack Welch at GE, Jorma Ollila at Nokia, and Carlos Ghosn at Nissan. Think of the many executives whose missteps have brought lofty companies to their knees—such as Jürgen Schrempp at Daimler-Benz, Edgar Bronfman at Seagram, Jill Barad at Mattel, and Jean-Marie Messier at Vivendi. Or consider the executives whose misdeeds have devastated companies—for example, Jeffrey Skilling and his cohort at Enron, Dennis Kozlowski at Tyco, and members of the founding Tanzi family at Parmalat. If you recognize just a few of these names, you know they provide vivid testimony that top executives can greatly influence what happens to organizations—for good and for ill.

The small group of people at the top of an organization can dramatically affect organizational outcomes. Executives make big and small decisions. They shape the frameworks by which their organizations hire, mobilize, and inspire others to make decisions. They represent their organizations in dealings with external constituencies. And executives must accomplish all these things under conditions of uncertainty. Executives are not handed nicely distilled comprehensive summaries of the situations they face. Instead, the “facts” that confront executives—if they can be called facts—are typically ambiguous, contradictory, and far-flung, and they emanate from various parties who have their own motives. As a result, the situations that executives face are not knowable; they are only interpretable.

How, then, do executives interpret their situations? It all occurs through the lens of executives’ experiences, values, personalities, and other human characteristics. Psychologists have long known that, under conditions of ambiguity and complexity (as typifies executive work), individuals inject a great deal of themselves into their decisions (Mischel 1977). Under such situations, the facts or stimuli do not yield very reliable predictions of what an individual will do. Instead, the individual filters the facts through a web of personal qualities—including what he or she has seen before, what he or she values, and how his or her mind works. As such, the person’s actions are much more a reflection of the person than of the situation.

And so it is with top executives. If we as scholars want to know why organizations do the things they do, or perform the way they do, we will not focus strictly on objective contextual factors. No, the mainstay constructs of strategic management researchers—factors such as the environment, competitors, allies, and the company’s resources—will provide us woefully incomplete explanations of company behaviors. Instead, we need to also consider, in an integral way, the biases and dispositions of the people at the top of the firm. In doing so, we will find that human factors—deriving from personality, experiences, values, social connections, fatigue, envy, and so on—play a substantial role in affecting organizational outcomes.

The Essence of Strategic Leadership

The study of executive leadership from a strategic choice perspective, or more concisely, *strategic leadership*, focuses on the executives who have overall responsibility for an organization—their characteristics, what they do, how they do it, and particularly, how they affect organizational outcomes. The parties who are the subjects of strategic leadership research can be individuals (e.g., CEOs or division general managers), groups (top management teams), or other governance bodies (e.g., boards of directors).

We use the term *strategic leadership* because it connotes management of an overall enterprise, not just a small unit; it also implies substantive decision-making responsibilities, beyond the interpersonal and relational aspects usually associated with leadership. As will be seen, we are centrally concerned with why executives make the strategic choices they do. We do not rule out the interpersonal aspects of leadership; but unlike some theorists, we do not insist on their presence to invoke the word *leadership* (Kotter 1988; Kets de Vries 1994). If not so cumbersome, we might use less value-laden words, such as *headship* or *executiveship*.

We share with other strategy scholars an abiding interest in comprehending the factors that lead to superior organizational performance. And, like many of our colleagues, we believe that performance is determined in great part by the strategic choices and other major organizational decisions made within the firm.

But where does the company's strategy come from? Is it imposed by external norms and conventions (DiMaggio and Powell 1983)? Is it generated by formula, following a careful analysis of the company's resources (Barney 1991) or the external environment (Porter 1980)? Is it simply an incremental variation of the company's prior strategy (Quinn 1980)? (If so, where did *that* strategy come from?) To be sure, strategic actions are sometimes due to imitation, inertia, and careful, objective decision making. But a wealth of research and everyday observation indicates that strategy and other major organizational choices are made by humans who act on the basis of their idiosyncratic experiences, motives, and dispositions. If we want to understand strategy, we must understand strategists. The global furniture company IKEA would not look the way it does today if not for the distinctive philosophy and values of its founder and long-time CEO, Ingvar Kamprad. IBM, which was at death's door in 1992, would probably not be alive today, or look the way it does, if not for Louis Gerstner. And Enron would be alive today, if not for the unsavory ingenuity of a handful of top executives.

In the face of the complex, multitudinous, and ambiguous information that typifies the top management task, no two strategists will identify the same array of options for the firm; they will rarely prefer the same options; and they almost certainly will not implement them identically. Biases, egos, aptitudes, experiences, and other human factors in the executive ranks greatly affect what happens to companies.

The distinguished organizational theorist James Thompson wrote of the role of “the variable human” in influencing organizational action (Thompson 1967, 101). This is exactly the perspective we take, arguing that senior executives vary, and thus so do their choices. Executives vary in their experiences, capabilities, values, and personalities. These differences, in turn, cause executives to differ in their awareness and interpretation of strategic stimuli, their aspiration levels, their beliefs about causation, even their beliefs about what it is they are trying to accomplish and how urgent it is. It follows, then, that executives will differ in their behaviors and choices. The organization becomes a reflection of its top managers (Hambrick and Mason 1984).

Because strategic management is fundamentally a social and political activity, a behavioral theory of senior leadership extends beyond an interest in individual executives.

Decision makers are informed, influenced, and sometimes constrained by others, both inside and outside the organization. For this reason, we have an interest in senior-level management groups (typically called top management teams), in the roles and influence of boards of directors, and in the effects of external connections on executive decisions. Our perspective on strategic leadership resides at the intersection of cognitive, social, and political concepts.

In short, we are interested in the human element in strategic choice and organizational performance. By focusing on senior executives, however, we do not wish to be seen as glorifying them. Executives are important to a complete theory of strategic management precisely because of their limitations—the biases, filters, and varying motives that they bring to their decisions and indecisions.

Moreover, by focusing on top executives, we do not mean to imply that all strategic choices are generated at the apex of the organization. Strategies come from the top, but they also bubble up and accrete from below (Bower 1970; Burgelman 2002). Typically, however, the initiatives advanced by the operating levels of the organization are determined by the staffing, structural, and incentive decisions made by top executives. Thus, even though upper-level executives do not initiate all decisions, they have a predominant influence on what happens to their organizations. In general, no other small group has nearly as much effect on the form and fate of an enterprise.

Academic Attention to Executives: A Historical View

Scholarly interest in top executives has ebbed and flowed, in the extreme, over the past seventy years or so. At one point, senior managers were an integral part of major theories of organization (Barnard 1938; Selznick 1957; Chandler 1962). In early days of the field of strategy, top executives were seen as central determiners of the direction of the firm. For example, the Harvard model (Learned, Christensen, and Andrews 1961; Andrews 1971), which served as the principal guide for business policy thinkers in the 1960s and 1970s, emphasized the personal role of senior executives in shaping their firms. Consider these quotes from Andrews (1971):

Executives in charge of company destinies do not look exclusively at what a company might do and can do. [They] sometimes seem heavily influenced by what they personally want to do. (p. 104)

We will be able to understand the strategic decision better if we admit rather than resist the dimension of preference. (p. 105)

Strategy is a human construction. (p. 107)

In the Harvard model, the individuals at the top of the enterprise were seen as pivotal for understanding what happens to the enterprise.

But then organizations were disembodied, or essentially “beheaded,” as theorists adopted relatively mechanical models. First came the view that certain contextual conditions—notably, environment, technology, and size—determine an organization’s design (Hage and Aiken 1969; Hickson, Pugh, and Pheysey 1969; e.g., Blau 1970). According to this perspective, there were imperatives facing organizations, not choices to be made.

On the heels of the deterministic view came population ecology. Here, the focus was on explaining the birth, growth, and death of organizations. In the ecologist’s framework, the environment was the centerpiece, containing resources and favoring certain organizational

forms. Organizational variation was largely random, accidental, or rooted in history, not willfully achieved (Hannan and Freeman 1977). In fact, these theorists saw organizations as generally inertial, hemmed in by external and internal constraints, and not readily amenable to the influences of leadership.

And there was the new institutional theory (Meyer and Rowan 1977; DiMaggio and Powell 1983), which espoused that organizations are under great pressure to adopt practices and policies that appear legitimate in the eyes of external resource providers. Under this view, organizations are not expected or even allowed to be clever, innovative, or deviant. Rather, they are expected to conform—to prevailing norms and conventions, as well as to the profiles of industry leaders. In turn, the role of senior leadership is little more than administering the organization's ongoing conformity campaign.

Even the field of strategy, despite its long tradition of a managerial perspective, lost sight of senior executives in the late 1970s and early 1980s. In the influential 1979 volume edited by Schendel and Hofer to which many of the leading figures in the field contributed pieces and in which the field of "business policy" was re-anointed as "strategic management," attention to the role of senior executives was nearly absent. Instead, a focus on "techno-economic" frameworks was ushered in. Strategy scholars became preoccupied with product life cycles, portfolio matrices, industry and competitor analysis, market shares, experience curves, and generic strategies (e.g., Porter 1980). To some extent, this movement toward relatively quantifiable and concisely modeled conceptions of strategy was probably due to the yearning of strategy scholars to demonstrate that their domain was as analytically rigorous as any other. After years of trying to demonstrate academic legitimacy, scholars in the embryonic field of strategic management may have believed that the soft and fuzzy nature of executive behavior—and human factors in general—were best left behind or set aside for others to assess (Hambrick and Chen 2008).

The countertrend, toward renewed interest in top managers, can be traced as a two-step process. First came John Child's (1972) influential article on "strategic choice." Not content with organization theorists' deterministic conceptions of organizational forms, Child wrote: "Many available contributions to a theory of organizational structure do not incorporate the direct source of variation in formal structural arrangements, namely the strategic decisions of those who have the power of structural initiation. ... When incorporating strategic choice in a theory of organization, one is recognizing the operation of an essentially political process in which constraints and opportunities are functions of the power exercised by decision makers" (1972, 16). As an organization theorist, Child was interested primarily in improved understanding of organization structure (as the above quotes indicate). However, he adopted the term *strategic choice* to refer to any willful action of major significance to the organization—not only decisions about structure, but also about goals, technology, and human resources.

As an antidote to the prevailing mechanical view of organizational functioning, Child's paper captured a great deal of interest from academics. However, it did not directly form the basis for a new direction in empirical research (perhaps due to Child's equivocality as to who makes strategic choices in organizations). Invoking Cyert and March's (1963) concept of the "dominant coalition," Child argued that strategic choice is exercised by whoever has power in a given organization at a given time, but that the identity of these parties cannot be generally specified. The dominant coalition could be some combination of board members, executives, investors, technical employees, union leaders, or others. Under such a view, scholars could not reliably target a fixed locus of strategic choice in a cross-section of organizations; hence, systematic pursuit of Child's ideas was somewhat stymied.

Then came a sudden willingness to focus specifically on top executives as the primary

shapers of strategic direction. In 1982, John Kotter wrote *The General Managers*, a book on the key challenges of senior management positions, in which he posited how differences in managers' behaviors may be traceable to differences in their personal characteristics. In 1984, Hambrick and Mason presented a more formalized theory, the "upper echelons" perspective, proposing that senior executives make strategic choices on the basis of their cognitions and values, and that the organization becomes a reflection of its top managers. In the same year, Gupta and Govindarajan (1984) conducted a systematic study of division general managers, finding that their business units performed well to the extent that the managers' experiences and personalities aligned with the critical requirements posed by the chosen strategy of the business. At the same time, several other influential works on top executives appeared (e.g., Donaldson and Lorsch 1983; Meindl, Ehrlich, and Dukerich 1985; Miller, Kets de Vries, and Toulouse 1982; Wagner, Pfeffer, and O'Reilly 1984).

After that, the floodgates were open. Hundreds of academic and applied articles, books, and monographs on top executives and their organizations have been written in the past twenty-some years. It is now rare to pick up any issue of a major management or strategy journal and not find at least one article dealing with top executives. The array of topics is profuse and exhilarating, including studies of CEO-director friendships (Westphal 1999; Westphal and Stern 2007), CEO-COO duos (Hambrick and Cannella 2004), international experiences of top executives (Carpenter, Sanders, and Gregersen 2001), CEO tenure (Henderson, Miller, and Hambrick 2006), pay dispersion within top management teams (Henderson and Fredrickson 2001; Siegel and Hambrick 2005), CEO personality (Chatterjee and Hambrick 2007; Peterson et al. 2003), and executive mistakes (Finkelstein 2003).

That the fields of organization theory and strategy would return to a focus on top executives was perhaps inevitable, since the few people at the top of an enterprise have a major influence—through decisions and indecision, boldness and timidity—on its form and fate. If scholars wish to understand why organizations do the things they do and why they perform the way they do, then top managers must be a central part of any explanatory theory.

This book is meant to serve two purposes. The first is to take stock, assess, and integrate the now huge body of literature on top executives. As we shall see, the past two decades of explosive growth of this domain have not yielded a particularly orderly or concise set of findings. In fact, the literature on top executives is immensely diverse in methods and perspectives, and is often inconsistent in results. Our aim is to help the reader navigate and make sense of this expansive territory.

Our second objective is to go beyond what is already known and set forth new frameworks, perspectives, testable propositions, and methodological recommendations for the study of top executives. In places, our ideas are clearly speculative, meant to stimulate debate and systematic tests. The book is intended to provide a new platform for theory and research on strategic leadership—coalescing what is already known, identifying the priorities for what next needs to be known, and proposing how scholars might fruitfully conduct their inquiries.

The Scope of Strategic Leadership

Research on strategic leadership can be conducted at multiple levels of analysis. The prevailing conception of leadership generally considers the individual executive. In contemporary organizations, this particularly means chief executive officers (CEOs) and business unit heads. However, strategic leadership can also consider the small group of top executives, or the "top management team" (TMT). Other governance bodies, particularly

boards of directors, are also within the scope of strategic leadership.

Chief Executive Officers

The chief executive officer is the executive who has overall responsibility for the conduct and performance of an entire organization. The CEO designation has gained widespread use as a result of the need to draw distinctions among various senior executive positions in today's elaborate corporate structures. For example, sometimes a chief operating officer (COO), responsible for internal operational affairs, is among the executives who report to a CEO, who in turn is responsible for integrating internal and external, longer-term issues, such as acquisitions, government relations, and investor relations (Hambrick and Cannella 2004).

In most publicly traded corporations in the United States, the chairperson of the board of directors is also the CEO, while the president (if such a title even exists) is the COO. In many other countries (particularly in Europe), the chairperson is not an executive officer at all, but rather an external overseer, while the president, the senior-ranking employed manager, serves in the capacity of CEO (Crossland and Hambrick 2007). Other variations exist as well. Further complicating the scholar's task of identifying the CEO of a company, the label may not be explicitly bestowed on anyone. Still, theorists and other observers of organizations are drawn to the premise that some one person has overall responsibility for the management of an enterprise and that, in turn, that person's characteristics and actions are of consequence to the organization and its stakeholders.

Business Unit Heads

With the advent and growth of the diversified firm and the accompanying structure of divisionalization, multiple general management positions have been created in most large companies. Managers holding these posts do not have the scope of responsibility of CEO positions; but they often oversee very large organizations, have considerable autonomy, and sometimes are even bestowed such titles as president, managing director, or even CEO of their respective business units.

The need to focus on business unit managers is great, because so many of them exist in contemporary divisionalized firms and it is at their level that many strategic initiatives are formulated and executed. As we shall see, some of the most important early contributors to the study of strategic leadership focused on business unit managers (e.g., Gupta and Govindarajan 1984). However, such research has recently been sparse, probably due to the difficulty of obtaining data—as compared to data on CEOs and others at the corporate level.

Top Management Teams

The term *top management team* (TMT) has been adopted by strategic leadership theorists to refer to the relatively small group of most influential executives at the apex of an organization—usually the CEO (or general manager) and those who report directly to him or her. The term does not necessarily imply a formalized management-by-committee arrangement, but rather simply the constellation of, say, the top three to ten executives.

A scholarly interest in top management teams emerged in the early 1980s and has been pronounced ever since. Realizing that top management typically is a shared activity, researchers have moved beyond an examination of individual leaders to a wider focus on the top leadership group. In articulating their “upper echelons theory,” Hambrick and Mason (1984) gave this example of how an understanding of overall team characteristics can greatly enhance the researcher's ability to predict or explain a chosen strategy:

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Assume that two firms each have chief executives whose primary functional backgrounds are in production. In Firm A, three of four other key executives also rose primarily through production-oriented careers even though they are now serving in nonproduction or generalist roles. In Firm B, the mix of executive backgrounds is more balanced and typical—one from production, one from sales, one from engineering, and one from accounting. Knowledge about the central tendencies of the entire top management teams improves one's confidence in any predictions about the firms' strategies. (p. 196)

Our ability to predict that Firm A would pursue a strategy emphasizing production capabilities would be much stronger than any prediction we could generate about Firm B. Indeed, the limited empirical evidence as to whether the top executive alone or the entire top management team is a better predictor of organizational outcomes clearly supports the conclusion that the full team has the greater explanatory power (Hage and Dewar 1973; Tushman, Virany, and Romanelli 1985; Finkelstein 1988).

Boards of Directors

Finally, boards of directors are within the purview of strategic leadership theory. While not charged with the routine administration of the firm, boards are responsible for reviewing major policy choices. As we shall see, boards vary widely in the degree to which they involve themselves in strategic choices, but it is now well known that board characteristics affect such fundamental choices as acquisitions, diversification, divestitures, research and development spending, strategic change, executive compensation, and, of course, CEO dismissal (O'Reilly, Main, and Crystal 1988; Haunschild 1993; Golden and Zajac 2001; Shen and Cannella 2002b; Deutsch 2005; Shimizu 2007).

With the increasing call for board activism (Monks and Minow 2004; Finkelstein and Mooney 2003), the influence of boards over organizational outcomes will only grow. Perhaps best thought of as “supra-TMTs,” boards are an important target for strategic leadership research.

Additional Matters of Scope

Thus, in terms of who in the organization is of interest, we cast our net widely: CEOs, division managers, top management teams, and boards of directors. In some other ways, however, we restrict our scope and intent.

First, the book has a theoretical, predictive, explanatory focus: How can executive characteristics and behaviors be used to explain variance in organizational outcomes? Prescription will not be ignored, but it will be secondary. Until the basic phenomena can be understood and explained, prescription is premature. We believe this explains why the normative literature on leadership has resulted in so much confusion and skepticism.

Second, and correspondingly, the book is meant primarily for students of organizations—those who strive to assess and understand the phenomena of strategic leadership. We will discuss the evolution of theories, the fine points of research designs, and empirical research results. We aim primarily to stimulate and guide future thinking and research on this important topic.

Beyond students and scholars, yet another group may derive benefits from the book—those who are responsible for evaluating, selecting, motivating, and developing senior executives. Professionals involved in executive search, compensation, appraisal and staffing, as well as board members who must evaluate top executive performance and prospects, will

find here a considerable foundation on which they might create their tools and perspectives.

Overview of the Book

This book synthesizes what is known about strategic leadership and suggests new research directions. Although each chapter focuses on a relatively well-defined aspect of strategic leadership, many of these topics are interconnected. In striving for a synthesis of strategic leadership research, our approach has the effect of creating a set of overlaying research domains that build upon, as well as inform, previous chapters. As we suggest new frameworks and propositions to help guide future research, we will rely on a key underlying theme of the book—that the intersection of cognitive, social, and political perspectives greatly informs strategic leadership.

Our discussion of strategic leadership begins in [chapter 2](#) with an examination of a fundamental assumption of the entire book—that top managers do indeed have an important effect on organizational outcomes. The question, “Do top executives matter?” has a long history and a wide array of answers. At its core lies the debate between deterministic theories of constraint and strategic choice theories of executive action. As we argue, definitively resolving this debate is virtually impossible, since there is abundant evidence that both constraint and executive choice pervade organizational life. It is hard to imagine an organization not subject to both of these effects. For this reason, we present the concept of managerial discretion as a bridge between opposing camps, an attempt to step back and recognize that managerial effects on organizational outcomes are subject to the interplay of both constraint and choice; this interplay is itself driven by a set of knowable and measurable factors that are central to research on strategic leadership.

[Chapters 3](#) and [4](#) focus on executive effects on organizational outcomes, developing the idea that an executive’s “orientation,” a complex set of psychological characteristics and observable experiences, gives rise to his or her perceptions and choices. Building on classic work by the “Carnegie School,” we suggest a model of human limits on strategic choice that has clear implications for how organizational outcomes are often a reflection of top executive orientations.

[Chapter 3](#) focuses specifically on psychological attributes of executives: executive values, cognitive models, and elements of personality. We discuss the major dimensions of executive psychology and develop a set of propositions that link these dimensions to executive actions.

[Chapter 4](#) then emphasizes the role of executive experiences. By this we mean the wide set of experiences that executives bring to their positions, as embodied by such characteristics as tenure, functional background, and education. Research on demographic characteristics and organizational outcomes is abundant, and this chapter tries to make sense of what is known and not known about these relationships. This chapter offers suggestions for examining a broader set of executive experiences and executive populations than have traditionally been studied and calls for more attention to developing executive typologies. Perhaps most important, we build on work in social psychology to develop a model of when the associations between executive characteristics and organizational outcomes will be great or small.

In [Chapter 5](#), we broaden the unit of analysis from individual executives to top management teams. As we shall discuss, however, shifting from a focus on individuals to a focus on groups is more than just a change in the unit of analysis. Conceptually, top management teams are more than simply collections of individual executives, and one of the goals of this chapter is to indicate why. We argue that top management teams affect

organizational outcomes not just because of the collection of executive orientations that exist among senior executives (although this is important), but also because the interrelationships among executives have their own unique implications for organizational outcomes. Chief among these interrelationships are the distribution of power among top managers, as well as the heterogeneity of executive orientations, topics on which we suggest promising analytic and research directions.

Chapters 6 through 11 each focus on specific areas of strategic leadership, including executive turnover and succession, board-management relations, and executive compensation. These chapters build on the earlier ones in many ways, but they also are relatively self-contained, each addressing a set of issues that are well defined in the literature. As a result, each of these chapters draws upon a wide base of research, often from related fields, such as organizational sociology, managerial economics, and finance. Our goal has not been to conduct exhaustive literature reviews, but rather to develop frameworks in each chapter that parsimoniously capture existing literature and suggest a set of important, unresolved research questions.

Chapter 6 synthesizes what is known about the antecedents, or determinants, of executive turnover and succession. Chapter 7 examines the consequences of executive succession. Across these two chapters, we draw upon a model of the succession process that analytically distinguishes among the precipitating context for succession, the actual event and process, successor characteristics, and the effects of succession. This framework gives rise to four fundamental research questions that we address in these chapters: Will succession occur? How will succession occur? Who will get picked? And what will the consequences be? We develop some new ideas surrounding each of these questions. Executive successions are substantively and symbolically rich events; as a result, many of the issues discussed in other chapters are useful in understanding succession phenomena.

Chapters 8 and 9 shift the locus of strategic leadership from top executives to the board of directors. This transition enables an integration of board and executive perspectives on corporate governance and highlights how boards are in some ways “supra-top management teams.” Once again, we develop unifying frameworks to help clarify and reconcile existing research, and we suggest promising lines of inquiry. Chapter 8 focuses on two major research questions: What are the determinants of board characteristics? What determines the vigilance and behavior of boards? Chapter 9 examines an equally important question: How do boards affect organizational choices, strategy, and performance? Vast amounts of work have addressed governance and boards, and we believe our organizing framework across these two chapters helps to identify what is essential about boards from a strategic leadership perspective. Indeed, we use our framework as a springboard to develop a set of propositions that encapsulate much of what we still need to learn about boards.

Chapters 10 and 11 build directly on all the earlier chapters, in examining executive compensation. Chapter 10 considers the determinants of executive compensation: Why are executives paid the amounts they are? Why do executive compensation plans look the way they do? Chapter 11 then considers the consequences of executive compensation: What are the effects of executive compensation on the behaviors of executives, the behaviors of others, company strategy, and performance? This chapter also examines the intriguing issue of how compensation is distributed, or dispersed, among members of top management teams, and how such distributions affect team behavior and organizational outcomes. Consistent with the themes of the book, these chapters set forth a broad examination of how economic, social-psychological, and political perspectives help explain both the determinants and consequences of executive compensation. This broader view is valuable because, once again, it allows for both synthesis and analysis of a large and eclectic body of research. Overall,

these chapters suggest numerous new lines of inquiry for scholars interested in executive compensation.

In sum, the book is optimistic, portraying strategic leadership as a vibrant stream of research within strategic management that helps provide a fundamental understanding of how and why organizations make their choices. It is clear that there still is very much more we need to know. This challenge poses a great opportunity: the greater our understanding of strategic leadership, the more we will know about the essence of strategy, how organizations undertake strategies, and why they perform the way they do.

2

Do Top Executives Matter?

Those of us who teach in business schools rarely ponder the question, “Do managers matter?” Were we to do so, we would have to deal with unsettling questions about the basic worth of our work, as well as the scruples of taking our students’ time and money to help them become “better” managers. Perhaps we all implicitly have considered the issue of whether managers have much effect on organizational outcomes and have arrived at a reassuringly affirmative answer. After all, we are surrounded daily with news about executive brilliance and ineptitude, about CEOs saving companies and ruining companies, about shareholders and boards replacing ineffective top executives with promising new talent. “Of course managers matter,” we say to ourselves.

However, not all who have carefully considered the issue agree. In fact, there is a school of thought, supported by some evidence, that top managers in general do not have much effect on organizational outcomes. Before proceeding too far with a book on strategic leadership, we must confront this fundamental issue.

Such is the purpose of this chapter. We start with a discussion of what it is that top executives do, tracing a relatively well-developed literature on executive roles, responsibilities, and arenas of action. We then turn to the central debate, first reviewing the arguments and evidence of those who are skeptical about managerial effects, then the perspective of those who argue that top managers have considerable influence on their organizations. Our resolution of the debate is not to pick one view as correct, but rather to propose a middle ground: sometimes managers matter a great deal, sometimes not at all; usually their influence falls somewhere in between. “Managerial discretion,” or latitude of action, is the theoretical fulcrum we propose as a way of reconciling the two opposing camps. We then discuss the tendency for observers—and for society in general—to overattribute organizational outcomes to top executives, creating heroes and villains in the process and generally complicating the task of objectively tracing managerial effects. We close the chapter with an inventory of research priorities.

What Do Top Executives Do?

The head of an enterprise, say a CEO or a division president, has numerous roles to fulfill, not all of which square with typical images of top executives at work. Classic conceptions of the CEO depict a big person behind a big desk engaged in big actions—planning, organizing, coordinating, commanding, and controlling (Fayol 1949). Even loftier imagery is provided by Barnard (1938) and Selznick (1957), who emphasized the top executive’s job as defining institutional mission and goals, maintaining institutional integrity, and obtaining cooperation from organizational members. Adding further to the picture of the remoteness of the CEO job was the post–World War II proliferation of analytic approaches for rational decision making: for example, operations research, formal long-range planning, and portfolio analysis. The joint emergence of computer technology and the professionalization of management led to a belief, or heightened an existing one, that CEOs were, first and foremost, careful and

comprehensive deciders of major courses of action.

It is precisely because of these entrenched beliefs about and images of top executives that Henry Mintzberg’s book *The Nature of Managerial Work* (1973) was so startling and important. Mintzberg studied the minute-by-minute activities of five experienced CEOs, each for a week. What he found was that CEOs are *not* buffered from daily minutiae and crises, they do *not* engage in much reflective planning, and decision making is but a modest portion of what they do. Instead, CEOs were found to work at a hectic and unrelenting pace on a wide array of tasks; their activity is characterized by brevity, fragmentation, and interruption; they gravitate toward the current and well-specified and away from the distant and vague; they are attracted to and place credence in oral media; and they spend a great deal of time interacting—talking, cajoling, soothing, selling, listening, and nodding—with a wide array of parties inside and outside the organization.

On the basis of his data, Mintzberg distilled a set of ten managerial roles that he placed in three broad categories: interpersonal (figurehead, leader, and liaison), informational (monitor, disseminator, and spokesperson), and decisional (entrepreneur, disturbance handler, resource allocator, and negotiator). Table 2.1 presents a summary of Mintzberg’s executive roles.

Some studies have found that Mintzberg’s roles can be difficult to distinguish when observing discrete managerial activities (McCall and Segrist 1980; Kurke and Aldrich 1983). Other studies (typically examining various types of managers, not just CEOs) confirm the behaviors that Mintzberg observed, but argue that the roles can be further distilled, possibly down to as few as six: leader, spokesperson, resource allocator, entrepreneur, environmental monitor, and liaison (Tsui 1984). Kotter’s (1982) in-depth study of fifteen general managers confirmed Mintzberg’s general portrayal of managerial work but concluded that it could be distilled even further: short- and long-term agenda setting, internal and external network building, and getting the network to implement the agenda. None of these later studies is at odds with Mintzberg. When combined with yet other inquiries and models, they all indicate some basic dimensions of the top executive’s job, which we now discuss.

Table 2.1. Summary of Mintzberg’s Executive Roles

Role	Definition
Interpersonal	
Figurehead	Symbolic head; obligated to perform a number of routine duties of a legal or social nature.
Leader	Responsible for the motivation and activation of subordinates and for staffing, training, and associated duties.
Liaison	Maintains self-developed network of outside contacts and informers who provide favors and information
Informational	
Monitor	Seeks and receives a wide variety of special information (much of it current) to develop a thorough understanding of the organization and the environment; emerges as the nerve center of internal and external information of the organization.
Disseminator	Transmits information received from outsiders or from subordinates to members of the organization. Some information is factual, while

some involves the interpretation and integration of diverse value positions of organizational influences.

Spokesperson Transmits information to outsiders on the organization's plans, policies, and actions, results, and so on; serves as an expert on the organization's industry.

Decisional

Entrepreneur	Searches the organization and its environment for opportunities and initiates "improvement projects" to bring about changes; supervises the design of certain projects as well.
Disturbance Handler	Responsible for corrective action when the organization faces important, or unexpected disturbances.
Resource Allocator	Responsible for the allocation of organizational resources of all kinds—in effect, the making or approval of all significant organizational decisions.
Negotiator	Responsible for representing the organization during major negotiations with others

Adapted from Mintberg 1973; and Pavett and Lau 1982, 9.

Basic Dimensions of the Job

External and Internal Activities: Top executives operate at the boundary between their organization and the external environment (Thompson 1967). They gather information from outside, and they convey information, impressions, and reassurances to the outside. They alert insiders about external news and developments. They take actions to align the organization with the current and expected external environment (technology, market trends, regulatory forces, and competitors' initiatives); at times they try to modify the environment (through lobbying, trade associations, consortia, and joint ventures).

Strategy Formulation, Implementation, and Context Creation: Top executives may orchestrate the formulation of company strategy, including the choices of which products and markets to emphasize, how to outdo competitors, how fast to grow, and so on (Ansoff 1965; Porter 1980). Top executives also have a role in strategy implementation—allocating resources, establishing policies and programs, and developing an organization that is aligned with the strategic thrusts of the firm (Chandler 1962; Galbraith and Kazanjian 1986; Quinn 1980). And top executives create a context—through staffing, reward and measurement systems, culture and style—that influences the strategic choices made by the managers and technical specialists throughout the organization who are most familiar with marketplaces, technologies, and competitors (Bower 1970; Burgelman 1983).

Substance and Symbols: When we think of executive action, we usually gravitate to the substantive: acquiring or divesting a business, increasing a research and development (R&D) budget, opening a new factory, forming a task force to launch a total quality program, and so on. But, executives also operate in the world of symbols (Dandridge, Mitroff, and Joyce 1980). A symbol is something that has meaning beyond its inherent substance. By virtue of being at the top of the organizational hierarchy, executives' actions often convey extra meaning (Pfeffer 1981a). Some top executive actions are expressly symbolic, such as hosting a farewell dinner for a much-loved employee, holding a recognition ceremony to honor some extraordinary achievement, or personally appearing in the company's advertisements. However, to some extent, all executive actions carry added meaning, or what might be called "symbolic fallout," conveying surplus messages to observers who are trying to detect the executive's intentions, values, predispositions, and where he or she is headed. Executive decisions, for example to promote one person but not another, to close one plant but not another, or to have an important meeting in a given location but not another, all convey meaning beyond their inherent substance to parties inside and possibly even outside the

organization. In fact, some have said that the top executive's most important task is to establish and convey an "organizational meaning" (Barnard 1938). Despite its importance to management in general and executive leadership in particular, there has been little systematic research into the use of symbols by executives (Armenakis et al. 1995; Smircich and Stubbart 1985; Dutton and Ashford 1993). Further, while there are noted exceptions (e.g., Gioia and Thomas 1996; Gioia et al. 1994; Westphal and Zajac 1998, 2001), empirical work is lacking.

Thus, top executives are engaged, at least potentially, in a wide array of roles, responsibilities, and activities. We say "potentially" because the roles that are emphasized vary immensely among executives. For example, the CEO of a publicly held corporation may engage in many more external activities (with security analysts, external board members, business journalists, and so on) than the CEO of a privately held company. The CEO of a company engaged in a turnaround effort will focus on different matters from the CEO of a company with abundant slack resources. In fact, Mintzberg (1973) laid out a series of descriptive hypotheses about how several contingency factors cause variation in managerial work. These contingency factors include environmental, organizational, situational, and individual factors, such as the executive's personality. We know of no studies that have attempted to directly test Mintzberg's hypotheses. However, as we will see throughout this book, numerous studies have documented the tendency for executives' own attributes (their experiences, education, functional background, personality, and so on) to affect their behaviors and choices.

That top executives would act on the basis of their own predispositions is fully understandable. Senior managers are embedded in ambiguity, complexity, and information overload. They encounter far more stimuli than they can comprehend, and those stimuli are typically vague, ill-formed, and contradictory (March and Simon 1958). Thus, the top executive faces the classic case of what the renowned psychologist Walter Mischel (1968) calls a "weak situation," that is, one in which the characteristics of the situation are not clear-cut enough to dictate a course of action. In such circumstances, the decision maker's personal frame of reference, not the objective characteristics of the situation, becomes the basis for action. It is precisely because of the multiplicity of executive roles, activities, and courses of action, along with the ambiguity and overload of the information confronting executives, that it is critically important to study how executives affect the form and fate of their organizations. Ultimately, executives' experiences, interpretations, and preferences greatly influence what happens to their companies.

Do Managers Matter? A Doubtful View

As intuitively reasonable as it may seem, the idea that top executives hold great sway over organizational outcomes is not universally held. Some theorists have set forth cogent arguments about the strict limits within which executives operate. And empirical evidence has been presented that, at least on its face, suggests top executives have far less effect on organizations than do other factors.

Population ecologists particularly have argued that organizations—and their top managers—are largely inertial, hemmed in by environmental and organizational constraints. Hannan and Freeman (1977), for example, noted several internal constraints on managerial action: fixed investment in specialized assets, restricted information flows, internal political constraints, and entrenched norms and cultures. Similarly, they identified some significant external constraints: legal and fiscal barriers to entry and exit from markets, restricted access to external information, and legitimacy constraints.

Institutional theorists have argued that legitimacy constraints on organizations are particularly confining (e.g., DiMaggio and Powell 1983). Under great pressure to appear “normal” and rational, organizations must adopt numerous conventions that pull them into conformity with external expectations. Moreover, in the face of uncertainty, managers may be compelled to conclude that the least risky course of action is to imitate the choices of their counterparts (particularly the more successful ones) in other organizations. So, a process of “mimetic isomorphism” leads to remarkable homogeneity, particularly within an industry (Spender 1989; Hambrick, Geletkanycz, and Fredrickson 1993; Haveman 1993a).

An additional reason that managers may account for little variance in organizational outcomes is that managers as a group are exceedingly homogeneous (March and March 1977); that is, there is not much variance in the independent variable. Certainly on the surface, CEOs are not a diverse lot. In America’s *Fortune* 500 companies, almost all CEOs are white men, aged fifty to sixty-five, who have college degrees and significant experience in large companies. In some countries, the pathways to large-company presidencies are even more restricted, often requiring graduation from one of a small set of elite universities (e.g., Kadushin 1995; Whitehill 1991; Kim and Cannella 2007). If top executives are drawn from a very narrow pool and then subjected to a long period of common socialization, we cannot expect them to exhibit much variety in thought or action.

Thus, for reasons of substantive constraint, institutional pressures for conformity and imitation, and extreme homogeneity of the top executive population, some have argued that managers do not matter. Several well-known empirical studies seem to point to that conclusion.

The most commonly cited evidence of minimal executive effects is Lieberman and O’Connor’s (1972) study of top executives in large corporations. Using an analysis of variance procedure on a sample of 167 companies over a twenty-year period, the authors statistically isolated the portion of company performance (as measured by sales, profits, and return on sales) that could be attributed to the top executive in place in a given year. After the authors controlled for the year, industry, and specific company, leadership explained only between 6.5 and 14.5 percent of variance in the three performance measures examined. Lieberman and O’Connor concluded: “In short, all three performance variables are affected by forces beyond a leader’s immediate control” (1972, 121).

The second work often cited as evidence of negligible managerial effects is Salancik and Pfeffer’s (1977b) study of city mayors. Examining data on thirty U.S. cities over a seventeen-year period, the authors employed analysis similar to that of Lieberman and O’Connor. However, instead of explaining variance in organizational performance, Salancik and Pfeffer sought to explain variance in city expenditures in eight different budget categories. As did Lieberman and O’Connor, they inserted control variables, for city and year, before assessing the amount of variance explained by the mayor. They found that the individual mayors accounted for 5 to 15 percent of variance in the expenditure categories. And, like Lieberman and O’Connor, they concluded that there is a relatively confined role for leaders: “Leadership in organizations operates within constraints deriving from internal structural and procedural factors and from external demands on the organization” (Salancik and Pfeffer 1977b, 492).

A more recent study points to a similar conclusion. From a thirty-year (1969–1999) sample of approximately 1,500 large public U.S. firms, Bertrand and Schoar (2003) generated a subsample of those senior executives (CEO, CFO, COO, and division presidents) who had worked in at least two firms during this time period. Controlling for year, industry, and firm-fixed effects, these authors identified—for several firm-level outcome variables—the proportion of variance attributable to CEOs and top management teams. Their results suggest that as little as 5 percent of variance in return on assets, for instance, may be attributable to

firms' top managers.

So, on the one hand, reasonable logic and large-sample data provide a basis for believing that top executives do not matter very much. And, while Lieberman and O'Connor (1972) and Salancik and Pfeffer (1977b) are relatively old studies, they are still cited as providing evidence that the "true" effect of leaders is small (Weber et al. 2001). On the other hand, a great deal of everyday observation, as well as other systematic studies, points to a very different conclusion.

Do Managers Matter? A Positive View

Some companies do not change much over time. But many do change, and at the hands of their top executives. Consider these firms: Nokia, the telecommunications equipment company; IBM, the information products and services firm; and Pearson, the media and publishing company. Over the last twenty years or so, in relatively short order, these companies have dramatically altered their mix of businesses. Their founders would not recognize them today, nor would their CEOs from even 1990. These companies are fundamentally different because of choices made by top executives.

Executives make many kinds of choices. Sometimes, as with the companies noted above, the choices are bold and quantum; sometimes they are incremental; sometimes they maintain the status quo; sometimes they are not choices at all, but rather a failure to generate and consider choices. But managers act. As we shall argue throughout this book, they act on the basis of their own highly idiosyncratic experiences, repertoires, aspirations, knowledge of alternatives, and values.

Problems with Lieberman and O'Connor's Study

Before presenting affirmative evidence about managerial effects, we wish to return to Lieberman and O'Connor's (1972) oft-cited finding that top executives account for little variance in organizational performance. Their study, as influential as it is, had several methodological and analytic problems, all of which biased the results against observing managerial effects.

The most widely noted criticism of Lieberman and O'Connor's study deals with their choice of performance measures (Hambrick and Mason 1984; Romanelli and Tushman 1988). Two of their three performance measures—sales and earnings—are primarily indicators of the firm's size. In their data analysis, the authors sought first to explain variance by using three independent variables: year, industry, and company. Not surprisingly, these variables were exceedingly strong predictors of sales and earnings, with explained variance as high as 97 percent. For example, if we know that a company is in the steel industry, and specifically it is U.S. Steel in the year 1950, our ability to estimate the company's sales level will be relatively high. However, only after controlling for industry and year was the analysis rerun with leadership—represented by a dummy variable for each of the individual CEOs—included to determine how much additional variance could be explained. Since by this point almost all the variance had been explained, the apparent added effect of leadership was nil. When Weiner and Mahoney (1981) replicated Lieberman and O'Connor's study, they allowed the leadership variable to enter the analysis at the same stage as the other variables and found that leadership, or "stewardship," accounted for 44 percent of the variance in profitability of major firms.

Other problems bias Lieberman and O'Connor's study as well. First, they designated a

new leader whenever a new president or board chairperson was appointed, without any attempt to identify the CEO per se. But if a chairperson (who is also the CEO) names a new president, there in fact has not been a change in CEO; if the president serves as the CEO and there is a change in the chairperson, there has not been a change in CEO; or if a chairperson relinquishes the CEO duties to an incumbent president, there is a change in CEO even though the two parties have not changed. In American companies, these are all common occurrences (Vancil 1987). Hence, Lieberman and O'Connor's method for assigning specific CEOs to particular periods of time must have contained considerable error, making doubtful any attempts to associate specific CEOs with performance levels in corresponding periods.

Next, Lieberman and O'Connor excluded from their sample any industries heavily populated with diverse firms, as well as any firms that engaged in major mergers or acquisitions during the period of the study. However, altering a firm's portfolio of businesses—through diversification, acquisitions, and divestitures—is the *primary way* for an executive to have an immediate quantum effect on the form and fate of the firm. By excluding such cases, Lieberman and O'Connor tightly restricted their sample to more incremental strategies and, not surprisingly, an apparently lessened executive effect.

Our point is not to dismiss the Lieberman and O'Connor study. The authors had good reasons for the research design choices they made. However, their choices consistently biased their findings away from observing managerial influence on corporate outcomes. Hence, their study provides far less than the definitive word on the matter.

Evidence of Executive Effects

Beyond abundant anecdotal evidence that top executives can substantially alter organizations (e.g., Tichy and Devanna 1986; Tichy and Sherman 1993), numerous large-sample studies point to executive effects as well. Some of those studies, such as that of Weiner and Mahoney (1981), have been directly aimed at demonstrating the limitations of Lieberman and O'Connor's (1972) study. Other works have gone beyond methodological refinements, introducing important theoretical perspectives. For example, Smith, Carson, and Alexander (1984) used a sample of Methodist ministers to demonstrate that leaders who had been very effective in prior assignments tended to deliver higher performance in their current assignments (as measured by church attendance and financial statistics) than leaders who had been previously less effective. In their view, the inclusion of a measure of managerial quality enhances the ability to predict managerial effectiveness. Similarly, Pfeffer and Davis-Blake (1986), Cannella and Rowe (1995), and Rowe and colleagues (2005) found that the prior records of professional sports team coaches helped predict their performance in new coaching assignments.

Numerous other studies have examined and found significant associations between executive attributes or succession and organizational performance. A few examples will serve to illustrate this abundant stream of research. Virany and Tushman (1986), for example, found that the management teams of better-performing microcomputer firms had significant prior experience in the industry and tended to include the firm's founder. Gupta and Govindarajan (1984) found that different types of general manager expertise were associated with business performance, depending on the strategy being pursued by the business. Murray (1989), from a sample of twenty-six oil companies, found that top management teams composed of members of diverse tenures outperformed those with more homogeneous tenures. Haleblan and Finkelstein (1993) studied a sample of computer and natural gas companies and found that the size of the top management team was positively associated with company performance, while a measure of CEO dominance was negatively associated with performance.

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Not all research on top executives has sought to examine direct effects on organizational performance. Some investigators have focused on understanding how top management characteristics are associated with strategies and structures. For example, Hage and Dewar (1973) found that the values held by top management teams affected their organizations' subsequent degree of innovation. Miller and Droge (1986) found that chief executive personality influenced the structure of the organization. And Helmich and Brown (1972) found that whether a new chief executive comes from inside or outside the organization affects how much organizational change will occur early in his or her tenure.

These comprise just a minor sampling of the evidence that managers have influence on their organizations' profiles and performance. We do not wish to imply that such influence is total or easy to exercise, but it exists.

Moreover, we do not seek to extol the virtues of top managers. Executives are worth studying as much for their limitations as for their achievements. In fact, population ecologists may have overstated their initial case against managerial effects, precisely because they required any such effects to be positive. This quote illustrates the ecologists' early view of the adaptation, or strategic choice, perspective: "According to the adaptation perspective, subunits of the organization, usually managers or dominant coalitions, scan the *relevant* environment for opportunities and threats, formulate strategic responses, and adjust organizational structure *appropriately*" (Hannan and Freeman 1977, 929; emphasis added).

Such an interpretation omits the possibility that managers scan the *irrelevant* environment and formulate responses *inappropriately*. Population ecologists tend to equate deteriorating organizational performance with an absence of managerial effect, when what they may be observing is simply unwise or unlucky choices on the part of managers. Part of the problem may be terminology. Ecologists use interchangeably the terms *adaptation* and *strategic choice* to describe the model that rivals theirs. Because *adaptation* clearly connotes success in adjusting to the environment, it may be that in observing that organizations regularly fail, ecologists assume that organizations do not adapt, and beyond that, that strategic choices are not made—or are made but not implemented.

Later work by population ecologists envisioned a more significant role for top executives in influencing organizational outcomes (e.g., Hannan and Freeman 1984; Haveman 1992). In fact, some empirical research by ecologists has explicitly examined the effects of executive departures on survival rates of organizations (Carroll 1984; Haveman 1993b; Haveman and Khaire 2004). Such could not have been considered under the earliest formulations of the ecological perspective. Indeed, more recently, strategic choice has been posed as a link or bridge between a number of diverse perspectives, as well as a key driving force behind more recent evolutionary perspectives (Child 1997). Viewing both organizations and the environments in which they are embedded as social structures, with numerous linkages between them, provides the underlying logic for this approach.

Managerial Discretion

So, do managers matter a great deal, all the time? No, the amount of leeway available to senior executives, even CEOs, varies widely. In an effort to bridge opposing views about how much effect top executives have on organizational outcomes, Hambrick and Finkelstein (1987) introduced and elaborated on the concept of executive discretion, or latitude of action. Depending on how much discretion exists, an organization's form and fate may lie totally outside the control of its top managers, completely within their control, or more typically, somewhere in between.

For discretion to exist, an executive must have, and be aware of, multiple possible courses of action. As such, discretion is not absolute. It stems from contextual forces, but it also is derived from within the executive. Stated another way, one executive might create or detect alternative courses of action in a given situation, while another in the same situation might not be aware of such alternatives. Thus, as we discuss below, an executive’s discretion is in part a function of his or her own characteristics, especially cognitive limits.

Moreover, an executive’s discretion is rarely explicitly defined. Executives typically do not know exactly what actions might be allowed by powerful parties. So, they operate on the basis of rough estimates of the extent of their discretion, sometimes floating trial balloons to test the boundaries; occasionally they even overstep those boundaries, only *then* to be sanctioned by governing or powerful stakeholders.

A CEO’s degree of discretion does not occur by happenstance. It is derived from three sets of factors: environmental, organizational, and individual managerial characteristics. So, as stated by Hambrick and Finkelstein (1987, 379), “a chief executive’s latitude of action is fundamentally a function of (1) the degree to which the environment allows variety and change, (2) the degree to which the organization itself is amenable to an array of possible actions and empowers the chief executive to formulate and execute those actions, and (3) the degree to which the chief executive personally is able to envision or create multiple courses of action.”

As Figure 2.1 indicates, Hambrick and Finkelstein posited some specific determinants of discretion within each of these three spheres. We now discuss those.

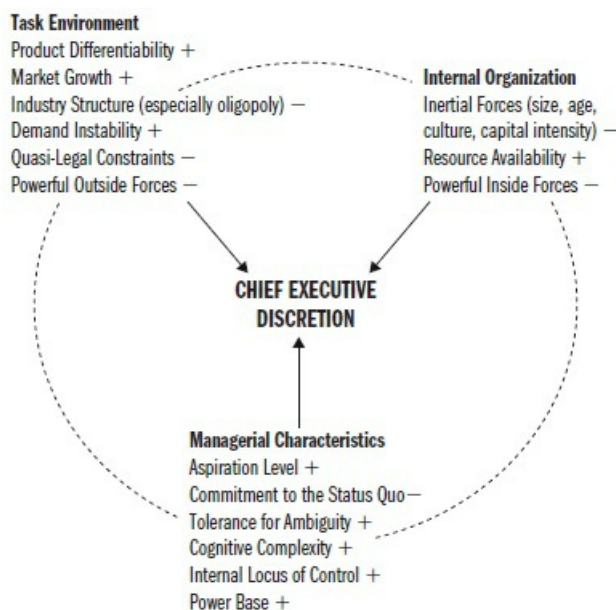


Figure 2.1. The Forces Affecting Chief Executive Discretion

Environmental Sources

The characteristics of the firm’s task environment greatly affect the level of executive discretion and, in turn, how much influence managers have on organizational outcomes. Let us return briefly to Lieberman and O’Connor’s study, which, as discussed above, is primarily known for demonstrating minimal managerial effects. A less-noted finding from their study is that managerial effects on corporate performance differed substantially across industries. Firms in the publishing and soaps/toiletries industries had the greatest amount of variance in

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profit margins explained by executive leadership, while firms in the clay products and shipbuilding industries had the least (see Wasserman, Nohria, and Anand 2001 for more recent analysis of cross-industry differences in CEO effects). Hambrick and Finkelstein (1987) attempted to explain and extend these results by arguing that the former industries provided far more executive discretion than the latter, and that, in general, environments confer discretion to the extent that (1) there is a relative absence of clear means-ends linkages, that is, where a wide range of options can meet stakeholders' nominal tests of plausibility; and (2) there is an absence of direct constraints.

In turn, Hambrick and Finkelstein set forth the following industry determinants of executive discretion:

- Product differentiability
- Market growth
- Demand instability
- Low capital intensity
- Monopolistic and purely competitive industry structures (as opposed to oligopolies)
- Absence of legal and quasi-legal constraints (e.g., regulation)
- Absence of powerful outside forces (e.g., large, concentrated customers, suppliers, funding sources)

Preliminary attempts to identify high- and low-discretion industries, for purposes of empirical inquiry, relied primarily on qualitative application of Hambrick and Finkelstein's ideas. For instance, Finkelstein and Hambrick (1990) examined aggregate indicators of product differentiability, market growth, and so forth of sixteen major industries to select the computer, chemical, and natural-gas distribution industries as high-, medium-, and low-discretion environments, respectively. Similarly, Hambrick, Geletkanycz, and Fredrickson (1993) used qualitative, gestalt judgments to assign foods/beverages, computing equipment, and scientific/measuring equipment as high-discretion industries, and public utilities and telecommunications services as low discretion, citing the wide differences between the two sets of industries in terms of differentiability, capital intensity, degree of regulation, and growth rates.

Subsequently, more rigorous approaches have been undertaken. Haleblan and Finkelstein (1993) used archival indicators of advertising intensity, research and development (R&D) intensity, market growth, and degree of regulation to create an overall index of discretion in the computer and natural gas industries. The components of the index were highly internally consistent, and the index score differed widely between the two industries.

Hambrick and Abrahamson (1995) used a panel of academic experts to rate the overall amount of managerial discretion in seventeen industries. They found a very high degree of reliability among raters, and, moreover, a high degree of agreement between the academics' ratings and those of security analysts who specialized in each of the seventeen industries. Hambrick and Abrahamson then examined the associations between the panelists' ratings and actual objective characteristics of industry discretion (from Compustat data), as originally set forth by Hambrick and Finkelstein. Using regression analysis, they were able to estimate the implicit weights that the panelists attached to specific industry characteristics (e.g., market growth) in rating an industry's overall discretion. The authors then applied these weightings of industry characteristics to determine the overall amount of discretion of fifty-three additional industries. [Table 2.2](#) lists, in rank order of discretion, the seventeen industries used for establishing the weights, as well as the other fifty-three. As can be seen, such industries as

computer programming, perfumes and cosmetics, and motion picture production received very high discretion scores. Such industries as natural gas transmission, electric services, and water supply were rated as very low discretion.

Table 2.2. Ratings of Managerial Discretion in Seventy Industries

Industry Name	Standard Industrial Code	Discretion Score
Computer and software wholesaling	5045	6.89
Computer communication equipment	3576	6.72
Electro-medical apparatus	3845	6.72
Computer storage devices	3572	6.62
Perfume, cosmetic, toilet preparation	2744	6.60
Catalog, mail-order houses	5961	6.44
Medical laboratories	8071	6.43
*Computer programming	7372	6.38
In vitro, in vivo diagnostics	2835	6.36
Help supply services	7363	6.16
*Motion picture production	7313	6.08
Photographic equipment and supplies	3861	5.99
*Computer equipment	3570	5.77
Telephone and telegraph apparatus	3661	5.70
Variety stores	5331	5.66
*Engineering/scientific instruments	3826	5.63
*Games and toys	3944	5.55
Computer integrated system design	7373	5.55
*Pharmaceuticals	2834	5.54
*Surgical/medical instruments	3841	5.42
Women's misses, junior's outerwear	2330	5.32
Eating places	5812	5.22
Miscellaneous amusement and recreation services	7990	5.21
Industrial measurement instruments	3823	5.19
Motor vehicles and car bodies	3711	5.18
*Radio/TV communication equipment	3663	5.17
Real estate investment trusts	6798	5.15
Orthopedic, prosthetic, surgical appliances	3842	5.07
State commercial banks	6022	5.06
Newspaper publishing	2711	5.06
Personal credit institutions	6141	5.04
Chemicals and allied products	2800	5.02
*Book publishing	2731	4.92
Search and navigation systems	3812	4.91
National commercial banks	6021	4.81
Family clothing stores	5651	4.79
Drug and proprietary stores	5912	4.78
Women's clothing stores	5621	4.75
Department stores	5311	4.75
Electric lighting, wiring equipment	3640	4.73
Television broadcast stations	4833	4.72
Men's youth, boy's furnishings	2320	4.72
Grocery and related products – wholesale	5140	4.71
Converted paper, paperboard (except boxes)	2670	4.68
Hotels, motels, tourist courts	7011	4.67

Hazardous waste management	4955	4.65
*Semiconductors	3674	4.61
Insurance agents, brokers, and service	6411	4.54
Paper mills	2621	4.46
Engineering services	8711	4.46
Water transportation	4400	4.34
*Instruments to measure electricity	3825	4.33
Grocery stores	5411	4.32
Savings institutions, federally chartered	6035	4.32
*Security brokers	6211	4.27
Natural gas distribution	4924	4.05
Commercial printing	2750	4.03
Motor vehicle parts and accessories	3714	4.92
Air conditioning, heating, refrigeration equipment	3585	3.80
Phone communication (except radiotelephone)	4813	3.72
Railroads, line-haul operating	4011	3.51
Drilling oil and gas wells	1381	3.41
*Certified air transportation	4512	3.23
Petroleum refining	2911	3.07
Water supply	4941	3.04
*Trucking (except local)	4213	2.72
*Gold and silver ores	1040	2.42
*Petroleum/natural gas production	1311	2.33
Electric services	4911	2.25
*Blast furnaces/steel mills	3312	2.08
Natural gas transmission	4922	2.01

* These seventeen industries were included in the set rated by academic experts and security analysts; multivariate analyses of objective industry characteristics provided the basis for rating the other fifty-three industries.

Adapted from Hambrick and Abrahamson 1995.

Up to this point, most research examining environmental sources of discretion has equated a firm's environment with its industry. Recently, though, some work has begun to explore how discretion may vary systematically at a national level. Using a size- and industry-matched sample, Crossland and Hambrick (2007) found that the proportion of variance in firm performance attributable to CEOs was significantly greater in U.S. firms than in comparable German and Japanese firms. These differences in CEO effects are consistent with prevailing cross-national differences in formal and informal national institutions (North 1990), such as legal tradition, firm ownership structure, board governance, and cultural values. Relatedly, Crossland (2007) used existing data on several national institutions to generate a multicountry taxonomy of discretion. This taxonomy suggests that certain national systems (e.g., Anglo-American countries) tend to permit greater executive discretion than others (e.g., northern European and East Asian countries).

It is also possible that macro-environmental factors have brought about a general expansion of managerial discretion in recent years (Hambrick et al. 2004). Beyond the obvious trend of deregulation in many countries, more options simply exist on the organizational landscape. Companies can select unique combinations of businesses in which to be active; they can be fully active in a business or partly active through joint ventures or other alliances; they can select among myriad geographic locales for producing their products and still others for selling them; they can use full-time permanent employees or contingent temporary workers. In short, societal and economic trends, as well as organizational innovations, have expanded the choices for senior executives, perhaps well beyond what existed when Lieberman and O'Connor (1972) conducted their study that pointed to limited managerial effects.

Organizational Sources

In addition to environmental factors, the organization may have characteristics that enhance or, conversely, limit the chief executive's discretion. These factors include inertial forces, such as organizational size, age, a strong culture, and capital intensity, all of which limit executive latitude. Large, mature organizations with very entrenched cultures are not easily changed. Their top executives operate under considerable inertial constraints.

Also affecting executive discretion is the amount of resources available to the organization, as well as internal political conditions (as determined by the distribution of ownership, board composition and loyalties, and internal power concentrations). For example, executives have far more discretion when ownership is widely dispersed than when one or a few owners own concentrated blocks (McEachern 1975; Hambrick and Finkelstein 1995). A CEO who is also chairperson of the board has more discretion than a CEO who does not hold both posts (especially when the chairperson is the prior CEO and strongly committed to existing policies) (Lorsch and MacIver 1989; Finkelstein and D'Aveni 1994; Harrison, Torres, and Kukulis 1988). In short, characteristics of the organization greatly affect how much latitude executives have over strategy and policy.

Recently, Shen and Cho (2005) developed a theoretical framework for explaining involuntary executive turnover, and their framework relied heavily on the discretion construct. Their treatment is particularly germane to the concept of discretion because they addressed several issues that had been missing from the broader literature. First, they pointed out that the management and economics literatures both use the term *managerial discretion*, but the term has very different meanings in the two fields. In the economics literature, managerial discretion describes the extent to which managers are free to pursue their own interests, rather than shareholders' objective of maximizing wealth (see, for example, Jung, Kim, and Stulz 1996; Williamson 1963). In the management literature, the concept of discretion refers to the range of options open to executives, while the extent to which those options represent the interests of executives versus shareholders is not expressly discussed. To resolve this contrast in usage of the same term, Shen and Cho divided the construct of managerial discretion into two dimensions: latitude of actions and latitude of objectives. Latitude of actions corresponds closely to the Hambrick and Finkelstein concept of discretion. Latitude of objectives, on the other hand, refers to the extent to which a manager can set objectives for the firm that may differ from those of owners. The authors then developed the logic as to how these two dimensions, independently and in interaction, influence the causal antecedents and performance outcomes of involuntary executive turnover.

Hendry (2002) also discussed the divergence between the discretion concept in the management and economics literatures, though not as directly as Shen and Cho. Hendry described the problem of "honest incompetence" and its implications for the agency relationship between managers and shareholders, or managers and other powerful governance forces. Because managerial competence is not assured, it becomes a second dimension that those involved in governance activities must consider.

Hendry's paper raises some very interesting dilemmas, highlighting the role of governance in developing managerial competence, and in ameliorating selection mistakes. The extent to which a manager is coached and developed may have a lot to do with his or her ultimate capabilities as a strategic leader. And, the level of discretion is a key factor in this development process.

More recently, Finkelstein and Peteraf (2007) offered a new perspective on managerial discretion that posited a fourth source of discretion—managerial activities. Building on research on agency theory and transaction costs, they argued that a focus on the activity level of analysis opens up the question of how managers might evade or minimize constraints

imposed upon their actions. This leads naturally to a consideration of the dynamics of discretion, an aspect of the theory not yet addressed in the literature, but one that can offer insight on central organizational issues such as how managers enact environments, the nature of managerial capabilities, and the interplay of constraint and choice.

Finkelstein and Peteraf (2007) made three points. First, they argued that some types of activities circumscribe discretion more than others, just as some types of environments, organizations, and personal characteristics limit managerial discretion more than others. Second, by focusing on the key attributes of activities—Finkelstein and Peteraf (2007) specifically highlight uncertainty, complexity, and observability—it is possible to develop predictions as to which types of activities offer more, or less, discretion. And third, managers can create or select activities in which they have greater opportunities to have an impact on organizational outcomes. In sum, Finkelstein and Peteraf (2007) offer a new perspective on discretion that extends the original conceptualization in interesting ways, specifically by bringing in the activity level of analysis to the core theory of discretion.

Individual Sources

As noted above, discretion is derived in part from executives themselves. By virtue of their personal characteristics, chief executives differ in the degree to which they generate and are aware of multiple courses of action. Some executives see alternatives that others do not. Some executives, because of their own persuasive and political skills, can consider options that others cannot. Hambrick and Finkelstein (1987) posited the following as specific individual-level attributes affecting discretion: aspiration level, tolerance for ambiguity, cognitive complexity, locus of control, power base, and political acumen.

So far, researchers have not empirically examined these individual-level bases of discretion. However, this is a critically important arena for investigation, since the creation of discretion may be the critical ingredient in executive capability:

Managerial quality could be defined in part as the ability to perceive, create and enact discretion. Managerial excellence is a function of sheer awareness of options.

Although it is an open (and researchable) issue, we suspect that managerial performance is more a matter of generating options than of selecting among them. Namely, among a given set of options, to most knowledgeable executives one will typically tend to stand out as the best. Thus, the opportunity for managerial contribution lies in improving on the list. (Hambrick and Finkelstein 1987, 374)

Namely, executives can shape their own discretion. Effective managers find and create options that others do not have. They may do this through creativity and insight, political acumen, persistence, or sheer will. Managers, even in a given situation, are not uniformly hemmed in. Child (1997), for example, noted that executives have various interpersonal linkages to the external environment, and can often use these linkages to influence the environment's effect on the organization, thus setting their own level of discretion (within limits).

Along those same lines, Carpenter and Golden (1997) provided evidence on the role of perception and locus of control¹ in the discretion context. Their study examined the age-old strategic leadership question, "Why do different managers, when confronted with the same situation, respond differently?" They argued (and empirically tested) for two distinct explanations. First, following Hambrick and Finkelstein (1987), they pointed out that an executive's locus of control will affect the amount of discretion the manager has: internals will have more discretion than externals. Second, the authors noted that managers can (and

do) use impression management tendencies to influence how much power others perceive them to have. That is, through impression management, managers may be able to increase their own level of discretion.

Carpenter and Golden found qualified support for these ideas in a simulation involving executive MBA students. For example, they found that a given manager's perception of his or her own discretion relied upon locus of control, but *only* in low-discretion situations. Further, they found that impression management techniques could increase others' perceptions of the manager's discretion, but again, only in low-discretion situations. Their study provided important evidence that personality is an important factor in individual-level discretion, and that a given manager's perceived level of discretion is an important determinant of actual discretion.

Effects of Discretion

Executive discretion can be expected to affect a variety of phenomena of interest to organizational scholars. For example, Hambrick and Finkelstein (1987) argued that in situations of low discretion, the following could be expected: older CEOs who are promoted from within (to fulfill largely figurehead roles), low executive compensation, little use of incentive executive compensation, low administrative intensity, low involuntary turnover of CEOs, stable strategy, and changes in organizational performance tied closely to changes in the task environment. Situations of high discretion would tend to show opposite effects.

Equally important, however, is that discretion serves to attenuate the relationship between executive characteristics (values, experiences, and so on) and organizational outcomes. Namely, if high discretion exists, executive orientations become reflected in organizational outcomes; if low discretion exists, they do not. On this matter, research support is clear and consistent. For example, Finkelstein and Hambrick (1990) found that executive tenure was positively related to strategic persistence and strategic conformity to industry norms (reflecting presumably risk-averse and imitative tendencies of long-tenured executives) in high-discretion industries, but not in low-discretion industries. The authors also found that when the organization characteristics allowed top managers significant latitude—as indicated by abundant slack or small company size—strategic choices were more likely to reflect the tenure of the top executives than when slack was limited or the company was large.

In a similar vein, Halebian and Finkelstein (1993) found that the relationship between TMT size and firm performance was significant in a high-discretion environment (computer industry) but not a low-discretion environment (natural gas industry). Also, Forbes (2005) argued that small ventures are high-discretion settings (akin to Mischel's 1968 "weak situation") and therefore yield stronger links between executive characteristics and firm outcomes.

Abrahamson and Hambrick (1997) provided important evidence that discretion influences attentional homogeneity within an industry—and by implication, the extent to which individual differences among managers will have effects on the decisions made. They developed an attention-interpretation-action framework to demonstrate that as attentional homogeneity increases among industry participants, the interpretations of strategic situations and the resulting actions decided upon become more and more consistent across participants. This study provided evidence to bolster the earlier assertion that executive choice sets may vary substantially over time, depending upon industry context.

Additional research, while not specifically invoking the concept of discretion, provides further evidence in line with the above suppositions. For example, Miller, Kets de Vries, and Toulouse (1982) found that CEO locus of control was strongly associated with organizational

strategy and structure in small firms but not in large firms. The authors wrote, “these [small firms] might be more easily dominated than large ones, which, all things being equal, are more difficult to control” (page 249). In the same vein, Reinganum (1985a) found evidence that the stock market distinguishes between high- and low-discretion situations. On the announcement of CEO succession, stock prices rise abnormally, but only for small companies and when the predecessor CEO is totally departing the firm—these being conditions in which a new CEO can have an enhanced effect.

A good deal of research supports Hambrick and Finkelstein’s ideas that discretion affects executive compensation arrangements, with executives in low-discretion situations receiving relatively low levels of pay and little incentive pay. Rajagopalan and Finkelstein (1992) studied the electric utility industry from 1978 to 1987, a period of steadily increasing deregulation and, hence, increasing discretion. They found that executive compensation (for the CEO and top team) and the use of performance-contingent compensation increased over time as environmental discretion increased.

Rajagopalan (1997), using the same sample of electrical utility firms as mentioned above, described the importance of a fit between the level of discretion and the pay package provided to top executives. Using the Miles and Snow (1978) strategy categories of Prospector and Defender as proxies for the level of discretion, she argued that incentive compensation is an important determinant of firm performance only for Prospectors, because they naturally have higher discretion and therefore greater capacity for individual managers to influence performance.

Finkelstein and Boyd (1998) fleshed out the broad association between discretion, compensation, and firm performance. They predicted that compensation would be greater in high-discretion situations, to compensate managers for the fact that discretion makes the executive’s job more complex, demanding, and risky. They further predicted that the relationship between discretion and compensation would be stronger in high-performing firms. Their results generally supported these hypotheses. Additionally, their manuscript discussed in detail some dimensions of organizational discretion and their measurement.

Two other studies also contribute to the discretion-incentive compensation predictions made by Hambrick and Finkelstein. Magnan and St. Onge (1997) provided evidence to support their hypotheses that the compensation-performance relationship is moderated by executive discretion. Their study involved 300 large commercial banks, and they developed some very interesting (albeit industry-specific) measures of discretion. Further, their results held across both accounting and market-based measures of performance. In a later study, St. Onge and colleagues (2001) qualitatively examined incentive plan effectiveness, using in-depth interviews with eighteen senior managers. Their results supported the notion that the effectiveness of stock option plans depends on the extent to which those targeted by the plans have the capacity (discretion) to take actions that directly influence stock prices.

Other studies, while not always explicitly investigating managerial discretion, have yielded corroborative findings. For example, a study by Kerr and Kren (1992), while not labeling firms as high or low on discretion, found that such indicators of discretion as R&D and advertising intensity strengthened the association between CEO pay and performance. Balkin and Gomez-Mejia (1987) found that high-technology firms, which tend to be characterized by greater levels of discretion (Hambrick and Abrahamson 1995), use incentive pay plans more than other firms do. And Napier and Smith (1987) found that the proportion of incentive pay was significantly greater in more diversified (and hence, higher discretion) firms. Further, Jensen and Murphy (1990b) found that the use of incentive compensation for CEOs was much greater in small firms than in large firms, prompting the authors to conclude: “Higher pay-performance sensitivities for small firms could reflect that CEOs are more

influential in smaller companies” (p. 260).

A body of work in financial economics also provides insights into managerial discretion. The “investment opportunity set” is the full range of choices available to a firm or individual (Smith and Watts 1982). Similar to the managerial discretion literature, studies indicate that total compensation and the proportion of incentive-based compensation are higher when the investment opportunity set is greater (e.g., following industry deregulation) (Hubbard and Palia 1995).

A further stream of research suggests that executives may be aware, even if implicitly, of how much discretion they possess and that this awareness shapes their cognitive processing (Grinyer, Al-Bazzaz, and Yasai-Ardekani 1986; Javidan 1984). For example, in a large-sample study, Hambrick, Geletkanycz and Fredrickson (1993) found that in high-discretion industries, a firm’s current level of performance was positively related to the top executive’s commitment to the status quo (the belief that the organization’s strategy and leadership characteristics in the future should remain as they are). This included, of course, the tendency for executives in poor-performing firms to believe that their firms should change. However, in low-discretion industries, no such association was found, leading the authors to state: “for the executive in a low-discretion situation, there is not a strong connection between current performance and a belief in the correctness of current organizational strategy and leadership profiles. In this instance, performance, be it high or low, emanates largely from uncontrollables—the environment, the organization’s confining history, etc.” (1993, 406).

It is an open and interesting question as to whether executives modify their beliefs about the potency of executive action after sustained exposure to a high-or low-discretion situation, or whether managers with certain types of beliefs and personalities (say, in terms of locus of control) are drawn to high- and low-discretion settings.

In general, executive discretion is an important construct for helping to bridge the debate about the influence of executives on organizational outcomes. Moreover, discretion may be a conceptual lever for improving our understanding of such matters as executive compensation, executive dismissal, organizational inertia, and executive personality.

Executive Job Demands

The concept of executive job demands refers to the “degree to which an executive experiences his or her job as difficult or challenging” (Hambrick, Finkelstein, and Mooney 2005, 473). While the concept of job demands has a long history in organizational behavior research and industrial organizational psychology (Xie and Johns 1995; Janssen 2001; Karasek 1979), it has received little attention as it relates to executive work. Most research on executives seems to assume that all executives experience their jobs as equally difficult. However, the extent to which an executive finds his or her work challenging is likely to have a number of observable outcomes.

Executive job demands arise from three classes of antecedents. The first, task challenges, refers to the general difficulty of the situation. Environmental hostility or munificence, competitive rivalry or stability, and the rate of environmental change all influence task challenges. Additionally, firm-level factors, such as the amount of resources or legitimacy, can greatly influence the level of task demands. The second antecedent of job demands is performance challenges. Most of these arise from external interests that may hold sway over the firm. Such challenges as stakeholder pressures, concentrated ownership, and a viable and active market for corporate control are important to the performance challenge dimension. Additionally, the firm’s performance profile is a large factor in this antecedent. The third and

final antecedent of job demands is executive aspirations. This factor includes such determinants as need for achievement, locus of control, and the extent of incentive alignment that the executive experiences in his or her salary structure.

Hambrick, Finkelstein, and Mooney (2005) proposed several associations between job demands and performance. For example, increased job demands are likely to lead to less strategic rationality in decision making, more reliance on past experience and repertoires, and more reflection of executive background in decision making. Paralleling the effects observed in more micro-oriented studies, the authors proposed that the overall effect of job demands on performance will be curvilinear, with higher performance occurring when executive job demands are moderate. The authors also proposed some interactions between job demands, performance, and executive hubris. For example, executives who have performed well in extremely demanding situations may be more likely to develop hubris. Finally, the authors proposed some impression management behaviors that may follow from relatively high and relatively low job demand situations.

The Managerial Mystique

No discussion about whether managers matter would be complete without addressing the strong human tendency to believe that leaders matter. People seek to have heroes and villains as a way of explaining organizational and institutional successes and failures. Through the ages, people have blamed kings for droughts, prime ministers for poor economic conditions, and baseball managers for losing seasons. Humans gravitate to human (and simple) explanations for noteworthy events or trends. Indeed, this particular tendency is often referred to by psychologists as the “fundamental attribution error” (Weber et al. 2001, 583).

The work of James Meindl and his associates has been particularly instrumental in enhancing our understanding of “the romance of leadership.” In one paper, Meindl, Ehrlich, and Dukerich (1985) argue that leadership is a “perception” that allows people to make sense out of organizationally relevant phenomena. The authors explain the idea that attributions to leaders will be greatest when organizational performance is extreme—either very good or very bad. Their evidence, drawn from multiple methods and levels of analysis, is not definitive but is clearly intriguing. They find that business press headlines refer to a company’s leadership in direct proportion to the company’s performance: the better the performance, the more attention is showered on leaders. At a more macro level, the authors find that the number of doctoral dissertations written on leadership subjects increases in bad economic times (“Where’s the leadership to take care of this mess?”) and that the number of articles in the business press dealing with leadership increases in good economic times (“Hurray for all this great leadership!”). (The difference between the pattern for dissertations and the press perhaps says something about the cynical lenses of academics.) Finally, in a series of laboratory studies, Meindl and his associates found that subjects, after reading a vignette, were relatively likely to ascribe extreme performance—either good or bad—to the leader of a business; more moderate or neutral performance was less likely to be attributed to the leader.

In a follow-up study, Chen and Meindl (1991) examined the role of the press in bestowing heroic and villainous status on leaders. Tracking the press accounts of the rise and fall of Donald Burr and People Express airline, the authors found that the press endowed Burr’s ascendancy with a host of flattering images, then created an entirely new set of images of Burr to account for the company’s collapse—all the while striving to demonstrate a consistency in the two distinct sets of portrayals. This project and the research stream it represents highlight the tendency of people—exacerbated by the press—to attribute

organizational outcomes to senior leaders.

Recently, in a series of experimental studies designed to rigorously rule out alternative explanations, subjects consistently misattributed poor performance to leadership, when the cause was very clearly due to group size (Weber et al. 2001). Using some “weak link” games developed in game theory, the researchers explained how, for their experiment, group size was clearly and consistently the cause of poor outcomes. Whereas dyads nearly always come to optimal solutions in these games, groups of seven or more members seldom do so, regardless of how well they understand how the games work. In the experiment, the authors randomly assigned one group member as the “leader” and asked that person to exhort the group to behave according to very simple rules so that all would enjoy a favorable outcome. Very consistently, the larger groups failed to conform and tended to blame the failure on the group’s leader. When given an opportunity, poorly performing groups tended to vote to replace the leader with another randomly chosen from among the group’s membership. The authors argued that participants clearly understood how the game worked, but still failed to correctly attribute the outcome to group size (its true cause).

One interesting avenue for future research into executive attributions relates to several studies that indicate this “fundamental” attribution error (Tetlock 1985) may not be quite so fundamental after all (Harvey, Town, and Yarkin 1981). For example, Krull and colleagues (1999) found support for the idea that individuals in collectivistic cultures (such as China) were less likely to attribute outcomes to individuals, and more likely to perceive external causes, than were individuals from individualistic cultures (such as the United States). Thus, managerial mystique, or CEO celebrity (Hayward, Rindova, and Pollock 2004), may in fact be culturally contingent.

Executives also generate their own attributions about their effects on their organizations. Here, the data are clear and quite consistent with the human tendency to manage impressions. Executives tend to take credit for favorable outcomes and blame external forces for unfavorable outcomes. The predominant research method for detecting this pattern is content analysis of the letters to shareholders in annual reports (Bettman and Weitz 1983; Abrahamson and Park 1994). One such project captures the essence of the phenomenon in its title: “Strategy and the Weather.” Here, Bowman (1976) found that food companies that performed poorly very often blamed the weather and accompanying crop conditions, whereas food companies that performed well (and presumably faced the same weather) made no mention of the weather but instead pointed to the wisdom of their strategic choices.

The attributions made about executive influences on organizations are exceedingly interesting in their own right. Of course, these attributions also pose complications for the researcher who is interested in trying to objectively detect executive effects.

Conclusion

This chapter leads to a set of interconnected summary statements. First, senior executives operate in a wide array of spheres, encompassing substance and symbols, decisional and interpersonal roles, and external and internal activities. Further elaboration and development of the roles of human and social capital in the executive context are needed.

Second, there are numerous avenues by which top executives can influence organizational outcomes. Moreover, situated where they are (i.e., at the top), executives would seem to have the power to make things happen. Nevertheless, some research has concluded that top managers, including CEOs, do not have a strong effect on organizational performance. And although reservations can be raised about the analytic aspects of those studies, they cannot be

entirely dismissed. Constraints on executives do exist, more so in some instances than in others. Executives sometimes have very little latitude of action, sometimes a great deal, and usually somewhere in between. Executive discretion is the concept that allows us to describe and understand how much leeway exists. Discretion stems from factors in the environment, the organization, and the executive him- or herself.

Third, further elaboration of the discretion construct, as well as its different dimensions in the agency and strategic contexts, is needed. While the extent to which powerful stakeholders afford executives latitude in setting firm-level objectives is clearly important, it differs in important ways from the broader discretion construct that addresses the latitude of strategic actions available to the executive.

Fourth, even though executives rarely have total influence over what happens to their organizations, people tend to attribute extreme outcomes to leadership. This tendency gives rise to a romance of leadership—heroes, villains, and scapegoats. Executives themselves further complicate the observer's ability to assign outcomes to the right sources by taking credit for favorable outcomes and pointing to "uncontrollable factors" for unfavorable outcomes.

Considerable research is still needed, not so much on the most basic elements of what managers do and whether they matter, but on *how* and *when* they matter. This need is particularly great since so much idealized imagery, prescriptive folklore, and naïve attributions exist about top executives. Careful understanding of executives' roles and activities is warranted. Mintzberg (1973) and Kotter (1982) created a foundation for dissecting and classifying managerial roles, but too little research has extended these ideas. Particularly needed is an examination of the factors that affect an executive's involvement in various roles (external versus internal, decisional versus informational, and so on). Explanations based on environmental, organizational, temporal, and individual factors may allow important advances in understanding managerial work and even in generating prescriptions about "fitting" managers to specific circumstances. We particularly encourage research on the symbolic aspects of top executive work. We are convinced that this is an important side of executive behavior, yet very few systematic or generalizable insights about executive symbolism have been generated.

Executive discretion remains a fruitful target for research. Considerable work is needed in understanding the determinants of discretion. We particularly encourage examination of how organizational and individual characteristics affect the top executive's latitude of action, to complement the bit of progress made in understanding environmental sources of discretion (Hambrick and Abrahamson 1995).

Great opportunity also exists for research on the consequences of discretion. Some work has indicated that discretion affects executive compensation arrangements, but even here more needs to be known. Other possible consequences of discretion—including executive profiles, turnover rates, executive mobility and careers, administrative intensity, and executive personality—have gone largely unexplored (Rajagopalan and Datta 1996). Discretion, we believe, will be an important theoretical fulcrum for understanding these and other important organizational phenomena.

Finally, one of the most promising areas of research will be executive images and attributions. How an executive is perceived obviously affects his or her own professional capital, but it also affects the firm's legitimacy and its ability to attract support from stakeholders. Executives no doubt engage in impression management to improve their images; however, the press and other external information conduits (such as executive search firms and business associations) also greatly influence the ways in which executives are perceived. It may be that managerial attributions vary widely by national culture, with

individualist countries such as the United States imbuing more of a managerial mystique than do countries with collectivist cultures, such as Finland and Japan. We anticipate that executive reputation, stigma, prestige, and attributions will be prominent constructs in some of the most interesting research on top management over the next several years.

3

How Individual Differences Affect Executive Action

Top executives operate in a world of ambiguity and complexity. Unlike convenient business school case studies, in which all the “relevant facts” are packed into twenty-five pages, real strategic situations lack structure; the identification and diagnosis of problems are open to varying interpretations; and potentially pertinent information is often far-flung, elusive, cryptic, even contradictory. At odds with most strategy frameworks in textbooks, top executives do not deal in a world of tidily packaged, verifiable facts and trends. Even if executives were able and inclined to conduct in-depth comprehensive analyses of their situations, they would typically arrive at widely differing conclusions, because strategic situations are not knowable, they are only interpretable.

Consider, for instance, the myriad projections, estimates, and interpretations that entered into the decision by Google’s senior executives to acquire YouTube, an online video-sharing site, for a staggering \$1.65 billion in October 2006. YouTube first launched its service in December 2005, a mere eleven months before it was acquired, and it had yet to make a profit. Moreover, because YouTube was privately held, any valuation of the firm would contain considerable guesswork and leaps of faith. Naturally, then, many critics panned Google’s move. Concerns were raised about Google’s increased exposure to copyright litigation, and some skeptics openly wondered how YouTube’s grassroots business model could possibly ever yield a profit.

Presumably, other media companies such as Microsoft or Yahoo could have entered the fray, but decided that YouTube would never be a big moneymaker, or simply that \$1.65 billion was too much to pay. Obviously, someone was wrong—either the reluctant bystanders, or Google for paying so much. The actual payoffs in the years ahead for these parties will depend on dozens or even hundreds of possible future events or trends—few of which can be estimated with any precision. No one knows what will happen, but that does not stop strategic decision makers from estimating or assuming what will happen, having strong preferences for some options and objectives over others, and making choices.

Strategic decisions thus clearly represent what psychologist Walter Mischel (1977) called a “weak situation,” one in which stimuli are many, complex, and ambiguous. In such situations, the stimuli do not clearly point to ideal choices; instead, decision makers inject a great deal of themselves—their experiences, preferences, and personalities, for instance—into figuring out what to do. In weak situations, such as those typically encountered by top executives, the choices of decision makers vary widely and cannot be predicted by the stimuli themselves.

Such a view is consistent with the logic of the Carnegie School of decision theory, which is a central underpinning of our own line of argument. According to Carnegie theorists, complex choices are largely determined by behavioral factors, rather than by calculations of optimal actions (March and Simon 1958; Cyert and March 1963). In their view, bounded rationality, multiple and sometimes incompatible goals, myriad options, and varying aspiration levels all serve to limit the extent to which complex decisions can be made on a techno-economic basis. Instead, complex choices are a result of human limitations and biases. This is not to say that strategic decision makers are capricious or whimsical, but simply that

they act on the basis of what they know, believe, perceive, and want. And these factors can vary widely from strategist to strategist.

A Model of Human Limits on Strategic Choice

If bounded rationality characterizes executive decision making, then it is important to understand how this “boundedness” occurs. How is it that executives come to perceive only a limited portion of all potentially relevant information, often attaching peculiar interpretations to that information and assigning idiosyncratic weights to different possible outcomes?

Our model for portraying this process is shown in Figure 3.1. At the left-hand side is the “strategic situation,” which consists of all the many facts, events, trends, and other potential stimuli existing outside and inside the organization. This strategic situation includes, for example, external technological, demographic, geopolitical and competitive factors, as well as internal conditions, such as workforce morale, cost structures, marketing capabilities, technological wherewithal, and so on. Toward the right-hand side are “strategic choices” (decisions to diversify, enter into a joint venture, introduce a new profit-sharing system, and so on). We use the term *strategic choice* in the same way that Child (1972) did, to encompass a broad range: major choices made formally and informally, inaction as well as action, product/market and competitive actions usually associated with the term *strategy*, and also major administrative choices (such as decisions about staffing, structure, rewards, and so on). At the far right side of the model is organizational performance.

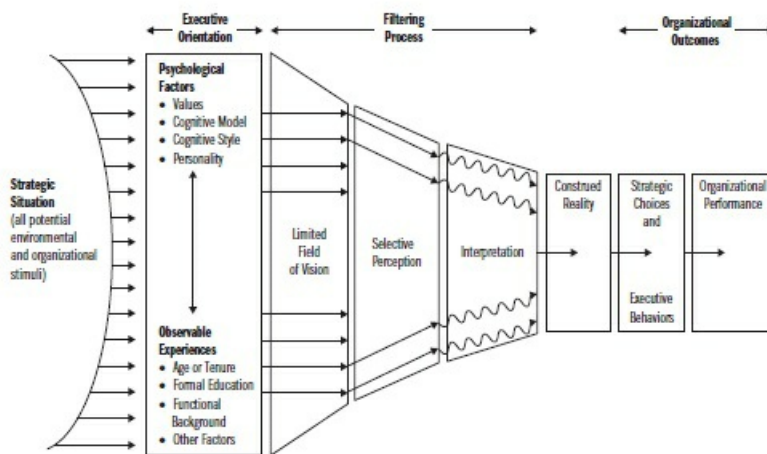


Figure 3.1. Strategic Choice under Bounded Rationality: The Executive’s Construed Reality (Adapted from Hambrick and Mason 1984; and Finkelstein and Hambrick 1996.)

Under most models of strategic behavior, as embraced by the academic field of strategic management, these three conceptual elements—situation, choice, and performance—are all that are needed. According to prevailing perspectives, if an executive knows all the relevant facts of the situation, she will be drawn to a logical, essentially obvious set of strategic behaviors, and her brilliance will be rewarded by outstanding performance. Conversely, those executives who—for whatever reasons—pursue strategies that do not follow logically from the requirements of the situation will deliver poor performance. What this typical model omits, of course, is any consideration of the human limits and biases of the strategist (or strategists).

The centerpiece of our model overcomes this omission by depicting the executive and the

information-filtering process by which he or she arrives at a “construed reality” of the strategic situation and decides what ought to be done about it. The wellspring of this human interpretive process is each decision maker’s “executive orientation,” which consists of an interwoven set of psychological characteristics (e.g., values, cognitive model, and personality) and more observable experiences (such as functional background, education, and age or tenure). This executive orientation, then, serves as the basis from which the executive interprets the strategic situation and decides on a course of action. So, standing between the “objective” situation and strategic choices are human factors: “Biases, blinders, egos, aptitudes, experiences, fatigue, and other human factors in the executive ranks greatly affect what happens to companies (Hambrick 1989, 5).

The Filtering Process

The logic of bounded rationality hinges on the premise that top executives are confronted with far more stimuli—both from within and outside the organization—than they can possibly fully comprehend, and that those stimuli are often ambiguous, complex, and even contradictory. Accordingly, in arriving at their own rendition of a strategic situation, or “construed reality” (Sutton 1987), executives distill and interpret the stimuli that surround them. This occurs through a three-stage filtering process, as depicted in the middle of [Figure 3.1](#). Specifically, executives’ orientations affect their *field of vision* (the directions in which they look and listen), *selective perception* (what they actually see and hear), and *interpretation* (how they attach meaning to what they see and hear).

Limited Field of Vision

As a first step in the filtering process, an executive will be exposed to only a subset of all potential stimuli. As Simon (1945) termed it, each decision maker has a limited and specific “focus of attention.” Researchers of environmental scanning have found that executives vary widely in how much they scan, as well as in their use of different sources for learning about external events and trends (Aguilar 1967; Kefalas and Schoderbeck 1973; Hambrick 1982). For example, while some executives expend great effort reading formal reports from external consultants and research organizations, others rely more on informal personal interactions to learn about environmental forces. Executives also differ widely in terms of which environmental sectors they most attend to, varying, for example, in their degree of attention to technological, competitive, regulatory, or international sectors (Ocasio 1997; Cho and Hambrick 2006). Research on environmental scanning supports the conclusion that a given executive cannot scan everything that might be pertinent (Aguilar 1967; Hambrick 1981b; Daft, Sormunen, and Parks 1988; Waller, Huber, and Glick 1995).

Moreover, research suggests that top executives may not even be fully abreast of events and conditions in their own organizations. Strategic projects can be initiated (Bower 1970; Burgelman 1983), morale can deteriorate greatly, and illegal behaviors can occur (Miceli and Near 1994), all without a top executive’s knowledge.¹ Obviously, an executive’s field of vision is proportionately more limited in a large, complex organization than in a small, simple one.

An executive’s network of contacts is a primary determinant of his or her field of vision (Chattopadhyay et al. 1996). Most senior executives have significant networks through which they both receive and disseminate information (Mintzberg 1973; Kotter 1982). However, these networks vary widely and can create significant differences in senior executives’ access to information. For example, a new CEO recruited from outside the firm will tend not to have the same internal network as a CEO promoted from within (Gabarro 1987). An executive who is actively involved in industry trade associations has a network different from that of an

executive who does not have a lot of intra-industry ties (Geletkanycz 1994). And an executive who sits on other companies' boards has an expanded field of vision by virtue of those associations (Lorsch and MacIver 1989).

To sum up, an executive cannot be looking in every direction or listening for every possible piece of news.

Selective Perception

Further filtering occurs because an executive selectively perceives only a portion of the stimuli within his or her field of vision.² Think, for example, of the executive who reads a consultant's report on technological trends in the industry. The executive's eyes may gaze upon every page, but chances are, he or she will not read or comprehend every word. The executive's grasp of, and interest in, the technological issues will affect how much of the report "gets through." But other factors will matter as well: the executive's general regard for the consulting firm, whether the executive likes the editorial style and layout of the report, whether the passages in the report are consistent with what he or she has heard or read elsewhere, and so on. The same filtering process may occur when the executive sits through a long meeting of presentations by subordinates or has a conversation with a supplier. Not all of the information within the executive's field of vision will register equally. Some will be vivid, meaningful, and engaging; some will slide into the executive's subconscious; and some will escape the executive's attention entirely.

Starbuck and Milliken (1988) refer to this as the process of "noticing," and they argue that noticing is a complex function of what is familiar and unfamiliar to the decision maker. On the one hand, people become relatively insensitive to familiar stimuli; on the other hand, with experience, people are able to notice the slightest perturbation in familiar stimuli. Not enough research has been done on executive "noticing" to be able to reconcile these complex phenomena. However, it is clear that strategists see only a portion of what they are watching, and they really hear only a portion of what they are listening to.

Interpretation

As a third step in the sequential filtering process, the executive interprets or attaches meaning to stimuli. This step, directly or indirectly, has been the object of most research on executive perception. Managers have been studied for whether they interpret certain stimuli as opportunities or as threats (e.g., Dutton and Jackson 1987); for how they categorize or group stimuli (e.g., Day and Lord 1992); for how they use available stimuli to draw conclusions or inferences (e.g., Milliken 1990); and other interpretive processes. Starbuck and Milliken (1988) refer to this stage as "sensemaking," arguing that it has various aspects: "comprehending, understanding, explaining, extrapolating, and predicting" (p. 51).

As an example of how executives can attach their own interpretations to information, Milliken (1990) found that college executives varied widely in drawing implications from a well-publicized and verifiable external trend, the imminent shrinking of the eighteen- to twenty-two-year-old population in the United States. Some executives saw this trend as a grave threat, others expressed little concern, and some even asserted that the trend would not occur. Beyond their varying interpretations of the trend itself, the executives differed even more widely in their judgments about how their institutions should respond to the trend.

Summary

The three-stage information-filtering process is made analytically tractable by thinking of it as a strictly sequential process: field of vision, selective perception, and interpretation (as portrayed in [Figure 3.1](#)). However, the three stages may interact in nonsequential ways. For

instance, if an executive comprehends, and is highly engaged by, the information coming from a specific source, he or she is likely to rely even more on that source in the future. In such a case, selective perception affects field of vision. Other iterative links in this filtering process can be anticipated as well.³

As a result of the three-stage filtering process, an executive's ultimate view of the strategic situation, or "construed reality," may bear little correspondence to the objective "facts" (even if those could be ascertained).⁴ And, more important, one executive's construed reality can be quite different from another's: "In the face of ambiguity and massive bombardment of information that typifies the top management task, no two strategists will necessarily identify the same array of options; if they were to pick the same major options, they almost certainly would not implement them identically" (Hambrick 1989, 5). Such a contention is useful, as far as it goes. But, we seek fuller explanation and prediction. For, if executives filter stimuli randomly, we do not have much of a theory.

It is the "executive's orientation," the person's interwoven set of psychological and observable characteristics, that engages the filtering process, and which in turn yields a construed reality, gives rise to strategic choices, and ultimately affects organizational performance. These orienting characteristics are the "givens" that an executive brings to an administrative situation (March and Simon 1958). If we wish to understand the strategic choices and performance of organizations—the right-hand side of [Figure 3.1](#)—we must examine and understand their top executives.

Executive Orientation: An Overview

Two major classes of personal characteristics constitute an executive's "orientation." First are psychological properties, such as values, cognitive models, and other elements of personality. These characteristics provide a basis from which the executive filters and interprets stimuli, and they dispose the executive toward certain choices. For example, Miller and Droge (1986) found that CEOs in a sample of companies differed significantly in their need for achievement, an element of personality. And the greater the CEO's need for achievement, the greater the organization's structural centralization and formalization, reflecting—the authors thought—the high achievers' strong desires to personally monitor and control all company actions and take credit for company successes.

The second set of characteristics that contribute to an executive's orientation are those observable dimensions of the person's experiences. Such variables as functional background, company tenure, and formal education have been prominent in studies of senior executives. For example, a well-known finding from several studies is that executives tend to make more and bigger strategic changes early in their tenures than they do later on; moreover, new executives from outside the firm make more changes than those promoted from within (Helmich and Brown 1972; Gabarro 1987; Baumrin 1990; Hambrick and Fukutomi 1991).

Researchers who use executive experiences to explain behaviors sometimes make assertions about psychological characteristics that are being proxied by the experiences. For instance, in the research just mentioned, the mechanism causing so much strategic change early in an executive's tenure (and less later on) could be the new executive's open-mindedness, eagerness to demonstrate efficacy, lack of entrenched relationships, or simply emotional (and possibly physical) energy. However, in the cited studies, these psychological qualities went unexamined, so the actual operative mechanism behind a robust and interesting relationship remains a "black box."

In contrast, psychological constructs have the advantage of conceptual clarity, and they

provide a pointed causal link to the executive behaviors or choices being explained. And it is certainly better to have an explanation for a relationship than to simply demonstrate its existence (Lawrence 1997).

But the use of psychological constructs poses its own major limitations for researchers of senior executives. First, top executives are very reluctant to submit to batteries of psychological tests. The larger and more visible the company, the greater the reluctance. Thus, it is not surprising that most studies of psychological characteristics of top executives are based on samples from small and medium-sized firms or nonprofit organizations. Second, if the researcher is interested in studying the effects of executive psychological characteristics on subsequent strategic choices, and perhaps even on further subsequent performance, any psychological data gathered must “await,” possibly for two years or more, the strategic and performance measures being explained. The elapsed time and expense of such a research program can be considerable. Finally, some psychological constructs have the drawback of doubtful validity when applied to senior executives. For example, debates have focused on whether the conventional scales for assessing personality dimensions are too general and too removed from the executive context to be useful for studying top managers (Boone and de Brabander 1993; Hodgkinson 1993).

Measures of executive experiences pose the obverse strengths and weaknesses. Data on executives’ backgrounds are abundant for various types of companies, over long time frames, and even for different countries. Such data are also relatively reliable. For instance, an executive’s tenure in the firm is open to essentially no measurement error; an executive’s primary functional background is open to little error and can be coded reliably. In this vein, Pfeffer argued for the use of experience, or demographic, variables: “It is possible for demography to do a better job at explaining variation in the dependent variables than measures of the presumed intervening constructs, for the reason that many of the intervening constructs are mental processes ... that are more difficult to access and reliably measure” (1983, 351).

Obviously, the chief drawback of demographic data is the “black box” problem. When a relationship between an executive’s experiences and an organizational outcome is observed, the nagging question is always “Why?” Sometimes the researcher will attempt to logically surmise what the experience variable might be tapping. For instance, Finkelstein and Hambrick (1990) used prior literature to argue that executive tenure in the firm is a proxy for an executive’s commitment to the status quo, risk aversion, and narrowness of information sources used. But, without data on these three possible operative mechanisms, there is no way of knowing which of them (or in what proportions) actually affected the relationships that the authors observed between executive tenure and strategic persistence.

Hambrick and Mason also acknowledged this problem: “Demographic indicators may contain more noise than purer psychological measures. For example, a person’s educational background may serve as a muddied indicator of socioeconomic background, motivation, cognitive style, risk propensity, and other underlying traits” (1984, 196).

Executive psychological characteristics and experiences are mutually dependent through two-way causality. As is often asserted, experiences affect psychological characteristics. For example, long tenure in the firm may induce a commitment to the status quo. But fundamental psychological qualities can also affect an executive’s experiences. For example, risk-averse individuals may tend not to change employers often, and hence they have long tenures; similarly, individuals with different cognitive styles may vary in how much formal education they pursue, as well as in their choices of curricula. So, as we show in [Figure 3.1](#), executive psychological and experience characteristics cannot reliably be put one before the other. They affect each other, and far more research needs to examine the associations

between the two categories of executive characteristics. If strong, recurring patterns are observed, it may even be possible to develop a useful typology of executive profiles, with each type consisting of a combination of experiences and psychological attributes.

In sum, the question is not whether psychological characteristics are better or worse than demographic background characteristics in providing us with an understanding of the effects that executives have on their organizations. They both have merits, and ultimately the two approaches will be used in concert.

The remainder of this chapter focuses on executive psychological factors and their influences on strategic choice. [Chapter 4](#) will examine the literature on executive experiences, or demographics.

Psychological Characteristics as Bases for Executive Action

Psychologists have numerous ways of characterizing people and their minds. The work on executive psychology, however, has focused primarily on three broad fronts: executive values, cognitive models, and personality. In this section, we examine some of the major ideas and findings regarding these three elements of executive psychology, defining each concept, discussing some of its major dimensions, and describing its theorized or demonstrated links to executive actions.

Executive Values

Top managers vary in what they want—for themselves, their organizations, their employees, and society. That is, executives vary in their values, and they act accordingly. In fact, values may greatly determine other executive psychological characteristics, including cognitions; therefore, we consider them first.

Rokeach defined values as follows: “To say that a person ‘has a value’ is to say that he has an enduring belief that a specific mode of conduct or end-state of existence is personally and socially preferable to alternative modes of conduct or end-states of existence” (1973, 159–160). Hofstede’s (1980) definition is very similar: “a broad tendency to prefer certain states of affairs over others” (p. 19). Hambrick and Brandon’s (1988) definition, which we adopt, is a minor modification of those of Rokeach and Hofstede: *a broad and relatively enduring preference for some state of affairs*.

Most theorists allow for both personal and social values. Personal values are conceptions of what the individual aspires to (e.g., prestige, family security, wealth, wisdom). Social values have to do with what the person finds desirable in others or in the broader social system (e.g., rationality, honesty, courage, world peace). Additionally, values can be either instrumental or terminal, dealing either with means (e.g., courage, honesty) or ends (e.g., equality, self-respect).

As each value is learned or adopted, it becomes integrated into an overall values system in which each value has its own place, perhaps of high or low priority. When managers confront situations in which they cannot satisfy all their values, they may have to choose, say, between behaving compassionately or behaving competently; they may have to choose between their own job security and stockholder wealth maximization. Their hierarchy of values drives those choices.

Values are relatively enduring, thus standing in contrast to ephemeral attitudes or emotions. However, values are not entirely fixed over a person’s adult life. Rokeach commented on a theoretical conception that allows for both stability and change in a person’s

value system: “It is stable enough to reflect the fact of sameness and continuity of a unique personality socialized within a given culture and society, yet unstable enough to permit rearrangements of value priorities as a result of changes in culture, society, and personal experience” (1973, 11).

Origins of Values

Values only exist in a social context. So, one can speak of “values” only in maturing or mature individuals who have been regularly exposed to models, rules, and sanctions of a social system. The social system exists in several layers—national culture, regional society, religion, family, and employing organizations—all exerting influence on a person’s values.

The influence of national culture in shaping values of executives has been heavily examined. Studies by Bendix (1956), Sutton, Harris, Kaysen, and Toblin (1956), Taguiri (1965), and Chatov (1973) all concluded that the values that business executives bring to their tasks are largely influenced by a national system of beliefs (see also Bailey and Spicer 2007). England (1975) found that national origin accounted for 30 to 45 percent of the variation in executive values. Hofstede (1980) and Schwartz (1992) similarly documented the strong role of national culture in accounting for values of individuals in different countries. And most recently, a monumental cooperative effort among 170 researchers around the world, the GLOBE Project, further reaffirmed the influence of national culture in shaping the values of individuals (House et al. 2004).

Several other recent studies have examined the similarities and differences in executive value systems across countries. For example, in a comparison of Egyptian, American, African, and Arab executives, Buda and Elsayed-Elkhoully (1998) found that Egyptian executives placed significantly greater emphasis on the importance of a comfortable life, while U.S. executives tended to be much more interested in social recognition. Relatedly, Jacoby, Nason, and Saguchi (2005) found differences in the values of U.S. and Japanese human resources executives. U.S. executives rated company share price as significantly more important, while Japanese executives rated “safeguarding employees’ jobs” as being more important. Finally, in a comparison of Australian, Japanese, Chinese, and Russian managers, Sarros and Santora (2001) found both similarities (e.g., harmony of self with others) and differences (e.g., the importance of power) in values across countries.

Other layers of the social system operate as well. Cohort history, and particularly the occurrence of wars, depressions, disasters, or major social movements, can sharply affect the values of a certain age-group in a society (e.g., Kluckhohn 1951; Jacob, Flink, and Shuchman 1962; Schmidt and Posner 1983). In addition, family influences, such as class, race, and religious upbringing, are all strongly associated with differing values (Rokeach 1969a, 1969b; Rokeach and Parker 1970).

At the occupational level, a self-selection process occurs, such that individuals entering a certain line of work tend to have values that differ from the population as a whole (Allport, Vernon, and Lindzey 1970; Rawls and Nelson 1975). Selection and socialization processes continue to operate after entry to an occupation. To the extent that the occupation has a codified body of standards and norms that are repeatedly reinforced, members can be expected to strengthen their values (e.g., Blau and McKinley 1979; Cafferata 1979). And for individuals who are highly successful within their occupations, their initial values will become especially reinforced (Mortimer and Lorence 1979).

The employing organization also exerts its own pressure on values. Organizations convey something of themselves in attracting employment candidates and, in turn, seek to hire individuals whose values “fit” the setting. After entry, socialization occurs (Feldman 1981), further shaping the values of members (Pfeffer 1981b; Louis, Posner, and Powell 1983). The

longer a member stays in the organization, the more his or her values will resemble those preferred by the organization (Wiener 1982). Members who achieve extraordinary success through abiding by and manifesting the organization's values—such as top executives—will particularly embrace those values. Recent studies suggest that executives may experience such social influence processes from others on their top management team. In a study of fifty-eight top management teams, Chattopadhyay, Glick, Miller, and Huber (1999) examined intra-TMT transmission of normative beliefs (e.g., the importance of particular strategic goals) and cause-effect beliefs (e.g., the efficacy of particular strategic emphases). Results showed that the beliefs of a focal senior executive were highly dependent on the beliefs of the other members of the team.

In sum, senior executives can be expected to have relatively entrenched value sets. Their extended exposure to value-shaping stimuli, their self-selection into settings compatible with their values, and the reinforcement they have received through their many successes all give rise to a well-defined value profile.

Value Dimensions

Theorists have set forth many value dimensions—far too many to fully reconcile or employ. Adding to the frustration is that few of the major theorists have addressed how or why their own value typologies differ from the others. In an attempt to overcome this disjointedness, Hambrick and Brandon (1988) undertook a systematic consolidation of four prominent value schemes: those of Allport, Vernon, and Lindzey (1970); Rokeach (1973); England (1967); and Hofstede (1980).

Hambrick and Brandon found that the vast majority of the previously unreconciled value dimensions identified by these prior theorists could be distilled into six constructs of central importance to students of executive behavior. As labeled and defined by Hambrick and Brandon (1988), these six robust dimensions are:

- *Collectivism*: To value the wholeness of humankind and of social systems, regard and respect for all people
- *Rationality*: To value fact-based, emotion-free decisions and actions
- *Novelty*: To value change, the new, the different
- *Duty*: To value the integrity of reciprocal relationships; obligation and loyalty
- *Materialism*: To value wealth and tangible possessions
- *Power*: To value control of situations and people.

Table 3.1. Cultural Values Identified by the GLOBE Project

<i>Power Distance</i>	To value unequal distribution of power
<i>Uncertainty Avoidance</i>	To value predictability
<i>Collectivism I (Institutional Collectivism)</i>	To value collective distribution of resources and collective action
<i>Collectivism II (In-Group Collectivism)</i>	To value pride and cohesiveness of proximate collectives (e.g., families and organizations)
<i>Assertiveness</i>	To value interpersonal assertiveness and directness
<i>Gender Equalitarianism</i>	To value gender equality
<i>Future Orientation</i>	To value planning and investing in the future
<i>Performance Orientation</i>	To value excellence and performance improvement

Adapted from House et al. 2004.

This distillation encompasses the vast majority of the value dimensions proposed by four
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sets of prominent theorists, thus providing some suggestive guidance to scholars who wish to consider executives' values. These dimensions, however, are not the final word on the conceptual landscape for the study of values.

It is especially informative to consider the value dimensions examined by the GLOBE project. As shown in [Table 3.1](#), GLOBE researchers identified nine value dimensions on which different cultures can be arrayed. Some of the dimensions align with the meta-categories identified by Hambrick and Brandon (e.g., power distance and power, uncertainty avoidance and novelty). Other GLOBE dimensions are distinctive or have their origins in typologies other than those assessed by Hambrick and Brandon.

It is also important to note that the GLOBE value dimensions are meant to describe cultures, or societies, rather than individuals. The assumption is that members of a society will tend to have values that mirror the society's values; of course, some individuals might deviate widely from societal averages, depending on how atypical their upbringing and formative experiences were. For example, Thompson and Phua (2005) found that a sample of Anglo-Saxon and Chinese executives did not completely reflect their expected cultural profiles, in terms of Hofstede's (1980) dimensions. Still, the GLOBE dimensions, as well as those identified by Hambrick and Brandon, are well-documented, well-validated vectors for considering the deeply ingrained, fundamental values of different business leaders.

Effects on Choices

Despite the abundant literature on executive values, relatively little theory or research has been set forth on how values are converted into action. Some work in this area has recently begun to emerge, however. Akaah and Lund (1994) found that self-reported personal values (such as religiousness) were associated with marketing executives' ethical behaviors. Also, in a study of CEOs of nonprofit organizations, Ritchie, Anthony, and Rubens (2004) found that CEOs with greater collectivism values held perceptions of organizational performance that corresponded more accurately to objective financial measures. In contrast, Agle, Mitchell, and Sonnenfeld (1999) found no significant direct relationship between CEO values (e.g., self-regarding vs. other-regarding) and corporate performance.

From a national perspective, several authors have found links between cultural dimensions and firm-level behavior. For example, in a twenty-three-country sample, Tosi and Greckhamer (2004) found a strong relationship between Hofstede's (1980) power distance scores and CEO compensation levels. Also, Geletkanycz (1997) found significant links between a senior executive's national culture (again using Hofstede's dimensions) and his or her commitment to the status quo in terms of company strategy. Again, national culture, or national values, do not exactly equate with an individual executive's values, but the societal setting has a major effect on the individual's hierarchy of preferences.

These studies help to provide a greater understanding of the relationship between executive values and actions. However, with limited exceptions, the few investigators who have explored the association between managerial values and actions have been primarily interested in cross-sectionally documenting that such a link might exist, rather than the process by which it occurs.

Following England (1967), we believe that executive values affect choices in two ways. First, there may be a direct influence, as when an executive selects a course of action strictly because of value preferences. The person may fully comprehend the facts on all sides of an issue, but then, regardless of the facts, will select the course of action that suits his or her values. England (1967) refers to this direct influence of values on action as "behavior channeling." When this occurs, the "filtering process" shown in [Figure 3.1](#) is skirted or immaterial.

Far more common, we believe, are the indirect influences that values have on executive actions. In this indirect mode, values work through the perceptual filtering process. Values affect the executive's field of vision—the intensity with which new information will be sought, the sources that will be used, and so on. Moreover, values affect selective perception and interpretation: the manager “sees what he wants to see,” “hears what she wants to hear” (Weick 1979a). This well-known process, which England called “perceptual filtering,” and which psychologists refer to broadly as “motivated cognition” (for reviews, see Higgins and Molden 2003; Kruglanski 1996), derives from early work by Postman, Bruner, and McGinnies (1948). Clearly, this process of motivated cognition invokes our overarching model of how executive orientations ultimately become reflected in strategic choices (Figure 3.1). The conversion occurs through the sequential filtering process of field of vision, selective perception, and interpretation, giving rise to four propositions:

Proposition 3–1A: An executive's values will affect his or her field of vision.

Example: Executives who highly value collectivism will be directly exposed to more information from individuals of low hierarchical rank than will executives without such values.

Proposition 3–1B: An executive's values will affect his or her selective perception of information.

Example: Executives who highly value collectivism will notice and be aware of a greater proportion of the information they are exposed to from lowrank individuals than will executives without such values.

Proposition 3–1C: An executive's values will affect his or her interpretation of information.

Example: Executives who highly value collectivism will place more credence in information from lowrank individuals than will executives without such values.

One can similarly anticipate how other values drive the filtering and interpretation process. And, when combined with the more direct effects of behavior channeling, the following overarching proposition can be reliably set forth:

Proposition 3–1D: An executive's values will be reflected in the choices he or she makes.

The topic of executive values is wide open for research. For, even though values are undoubtedly important factors in executive choice, they have not been the focus of much systematic study. Six avenues of inquiry would seem particularly important and promising.

First, we need much more examination of how executive values are shaped. What are the relative influences of professional and organizational factors, as opposed to early upbringing and family factors? To what extent do institutional forces in a society exert homogenizing influences on executive values? And what causes executives' values to change?

Second, and related to the first, is the need to study executive values from the perspective of agency theory. According to agency theory, executives are not supposed to pursue *their* values; they are supposed to pursue *shareholders'* values, that is, wealth maximization (Jensen and Meckling 1976). Monitoring systems, executive compensation schemes, and even the corporate takeover market are all meant to be devices for reining in executives' pursuit of their own, preferred agendas (Eisenhardt 1989a; Walsh and Seward 1990). What influence do these devices have on executive values? Do they drive out executives with

certain values? Do they cause executives to change their values; or do they simply submerge their values, only to exert them in other, nonbusiness arenas? Do value-dampening mechanisms create a counterproductive tension, prompting executives to pursue strategies they fundamentally do not prefer? For instance, what are the implications when a company, led by a founder who has strong non-economic values (e.g., Ling, Zhao, and Baron 2007), becomes a publicly traded corporation subject to the disciplines of Wall Street? A reconciliation of agency theory and executive values is greatly needed.

Third, there is a need for greater understanding of the links between values and cognition. How do executives screen and interpret information so that their conclusions suit their values? Very little research has been done on the associations between executive values and information processing, and this area of study should be a high priority. For instance, do executives who highly value rationality strive consciously to not allow their other values to affect their interpretation of information?

Fourth, researchers need to examine how executive values and specific situations interact to affect choice. Executives who highly value collectivism, for instance, may tend to respond very differently to major choices about organizational decentralization, involvement in trade associations, and corporate philanthropy—all of which would seem on the surface to follow from a collectivist orientation. If values and situations combine only in highly specific ways to affect executive choice, then the search for a parsimonious typology of values will be elusive, in which case researchers might be better off focusing on executive “attitudes” than on “values.”

Fifth, there is a need to study the links between executive values and corporate goal setting. Organizations vary widely in the performance measures they use to chart progress—some focusing on growth, some on market share, some on profitability, some on cash flow, still others on stock price. Moreover, organizations vary greatly in the height of the goals they set—some seek incremental improvements, while others have grand aspirations. Bateman, O’Neill, and Kenworthy-U’Ren (2002) undertook a study of top managers’ goals (goals both for themselves and their organizations), which demonstrated that managers differ widely in what they hope to achieve. The authors did not draw a connection between managers’ goals and their fundamental values, but we can expect that the link is substantial. Executive values must play an important role in the goal-setting process, but this role has not been examined.

Finally, researchers need to study the broad associations between executive values and organizational characteristics. Do executives, as Hage and Dewar (1973) found, tend to select strategies in line with their values? Hemingway and Maclagan (2004) laid out a comprehensive argument for how managerial values affect corporate social responsibility, which awaits empirical inquiry. Simsek, Veiga, Lubatkin, and Dino (2005) found, in a study of 400 firms, that CEOs who valued collectivism tended to have relatively well-integrated top management teams (TMTs), whereas CEOs who scored lower on collectivism tended to have more fragmented TMTs. Hambrick and Brandon (1988) developed an inventory of more than thirty relatively testable hypotheses of links between executive values and organizational characteristics. For example, they hypothesized that executives who value novelty will adopt organizational structures that are highly ambiguous (e.g., matrix structures) and will engage in relatively frequent reorganizations. These hypotheses—and numerous others that could be generated—might form the basis for future empirical work.

The basic premise that executive values are reflected in strategic choices was once a central element in prevailing models of strategy. For example, one of the early chapters in Kenneth Andrews’s (1971) classic treatise on strategy is titled “The Company and Its Strategists: Relating Economic Strategy and Personal Values”; it is full of case examples of executives favoring certain courses of action because of value preferences. For the most part,

however, systematic inquiry into the links between executive values and strategic choice has been sparse. To conduct such research, scholars face the challenge of developing and administering valid instruments to measure executive values. But the payoffs from such inquiries may be considerable because executive values almost certainly affect information processing and strategic choices (including approaches to strategy formulation and implementation), as well as organizational performance.

Cognitive Model

Ever since March and Simon's (1958) explication of bounded rationality, scholars have been interested in cognitive limits and biases in strategic decision making. Interest in managerial cognition has grown explosively (Srivastava 1983; Sims and Gioia 1986; Huff 1990), to the point that the sheer volume of theory and research on executive cognition is too extensive to be adequately summarized here. At the heart of this literature, however, is the premise that every manager is endowed (or burdened) with a cognitive model that determines whether and how new stimuli will be noticed, encoded, and acted upon. These cognitive models have been variously referred to as cognitive maps (Axelrod 1976; Weick and Bougon 1986), worldviews (Starbuck and Hedberg 1977; Mason and Mitroff 1981), "mindscapes" (Maruyama 1982), and other, often lyrical terms (summarized in Hodgkinson and Sparrow 2002).

Here, we will discuss three chief elements of an executive's cognitive model. Ranging from the most basic and disaggregated to the most complex and interwoven, the three elements are (1) cognitive content, or what the executive knows; (2) cognitive structure, or how an executive's knowledge and beliefs are arranged in his or her mind; and (3) cognitive style, or how the executive's mind works. As we shall see, these elements of cognition affect each other, so the dividing lines among them are not precise. Still, they allow a useful disentangling of some complex phenomena.

Cognitive Content

At the most basic level, an executive's cognitive model consists of what he or she knows, assumes, and believes. Consider the array of items that executives can possibly carry in their heads, creating a foundation for more elaborate information processing and strategic choice. An executive's cognitive content, which stems from personal and professional experiences, can include recollection of vivid events, such as an economic depression, a business bankruptcy, or a dishonest customer. It can include familiarity with management tools or concepts, such as sophisticated financial statement analysis, Porter's five-forces industry analysis, or psychographic market segmentation. Cognitive content also can include simple firsthand knowledge about other people, what they know, and how to reach them. For instance, an executive who is on a first-name basis with senior Pentagon officials, or who knows a variety of influential investment bankers, has cognitive content—in the form of acquaintances—that others may not have. Of course, cognitive content also consists of simple facts, data, and perceptions.

What an executive knows—or does not know—forms the basis by which new information is noticed and interpreted. Namely, an executive's existing knowledge provides a platform from which additional knowledge is sought, comprehended, and interpreted. In this vein, for example, George Heilmeyer (1993), a prominent executive in the 1990s and winner of the prestigious Industrial Research Medal, argued that CEOs who have deep technological expertise are best able to position their firms in a complex technological environment. Why should CEO expertise in technology matter? Because preexisting cognitive content affects the noticing, encoding, and acting on *new* technological data, which Heilmeyer presumed to be

beneficial. In line with this premise, Tyler and Steensma (1998) found that executives with technical degrees were more positively disposed toward technological alliances for their firms than were executives without technical education. In a related project, Tripsas and Gavetti (2000) documented how the cognitive baggage of Edwin Land, the founder of Polaroid, and of the firm's entire senior team greatly affected their information search behavior and the interpretations they attached to new information—in ways that contributed to the decline of the once-legendary firm.

Indeed, we can readily imagine that an executive's preexisting knowledge base, or cognitive content, will influence every step in the sequential information processing and interpretation model we laid out earlier:

Proposition 3–2A: An executive's cognitive content will affect his or her field of vision.

Example: Executives who have in-depth familiarity with advanced technology will seek out more information about technology than executives without such familiarity.

Proposition 3–2B: An executive's cognitive content will affect his or her selective perception of information.

Example: Executives who have in-depth familiarity with advanced technology will notice and be aware of a greater proportion of the technology information to which they are exposed than will executives without such familiarity.

Proposition 3–2C: An executive's cognitive content will affect his or her interpretation of information.

Example: Executives who have in-depth familiarity with advanced technology will require fewer pieces of information to form an opinion about a technological trend or development than will executives without such familiarity.

Proposition 3–2D: An executive's cognitive content will be reflected in the choices he or she makes.

Example: Executives who have in-depth familiarity with advanced technology will make earlier and larger investments in new technologies than will executives without such familiarity.

Perhaps because cognitive content is the most disaggregated way of considering what is in a decision maker's mind, and because it implies no particular priorities or complex associations, researchers of managerial cognitions have paid relatively little attention to it. We believe this omission is a mistake, because basic cognitive content is at the core of more sophisticated conceptions of managerial thinking. Researchers have focused instead on more elaborate and analytically complex ideas about cognitive structure and cognitive style.

Cognitive Structure

If cognitive content is the basic raw material for executive knowledge, then cognitive structure is how the content is arranged, connected, or situated in the executive's mind. The term *causal map* is widely used among cognition theorists (Axelrod 1976; Huff 1990), clearly connoting a spatial and topographical feature of thinking.

Isenberg (1984) referred to "terrain structures," or an individual's conceptions of where things—organizational resources, customers, competitors, subunits, and so on—are located, either relative to each other or relative to some set of dimensions. An executive may

cognitively differentiate between entities, considering them very dissimilar; or he or she may mentally juxtapose entities, in a belief that they are similar or of a kind. As an illustration, Isenberg asked senior executives to rate the overall similarity of all pair-wise combinations of the subunits of their organizations. He then used multidimensional scaling (a useful analytic method for gauging cognitive structures) to reveal each executive’s mental map of his or her organization. Figure 3.2 shows the “terrain structure” of the CEO of a metals corporation in three-dimensional space (the dimensions were labeled by the researcher). As the figure shows, the CEO considered primary fabrication (A) and mining (B) units as very similar to each other, but very different from the executive committee (D), the overall corporation (G), and the corporate staff (I, partly blocked by G). The public affairs committee (E) was seen by the CEO as quite distinct from any other part of the company.

A particularly abundant stream of research has focused on executives’ mental maps of their competitors (see Hodgkinson and Sparrow 2002 for a complete review). For instance, Gripsrud and Gronhaug (1985) found that the managers of retailing firms typically perceived only a small portion of all the other stores in their markets to be their competitors. The managers tended to see stores that were larger and geographically close to them as competitors and ignored other stores, some of which were actually direct rivals. Similarly, Reger and Huff (1993) examined how managers cognitively distinguished strategic groups in the Chicago banking market. They found that most managers agreed on the categorization of many of the banks, but they differed widely in their assignment of others. The authors did not speculate about the determinants of each manager’s own conception of the competitive arena, but their study clearly indicates that competitor identification and assessment is open to varying interpretations. If strategic choices hinge on competitive dynamics (Porter 1980; Chen and MacMillan 1992) and if executives arrive at their own highly personalized assessments of competitors (Zahra and Chaples 1993), then an understanding of how those assessments are derived would be of major practical significance.

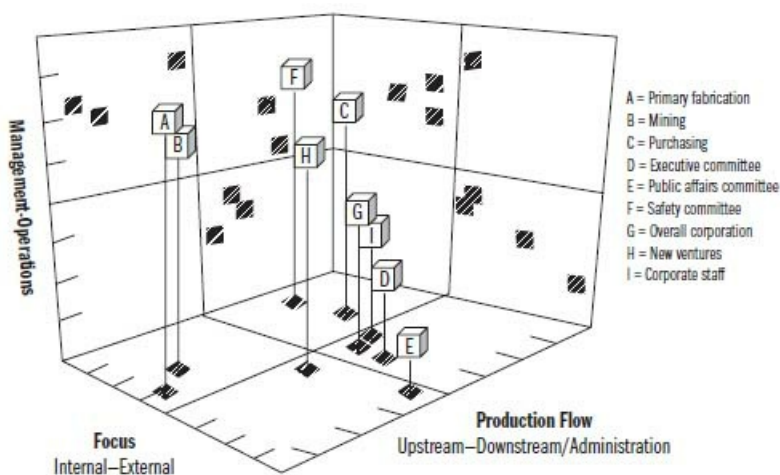


Figure 3.2. A CEO’s Cognitive Structure of the Company: Metals International, Inc. (Adapted from Isenberg 1984.)

In addition to simple associations, an executive’s cognitive structure also consists of myriad inferences, guiding the person from one observation to another. An executive could draw interpersonal inferences: “If emotional, infer friendliness; if blunt, infer trustworthiness” (Isenberg 1984). The executive can draw inferences about entities in the organization: “Marketing managers tend to produce overoptimistic forecasts”; “middle managers are more resistant to change than any other group in the organization.” And, of

course, executives carry a host of inferences about external factors: “Asians never actually say no”; “small advertising agencies are more creative than large ones.”

Beyond inferences, or beliefs about simple covariation, are an executive’s beliefs about causality, particularly about how certain strategic actions or emphases will affect organizational performance (Chattopadhyay et al. 1999). For instance, an executive might strongly believe that employee stock ownership enhances productivity, or that increased research and development (R&D) spending enhances innovation. In a classic article, Hall (1976) studied patterns of resource allocation at the *Saturday Evening Post* to infer the causal maps of top executives during that magazine’s death spiral. Similarly, Narayanan and Fahey (1990) used content analysis of annual reports and trade journal articles to extract the causal maps of executives at Admiral Corporation over the last fifteen years of the television manufacturer’s life. For instance, the authors used available data to construct the Admiral executives’ causal map for the years 1964 to 1966, as shown in [Figure 3.3](#). According to the schematic, the executives were preoccupied with the effects of the macroenvironment on the company’s performance, but they did not perceive much connection between their more proximate environment—especially their competitors, customers, and imports—and what was happening to their firm.

By this point, it should be clear that an executive’s cognitive structure is a highly personalized interpretation of reality, not necessarily aligning with objective conditions. Moreover, one’s cognitive structure can become self-fulfilling and self-reinforcing (Weick 1983). In some cases, elements of this structure are so well established and unshakable that contrary data are overlooked or, if noticed, severely discounted. Thus, we propose:

Proposition 3–3A: An executive’s cognitive structure will affect his or her field of vision.

Example: Executives who cognitively differentiate widely between customer groups will use a wider array of sources for staying abreast of customer behaviors and preferences than will executives who have more homogenized cognitive maps of customers.

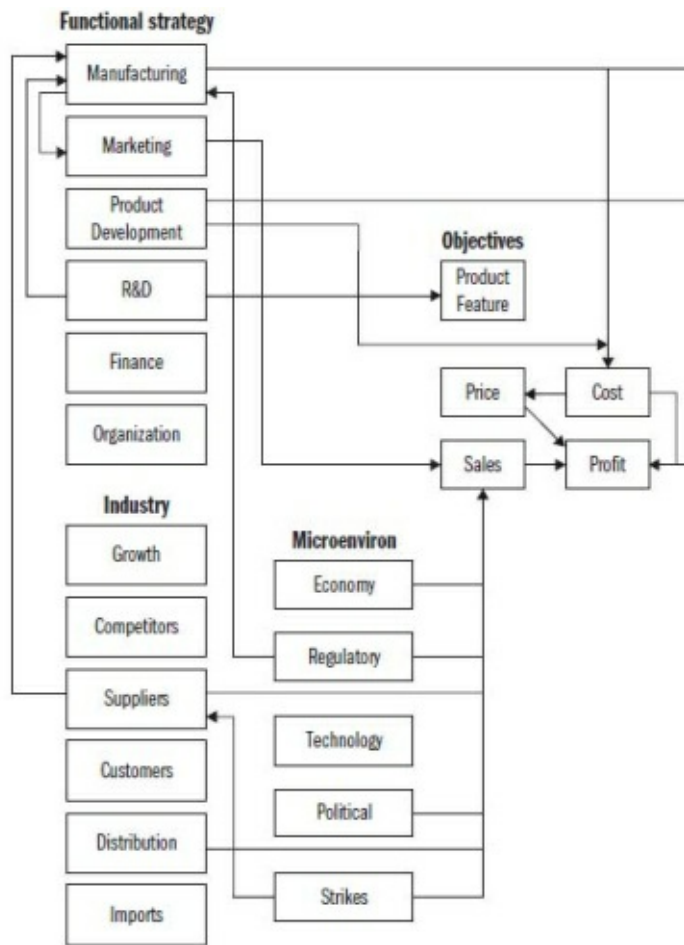


Figure 3.3. An Example of an Executive Causal Map: Admiral Corporation, 1964–1966 (Adapted from Narayanan and Fahey 1990, 127.)

Proposition 3–3B: An executive’s cognitive structure will affect his or her selective perception of information.

Example: Executives who cognitively differentiate widely between customer groups will notice and be aware of more extreme and unusual customer requirements than will executives who have more homogenized maps.

Proposition 3–3C: An executive’s cognitive structure will affect his or her interpretation of information.

Example: Executives who cognitively differentiate widely between customer groups will be more likely to see extreme or unusual customer requirements as an opportunity than will executives who have more homogenized cognitive maps of their customers.

Proposition 3–3D: An executive’s cognitive structure will be reflected in the choices he or she makes.

Example: Executives who cognitively differentiate widely between customer groups will develop more customized offerings and highly segmented strategies than will executives with more homogeneous maps.

Evidence that executives’ cognitive structures are reflected in their strategic choices,

while not abundant, have been observed in some studies. Fiol (1989) used textual analysis of CEOs' letters to shareholders to investigate whether revealed beliefs about the strength of organizational boundaries were related to the company's joint venture activity. In the ten chemical companies studied, she found that companies led by executives who perceived strong internal boundaries (demarcations between subunits and hierarchical layers) and weak external boundaries (imaginary dividing lines between the organizations and their environments) engaged in the most joint ventures. Day and Lord (1992) found that the cognitive structures of executives in machine tool companies were related to their organizations' strategies. In particular, executives who drew the finest distinctions between different types of strategic problems (in an experimental setting) were those whose firms had the widest arrays of product or service offerings. It cannot be determined from the data whether these cognitively complex executives had chosen complex business strategies or whether their cognitions had been influenced by their strategies. Allowing more confidence about causality, Thomas, Clark, and Gioia (1993) found in their study of a large sample of hospitals that the CEO's labeling of strategic issues as controllable (in a survey questionnaire) was positively related to subsequent service changes actually made by the hospital. Thus, the executives engaged in innovation and expansionary endeavors to the extent that their cognitive structures contained the belief that managerial actions could surmount, seize, or exploit strategic issues faced by their hospitals.

Priem (1994) had thirty-three CEOs of manufacturing firms complete a judgment task that required them to reveal their beliefs (or cognitive structures) about the optimal alignments among strategy, structure, and environment. Then, comparing these beliefs to the classic contingency prescriptions in the organizational literature, Priem found that firms whose CEOs had beliefs that closely adhered to customary prescriptions outperformed those firms whose CEOs had beliefs that differed from the normative ideals. This study is important for its careful, direct assessment of managerial judgment and its demonstrated explicit links to organizational policies and performance. This and the other studies we have noted provide consistent, but still sparse, indication that executives' knowledge structures affect their strategic choices.

Cognitive Style

"Numbers just don't speak to me. And, frankly, I'm not wild about conversing with them." This quote, from the CEO of a medium-sized apparel company, is emblematic of the distinct cognitive styles of some executives. Cognitive style refers to how a person's mind works—how he or she gathers and processes information. Chester Barnard was among the first to address different types of executive thought processes, saying that "mental processes consist of two groups which I shall call 'non-logical' and 'logical' " (1938, 302). By "logical," Barnard meant conscious thought that can be expressed in words or symbols—often called "reasoning." By "non-logical," he meant intuition, instinct, or tacit judgment. In Barnard's view, an effective executive has an abundance of both types of cognitive capabilities and can draw on either mode as the situation requires.

However, as the quote from the apparel company CEO suggests, it is not always that easy. Executives may differ widely in their cognitive styles and sometimes lack the "multidexterity" that Barnard envisioned. For instance, Mintzberg asked: "Why is it that some of the most creative thinkers cannot comprehend a balance sheet, and that some accountants have no sense of product development?" (1976, 49).

Mintzberg's answer, based on a wealth of research in psychology and medicine, was that managers may differ in their cognitive styles due to biological factors, particularly in the relative strength or dominance of the two hemisphere of the brain. He contended that individuals with dominant left hemispheres—the locus of logic, linear thinking, and

intellectual order—may make good *planners*. Conversely, those with dominant right hemispheres—the source of holistic information processing, imagination, and visual imagery—may make good *managers*.

Another conceptual approach to considering cognitive style (and related to the hemispheric model) draws from the work of Carl Jung, one of psychology’s classic theorists (Taggart and Robey 1981; Myers 1982; summarized in Hurst, Rush, and White 1989). Jung’s theory identifies two dimensions of cognitive style: perception (gathering information); and judgment (processing information). Perception occurs either by *sensation* (S; physical stimuli taken in by the five senses) or by *intuition* (N; discerning patterns, gaps, or implicit relationships among stimuli). Judgment, or information processing and evaluation, occurs either through *thinking* (T; linking ideas using logic and notions of cause and effect) or *feeling* (F; basing evaluation on personal and group values). Pairing each mode of perception with a mode of judgment yields four basic cognitive styles, as arrayed in [Table 3.2](#).

Table 3.2. Four Types of Cognitive Styles: Four Types of Executives

Mode of Judgment	Mode of Perception	
	Sensation (S)	Intuition (N)
Feeling (F)	<p>SF: Coach Tends to be:</p> <ul style="list-style-type: none"> • Fact-oriented • Personal • Friendly • Spontaneous <p>Informational Orientation</p> <ul style="list-style-type: none"> • Much scanning • Heavy reliance on oral, informal media • Cognitive structure corresponds to empirical reality 	<p>NF: Visionary Tends to be:</p> <ul style="list-style-type: none"> • Possibilities-oriented • Personal • Enthusiastic • Insightful <p>Informational Orientation</p> <ul style="list-style-type: none"> • Little scanning • Reliance primarily on oral, informal media • Cognitive structure is idiosyncratic; little correspondence to empirical reality
Thinking (T)	<p>ST: Administrator Tends to be:</p> <ul style="list-style-type: none"> • Fact-oriented • Impersonal • Practical • Orderly <p>Informational Orientation</p> <ul style="list-style-type: none"> • Much scanning • Heavy reliance on written, formal media • Cognitive structure corresponds to empirical reality 	<p>NT: Strategist Tends to be:</p> <ul style="list-style-type: none"> • Possibilities-oriented • Impersonal • Ingenious • Integrative <p>Informational Orientation</p> <ul style="list-style-type: none"> • Little scanning • Reliance primarily on written, formal media • Cognitive structure idiosyncratic; little correspondence to empirical reality

Drawing from several researchers’ portrayals of the four types of cognitive styles, [Table 3.2](#) describes the accompanying tendencies and informational orientations, in terms of amount of scanning, media used for scanning, and cognitive structure. We go further, attaching labels to describe the archetypical executive in each cell: administrator; strategist; coach; and visionary.

For instance, the ST, or administrator, tends to be fact-oriented, impersonal, practical, and orderly. This person engages in a great deal of scanning, placing heavy reliance on written, formal information sources. His or her cognitive structure tends to correspond to empirical reality, comprehending *what is*, but not *what will be* or *what might be*. The other three types

bear their own corresponding orientations.

Some of the most interesting research on Jungian types, as applied to top executives, has been done by Nutt (1986a). In one study, executives were asked to indicate their readiness to accept several briefly described capital investment proposals. Those executives with an ST profile accepted the fewest proposals, showing a general aversion to action and also rating the proposals as highly risky, often noting the sketchiness or incompleteness of the project descriptions. SF executives were most inclined to adopt the projects and rated them as relatively low-risk. The other two types, the NT and NF executives, were between the extremes.

In a later project, Nutt (1993) incorporated the idea that some executives had flexible, “multidextrous” decision styles, not always adhering to only one Jungian categories. In turn, he found that executives with such hybrid orientations, when faced with several hypothetical investment proposals that varied in how they were described, were willing to adopt more of them (and rated them as less risky) than were executives with only a single Jungian orientation.

Several projects have considered the idea that the cognitive processes, or styles, of entrepreneurs differ from those of more mainstream corporate managers (e.g., Alvarez and Busenitz 2001). Busenitz and Barney (1997), for example, argued that entrepreneurs tend to make inferential leaps in logic and rely less on fact-based stimuli than others. This portrayal, of course, is reminiscent of Jung’s N style (intuition).

Our portrayal of the Jungian framework as applied to executives is incomplete and speculative. However, we believe it is reasonable to conclude that executives differ significantly, and in ingrained ways, in how they access and process information, which in turn greatly affects their information filtering and interpretive processes, which ultimately influences their strategic choices. Thus:

Proposition 3–4A: An executive’s cognitive style will affect his or her field of vision.

Example: Executives whose perceptions are based primarily on sensation (Jung’s S) will scan more historical, verifiable data (and less future-oriented, speculative data) than will executives whose perceptions are based primarily on intuition (N).

Proposition 3–4B: An executive’s cognitive style will affect his or her selective perception of information.

Example: S-type executives will notice and be aware of proportionately more historical, verifiable data (and less future-oriented, speculative data) than will N-type executives.

Proposition 3–4C: An executive’s cognitive style will affect his or her interpretation of information.

Example: S-type executives will place greater credence in the relevance of historical, verifiable data (and less credence in future-oriented, speculative data) than will N-type executives.

Proposition 3–4D: An executive’s cognitive style will be reflected in the choices he or she makes.

Example: S-type executives will tend to pursue more incremental, imitative strategies than will N-type executives (who pursue more radical, innovative strategies).

Another way of viewing cognitive style is through the construct of “cognitive complexity”

(Schneier 1979). Cognitively simple individuals carry relatively few conceptual categories in their minds, they see each conceptual category in black-and-white terms, and they have parsimonious mental linkages among categories. Cognitively complex individuals, conversely, carry many conceptual categories, which they view as intricately interconnected. It is tempting to think of cognitive complexity as a positive executive trait, but one could readily imagine that it leads to decision paralysis, organizational complexity, and ambiguous leadership messages. Indeed, as relevant as the concept of cognitive complexity might be for students of executive behavior, relatively few studies have been done.

Hitt and Tyler (1991) found that cognitive complexity was not associated with executives' decision models in evaluating acquisition candidates. However, Wally and Baum (1994) found that a factor consisting of cognitive complexity and amount of education was positively related to the speed at which executives evaluated acquisition candidates. Thus, instead of slowing executives down, it seems that cognitive complexity may allow executives to process complex information quickly. A recent study by McNamara, Luce, and Tompson (2002) found that the amount of cognitive complexity that bank executives (individual CEOs and entire TMTs) exhibited in their descriptions of their competitors (via a survey methodology) was positively related to their bank's subsequent performance. Thus, although few studies of executive cognitive complexity have been undertaken, it appears to be a concept of theoretical and practical importance.

In sum, all three facets of executive cognitions we have discussed—cognitive content, structure, and style—play important roles in triggering and shaping the executives' attention to and filtering of new information. The currently burgeoning interest in managerial cognitions is highly warranted and should lead to important new insights about the forming of strategic choices.

Future Directions

Research on executive cognitive models might beneficially proceed along several lines. First, substantial work needs to be done on the antecedents, or determinants, of managers' cognitive models. The distinct influences of different types of experiences in shaping cognitions need to be understood. There is particularly a great need and opportunity to understand the role of social and professional networks in shaping executives' cognitive models (Galaskiewicz and Burt 1991; Burt 1992; Geletkanycz 1994; Balkundi and Harrison 2006).

Second is the need to examine the linkages among cognitive content, structure, and style. These three elements of cognition must substantially affect each other—with cognitive style constraining the executives' acquisition of new content, new cognitive content engendering a modified cognitive structure, and so on. Theorists need to understand the associations among these elements of executive cognition.

Third, researchers need to focus more on the implications of executive cognitions for strategic choices and other executive behaviors. While the need to delve into the cognitions themselves is great, the real significance of executive cognitions lies in their consequences. So, beyond describing cognitive models, investigators need to establish connections to choices, behaviors, and organizational performance.

Executive Personality

Beyond studying executive values and cognitions, scholars of top management have also shown considerable interest in executive personality, which we can define as an individual's relatively permanent, ingrained disposition. For example, Kets de Vries and Miller (1984)

drew on psychoanalytic theory, arguing that some CEOs have various neuroses that can give rise to predictable organizational dysfunctions. The compulsive CEO begets an organization driven by rules, an inward focus, and an incremental, risk-averse strategy. Other neuroses, such as paranoia and depression, similarly give rise to corresponding organizational pathologies.

In a less clinical vein, Gupta and Govindarajan (1984) examined the willingness of executives to take risks, finding that this personality factor was more conducive to organizational performance for businesses trying to build their market share than for those trying to maximize earnings while maintaining their market share. Additional personality factors, including need for achievement (Miller and Droge 1986), tolerance for risk (Wally and Baum 1994), and tolerance for ambiguity (Gupta and Govindarajan 1984), have also been the focus of research on senior executives.

In a recent study, Peterson, Smith, Martorana, and Owens (2003) examined how CEO personality affects the dynamics of top management teams (TMTs). The authors drew upon the well-accepted “Big Five” personality dimensions that psychologists have extracted from comprehensive meta-analyses. These dimensions are neuroticism, extraversion, openness, agreeableness, and conscientiousness. Using rigorous, quantitative coding of the biographies of seventeen CEOs as their method for measuring CEO personalities and TMT dynamics, Peterson and colleagues found considerable support for their hypotheses about how CEO personality shapes the functioning of TMTs. For example, the authors found that a CEO’s openness is positively related to the flexibility (as opposed to rigidity) of the TMT, and CEO agreeableness is positively related to TMT cohesiveness (as opposed to factionalism). Although the study sample was of only modest size and the coding of retrospective biographies has limitations, this study clearly highlights the promise of exploring how CEO personality influences what happens to companies.

Three specific streams of research on executive personality have been particularly pronounced, and to fail to single them out for attention would be a glaring omission. These areas of research deal with executive charisma, locus of control, and positive self-regard.

Personality and Charisma

A massive literature has examined the personality characteristics associated with charisma (summarized and extended in Conger and Kanungo 1988b). We say “associated with charisma” because the prevailing view is that charisma is not itself a personality trait but rather a relationship between a leader and subordinates, often enabled or enhanced by the leader’s personality (House, Spangler, and Woycke 1991). Thus, charisma is affected by personality but is not in itself a personality type.

The particular kinds of follower responses constituting a charismatic relationship include performance beyond expectations (Bass 1985); changes in the fundamental values of followers (Etzioni 1975); devotion, loyalty, and reverence toward the leader (House 1977); a sense of excitement and enthusiasm (Weber 1957; Bass 1985); and willingness on the part of subordinates to sacrifice their own personal interests for the sake of a collective goal (House 1977). Recently, the concept of charisma has been extended beyond direct reports to the CEO’s influence on external stakeholders (Fanelli and Misangyi 2006).

Flynn and Staw (2004) found that the influence of charismatic leaders extends beyond the boundaries of the organization. In an archival study, the authors found that the stock value of companies headed by charismatic CEOs appreciated more than the stock of comparable companies, even after differences in corporate performance were controlled. They also found that the positive effect of charismatic CEOs was magnified under poor economic conditions, in line with the prevailing view that charisma has its greatest effect under situations of

adversity. In an experimental study, Flynn and Staw also found that charismatic leadership influenced the willingness of investors to place money in the firm.

What are the personality qualities of leaders that tend to evoke such responses from others? Bass (1985) inventoried the following: self-confidence, self determination, insight into needs and values of their followers, and the ability to enhance or enflame those needs and values through persuasive words and actions. Conger and Kanungo (1988a) also included high activity level, confidence, commitment, and need for power as leader characteristics typified in the charismatic influence process.

In an elaborate study of U.S. presidents, employing extensive public accounts and historians' analyses, House, Spangler, and Woycke (1991) empirically examined the personality qualities associated with charisma. They found that charisma was (1) positively related to the president's need for power; (2) negatively related to the need for personal achievement; and (3) positively related to activity inhibition (a measure of the extent to which the executive uses power to achieve institutional rather than strictly personal goals). The authors' interpretations of these results were that (1) a need for power is prerequisite to developing the strong persuasive abilities that accompany charisma; and (2) charisma-prone executives have a genuine desire for institutional and collective achievement, rather than personal achievement.

The study by House and associates is instructive for at least two reasons. First, it represents a most impressive effort to bring rigor to an examination of very intangible aspects of leadership. The authors drew from a wide array of data sources, demonstrated their reliability, and included appropriate controls. This is an admirable effort, representing a direction in which more research on senior leadership should be headed.

Second, this study, as well as all other research on charisma (and "transformational leadership"), highlights that executives do not affect their organizations only through their strategic choices. They also have impact through their influence over others, who in turn put forth effort and make major choices affecting the organization's performance (Bower 1970). Thus, it is appropriate that our conception of executive activity, as discussed in [chapter 2](#) and as portrayed on the right-hand side of [Figure 3.1](#), extends beyond the realm of "Strategic Choice" to include "Executive Behaviors." The daily actions of executives, particularly in how they interact with others, can have a major effect on organizational functioning and performance.

Charisma is usually spoken of in favorable terms, and anecdotal evidence suggests that organizations sometimes experience remarkable achievements under charisma-prone leaders (Bass 1985; Tichy and Devanna 1986; Conger and Kanungo 1987). In turn, some large-scale studies have found positive associations between CEO charisma and company performance (e.g., Agle and Sonnenfeld 1994; Waldman et al. 2001). And the House, Spangler, and Woycke (1991) study of U.S. presidents found charisma to be positively associated with five diverse measures of presidential performance, encompassing international, economic, and social spheres.

However, the beneficial effects of charisma are not completely clear-cut, and at least one major study has found no association between CEO charisma and subsequent company performance (Agle et al. 2006). Why might charisma yield nonresults? It may be that the benefits of charisma are pretty much offset by its drawbacks. In fact, portrayals of charisma are not always positive. Conger (1990) has written eloquently about the "dark side" of charisma, noting the devastation wrought by the likes of Stalin, Hitler, and Jim Jones, the religious leader who precipitated a mass suicide of his followers in Guyana. If a charismatic leader induces mindlessness or blind devotion from others, or if these behaviors from followers induce arrogance or hubris in the leader, then the results will not necessarily be

good.

Particularly to the extent that the charismatic executive possesses and exhibits moral righteousness (House 1977) and extreme self-confidence (Bass 1985) and followers place blind faith in the leader and tend to suspend their disbelief in contrary perspectives, the following can be posited:

Proposition 3–5A: An executive’s personality characteristics associated with charisma will affect his or her field of vision.

Example: Executives with personalities that evoke charisma will receive information from their subordinates that is more filtered and distilled than will executives without such personalities.

Proposition 3–5B: An executive’s personality characteristics associated with charisma will affect his or her selective perception of information.

Example: Executives with personalities that evoke charisma will notice and be aware of proportionately less information that conflicts with their articulated vision than will executives without such personalities.

Proposition 3–5C: An executive’s personality characteristics associated with charisma will affect his or her interpretation of information.

Example: Executives with personalities that evoke charisma will place less credence in information unresponsive of their vision than will executives without such personality characteristics.

Proposition 3–5D: An executive’s personality characteristics associated with charisma will be reflected in his or her strategic choices.

Example: Executives with personalities that evoke charisma will be more persistent in their pursuit of a chosen strategy (even in the face of disconfirming evidence) than will executives without such personality characteristics.

With regard to the final proposition, it is worth noting that personality characteristics could have a significant effect on the well-known behavioral phenomenon of escalating commitment to a course of action (Staw 1976; Rubin and Brockner 1975). One of the key determinants of escalating commitment is the degree to which the decision maker has publicly declared his or her intentions. To the extent that charisma-prone executives have grand visions and articulate those visions—both of which are well-known accompaniments of charisma—they heighten the likelihood of escalating commitment to a course of action. One well-documented, ill-fated military escalation, U.S. involvement in Vietnam, occurred primarily during the tenure of the president scoring among the highest on the charisma score in the House, Spangler, Woycke study—Lyndon B. Johnson.

Locus of Control

Another executive personality variable examined in several studies is locus of control (Anderson 1977; Miller, Kets de Vries, and Toulouse 1982; Miller and Toulouse 1986a; Begley and Boyd 1987; Boone and de Brabander 1993). Most of these studies have used Rotter’s (1966) conception of internal versus external orientations. “Internal” individuals believe that events in their lives are within their control. “Externals” believe that events in their lives are outside their control, stemming from fate, luck, or destiny.

It may strike some as implausible that an “external”—someone who sees events as outside their control—could even rise to a top management position at all. After all, executive

selection processes would seem to strongly favor “take-charge” types, such that managers would seem to be at a big disadvantage in mid-career advancement tournaments if they act as if the fate of their operation is outside their influence. Still, all available studies of the locus of control of top executives find a range of scores on this personality variable (although skewed toward an internal orientation), suggesting that a wide array of contexts and advancement conduits exist so as to allow considerable diversity in executive profiles.

We can reasonably expect that managers who are externals would be passive, reactive, and not innovative. In highly competitive or turbulent environments, these qualities would lead to poor organizational performance. In fact, researchers have found evidence that groups led by internals perform better than those led by externals (Anderson and Schneier 1978), and that internal managers are more task-oriented and perform better in stressful situations than externals (Anderson 1977; Anderson, Hellriegel, and Slocum 1977).

In the literature examining locus of control of top executives, similarly beneficial effects from “internal” (not to be confused with internally appointed) CEOs have been consistently observed. Miller and Toulouse (1986a; 1986b) found that CEOs with internal locus of control were associated with high organizational performance. And other studies reported a relationship between internal locus of control of managers and the success of small firms and new ventures (Brockhaus 1980; Van de Ven, Hudson, and Schroeder 1984).

However, the study by Miller, Kets de Vries, and Toulouse (1982) has been the most widely noted examination of executive locus of control. With a sample of Canadian top executives, they found that firms led by internals were more innovative and more likely to be in dynamic environments than were firms led by externals. The authors concluded, “Managers who believe that their destiny lies in their own hands are more likely to try to control it actively” (p. 245). In a supplementary analysis, the authors found that the associations between executive locus of control and organizational innovation and environmental dynamism were far stronger in the case of long CEO tenures than of short ones, causing the researchers to further conclude that executive personality shapes strategy, rather than that strategy and environment affect the types of individuals who become top executives of specific firms.

Reasonably, however, we must anticipate two-way causality. If an environment confers relatively little executive discretion, or latitude of action, it is unlikely that an “internal” individual will be drawn to the firm or climb to executive ranks within it (Hambrick and Finkelstein 1987). Rather, externals would be more likely to self-select themselves into such constrained settings, where they would be comfortable and flourish. As externals, they would engage in minimal innovation, which would exactly suit the confining, low-discretion environment.

Thus, causality may be not just two-way, but “circular,” as shown in [Figure 3.4](#). A high-discretion situation (conferred by environmental and organizational factors) tends to attract and select a top executive with an internal locus of control, who then engages in considerable strategic action and innovation. If the executive’s actions yield high performance, then even more discretion is created (Hambrick and Finkelstein 1987), the executive’s sense of efficacy is enhanced (Weick 1983), and the cycle is reinforced. If this loop is somehow arrested (for instance, because the environment changes from high-discretion to low-discretion, or, despite the company’s efforts at innovation, performance is impaired by exogenous shocks), then a whole new cycle could be initiated, but with different characteristics: low discretion, an executive with an external locus of control, little innovation, poor performance, a perception of even less discretion, and so on.

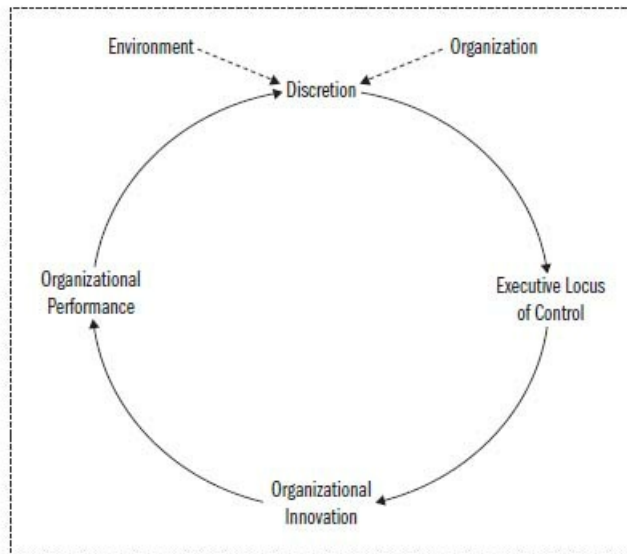


Figure 3.4. A Self-Reinforcing Cycle of Executive Efficacy

The concept of executive locus of control allows some very direct links to be drawn back to our model of the sequential filtering process by which executives arrive at their individualized reality:

Proposition 3–6A: An executive’s locus of control will affect his or her field of vision.

Example: Executives with an internal locus of control (“internals”) will devote more effort to environmental scanning, and use a wider array of sources, than will executives with an external locus of control (“externals”).

Proposition 3–6A: An executive’s locus of control will affect his or her selective perceptions of information.

Example: “Internal” executives will notice and be aware of a greater proportion of the information they scan than will “external” executives.

Proposition 3–6C: An executive’s locus of control will affect his or her interpretation of information.

Example: “Internal” executives will be more likely to consider environmental trends as “opportunities or threats requiring action” than will “externals.”

Proposition 3–6D: An executive’s locus of control will be reflected in his or her strategic choices.

Example: Organizations led by “internals” will be more innovative, more adaptive to the environment, and have higher performance than will organizations led by “externals.”

While locus of control is of demonstrated relevance to executive leadership, it is only one vantage on managerial personality. Indeed, locus of control provides us a narrow glimpse of a broader, perhaps far more fundamental, personality dimension: positive self-regard. Namely, executives differ in how highly they think of their abilities and the wisdom of their choices—which takes us to our next topic.

Positive Self-Regard

Most models of organizational maladaptation involve images of executives who are sluggish or asleep at the wheel. Consider, for example, some of the labels that scholars have attached to executives who fail to adapt: risk-averse, timid, committed to the status quo, trapped by history, and blinkered. How, then, do we account for executives who undertake bold or risky moves? After all, some executives are able to make quantum changes, as warranted by their environments. Indeed, some executives take even bigger, bolder actions than seem called for.⁵

Take the case of Jean-Marie Messier. Prevailing theories of strategic behavior provide basically no explanation for Messier's attempts, in 1996–2001, to convert Paris-based Compagnie Generale des Eaux—which was a global leader in water, electrical, and waste utilities—into a media and entertainment enterprise, which he renamed Vivendi. The core businesses were highly profitable and faced steady long-term growth prospects worldwide (Montgomery 1998), so there was no need to escape to more abundant pastures (Rumelt 1974; Porter 1980). The company's existing capabilities provided little or no foundation for the new direction (Barney 1991). Unrelated diversification was distinctly out of favor at the time, so Messier could not have felt any conformist pressures to diversify (DiMaggio and Powell 1983). And he himself had no experience in the world of media and entertainment, so it cannot be said that he gravitated to what he knew best (Hambrick and Mason 1984).

Instead, numerous observers—commenting before, during, and after the collapse of Vivendi—traced Messier's strategic actions to his personality. Various descriptions as “colorful,” “self-absorbed,” and “egomaniacal,” Messier appears to have been highly narcissistic—full of extreme self-admiration but in need of creating a drama that would attract even more admiration (e.g., Cukier 2000; Leonard 2001; Fonda 2002). Namely, Messier may have undertaken bigger, bolder, splashier actions than were objectively called for, because of a belief in his own potency as well as his need for effusive applause. If we think of narcissism as a personality dimension that has a normal distribution among a general population (Emmons 1984), we can anticipate that almost all CEOs of major companies are in the upper half of the distribution. It would seem, however, that Messier, who sometimes signed his emails “J6M”—short for Jean-Marie Messier Moi-Meme, Maitre du Monde (Jean-Marie Messier Myself, Master of the World)—was at the very high end of the scale.

In recent years, scholars of executive behavior have become very interested in a constellation of personality characteristics that we broadly refer to as “positive self-regard.” The specific dimensions that make up this meta-construct include core self-evaluation, narcissism, hubris, and overconfidence. The first two of these are relatively ingrained personality dimensions, while the latter two are psychological states brought on by a combination of personality and contextual stimuli. Although researchers face daunting challenges in measuring these qualities in executives, some empirical work has been done. And, regardless of the methodological hurdles, the implications of positive self-regard in executives are so substantial—for our understanding of risk taking, innovation, and TMT dynamics, at a minimum—that the construct warrants serious attention and analytic pursuit.

Core Self-Evaluation

Of all the dimensions that compose the broad constellation of “positive self-regard,” the most fully developed from a psychometric standpoint is the concept of “core self-evaluation.” This concept, which was identified and extensively validated by Timothy Judge and associates, concisely describes how individuals broadly evaluate themselves and their relationship to their environment (Judge, Locke, and Durham 1997). Findings indicate that core self-evaluation (CSE) encompasses and consolidates the common, overlapping portions of four

wellstudied but previously unconnected personality dimensions: self-esteem, self-efficacy, locus of control, and emotional stability (Judge, Bono, et al. 2002; Judge, Erez, et al. 2002).

Self-esteem, conceptually the most central component of CSE (Judge, Locke, and Durham 1997), is an individual’s global evaluation of self-worth (Baumeister, Smart, and Boden 1996). *Self-efficacy* refers to one’s belief in his or her capability to successfully execute and perform tasks (Gist and Mitchell 1992). Although assessments of *self-competence* can vary somewhat depending on the task being performed, individuals possess a generalized self-efficacy that is stable across domains (Bandura 1977). *Locus of control*, as discussed earlier, is the belief one holds about who or what controls the occurrence of life events (Rotter 1954). Individuals with an internal locus of control believe that their fate is determined by their actions, whereas those with an external *locus of control* believe that what happens to them is determined by factors outside of their control. *Emotional stability*, one of the “Big Five” personality traits (Costa and McRae 1992), is sometimes known by its converse, neuroticism. Because these labels can lead to various interpretations, it is essential to understand that it is (absence of) *anxiety* that is at the heart of this construct (Judge et al. 2003).

Figure 3.5 provides a qualitative, stylized portrayal of the CSE construct. As the figure indicates, the four component variables overlap considerably, and CSE is at the core, or center, of their overlap, constituting an overall personal sense of confidence, self-regard, and self-worth. In short, high-CSE individuals are sure they will prevail.

In a theoretical paper, Hiller and Hambrick (2005) set forth the implications of CSE for executive behavior. Asserting that executives vary on the CSE dimension, the authors proposed that CEOs who have high levels of CSE will manifest their sense of self-potency and self-regard in multiple ways: They will engage in relatively fast, intuitive (as opposed to comprehensive), and centralized decision making; they will be relatively likely to undertake quantum, large-stakes strategic initiatives that deviate from industry norms; and, in turn, they will tend to deliver extreme performance, that is, big wins and big losses.

Empirical research on CSE in executives has yet to commence. While recognizing that data collection will be a challenge, Hiller and Hambrick laid out several suggestions, including the use of shortened CSE surveys geared specifically to executives, asking close associates to rate their CEO’s level of CSE, and the use of unobtrusive indicators (such as content analysis of speeches).

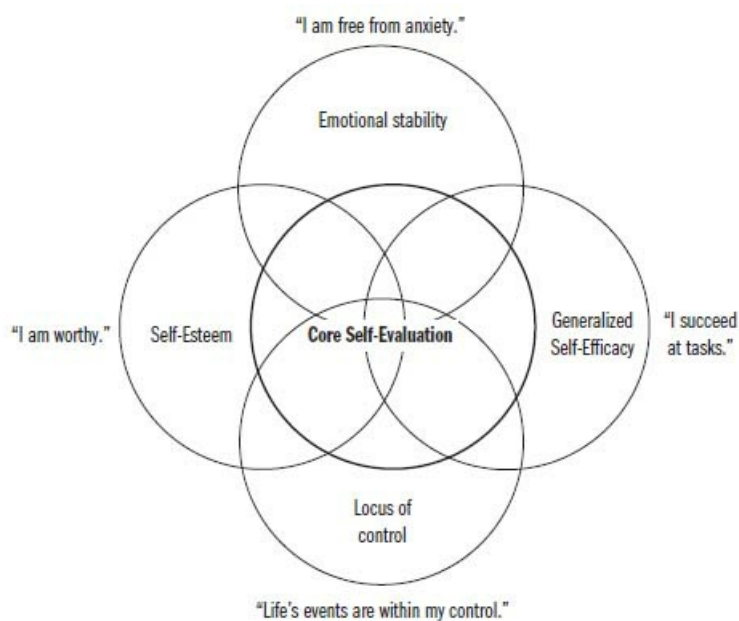


Figure 3.5. Qualitative Portrayal of the Conceptual Space Occupied by CSE (Adapted from Hiller and Hambrick 2005.)

Narcissism

The term *narcissism* entered the psychology literature more than one hundred years ago (Ellis 1898), referring to the young man in Greek mythology, Narcissus, who fell in love with his own reflection in a pool and ultimately perished as a result of his self-preoccupation. Initially, narcissism was viewed as a mental disorder, and it still retains that meaning among clinicians. In recent decades, however, personality researchers have shown that narcissism can be thought of and measured as a continuum, and that individuals can be assigned scores along that continuum (Emmons 1987; Judge, LePine, and Rich 2006). For these theorists, narcissism is defined as the degree to which an individual has an inflated self-view and is preoccupied with having that self-view continuously reinforced (Campbell, Goodie, and Foster 2004). Paradoxically, then, narcissists are full of self-admiration, but crave frequent bolstering of their self-view.

Although extreme narcissism is often anecdotally observed (and typically bemoaned) in some CEOs, systematic research has been stymied by the obvious challenges of collecting data on such a sensitive personality characteristic. A recent study, however, provides an example of how research on this important trait might proceed. Specifically, Chatterjee and Hambrick (2006) used unobtrusive indicators to measure the narcissistic tendencies of CEOs, and they showed that their CEO narcissism scores were highly related to subsequent company strategy and performance.

In their study of 111 CEOs in the computer hardware and software industries, Chatterjee and Hambrick measured the narcissistic tendencies of the executives in the second and third year of their tenures, using five indicators from multiple sources: the prominence of the CEO's photograph in the company's annual report; the prevalence of the CEO's name in the company's press releases; the CEO's use of first-person singular pronouns (I, me, my, mine, myself) relative to first-person plural pronouns in interviews; the CEO's cash compensation divided by the cash compensation of the second-highest paid executive; and the same ratio for noncash compensation. These five indicators statistically cohered, as indicated by interrelations and factor analysis, allowing their aggregation into an overall narcissism score for each CEO.

The authors then examined the associations between the CEO narcissism scores (again, calculated for the early years of each CEO's tenure) with characteristics of company strategy and performance (measured in later years, to avoid any circularity). As hypothesized, CEO narcissism was positively associated with strategic dynamism and grandiosity; and it was associated with extreme and volatile organizational performance. As we saw with the example of Jean-Marie Messier, narcissists need drama; if drama is lacking, they will create it, so as to garner the "oohs and aahs of the crowd." The outcome might be outstanding, or it might be abysmal. But it will have been a great show.

As an ingrained personality trait, narcissism in CEOs can be expected to have substantial implications for an array of organizational phenomena, including impression management, top management team dynamics, and governance. And it relates to hubris and overconfidence, to which we now turn.

Hubris

Like narcissism, hubris has its origins in Greek mythology, referring to exaggerated self-confidence or pride, often with the connotation that retribution will follow (Hayward and Hambrick 1997). The first prominent mention of hubris in the literature on top executives

was by Richard Roll (1986), who was otherwise at a loss for explaining why CEOs make large corporate acquisitions despite abundant evidence that such deals generally do not deliver the hoped-for results. Hayward and Hambrick (1997) extended and tested Roll's "hubris hypothesis" by examining how much (above pre-bid market prices) CEOs will pay for acquisitions. This acquisition premium reflects the acquiring CEO's assessment of how much more valuable the acquired company would be if it were under his or her management.

Lacking any direct measure of CEO hubris, Hayward and Hambrick relied on three indicators, or proxies, of "sources of hubris," all three of which were highly related to the size of acquisition premiums. The first two measures, the acquiring company's recent performance under the CEO and recent media praise for the CEO, were situational conditions that were thought to generate hubris. The third measure, the ratio of the CEO's pay relative to the second-highest paid executive, was thought to capture the CEO's sense of self-importance, which is perhaps more of a stable individual trait. Self-importance is a central element of the narcissistic personality (Judge, LePine, and Rich 2006), and thus Hayward and Hambrick were partially invoking the concept of narcissism as a contributor to hubris. Indeed, their particular mix of measures points to the idea that hubris is a psychological state brought on by some combination of confidence-buoying stimuli *and* one's ingrained narcissistic tendencies.

Overconfidence

Overconfidence is an overestimation of certainty about being correct or producing a certain outcome (Russo and Schoemaker 1992). The tendency for individuals to overestimate their abilities and chances for success has been examined extensively in the literature on negotiations and decision-making (e.g., Bazerman and Neal 1982; Busenitz and Barney 1997; Neale and Bazerman 1985), primarily in line with the idea that overconfidence occurs more frequently in some decision situations than in others. For instance, a paper by Simon and Houghton (2003) found that a sample of computer executives were more overconfident (measured as the differential between *a priori* estimates of success and *ex post* results) about highly novel product introductions than they were about more incremental product introductions.

Only recently, however, have researchers considered the idea that overconfidence emanates, in part at least, from individual differences. Interestingly, these studies have been done primarily in the field of finance. One such investigation, by Malmendier and Tate (2005b), examined the relationship between CEO overconfidence and corporate investment. They identified overconfident CEOs as those who fail to exercise stock options that are highly "in the money" and who habitually acquire stock of their own company. They found that these overconfident CEOs invested a higher percentage of the company's cash flow in investment projects (rather than releasing it as dividends) than did CEOs who were not overconfident. As a result, overconfident CEOs ended up investing in many projects that they should not have, presumably because they had inflated estimations of their personal abilities to produce success. The authors did not directly consider the sources, or determinants, of overconfidence, but they implied that it is traceable to ingrained personality factors, when they opened their paper by saying, "we argue that personal characteristics of CEOs in large corporations lead to distortions in corporate investment policies" (p. 2661).

In another paper, Malmendier and Tate (2005a) turned to the situational stimuli that can affect an executive's outlook and behavior. Examining a sample of CEOs who achieved "superstar" status via prestigious awards from the business press, they found that these CEOs subsequently underperformed (beyond what would be expected by mean reversion), both relative to the overall market and relative to a sample of "hypothetical award winners" that had matching firm and CEO characteristics. The authors did not examine the strategic

behaviors that brought about the subsequent poor performance from these award-winning CEOs, but the implied mechanism was overconfidence. It would be very interesting to couple the ideas in this paper with those in another intriguing paper about “celebrity CEOs” (Hayward, Rindova, and Pollock 2004), in an effort to understand how acclaim tends to affect an executive’s confidence and risk-taking behaviors.

From the work of Malmendier and Tate, we conclude that the terms “overconfidence” and “hubris” are essentially synonymous. They both refer to an exaggerated sense of confidence, or extreme conviction in a course of action. And they both primarily refer to a psychological state that arises out of a combination of ingrained personality and the stimuli at hand. Now researchers need to advance our understanding of how these two mechanisms interact to cause extreme executive actions.

Conclusion

In this chapter we have had two aims. The first was to present our core model of how and why executives differ in their strategic choices. We have argued that executives confront a multitude of typically ambiguous information, and that their personal orientations—both their experiences and psychological factors—greatly determine which elements of the information will be comprehended and how they will be interpreted. Thus, decision makers act on the basis of highly filtered, personalized, idiosyncratic understandings of their situations, options, and potential effects of options.

Our second aim has been to elaborate on one half of the concept of executive orientation: psychological factors. Here we have discussed the role of executive values, cognitive models, and three personality factors—charisma, locus of control, and positive self-regard—that have been subjects of considerable theory and research. These psychological characteristics have substantial influence on the executive’s eventual construed reality and, in turn, on strategic choices and organizational performance. We now turn to the second major element of executive orientation, the executive’s experiences.

4

Executive Experiences and Organizational Outcomes

All of us—including senior executives—exist in a web of our own personal and professional experiences. We may try to be open-minded, objective, and thorough; but we are confined greatly by what we already know and believe, by what we have already experienced. Particularly in complex situations, decision makers rely on the familiar, often drawing on solutions that have worked well in the past (Cyert and March 1963). Experiences serve to shape values, beliefs, and cognitive models in ways that substantially affect decision making and behavior (Hitt and Tyler 1991). Thus, executives' demographic backgrounds, which are reflective of their experiences, will be associated with strategic choices.

The past twenty-five years have witnessed an explosion of research on the relationships between executives' background characteristics and organizational outcomes. This work can be seen as a natural bridge between micro and macro aspects of research, as it brings the individual (CEO, executive, director) and the small group (top management team, board of directors) into the forefront of theory on organizations and strategy. Following Pfeffer's (1983) call for research on organizational demography and Hambrick and Mason's (1984) framework for viewing organizations as reflections of their top executives, the study of executive background characteristics reemerged as a central concern for scholars in organization theory and strategy. We say "reemerged," since in the very earliest days of the field of business policy, senior executives played a central role (Barnard 1938; Andrews 1971), only to become eclipsed by efforts to understand environments, strategies, and organizations—without any particular regard for the decision makers involved. As these "unpeopled" theories reached the limits of their explanatory power, researchers returned to a focus on how human factors affect organizational outcomes.

To date, the preponderance of research on executive experiences has pursued the general logic that experiences shape executives' cognitions and values and hence are reflected in their strategic choices. A smaller stream of research has posited the reverse causality—that certain strategic (e.g., Datta and Guthrie 1994), structural (e.g., Fligstein 1987), performance (e.g., Ocasio and Kim 1999), or environmental (Rajagopalan and Datta 1996; e.g., Ocasio and Kim 1999) conditions give rise to particular types of executive characteristics, typically due to intentional or emergent alignment of executive qualities with contextual conditions. A third research focus has been essentially a hybrid of the other two, pursuing the idea that different strategic conditions call for different types of executive qualities and that organizations will perform well to the extent that their executives have these appropriate characteristics.

Various types of executive experiences have been examined for their associations with organizational outcomes. However, four sets of executive background characteristics account for the vast majority of inquiries: executive tenure, functional experiences (marketing, finance, and so on), formal education, and international experience. In this chapter, we will review and integrate the studies that have examined these four sets of executive characteristics. For each, we will discuss three types of observed associations. The first is the link to executive psychological constructs and perceptions. Such a review helps to establish the most fundamental implications of executive experiences. However, because most studies of executive experiences continue to treat psychological processes as a "black box," we will

have relatively little to report here; thus, at times we will supplement this discussion with studies of links between demographics and psychological properties in non-executive populations. Second, we will summarize the links to organizational strategy and conduct. This is the area on which most upper-echelons research has focused, in line with the general premise that executives' experiences are reflected in their strategic choices. The third set of results includes those examining the link between executive characteristics and organizational performance. In some cases, these relationships are direct; more often, they are contingent, with the association between characteristics and performance depending on specific contextual conditions.

Executive experiences influence strategic choices through the same three-stage information filtering process presented in [Figure 3.1](#). To be sure, numerous propositions could be set forth as to how experiences, or demographic characteristics, affect an executive's field of vision, selective perception, and interpretation of strategic stimuli. For instance, we can expect that executives with long tenures in their organizations receive a greater proportion of their information from internal sources than do executives with short tenures. As a further example, executives whose primary functional experiences are in marketing and sales can be expected to attach more marketing and sales implications to strategic stimuli than executives with other functional backgrounds. The potential inventory of promising propositions for links between executive experiences and the information-filtering process is so extensive that, for the sake of space, we do not formally present them. Instead, we limit our propositions to those dealing with links between experiences and either psychological characteristics or organizational strategy and performance.

We should also note that some studies on the effects of executive experiences have invoked the resource-based view (RBV) of the firm, arguing that top managers represent resources that have potential value to a firm (e.g., Castanias and Helfat 2001). In line with classic work by Gary Becker (1964), such logic envisions that an executive's experiences amount to his or her human capital—knowledge, skills, and connections. While there are commonalities between upper-echelons and RBV logics, two differences are noteworthy. First, the RBV has less interest in the psychological processes by which executive characteristics are converted into behaviors and organizational outcomes. Second, the RBV does not acknowledge that a given type of executive experience—which is, after all, a “resource”—could be a liability for a firm. As we shall discuss, however, certain executive experiences can impair the vitality of organizations.

Executive Tenure

Research and theory on executive tenure has clustered generally around one major idea: long-tenured executives tend not to make major changes in their organizations. In fact, there is considerable evidence of this important phenomenon. However, as simple and stark as this conclusion is, the processes by which it occurs—and even the concept of executive tenure itself—warrant elaboration.

Executive tenure has been conceived in various ways: tenure in the position (e.g., Hambrick and Fukutomi 1991; Miller 1991); tenure in the organization (e.g., Thomas, Litschert, and Ramaswamy 1991); and tenure in the industry (Hambrick, Geletkanycz, and Fredrickson 1993).¹ Obviously, these three types of tenure covary and are even conceptually nested, since all time spent in the position is also spent in the organization and in the industry, and all time spent in the organization is also spent in the industry. Still, each type of tenure can be considered separately.

Tenure and Executive Psychology

Relatively little empirical research has examined the psychological accompaniments of executive tenure. Some evidence is available, however, and theorists have set forth extensive arguments about the tendencies for executives' mind-sets and orientations to evolve over their time in office. In this vein, Hambrick and Fukutomi (1991) drew on widespread but fragmentary literature to develop a comprehensive model of the "seasons of a CEO's tenure." They argued that, during an executive's time in office, critical trends tend to occur on five fronts. We will summarize their arguments (Table 4.1) and formalize them as propositions.

Table 4.1. The Five Seasons of a CEO's Tenure

Critical CEO Characteristics	1 Response to Mandate	2 Experimentation	3 Selection of an Enduring Theme	4 Convergence	5 Dysfunction
<i>Commitment to a Paradigm</i>	Moderately strong	Could be strong or weak	Moderately strong	Strong; increasing	Very strong
<i>Task Knowledge</i>	Low, but rapidly increasing	Moderate; somewhat increasing	High; slightly increasing	High; slightly increasing	High; slightly increasing
<i>Information Diversity</i>	Many sources; unfiltered	Many sources, but increasingly filtered	Fewer sources; moderately filtered	Few sources; highly filtered	Very few sources; highly filtered
<i>Task Interest</i>	High	High	Moderately high	Moderately high but diminishing	Moderately low and diminishing
<i>Power</i>	Low; increasing	Moderate; increasing	Moderate; increasing	Strong; increasing	Very strong; increasing
<i>Overall Pattern</i>	Legitimacy-building	Repertoire expansion	Selects what has worked best so far, what is most comfortable May revert to initial repertoire	All actions reinforce and bolster the theme Primarily incremental change	Relatively few actions at all Outside interests increase
<i>General Duration (years)</i>	1-2	1-2	1-2	3-5	All remaining years

Adapted from Hambrick and Fukutomi 1991.

Under pressure to quickly demonstrate their efficacy—and usually with a directional mandate from their board—CEOs start their jobs with relatively strong commitment to their paradigms (implicit mental model of priorities, options, and causal relations). After early success and gaining a foothold, CEOs may have a brief period in which they experiment and are more open-minded. However, they soon tend to commit psychologically to whatever approach has been most comfortable and effective. Then, with each passing year in the position, CEOs become more and more committed to their paradigms, bringing a heightened sense of correctness in established ways of operating and viewing the world. In describing the same phenomena, Miller (1991) referred to the "overconfidence" that accompanies executive tenure. Thus,

Proposition 4-1A: After an initial period of strong commitment to their paradigms, often followed by a brief period of open-mindedness and paradigm recalibration, executives' commitment to their paradigms increases steadily during their remaining time in office.

Second, as a CEO's tenure advances, his or her sources of information become increasingly narrow and restricted, and the information is more finely filtered and distilled. This occurs because of habituation, the establishment of informational routines, the cultivation of trusted sources, and the tendency for those sources to cater to the executive's information preferences. For example, Aguilar (1967) found that new general managers tended to rely about equally on external and internal sources of information about the business environment; however, as they developed more reliable internal networks, the managers greatly reduced their use of external information sources. In the same vein, Tushman and Romanelli (1985) and Miller (1991) argued that the amount and quality of information gathering and analysis may decline with tenure. More recently, McDonald and

Westphal (2003) found that CEO tenure was negatively associated with advice seeking; that is, long-tenured executives tend to stick to their own counsel. Thus,

Proposition 4–1B: As their tenures advance, executives tend to receive narrower and more finely filtered information.

Third, executives evolve in their level of task knowledge. An executive appointed from inside the firm may not have the same knowledge deficit as an executive appointed from the outside, but in general, any executive new to a position confronts some unfamiliar elements (in terms of facts, trends, contacts, and so on). However, the executive’s task knowledge increases rapidly at first but then advances only very gradually.

Proposition 4–1C: As their tenures advance, executives acquire more task knowledge—at first rapidly and then more slowly.

Fourth, Hambrick and Fukutomi (1991) argued that executives are not immune from the tedium that comes with repetition and relative mastery of any type of work. Executive positions may involve relatively great novelty and challenge, but they also have substantial elements of sameness and routine (reviewing budgets and capital requests, making plant visits, preparing for board meetings, and so on). After doing these tasks numerous times, the executive may feel less of a challenge in the position and may experience (perhaps unknowingly) a dulled acuity.

Proposition 4–1D: Executives start their positions with a high degree of task interest, which declines after several years.

Fifth, and finally, in the Hambrick and Fukutomi framework, it is expected that an executive’s (particularly a CEO’s) power increases with tenure. This increase can occur through co-optation of the board (since the CEO often has a major role in board appointments), the development of a patriarchal aura, or the accumulation of shareholdings. Miller (1991) referred similarly to the “autonomy” that comes with executive tenure.

Proposition 4–1E: As executives’ tenures advance, their power increases.

Taken together, these trends create discernible phases or seasons within an executive’s tenure in a position, giving rise to distinct patterns of executive attention and behavior and ultimately affecting performance. [Table 4.1](#) shows how the five trends are delineated across the seasons posited by Hambrick and Fukutomi.

This “seasons” model is important in that it is longitudinal, grounded in prior theory and evidence, and supported by Miller’s (1991) logic that CEOs become “stale in the saddle.” Below we will describe recent studies that have used this model as a springboard for new explorations into the effects of CEO tenure, but for now we can conclude that executives tend to follow a discernible pattern over their time in office. In addition, it seems clear that the most basic implication of that pattern—that executives tend to become inertial as their tenures mount—is consistent with available psychological and organizational evidence.

Theorists also have posited that tenure in the organization affects an executive’s cognitions. Organizational tenure is thought to be associated with rigidity and commitment to established policies and practices (March and March 1977; Katz 1982). Tenure causes the executive to have a great stake in the status quo (Stevens, Beyer, and Trice 1978), since his or her competences have been deemed valuable for the firm’s *current* configuration. Organizational tenure also may restrict information processing through the executive

establishment of routine, familiar information sources, and development of predictable repertoires for dealing with information (Katz 1982; Miller 1991).

In line with this focus on cognition and decision making, Hambrick, Geletkanycz, and Fredrickson (1993) studied the correlates of executive commitment to the status quo (CSQ)—that is, the executive’s belief in the continuing correctness of current organizational policies and profiles. In their large sample of senior executives, the authors found that the executive’s tenure in the organization had a significant positive effect on CSQ.

Proposition 4–2: The longer an executive’s tenure in the organization, the greater his or her commitment to the status quo.

However, in the study by Hambrick and associates, the effect of an executive’s tenure in the *industry* on his or her CSQ was even more pronounced. The authors interpreted this finding as testimony to the strength of industry conventions, “recipes,” and “common bodies of knowledge” (Hambrick 1982; Spender 1989), concluding: “Membership in an industry inserts a person into a social setting in which actions, contexts, and outcomes are subjected to a shared interpretation (Burrell and Morgan 1979). Those individuals who have participated in this ‘social construction of reality’ for the longest time are most convinced of its correctness. In fact, they may have difficulty even conceiving of alternative logics” (Hambrick, Geletkanycz, and Fredrickson 1993, 412).

The power of industry experience to shape managerial perceptions was demonstrated again by Sutcliffe and Huber (1998), who found that perceptions of the environment were more similar among top executives within the same industry than across industries. Further, other investigators have studied critical transitions in the airline, banking, and steel industries, concluding that in each of these, a well-developed “industry knowledge” had been established that long-tenured executives had great difficulty transcending (Marcus and Goodman 1986; Goodman 1988; Newell 1989).²

Proposition 4–3: The longer an executive’s tenure in the industry, the greater his or her commitment to the status quo.

Finally, we may anticipate that tenure in each layer of a social system—in a position, in an organization, and in an industry—adds in its own way to the informational constriction and social-psychological “embeddedness” of an executive (Granovetter 1985). Therefore, we posit:

Proposition 4–4: Tenures in the position, in the organization, and in the industry have independent and additive effects on an executive’s commitment to the status quo. Executives with long tenures of all three types are most committed to the status quo.

Researchers have used CEO tenure as a proxy for an array of personal qualities, including the executive’s firm-specific human capital (e.g., Agrawal and Knoeber 1996; Bergh 2001), conservatism and rigidity (e.g., Finkelstein and Hambrick 1990; Miller 1991; Boeker 1997b; Miller et al. 1996; Altemeyer 1966; Sørensen 1999), and power (e.g., Barkema and Pennings 1998; Hermalin and Weisbach 2003; Baker and Gompers 2001). However, if a given variable has such potentially different meanings, it places an onus on researchers to demonstrate construct validity, or at least to try to control for these alternative meanings. Perhaps because of this multiplicity of meanings, broad process models like Hambrick and Fukutomi (1991) and Miller and Shamsie (2001) are particularly attractive since they encompass multiple implications of CEO tenure.

Tenure and Organizational Strategy

Studies examining the associations between executive tenure and organizational strategies have been quite consistent in their findings. The first robust conclusion is that executive tenure is inversely related to organizational change. In an in-depth study, Gabarro (1987) found that almost all the actions taken by new general managers occur in the first two and one-half years in office. After that comes a period of “refinement,” in which only a few changes are made by the managers, primarily to fine-tune the organization. Figure 4.1 portrays how Gabarro’s managers varied their intensity of efforts at organizational change over their first three years in office.

Evidence of the inhibiting effect of company tenure on strategic change also was set forth by Wiersema and Bantel (1992).³ In their study of eighty-seven firms, they found that top executive tenure was negatively related to change in company diversification strategy over the subsequent three-year period. They concluded that executives with short tenures, particularly new executives from the outside, are more likely to view the firm as a blank slate that can take on many possible forms. Long-tenured executives, conversely, were seen as more encumbered by the history and current configuration of the company.

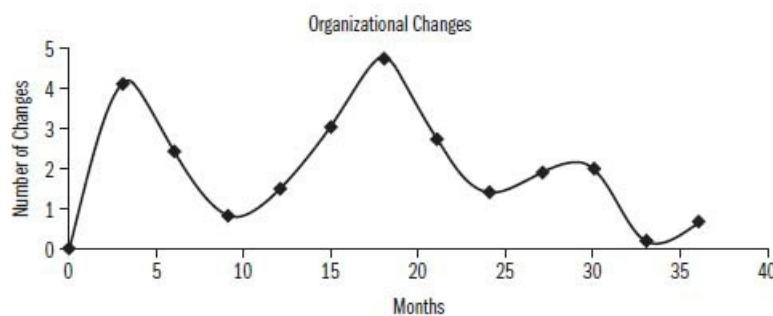


Figure 4.1. Gabarro’s Study of General Managers: Average Number of Organizational Changes Per Three-Month Period (Adapted from Gabarro 1987.)

Additional evidence that executive tenure reduces strategic change was offered by Finkelstein and Hambrick (1990). In a study of one hundred companies in three industries, the authors found that the company tenure of the top executives was highly positively related to strategic persistence, or absence of strategic change, over the ensuing year. This relationship was monotonic—every increase in tenure brought a greater degree of strategic persistence—over the full range of tenure lengths. The authors also found that executive tenure was positively related to strategic conformity, or the company’s adherence to the general strategic tendencies of the industry. The authors posited a logic for the effect of company tenure on conformity: “Executives with short tenures have fresh, diverse information and are willing to take risks, often departing widely from industry conventions. As tenure increases, perceptions become very restricted and risk taking is avoided. The lowest-risk thing to do is follow the general tendency of mainstream competitors” (1990, 488).

In a study of U.S. railroads, Grimm and Smith (1991) found that the tenure of top executives in the railroad industry was inversely related to the degree that their firms changed

strategies after deregulation. In line with Hambrick, Geletkanycz, and Fredrickson (1993), they found that industry tenure had an even greater effect on strategic inertia than did company tenure. And Boeker (1997a) found in a study of sixty-seven Silicon Valley semiconductor manufacturers that both CEO and top management team tenure were negatively related to strategic change.⁴

Proposition 4–5: The longer an executive’s tenure (in the position, the organization, or the industry), the less the strategic change that ensues in the organization.

Proposition 4–6: The longer an executive’s tenure (in the position, the organization, or the industry), the greater the organization’s strategy conforms to industry averages.

If strategic change diminishes over an executive’s time in office, the question arises as to how this decline occurs. What happens to executives over time that causes complacency and inaction? With Hambrick and Fukutomi (1991) as a conceptual template, empirical research has made significant strides in addressing this question in recent years. Perhaps the study that comes closest to empirically modeling the “seasons” pattern is a fascinating analysis, conducted by Miller and Shamsie (2001), of product line experimentation by senior executives in Hollywood studios. Adopting a longitudinal research design, these authors tracked the launch of film genres and products and studied how the tenures of studio chiefs affected the extent of experimentation along these dimensions, as well as overall firm performance. With respect to strategy, they found that the tenure of studio chiefs was negatively related to experimentation. Miller and Shamsie observed a pattern of behavior of studio chiefs over time that was remarkably consistent with Hambrick and Fukutomi (1991) and Miller (1991), as we now review.

- *The Learning Stage:* New executives are open to experimentation, even actively seeking it out. They look for new market opportunities, take chances, and often make mistakes. For example, Miller and Shamsie cite Jack Warner’s decision early in his career to bring stage star Al Jolson back to the screen in *The Jazz Singer*, beginning the “sound” era of film. The authors also document high-risk flops.
- *The Harvest Stage:* Now somewhat more experienced, with a skill set to leverage, executives shift from experimentation to exploitation. They have now developed a set of managerial routines that work, and firm performance is typically solid. In this vein, for example, deep knowledge was exploited and reinforced at MGM with Louis B. Mayer’s persistent emphasis on musicals, and at Warner with Jack Warner’s long string of crime and gangster hits.
- *The Decline Stage:* After about fifteen years at the helm, executives feel they have little to learn, become complacent, and no longer follow market trends. Past patterns of behavior are repeated, regardless of whether they still make sense. Accordingly, Miller and Shamsie quote film historians to the effect that the great studio heads had “had the course,” or were no longer “sparking” (2001, 738).

Recently, Wu, Levitas, and Priem (2005) examined the relationship between CEO tenure and firm inventiveness (measured as the number of patents filed in a year) in a sample of eighty-four firms in the biopharmaceutical industry. Developing an argument in line with Hambrick and Fukutomi (1991) and Miller (1991), and in contrast to the monotonically negative relationship uncovered by Miller and Shamsie (2001), these authors found an inverted U-shaped relationship between CEO tenure and firm inventiveness.

Going a step further, Wu, Levitas, and Priem (2005) also hypothesized and found that the inverted U-shaped relationship between CEO tenure and firm inventiveness was moderated by the firm's level of technological dynamism. For all the reasons that short-tenured CEOs are more experimental (Hambrick and Fukutomi 1991; Miller 1991; Miller and Shamsie 2001), the payoff comes in fast moving environments; in such settings, adherence to the status quo, which characterizes long-tenured CEOs, is precisely the wrong stance. The net result is that short-tenured CEOs encourage more inventiveness in technologically dynamic environments, and long-tenured CEOs spur more invention in technologically stable environments. This finding is interesting, as it brings environmental dynamism to the fore as a potentially important moderating factor in how tenure patterns affect outcomes.

Proposition 4–7: The relationship between executive tenure and strategic change is moderated by environmental dynamism.

Evidence suggests that top executive tenure has an effect not only on strategic persistence and strategic conformity, but also on the specific type of strategy pursued. At least three studies have found that long-tenured executives tend to pursue what Miles and Snow (1978) called “Defender” strategies (emphasizing stability and efficiency), whereas short-tenured executives are more likely to pursue “Prospector” strategies (emphasizing product or market innovation). One of these studies, by Chaganti and Sambharya (1987), examined the top executive characteristics and company strategies of the three major tobacco companies headquartered in the United States. The second study, by Thomas, Litschert, and Ramaswamy (1991), was based on a sample of 224 firms in the electronic computing industry. Both sets of authors argued that long tenures lead to an “internal” focus, rather than an emphasis on product or market innovation. Finally, Barker and Mueller (2002) found that CEO tenure was negatively associated with R&D spending in their study of 172 large firms.⁵

Proposition 4–8: The longer an executive's tenure, the greater the strategic emphasis on stability and efficiency, rather than product or market innovation.

Tenure and Performance

If executive tenure affects strategy, it must also affect performance. Accordingly, an array of studies has examined this straightforward question: Is long CEO tenure a good thing or a bad thing for an organization? The results, somewhat predictably, have been mixed. Pennings, Lee, and van Witteloostuijn (1998) found, in their sample of accounting firms in Holland, that executive (partner) tenures were negatively related to firm dissolution.⁶ Similarly, Waldman, Ramirez, House, and Puranam (2001) found that CEO tenure had a positive relationship with profit margins. In contrast, Sorenson's (1999) study of commercial television stations found that top management team tenure was negatively related to growth. Studies by Boone, de Brabander, and Witteloostuijn (1996), Iaquinto and Fredrickson (1997), and Balkin, Markman and Gomez-Mejia (2000) did not find any significant effects of tenure on performance.

Instead of positing a universal linear relationship between CEO tenure and performance, it may be far more sensible to argue that the relationship will be *curvilinear*, and that this curvilinear pattern will differ somewhat, depending on contextual conditions. Constructing this line of thought is relatively straightforward. If we assume that CEOs are selected because their competences and paradigms largely suit the contextual conditions that exist when they enter office (Vancil 1987; Henderson, Miller, and Hambrick 2006), and that it takes a bit of time for CEOs to learn the specifics of their new posts and to implement their early ideas,

then we can reasonably anticipate that, in general, performance will improve over the CEO's first few years in office. At some point, though, established repertoires become rigid (Leonard-Barton 1992), information restriction occurs, and executives develop a faulty conviction that their earlier successful formulas are still appropriate.

Evidence of these trends exists in Miller's classic "stale in the saddle" essay. In a study of ninety-five Canadian companies, Miller found that the alignments between environmental and organizational characteristics, as prescribed by contingency theory (e.g., Burns and Stalker 1961; Lawrence and Lorsch 1967), indeed existed for companies whose CEOs had tenures of less than ten years; however, the alignments did not exist for long-tenured CEOs. Moreover, the greater the misalignment between environmental and organizational characteristics, the worse the company's performance. Miller concluded that long-tenured CEOs become "stale in the saddle"—committed to the status quo, risk-averse, and insulated from fresh, accurate information—and their companies suffer for it.

New CEOs are unlikely to have developed very deep repertoires; they are still "learning on the job." Over time, however, they gain in knowledge and expertise about the firm they are running and the strategic and organizational challenges facing it. They also tend to extend their reach to other organizations and individuals by leveraging their status and the information-capturing opportunities that come with it. Hence, both human and social capital increase over time. However, at some point (Hambrick and Fukutomi [1991] suggest after seven or eight years as CEO, and Miller and Shamsie [2001] pinpoint the inflection point at eight to ten years),⁷ the processes of risk-aversion, information restriction, and power entrenchment take over and an organizational downturn occurs. Long-tenured executives may indeed develop deeper repertoires that provide potentially valuable firm-specific human capital, but they do so in narrower and narrower areas of expertise based on their experience.⁸ Hence, new learning by long-tenured CEOs slows down (Miller and Shamsie 2001); to the extent that their preestablished skill sets and mind-sets are increasingly out of date for their environments, firm performance will deteriorate (Helfat et al. 2007).⁹

Thus, theory and evidence suggests that the relationship between executive tenure and firm performance is inverted U-shaped (Hambrick and Fukutomi 1991; Miller 1991; Miller and Shamsie 2001; Wu, Levitas, and Priem 2005; Henderson, Miller, and Hambrick 2006).

Proposition 4–9: The relationship between top executive tenure and firm performance is inverted U-shaped.

An intriguing possibility is that companies that undertake considerable innovation and change—such as radical new product development, large acquisitions, or other activities that shake up the status quo—may avoid or delay the onset of CEO staleness (or "long-tenure syndrome"). However, evidence of such an effect is lacking. In fact, available evidence actually supports the opposite scenario: for firms in highly dynamic environments, CEO performance peaks very early in the tenure, and the downturn is swift and steep.

This evidence comes from a study by Henderson, Miller, and Hambrick (2006) that examined how the relationship between CEO tenure and company performance differs between highly stable and highly dynamic industries. The authors argued that stable, predictable settings favor CEO continuity and longevity, as there is a premium on incremental fine-tuning of existing formulas. In support of this view, they found that, in a large sample of firms in the very stable brandedfoods industry, performance steadily increased over a CEO's tenure until around year fifteen (far later than observed in other samples) and only then gradually declined.

In contrast, the authors argued that highly dynamic, discontinuous industries tend to

render CEOs quickly obsolete. CEOs' repertoires and mind-sets are appropriate when they start their jobs but then become rapidly misaligned with the changing environment. Using a large sample of firms from the highly dynamic computer industry, the authors found an extreme form of support for their hypothesis: after all appropriate statistical controls, the computer company CEOs delivered their very best performance in the first two years of their tenures and then, on average, performed worse with each additional year in office. This extreme result is consistent with Virany, Tushman, and Romanelli's (1992) finding that short executive tenures were associated with performance improvements in the turbulent minicomputer industry. More generally we can propose:

Proposition 4–10: The greater the environmental dynamism, the earlier the relationship between executive tenure and firm performance turns negative.

The relative advantages of long executive tenure may depend not only on the requirements of the external environment but also on those emanating from the firm's chosen strategy. In this vein, Thomas, Litschert, and Ramaswamy (1991) found that Prospector companies in the computer industry had executives with shorter organizational tenures than did Defender companies. In their most compelling test, the authors found that high company performance accrued to those firms whose executive tenures most closely conformed to the "ideal" for their strategic type. This study takes the perspective that top executives are responsible for implementing a chosen strategy. If the strategy requires product or market innovation, then short executive tenures—presumably conferring freshness, open-mindedness, and an external focus—are advantageous. If the strategy is one of stability and efficiency-seeking, longer tenures and the benefits of internal experience are called for. Thus,

Proposition 4–11: Long executive tenure is more positively (or less negatively) associated with organizational performance in Defenders than in Prospectors.

It is clear that executive tenure may have far-ranging implications for organizational functioning and fates. Figure 4.2 summarizes some of the major findings regarding executive tenure.

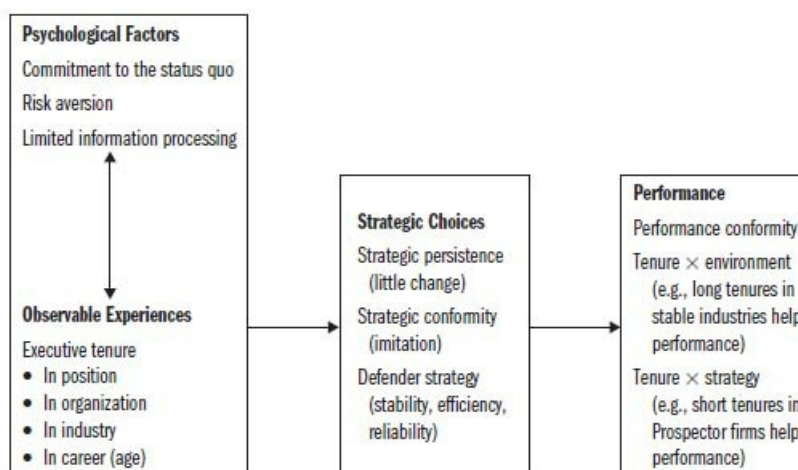


Figure 4.2. Executive Tenure: Some Observed Associations

Functional Background

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Consultants and academics have long exhorted companies to expose their managers to multiple functions, both because it would enhance their breadth of perspective in their current assignments and because such a policy would yield broader-gauged top-level executives (Ouchi and Jaeger 1978; Raskas and Hambrick 1992). To be sure, some top executives have significant experiences in multiple functions. However, many have spent the greater part of their careers in one primary functional area, such as marketing, finance, or engineering.

It is reasonable to expect that an executive's functional experiences provide a lens through which he or she sees business problems and solutions in general (Dearborn and Simon 1958). As Fligstein put it, if people have "spent their [careers] attempting to market products, then their central concern will be tactics that increase the sale of products" (1990, 357). A correspondence between functional experiences, psychological tendencies, and strategic choices could occur through at least three mechanisms. First, individuals may be drawn to functional areas that suit their personalities or aptitudes (e.g., Schein 1968). At the start of their careers, individuals in different functions already have different cognitive models and values. Second, with the passage of time and the accumulation of successes in a functional area, an individual becomes more and more socialized and inculcated with the mode of thinking and acting that is typical for that professional area (Blau and McKinley 1979; Mortimer and Lorence 1979). And third, even when individuals eventually operate outside their functional areas, say in general management positions, past learning—reinforced by years of rewards that serve to condition how they think (Waller, Huber, and Glick 1995)—lead executives to gravitate toward perceiving problems in familiar terms, generating and preferring familiar solutions (March and Simon 1958). Functional experiences of senior executives can even influence their conceptions of how well the organization is performing (Waller, Huber, and Glick 1995). In fact, it was a belief in the orienting and filtering effects of functional experiences that generated Dearborn and Simon's seminal study (1958) that ultimately led to today's widespread interest in the effects of executive backgrounds on decision making.

Functional Experiences and Executive Perceptions

Dearborn and Simon (1958) argued that exposure to the goals and reinforcements of a particular functional area will cause managers to attend to certain information in a complex business situation and, in turn, to interpret that information in terms that suit their functional expertise. To test these ideas, Dearborn and Simon had twenty-three middle managers from a single company read a ten-thousand-word business case that presented a large number of facts with virtually no structure or interpretation. The managers were then asked to identify the major problem facing the company. As the researchers expected, the managers tended to gravitate to interpretations that mirrored their functional backgrounds. For example, sales executives mentioned more sales-related problems than did executives from other functional areas. However, a careful reading of the results in an appendix leads one to conclude that Dearborn and Simon's findings are only suggestive, not definitive. There were not wholesale differences between functions, although some evidence of functional bias in interpreting business problems was observed.

Thirty years later, Walsh (1986) conducted an elaborate replication and extension of Dearborn and Simon's study. He had 121 participants enrolled in an executive MBA program perform two tasks: (1) read a thousand-word business case and identify the major problems faced by the company; and (2) sort cards with business terms into piles to reveal underlying cognitive structures. Walsh hypothesized that the participants' handling of these tasks would reflect their functional backgrounds, but this theory was not at all borne out. No discernible functional biases were revealed in either of these information-processing endeavors.

Why did Dearborn and Simon find functional biases (albeit, of a limited nature) and Walsh observe none? The differences between the two studies shed light on the underlying conditions that bring about functionally skewed information processing.

First, consider the basic differences between the mid-1950s and the mid-1980s, the eras in which the two studies were conducted. In the mid-1950s, there was not a pervasive concept of general management in America. All but a few companies had only one general manager, the CEO. There were relatively few MBA programs, a handful of business magazines, very few executive seminars, and certainly no best-selling books on managing. By the mid-1980s, all managers in business were bombarded with information and insights beyond their primary professional areas. Most major companies had numerous general management and quasi-general management positions. MBAs, trained primarily for breadth, were in profusion. Executive seminars abounded. Books by Peters and Waterman (1982) and Iacocca (1984) had led a series of best sellers on general management that pulled many business people beyond their parochial zones.¹⁰ Moreover, many corporations had adopted programs to expose promising managers to diverse experiences. In short, by the 1980s managers may have been genuinely less confined by their functional backgrounds than were their predecessors in the 1950s. We can expect that the broad cultural milieu may affect the degree of cognitive parochialism of managers in general.

Proposition 4–12: The greater the emphasis on general management in the broader cultural milieu, the weaker the relationship between executives' functional backgrounds and their interpretation of strategic stimuli.

It is also noteworthy that Dearborn and Simon's subjects were participants in a short company training program, whereas Walsh's subjects were enrolled in a two-year executive MBA program. We may expect that Walsh's subjects were observed amidst intensive socialization into a multifunctional perspective; they had self-selected themselves into this quite extensive experience; and since companies customarily pay tuition for such programs, their supervisors probably selected the individuals on the basis of their promotability and potential for general management positions. Therefore, Walsh's participants may have been far less functionally confined than their peers who were not enrolled in such a program, and they were certainly less confined than Dearborn and Simon's subjects.

Proposition 4–13: The more formal management education that executives have, the weaker the relationship between their functional backgrounds and their interpretations of strategic stimuli.¹¹

The third point of reconciliation, seemingly minor, may be the one of greatest theoretical significance. The case Walsh had his subjects read was one thousand words long (three pages), and he gave them twenty-five minutes to study it. This would not seem to be an instance of information overload in which the manager would have to engage in mental shortcuts or fall back on the familiar. Rather, the manager could be very thorough and deliberate, quite readily assessing all available information. Namely, the task may not have met the conditions envisioned by the Carnegie School when they developed the concept of bounded rationality. In comparison, Dearborn and Simon's case was ten thousand words long, and the chances of complete mastery of the material, or the surmounting of cognitive biases, were far lower. That is, functional background—or any biasing experience—has its greatest effect on interpretation and choice when the manager (1) faces an abundance of complex, ambiguous information and (2) has to deal with the information under urgency or other forms of pressure. Correspondingly, when executive job demands (Hambrick,

Finkelstein, and Mooney 2005) are high, executives can be expected to scan, selectively perceive, and interpret strategic stimuli in line with their functional experiences.

Proposition 4–14: The more ambiguous and multitudinous strategic stimuli are, the stronger the relationship between executives' functional experiences and their interpretation of the stimuli.

Proposition 4–15: The less time executives have to consider strategic stimuli, the stronger the relationship between executives' functional experiences and their interpretation of the stimuli.

Proposition 4–16: The greater the executive job demands, the stronger the relationship between executives' functional experiences and their interpretation of the stimuli.

Beyer, Chattopadhyay, George, Glick, ogilvie, and Pugliese (1997) conducted an interesting extension of Dearborn and Simon (1958) and Walsh (1988), which is additionally informative. Their study centered on a critical difference between the two prior studies. Whereas Dearborn and Simon had instructed managers to identify “the most important problem” confronting the company in the case study, Walsh’s directions were to identify “all of the important problems.” In a study of selective perceptions, this difference in instructions would seem important. Beyer and colleagues addressed this distinction by giving half their sample of MBA students the same case as Walsh used, with Walsh’s directions to identify “all of the important problems”; the other half were given the same case but were instructed to identify just “the most important problem.” Not surprisingly, the experimental condition was a highly significant predictor of selective perception: the “most important problem” subjects identified fewer problems and attended to fewer areas than did the “all of the important problems” subjects. Of greater note, the authors found that functional backgrounds were not related to the issues that the subjects attended to, but they were related to the issues and areas that the subjects *did not attend to*. For example, experience in production and operations was negatively related to identifying problems in human resources. It may be, then, that functional experiences exert two types of cognitive pulls on managers: toward certain directions and, as importantly, away from others. While this is a potentially interesting finding, and one that is consistent with Dearborn and Simon’s contention that functional backgrounds restrict cognitive processing, we must temper these results by noting that this study relied on MBA students as subjects, not seasoned managers. We would not expect young MBA students to have had a chance to develop the deeper functional expertise and identification that experienced managers would have. With experience comes more entrenched knowledge structures and probably more parochial perspectives (Ford and Baucus 1987). In fact, it may be that the longer an executive has been immersed in a functional area, the more restrictive his or her cognitive processing becomes.

Proposition 4–17: The longer the length of service in a functional area, the stronger the relationship between executives' functional experiences and their interpretation of strategic stimuli.

One final note from Beyer and colleagues (1997) may be relevant for our upcoming discussion of educational background: it turns out that the MBA students’ experiences in production and operations, in marketing and sales, and in finance and accounting were *all* negatively related to their attention to, and identification of, human resources problems. We interpret this pattern as representative of the general lack of sophistication of MBA students toward the “soft” side of business, namely people, processes, and culture, and another

indication of the inherent limitation in relying on MBA students in a study of selective perceptions. We return to this topic of the “MBA mind-set” later in this chapter.

Links to Strategy and Performance

Inquiries into the effects of executive functional background on organizational profiles have centered on two classes of organizational strategy. The first is the company’s competitive strategy in its major line of business, or its business strategy. The second is the company’s diversification profile, or its corporate strategy. In each of these streams, some recurring and intuitively reasonable patterns emerge.

Competitive strategies can take many forms, but the typology of Miles and Snow (1978) has been instrumental in identifying some major classes of strategic profiles. Research on executive functional backgrounds and business strategy has particularly applied the Miles and Snow typology. In their study of major tobacco companies, Chaganti and Sambharya (1987) found that the top executive ranks of the Prospector company they examined (Philip Morris) differed from those of the Analyzer (R. J. Reynolds) and Defender (American Brands) companies. Specifically, the Prospector had proportionately more executives with marketing and R&D backgrounds and fewer with finance backgrounds. Thomas, Litschert, and Ramaswamy (1991) examined the functional backgrounds of CEOs of computer companies and found similar results. Of the Prospector companies studied, 77 percent of their CEOs had experience primarily in “output-oriented” functions (i.e., marketing, sales, and R&D), compared to only 10 percent of the CEOs in the Defender companies. Conversely, 90 percent of the Defender’s CEOs were primarily from “throughput-oriented functions” (manufacturing, accounting, finance, administration), compared to 23 percent of the Prospector CEOs.

Proposition 4–18: Executives with primary experiences in output functions tend to pursue Prospector strategies. Executives with primary experiences in throughput functions tend to pursue Defender strategies.

This pattern was similar to that found by Strandholm, Kumara, and Subramanian (2004). In a study of 187 hospitals, these authors found that “efficiency-focused” strategic changes occurred in firms where top managers had more experience in internal operations. In contrast, top managers in firms engaging in market-oriented strategic changes were more likely to have backgrounds in external functions than their counterparts in other firms. Also in line with this pattern are two other studies: Barker and Mueller (2002) found that CEO experience in output functions was positively related to R&D spending. And in a study of fifty-three senior executives, Tyler and Steensma (1998) found that executives who rated their experience as primarily in R&D or engineering were more likely to favorably rate a technology alliance opportunity than executives with other functional experiences.

Beyond the descriptive tendency for executives to pursue competitive strategies in line with their own functional dispositions is the possibility that they are wise to do so. There may be performance advantages in having a fit between executive functional expertise and strategy. For example, in the Strandholm and colleagues (2004) study just noted, firm performance was generally higher when managerial characteristics aligned with strategic context. In addition, Thomas, Litschert, and Ramaswamy (1991) found that the best-performing Prospectors had CEOs with output-oriented functional backgrounds; the best-performing Defenders had CEOs with throughput-oriented backgrounds; and, most noteworthy of all, firms tended to perform less well when they had CEOs that did not fit their strategy. In a similar study, Beal and Yasai-Ardekani (2000) reported considerable support

for the managerial fit hypothesis. For example, the R&D experience of a firm's CEO was more strongly related to firm performance to the extent that the firm followed an "innovation differentiation" strategy; and the combined accounting and engineering experiences of CEOs were positively associated with firm performance when there was a strategic emphasis on low-cost leadership and quality differentiation.

Proposition 4–19: Firms pursuing Prospector strategies perform well to the extent that their top executives have experience in output functions. Firms pursuing Defender strategies perform well to the extent that their top executives have experience in throughput functions.

Proposition 4–20: Firms pursuing competitive strategies that fit the managerial characteristics of their top executives will perform better than those firms that do not have such alignment.

At least two other studies have found performance advantages stemming from an alignment of executive functional background and competitive strategy. Gupta and Govindarajan (1984) found that business units pursuing "build" strategies (involving aggressive market share quests) performed better to the extent that their general managers had experiences in marketing and sales; there was no such association in businesses pursuing "hold" or "harvest" strategies, in which operational and efficiency competences are presumably more valuable. (Gupta and Govindarajan did not collect data on operational and financial functional experience, so it is not known whether such experience would in fact be beneficial for "hold" or "harvest" missions. We would anticipate that this would be the case.)

Barbosa (1985) found further evidence that business innovation is enhanced by certain functional capabilities among top executives. In a large-scale study of the forest products industry, he found that the conversion of product innovation efforts (R&D spending and staffing levels) into actual product innovations (patents, sales from new products, and so on) was strongly related to the degree of marketing experience among the company's top executives. He concluded that a marketing orientation among top executives confers more of a customer-based, creative, expansionist capability in the firm, which serves to enhance the yield from innovation efforts.

A second major research stream has examined the association between executive functional backgrounds and the company's diversification strategy. The chief line of argument has been that companies that have minimal substantive connections among their business units (at the extreme, mere holding companies) are likely to have top executives with financial, legal, and administrative backgrounds, while companies with more substantive interdependencies would be led by executives with experience in more "core" functions, such as marketing and sales, R&D, and operations. Both Hayes and Abernathy (1980) and Fligstein (1990) make the point that executives with dominant functional experience in finance, accounting, or law tend to see firms as portfolios of businesses and hence are more likely to seek growth via diversification.

A series of studies have tested this idea. Song (1982), in one of the first studies in this stream, found that firms that were diversifying primarily through acquisitions were relatively likely to have CEOs with financial and legal backgrounds, while companies diversifying through internal, organic extensions were more likely to have CEOs with core function experience (in operations, R&D, and marketing and sales). Finkelstein (1992) similarly found that firms whose top management teams had dominant backgrounds in finance were more diversified and spent more for acquisitions than other firms; Jensen and Zajac (2004) found that finance CEOs were associated with diversification and acquisition activity; and Palmer

and Barber (2001) reported that the likelihood of making diversifying acquisitions was greater for firms with finance CEOs.

Michel and Hambrick (1992) extended these ideas in a somewhat more fine-grained way, arguing that a company's top executives would have core-function experiences (in marketing/sales, operations, R&D/engineering) in direct proportion to the amount of strategic interdependence existing among the firm's major lines of business. Building upon Rumelt's (1974) framework, the authors posited that four categories of diversified firms lie on a continuum, ranging from very low to very high strategic interdependence: unrelated; related in a loosely linked way; related in a tightly constrained way; and vertically integrated. They found, in line with their hypothesis, that the proportions of senior executives with primarily core-function experience were as follows:

Unrelated	18 percent
Related-linked	27 percent
Related-constrained	35 percent
Vertically integrated	44 percent

The differences were highly statistically significant.

However, in pursuing the idea that companies perform better to the degree that executive backgrounds fit the firm's chosen strategy, Michel and Hambrick found results quite contradictory to their expectations. For the unrelated firms, profitability was positively related to executive expertise in core functions; for the vertically integrated firms, profitability was negatively related to core function expertise. The authors concluded that the actual executive profiles associated with these two types of diversification strategies, as reported above, may have been counterproductive: "The average unrelated firm may have had managers with less core function expertise than was optimal. ... [They] may have had critical voids in operating knowledge, impairing their ability to evaluate division requests, performance patterns, and acquisition candidates beyond the most superficial financial and administrative levels." The authors concluded that the high percentage of executives with core function expertise in the vertically integrated firms may have been similarly counterproductive: "These firms may have benefited from more objective, staff-analytic executives who were not overly committed to a specific business or way of operating" (1992, 32).

Hayes and Abernathy (1980), in their influential article "Managing Our Way to Economic Decline," were among the first to raise the idea that functional capabilities of senior executives would significantly affect the health of companies. They envisioned a universal effect—that executives with experience in core functions will produce superior returns. So far, the most direct tests of this supposition, particularly by Michel and Hambrick, provide no support for it. As yet, we know of no evidence of a generally advantageous functional profile for top executives. Instead, the external environment and the company's chosen strategy create a context in which certain functional orientations may have distinct, but conditional, benefits.

Future Research on Functional Experiences

One of the conclusions that emerges from our review of work on functional backgrounds and selective perception is that managers often—but not always—attend to information that fits their functional backgrounds. The concept of managerial attention has been the subject of

considerable research (e.g., March and Shapira 1987; Daft, Sormunen, and Parks 1988; Starbuck and Milliken 1988), but recent work has brought new life to the importance of this concept for understanding executive behavior. In a pivotal essay, Ocasio (1997) argued for an “attention-based view” of decision making, whereby the actions taken by decision makers depend on the “issues and answers” they pay attention to, which in turn are influenced by both the decision-making context and the organization’s rules, resources, and social relationships. Further, Ocasio suggested that “the most critical players in attention regulation are typically the CEO and the top management group” (1997, 197). Hence, an intriguing possibility is that senior executives with particular experiences will attend to different “issues and answers”; to the extent that managerial attention is a critical mediator, as Ocasio (1997) suggests, organizational outcomes are a reflection of those managerial attention patterns.

This is precisely the position taken by Cho and Hambrick (2006) in their study of executive characteristics in the airline industry as it underwent deregulation. They hypothesized, and found, that top management teams that added executives (post-deregulation) who had greater output-oriented functional experience and non-airline experience exhibited the greatest shifts in attention from an engineering orientation to an entrepreneurial orientation. Further, the researchers found that changes in executive characteristics only affected changes in actual strategy to the extent that managerial attention patterns also shifted. Hence, this study yields a fascinating finding on how managerial characteristics are translated into strategic outcomes—via the mediating role of managerial attention. Clearly, this study calls out for more investigation of the relationships among managerial characteristics, managerial attention, and organizational outcomes.

Another implication of this study relates to the tension between psychological and demographic attributes in studies of strategic leadership. By demonstrating that changes in managerial demography lead to changes in what managers attend to, Cho and Hambrick (2006) shed light on how any attribute of an executive—psychological or demographic—translates into organizational outcomes. If it is indeed managerial attention patterns that count, and if executive background characteristics affect those attention patterns, then demographic characteristics are highly pertinent in understanding the relationship between top managers and strategic choices. The research of Ocasio (1997) and Cho and Hambrick (2006) help move us closer to deciphering the “black box” of the decision-making process that illuminates the causal chain from executive characteristics to strategic action.

A second new direction is suggested by work in the resource-based view (RBV) tradition. The premise that functional backgrounds are valuable to a firm to the extent they fit environmental and strategic challenges is wholly consistent with classic contingency theory (Thompson 1967; Pfeffer and Salancik 1978; Hambrick 1981a), but RBV research focuses on a different conception of fit. RBV assesses the value of a resource, including executive experiences such as functional backgrounds, against a set of defining criteria—scarcity, inimitability, value,¹² and nonsubstitutability (Barney 1991).¹³ When these tests of resource value are applied to managerial characteristics, it raises the intriguing idea that the impact of a firm’s top executives on performance depends at least in part on the profile of executives at competitor firms. For example, if a firm’s top executives are no different from those of competitors, they do not pass the inimitability test and hence are of less distinctive value. While we introduce this proposition in this section on functional backgrounds, we keep it sufficiently general to indicate that other aspects of managerial experience may have similar effects.

Proposition 4–21: The effects of top executive characteristics on firm performance are greater to the extent that those characteristics differ from executive profiles at competitor firms.

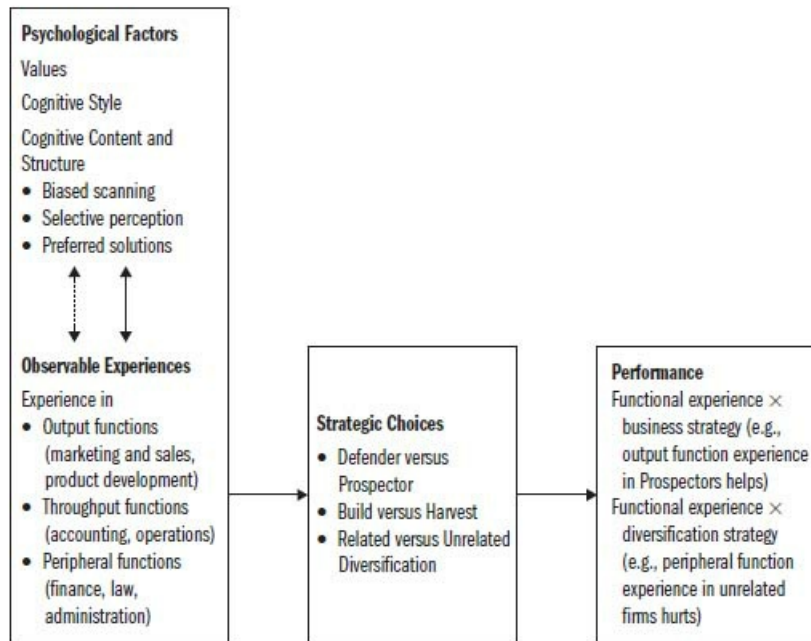


Figure 4.3. Executive Functional Background: Some Observed Associations

Figure 4.3 summarizes some of the observed associations among executive functional experiences, psychological factors, strategic choices, and organizational performance.

Formal Education

Since top executives typically are many years beyond their formal education, it may seem unlikely that their educational experiences would affect their current strategic choices and behaviors. Yet a significant body of research suggests that the schooling of senior managers is reflected in the characteristics of their organizations.

A substantial literature in developmental psychology and higher education exists regarding the effects of education on individual values and cognitions, as well as on the types of individuals who self-select themselves into certain educational experiences (e.g., Smart and Pascarella 1986; Byrne 1984; Cherrington, Condie, and England 1979; Schein 1968; Altemeyer 1966). However, very little research has examined associations specifically between education and executive psychological constructs. One possibility is that education confers, or is at least associated with, intellectual dexterity. In a survey study of 106 CEOs, Wally and Baum (1994) found a significant correlation between amount of formal education and a measure of cognitive complexity, or the ability to discern patterns and distinguish among objects. Hitt and Tyler (1991) found a weaker but still positive link, thus suggesting this relationship:

Proposition 4–22: An executive’s amount of formal education is positively associated with cognitive complexity.

Further in line with the premise that formal education reflects an individual’s cognitive ability, particularly open-mindedness, researchers have found that education is associated with receptivity to innovation (Becker 1970a, 1970b; Rogers and Shoemaker 1971). Moreover, evidence has generally indicated a positive link between the education level of

senior executives and the amount of innovation in their organizations. Kimberly and Evanisko (1981) were among the first to document this pattern, finding that the amount of formal education of hospital chief administrators was positively associated with the adoption of both technological and administrative innovations in hospitals. Similar positive associations between executive education levels and organization innovation have been observed in forest products companies (Barbosa 1985) and computer companies (Thomas, Litschert, and Ramaswamy 1991); Barker and Mueller (2002), however, found no significant relationship between education level and R&D spending. Norburn and Birley (1988) found that the amount of education of top executives was positively associated with strategic portfolio changes in a large sample of diversified firms, and Hambrick, Cho, and Chen (1996) reported significant associations between education level and several types of strategic initiatives in the airline industry. Thus, the effects of executive education levels on organizational innovation, change, and growth are widely documented.

Hambrick and Mason (1984) cautioned that any observed associations between education and innovation may be due to an unobserved spurious effect from executive age, since there has been a steady tendency toward increased education levels of executives over the past thirty or forty years, and hence young executives tend to be more highly educated than their older colleagues and predecessors. However, at least three studies have used multivariate analysis, controlling for age, and they still find significant effects stemming from education (Barbosa 1985; Bantel and Jackson 1989; Wiersema and Bantel 1992). Another possible confounding factor—the inevitable correlation between the amount of innovation in an industry and the amount of education—can similarly be set aside because almost all studies cited have controlled for industry effects. Hence, while results have not been uniform, the association between the level of education of senior executives and the amount of innovation and change in their organizations appears to be quite robust.

Proposition 4–23: The greater the amount of formal education of top executives, the more innovative their organizations.

The effects of education level on organizational performance, however, are not as widely observed or clear-cut. Of course, one can conceive of growth as a performance indicator, in which case executive education levels seem to have a salutary effect (Norburn and Birley 1988). However, effects on profitability and shareholder returns have barely been examined.¹⁴ Here, we must reasonably expect contingency effects: high levels of formal education are more conducive to organizational performance in some environments, and in pursuit of some strategies, than others. Once again, the contingency model tested by Thomas, Litschert, and Ramaswamy (1991) is instructive. They not only found that the CEOs of Prospector firms were more highly educated than the CEOs of Defender firms, but also that the best performing firms of each type also differed similarly; firms did less well to the extent that their CEOs had profiles differing from the “ideal” for their type. Thus, some competitive and marketplace conditions call for more formal education—and concomitant open-mindedness, information processing abilities, and cognitive flexibility—than do other settings.

Proposition 4–24: The amount of formal education of executives is more positively associated with organizational performance for Prospectors than for Defenders.

In addition to examining the organizational implications of the amount of education of executives, some studies have considered particular fields of study. The two chief premises of this line of inquiry are that (1) individuals with certain dispositions, aptitudes, and cognitive

styles tend to pursue certain compatible educational curricula; and (2) educational curricula differ in the influences they exert on individuals (Hitt and Tyler 1991). So, for example, in the Tyler and Steensma (1998) study noted earlier, executives with a degree in engineering or physical sciences were more likely to favorably rate a technology alliance opportunity than executives with other educational backgrounds. In addition, Hitt, Bierman, Shimizu, and Kochhar (2001) examined the role of human capital at ninety-three law firms and found a curvilinear association between their human capital measure (based on the quality of the partners' law schools and the partners' tenures in their firms) and firm performance (measured as income to total revenue). This pattern was consistent with the authors' expectation that it is costly to acquire human capital, but that over time the payoff surpasses the cost.

As might be expected, however, there particularly has been an interest in investigating the organizational implications of having senior executives with formal education in business administration, particularly MBA graduates. The work to date, however, has produced somewhat disparate results.

Kimberly and Evanisko (1981), in addition to examining overall amount of education, also explored whether hospital administrators educated specifically in administration would be associated with organizational innovation. They found no such relationship: executives educated formally in fields of administration were associated with no more or less innovation than those with formal education in other fields. (As noted above, formal education, in general, was positively associated with innovation.) Geletkanycz and Black (2001) reported a somewhat analogous result: they found no effect of executives with MBAs on commitment to the status quo. And in a study of large firms, Barker and Mueller (2002) reported that companies with a greater proportion of MBA executives spent less on R&D than did other firms. Grimm and Smith (1991), on the other hand, did find that U.S. railroads that changed their strategies after deregulation were more likely to have MBAs among their senior executives than were the railroads that did not change their strategies.

Bertrand and Schoar (2003) studied large companies over a thirty-year period and found that firms with CEOs who had MBAs spent more on capital expenditures, took on more debt, and issued fewer dividends than other firms. Their interpretation of this pattern: "CEOs with MBA education appear to follow more closely the 'textbook guidelines' when making investment decisions" (2003, 1203). In addition, these authors found that CEOs who had MBAs made more diversifying acquisitions than their peers without the degree.

This focus on diversification is reinforced in two studies that looked specifically at the pedigree of MBA degrees. According to these studies, having an *elite* MBA facilitates exposure to the inner circle of business activity (Useem and Karabel 1986) and helps to open doors and obtain information (Collins 1979)—key ingredients for merger and acquisition (M&A) activity. Executives with MBA degrees—and elite MBA degrees in particular—have also been socialized into what Espeland and Hirsch (1990, 88) have called a "firm-as-portfolio" model of business that assumes MBA executives can manage any type of business. Drawing on these ideas, Palmer and Barber (2001) found that after controlling for an array of other social class indicators (deriving from religious, board, and ownership affiliations), CEOs with elite MBA degrees made more acquisitions than other CEOs.¹⁵ This result is wholly consistent with an earlier study by Palmer, Jennings, and Zhou (1993), which found that companies with CEOs who had MBAs from a small set of elite schools were relatively likely to adopt the multidivisional corporate form (M-form). The authors viewed the M-form as an administrative innovation that diffused through leading-edge social networks of business executives. The executives with elite MBAs created and propagated the convention of the M-form organization.

Finally, two studies provide data on the performance effects of MBAs. In a study of high-technology firms, Hambrick, Black, and Fredrickson (1992) found that companies led by CEOs with MBA degrees were more profitable than those without such CEOs. The authors argued that executives with MBAs tend to confer formalization and control on organizations; in high-technology companies, which can tend toward chaos, these are valuable capabilities. And, with a much broader and larger-firm sample, the Bertrand and Schoar (2003) study discussed above reported a similar result for CEOs.

In sum, when looking at this research stream as a whole, it appears that executives with MBA degrees behave differently from executives without MBA degrees. And, while there is no single pattern of behavior that emerges, several leading tendencies are evident. MBA-educated executives have been schooled in the technology of financial management, and so their investment decisions follow “financial textbook guidelines” (Bertrand and Schoar 2003, 1203; see also Graham and Harvey 2001), and they are prone to engage in diversifying acquisitions (Palmer, Jennings, and Zhou 1993; Bertrand and Schoar 2003). Although acquisitions do not necessarily yield favorable results (Haleblian and Finkelstein 1999), there is some evidence that firms with MBA-educated executives tend to produce better bottom-line results than other firms (Hambrick, Black, and Fredrickson 1992; Bertrand and Schoar 2003). It may be that an MBA degree confers a bundle of skills on executives that are sufficiently valuable in the RBV sense (Barney 1991) to create firm value.

Left unanswered in all this is whether the shareholder maximization ethic of MBA-educated executives affects the firm’s attention to other stakeholders, such as customers, employees, and communities. One can imagine the direction in which stakeholder tradeoffs will be managed by such top executives, and conflict would not be unexpected. Further, to the extent that financial sophistication dominates other concerns (Andrew Fastow, the CFO of Enron, was an extreme case in this regard), would such behavior then have long-term consequences for the firms run by MBA-trained executives? That remains an empirical question.

Another line of thought, first proposed by Hambrick and Mason (1984, 201), argues that the analytic techniques learned in an MBA program are geared primarily to avoiding big losses or mistakes, and that MBA-educated executives tend to be “organizers and rationalizers.” When a clear-cut, unambiguous environmental shift occurs, companies led by MBA-educated executives are relatively likely to respond (Grimm and Smith 1991); and MBA-educated executives inject control into their organizations (Hambrick, Black, and Fredrickson 1992).

In short, these findings suggest that formal education in business is associated with “alert moderation”—strategies that are responsive to clear-cut trends in the environment but that are relatively conformist and tightly controlled. Why might these patterns occur? Because (1) individuals who enroll in MBA programs are, by predisposition, generally risk-averse and conventional; (2) MBA curricula reinforce and enhance risk-aversion and mainstream mind-sets; and (3) executives with MBAs are more likely to be in the social and business elite (Useem and Karabel 1986), in which conformity and conventionality are valued.¹⁶

Proposition 4–25: Firms whose managers have had little formal management education show greater variation from industry performance averages than firms whose managers are highly educated in management.

There is widespread interest, and at the same time cynicism, about the effects of MBA programs on the health and vitality of corporations. Focusing on the executives who have graduated from such programs, while comparing their strategic actions and performance to those who have not, is one potentially promising way of advancing this debate. Attention to

the overall amount of education, and even the specific educational institutions, of executives (Useem and Karabel 1986; D’Aveni 1990) may yield important insights into the origins of strategic choice and performance.

Figure 4.4 summarizes some observed and hypothesized associations among formal education of executives, psychological factors, strategic choice, and organizational performance. As with executive tenure and functional backgrounds, we can say that some important patterns have been established but that their subtleties and the operative mechanisms through which they occur remain important targets for future study.

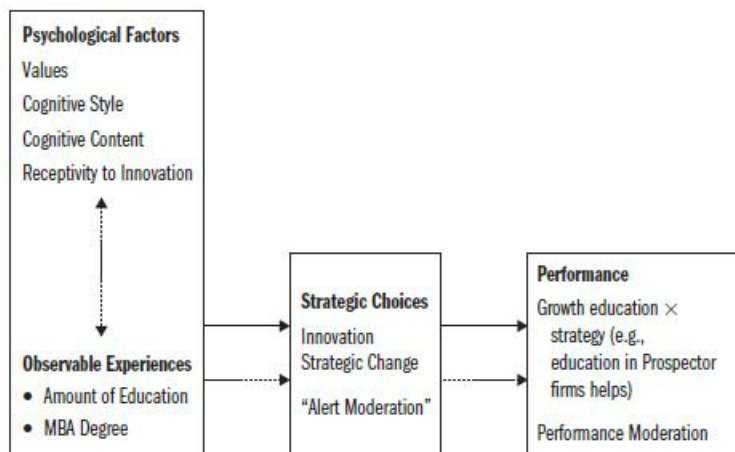


Figure 4.4. Executive Formal Education: Some Observed and Hypothesized Associations

International Experience

Over the past decade or so, there has been a rush of interest in a managerial background characteristic that had previously drawn little attention: international experience. In some ways, this trend is not surprising. With globalization accelerating, emerging markets opening up, and the war for talent heating up, international executive experience has gained great importance to firms (Kim and Mauborgne 1991; Carpenter, Sanders, and Gregersen 2001). Executives with significant international experience are likely to have more understanding of global markets and business practices and are more attuned to opportunities to compete globally than are executives without such experience (Chen and Stucker 1997). Hence, international experience may be related to subsequent strategic choices involving internationalization.

International experience seems to meet at least some of the tests for qualification as a valuable resource in the RBV framework, since such experience is still relatively uncommon for senior executives (Carpenter, Sanders, and Gregersen 2001) (although we would expect this advantage of rarity to be rapidly diminishing); it is hard to imagine what might substitute for the direct experience of working in an international context (Sambharya 1996); managing global environments is among the most complex challenges facing senior executives, making such experience of great value to a firm (Sanders and Carpenter 1998); and the ability to build social capital on an international basis is a source of uniqueness (Daily, Certo, and Dalton 2000). Hence, it may be that the international experience of a firm’s executives helps to create opportunities that may translate into better performance, particularly in those strategic contexts where international experience is highly advantageous.

These ideas have been subject to empirical investigation in a number of studies. In one of the first to explicitly invoke the resource-based view as theoretical rationale, Roth (1995) argued that a CEO's functional and international experiences were representative of capabilities that were valuable in managing international interdependence. Specifically, he argued that a broad functional background on the part of CEOs facing high international interdependence is advantageous because such contexts create considerable information-processing challenges that narrower functional perspectives are ill-suited to manage (Galbraith 1973; Michel and Hambrick 1992). Further, he suggested that CEO international experience is helpful in managing international interdependence. In his sample of seventy-four CEOs of medium-sized firms in global industries, Roth (1995) did not find a main effect for international experience or functional background on firm performance. But, in line with his theorizing, he did find that international experience in firms with a high degree of international interdependence was positively related to firm performance.

Two other studies tested the international experience–firm performance relationship. Daily, Certo, and Dalton (2000) found support for this direct relationship, but they also found that the relationship was even stronger for the most highly internationalized firms. In their large sample of *Fortune* 500 firms, these authors measured each executive's international experience as the number of international assignments and total years in such assignments.

Similarly, Carpenter, Sanders, and Gregerson (2001) found that the number of years that a CEO reported working in international assignments was positively related to two measures of firm performance, and that the interaction of CEO international experience with top management team international experience and with global strategic posture (a composite measure of internationalization of a firm's strategy) were both positively related to firm performance. These authors tested whether measuring international experience by including the number of countries and length of experience an executive had in each country yielded different results, but these alternatives did no better than the simpler measure. Examining alternative measures of international experience was a positive feature of this study; subsequent work may wish to extend this to include consideration of the specific origin of such experience (e.g., which countries or regions), the functional specialization associated with the international experience, and the breadth of industry experience across these and other attributes.

Other studies have examined the more intermediate relationship between international experience and global strategy. In a study of fifty-four U.S.-based multinational corporations, Sambharya (1996) found that the international experience of top management teams was positively related to international diversification. Reuber and Fischer (1997) found in their sample of small Canadian firms that international experience was related to the likelihood of entering into international partnerships. And, in a study by Carpenter and Fredrickson (2001), top management team international experience was positively related to a composite measure of global strategic posture (foreign sales, foreign production, and geographic diversity).

Future Directions

The fundamental idea that executive dispositions will be reflected in organizational outcomes is clearly bearing fruit. The past twenty-five years have seen a steady accumulation of evidence that the psychological and background characteristics of senior managers affect the choices they make—or at least that executive and organizational characteristics covary. However, we are far from definitive conclusions; considerably more research on these issues is needed. Here, we will identify several high priorities, focusing first on specific thrusts that we see as promising and then describing an integrated perspective that warrants attention.

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Promising Avenues of Research

A Search for Executive Types

The academic field of strategy has benefited immensely from the development of several robust, powerful strategy typologies. The classification systems set forth by Rumelt (1974), Miles and Snow (1978), and Porter (1980) have been particularly useful in allowing strategy researchers to move away from having to examine one strategy variable at a time. Similar typologies of senior level executives are urgently needed if the field of strategic leadership is going to achieve any theoretical parsimony and predictive power.

Typologies rest on the premise that phenomena of interest do not occur in endless combinations, at least not with equal likelihoods (Hambrick 1984). Clearly, this premise would seem to be valid for a population of senior executives. We can reasonably expect that certain combinations of psychological and experience characteristics recur with disproportionate frequency among executives. If these pronounced executive profiles could be identified, research and theory building regarding executive effects on organizations could advance greatly.

In the early 1980s, some executive typologies were set forth. For example, Wissema, Van der Pol, and Messer (1980) described six types of managers (e.g., “Pioneer,” “Administrator,” “Economizer”) and proposed their appropriateness for different strategic circumstances. Leontiades (1982) articulated a different typology, yet, as with the work of Wissema and associates, there was no empirical test of the framework.

Another attempt, grounded in a quantitative analysis of twenty-seven published cases on executive behavior, extracted four major, recurring “leadership patterns”: entrepreneurial, bureaucratic, political, and professional (Shrivastava and Nachman 1989). This is the direction that we would encourage. But, instead of using data on executive behaviors to create the taxonomy or typology, we would go one step back in the causal chain and use data on the fundamental characteristics of the executives themselves (such as their risk orientation, cognitive style, values, tenure in their company, functional background, and education).

To develop such a taxonomy will require far-ranging data on a sizable cross section of senior executives. Such an undertaking may be possible only for certain research groups that have in-depth, psychometric access to large numbers of executives from diverse settings. The Center for Creative Leadership and major university executive programs are sites where such research might be done. Until we have the analytic parsimony provided by typologies, we must resign ourselves to relatively piecemeal and fragmentary examinations of executive characteristics.

Causality

One cannot possibly read this chapter on executive and organizational covariation without wondering about the direction of causality. While all the work we review here focuses specifically on the effects of managerial characteristics on firm outcomes, [chapter 5](#) (which surveys determinants of top management team characteristics) and [chapter 6](#) (which surveys determinants of CEO successor characteristics) will review research that models a reverse causality. The fact that there are research streams in each of these areas speaks to the complex temporal interaction of executive and organizational attributes. We recognize the challenge and reality of two-way causality, and we believe there is a need for an integrative theory that can model the dynamic nature of the covariation between executive and organizational characteristics. Over time, a reinforcing spiral probably occurs: managers select strategies that mirror their beliefs and preferences; successors are selected according to how much their qualities suit the strategy; and so on.

To date, relatively few upper-echelons studies have been designed in a way as to allow convincing conclusions about causality. This must be a high priority going forward, and it can be accomplished through careful research designs and data analysis. Longitudinal designs using cross-lagged correlations, change scores (or first-difference scores), controls for prior states, and simultaneous equation modeling are among the means that researchers must adopt if they are to shed clearer light on the degree to which executive characteristics give rise to organizational characteristics, as opposed to the reverse.

Moderators and Mediators

This chapter has reviewed abundant research on the effects of executive experiences on strategic choices and firm performance. Some of this work has gone beyond straight main effect hypotheses, and this is clearly the right direction for future research. In fact, we believe some of the most exciting work in this arena will come from studies that extend upper-echelons theory to more fully explain executive effects. We have already touched on several key moderators—managerial power, managerial discretion, technological and environmental dynamism, and executive job demands.

Beyond moderators, there are mediators of importance as well. A mediator is an intervening mechanism between an independent and dependent variable. For example, Cho and Hambrick (2006) found that managerial characteristics will be reflected in strategy to the extent that they are first reflected in managerial attention.

More generally, it is essential to point out that the gulf between executive characteristics and organizational outcomes is huge. First, an executive's background characteristic (say, tenure) needs to be reflected in his or her preferences or cognitive biases about alternative actions. Those preferences must then be converted to choices (which means that incentives, power dynamics, and governance issues are relevant mediators or moderators). Then the choices must be executed (processes, politics, and implementation issues are relevant mediators or moderators). For this whole chain to then yield beneficial results for the firm, there must be a fit with the demands of the environment and the capabilities of the organization. Research on executive characteristics¹⁷ should begin to address these intervening factors; in some ways, this is the real "black box" that researchers must start to crack.

A Still-Untapped Perspective: The Factors Affecting the Predictive Strength of Executive Characteristics

The central idea of this chapter, indeed of the entire book, is that executives make choices on the basis of their own highly personalized interpretations of problems, options, and outcomes—and hence, that the organization becomes a reflection of its top managers. Readers familiar with the social psychology literature will recognize our emphasis on individual "dispositions" as predictors of behavior. So, too, will these readers recognize that many social psychologists place far greater weight on situational factors in affecting human behavior. Indeed, during the latemiddle part of the twentieth century, the dispositional paradigm was in utterly low repute, regarded as somewhat atheoretical and, in any event, simply not yielding very strong predictions of human behavior.

More recently, however, social psychologists have focused more on the middle ground—an "interactionist" perspective, in which dispositional and situational factors operate in tandem to determine behaviors (Weiss and Adler 1984; Snyder and Ickes 1985). The role of individual dispositions has been rehabilitated, and now the critical question addressed by

many social psychologists is not whether one view or the other is correct, but rather, when is each more correct? This perspective stems from Kurt Lewin's seminal proposition that "every psychological event depends upon the state of the person and at the same time on the environment, although their relative importance is different in different cases" (1936, 12).

Walter Mischel's concept of "situational strength" (1968) was one of the major breakthroughs in identifying the circumstances under which dispositional versus situational factors prevail as predictors of behavior. However, other factors that affect the predictive strength of situation versus dispositional also have been examined by scholars interested in this debate. Indeed, in an exhaustive review of the "interactionist" framework, Snyder and Ickes (1985) proposed that the relative predictive strengths of dispositional and situational factors in social behavior hinge on these matters:

- Which traits (dispositional characteristics)?
- Which behaviors?
- Which people?
- Which situations?

If strategic leadership scholars are similarly interested in comprehending the conditions under which executive characteristics are most predictive of strategic choices, more attention must be paid to the questions raised by Snyder and Ickes. So far, the only significant attempt to adopt the interactionist perspective in research on executive leadership is the concept of executive discretion, or latitude of action, discussed at length in [chapter 2](#). However, we believe Snyder and Ickes's (1985) analysis provides an excellent point of departure for considering a wider set of forces that will affect the ability of strategic leadership researchers to use executive characteristics to make significant predictions. Our purpose in proposing these factors is not so that researchers may "stack the deck," always examining conditions that favor the effects of executive characteristics, but rather so that scholars may finally start to understand the subtleties of executive effects on organizations.

In addressing Snyder and Ickes's questions in the context of strategic leadership research, we focus predominantly on executive demographic factors as possible predictors of executive choices and organizational outcomes, both because demographic factors have a prominent place in research on executives and because these factors are not directly addressed by Snyder and Ickes. Our line of argument also applies to the use of psychological constructs (e.g., personality) as predictors of behavior, which was the domain that Snyder and Ickes addressed. We must acknowledge that much of our discussion is speculative, because as just noted, very little executive leadership research or theory has adopted the interactionist model.

Which Traits?

Social psychologists have found that some individual traits, as measured by psychological instruments, are more predictive of behaviors than are others and that some traits are manifested more consistently than others. The same can be expected for executive demographic characteristics: some may provide stronger predictions of strategic choices than others. Take the case of an executive's tenure in an industry. It is reasonable to expect that tenure in a highly concentrated, homogeneous industry would be more strongly associated with commitment to the status quo and strategic conformity to industry norms than would tenure spent in a more heterogeneous and dispersed industry. Two reasons could account for this. First, the homogeneous industry has a strong, shared conventional wisdom and widely held "recipes" (Huff 1982; Spender 1989; Sutcliffe and Huber 1998) that have become part of

the entrenched belief system of executives who have been a part of the industry for a long time. Second, and following directly from the first reason, executive tenure in the homogeneous industry is simply a more reliable proxy, a more telling indicator, of executive experiences than is tenure spent in a more diffuse industry.

Similar differences between other demographic experiences can be expected. For example, tenure spent in an organization with a strong culture will be more predictive of executive psychology and behavior than tenure spent in an organization with a weak culture. As for functional experience, it may be that certain functions have very strong professional norms and shared values, serving to homogenize the outlooks and predispositions of individuals who have been members of those functions. In contrast, other functions may exert far less socialization and homogenization. For instance, it may be that long experience in accounting is more predictive of an executive's outlook and behavior than, say, experience in marketing. Gupta and Govindarajan (1984) found that the number of years that general managers had spent in marketing and sales was marginally positively related to executive tolerance for ambiguity. It may be that if they had measured years spent in some other function, say accounting, they would have observed far stronger relationships (although, with accounting, possibly a negative sign). Differences might also be expected between various types of educational experiences. In short, the ability to predict executive choices from background characteristics may vary widely, depending on the specific background factor being considered.

Which Behaviors?

Not all behaviors are equally amenable to prediction, and certainly not from a given executive characteristic. As Snyder and Ickes (1985) discussed, aggregations of acts are easier to predict than are single acts. This, of course, is a fundamental axiom of construct reliability. Interestingly, it was a focus on single acts in experimental settings that contributed to social psychologists' early conclusions that dispositions do not account for much variance in these acts. As soon as the experimenters moved to an examination of multiple or aggregated tasks, they encountered greater predictive strength, primarily because of increased reliability of the criterion measure.

For the most part, researchers of executive leadership tend to focus on aggregated acts or outcomes. For instance, diversification strategy, levels of innovation, even R&D spending all represent numerous managerial choices. However, researchers are occasionally tempted to study single decisions or acts; when they do so, they must anticipate reduced predictive power. For instance, studies attempting to predict discrete choices—for example, whether a firm will make an acquisition or not, whether a firm will pay greenmail or not, or whom a CEO will pick as his or her successor—may face long odds in terms of the likelihood of generating strong results.

A behavior is also predictable from an executive characteristic to the extent that the behavior is "prototypical" of what the trait is theoretically expected to engender. For example, it might be tempting to consider CEO experience in R&D as generally predictive of organizational innovation. However, it is probably the case that a CEO's experience in R&D is a strong predictor of R&D spending, a moderate predictor of a firm's adoption of competitors' innovations, and a very poor predictor of adoption of administrative innovations. These organizational outcomes—tapping different aspects of innovation—vary in how prototypical or central they are to the executive orientation engendered by experience in R&D.

Which People?

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Are there some executives who vividly and regularly manifest their background characteristics in their actions and others who simply do not? If so, can we analytically distinguish between them? Snyder and Ickes (1985), in addressing this issue for social psychological research in general, invoked the concept of “self-monitoring,” the tendency to comprehend and regulate one’s behavior in the context of specific situational cues. High self-monitors, Snyder and Ickes argued, are responsive, or sensitive, to the specific context; low self-monitors act more blithely on the basis of their values, personality, and inherent beliefs.

We can reasonably expect that executives, too, vary in their self-monitoring tendencies and that this variation will cause differences in the degree to which their personal dispositions appear in their decisions. For example, in the resource allocation process, low self-monitor CEOs may be inclined to favor the functional area in which they rose. This is a phenomenon observed in many companies, and it reflects the basic logic from the upper-echelons perspective. In contrast, high self-monitor CEOs may be very alert to their natural tendency to treat their old home function favorably, and that doing so exposes them to complaints about favoritism; under high self-monitors, the home function may not receive disproportionate resources (and in extreme acts of self-monitoring, the home function might even receive less than its due share).

Executives might also vary in how much they value rationality and fact-based decision making, causing them to differ in how much they allow their *other* biases and dispositions to affect their choices. In their discussion of executive values, Hambrick and Brandon (1988) posited that an executive who strongly values rationality strives to gather and evaluate facts, perhaps taking in a wide array of viewpoints, and thus may be relatively unlikely to act primarily on the basis of past experience and preference. Although executives as a whole may tend to place a high value on rationality, they almost certainly are not uniform in this regard. By considering executive belief in rationality, self-monitoring, and yet other unspecified factors, we may have a way of understanding why the experiences of some executives are more strongly reflected in their strategic choices than are those of others.

Which Situations?

By manipulating situational characteristics, social psychologists have been able to alter the amount of variance in behaviors due to dispositional factors. Mischel’s (1968) distinction between strong and weak situations is seminal in this regard, with far more dispositional effect observed when the situation is “weak.” It is because strategic situations faced by senior executives are generally weak—complex, ambiguous, with many interpretations and information overload—that research regarding executive effects on organizations has consistently yielded significant results and is a promising avenue of inquiry. However, strategic situations may vary widely in how strong or weak they are, and researchers should be aware of this, both for reasons of theory and research design.

A weak situation is unstructured and without clear means-ends causal connections, and it is here that executive effects will be most pronounced. For instance, an executive’s choices in a very heterogeneous industry, in which firms pursue widely differing strategies, will be more reflective of his or her characteristics than choices made in a homogeneous industry. In the latter, the “correct pathway” to organizational effectiveness is apparent, even if only by convention.

Conclusion

One of the key conclusions that emerges—not just from this latter section on the importance of situational context in identifying when managerial characteristics will be particularly predictive of organizational outcomes, but from the entire chapter as well—is that we must return to the concept of discretion as a pivotal way of viewing strategic situations. In a high-discretion situation—one in which the environment and organization confer wide latitude of action—executive characteristics are likely to be reflected in organizational choices. In situations of low discretion—in which there are constraining forces or simply strong convictions about means-ends connections—executive dispositions do not correspond much with strategic choices.

The study of strategic leadership will advance not simply by searching for evidence of executive effects on organizations, but rather by isolating the conditions under which those effects are great or small. In doing so, researchers will not only aid each other's efforts in theory refinement and establishment of appropriate research designs; they also will contribute to eventual practical implications in the arenas of executive selection, succession, evaluation, and rewards.

5

Top Management Teams

Although the pyramid headed by an all-powerful individual has been a symbol of organizations, such omnipotence is possible only in simple situations where perfected technologies and bland task environments make computational decision processes feasible. Where technology is incomplete or the task environment heterogeneous, the judgmental decision strategy is required and control is vested in a dominant coalition.

(Thompson 1967, 143)

One of the most enduring ideas in organization theory is that environments impose constraints on individuals (Lawrence and Lorsch 1967), making it exceedingly difficult for any one person to control all aspects of organizational life. The conditions for omnipotence noted by Thompson (1967) are rare, for they imply the absence of decision-making uncertainty. Rather, given the great ambiguity and complexity inherent in strategic decision making (Mintzberg 1973), the formation of a coalition at the top is more plausible. As a result, when modeling how strategic leaders make strategic decisions, it seems that we are “left with something more complicated than an individual entrepreneur” (Cyert and March 1963, 30).

Scholars have been drawn to the study of top management teams (TMTs) for five main reasons. First, as an aggregation of subunits and individuals, organizations have multiple goals that are often in conflict (Cyert and March 1963; Weick 1979b). The existence of these multiple goals, and hence of multiple preferences, at the top of organizational hierarchies is likely to affect how organizations strive toward organizational outcomes, as well as the characteristics of those outcomes. Second, almost all descriptions of strategic decision-making processes typically emphasize the relevance of stages, sequences, and processes that involve a group of top managers interacting toward desired ends (Pettigrew 1973; Mintzberg, Raisinghani, and Theoret 1976; Nutt 1984; Roberto 2003). Indeed, the top management team is at the strategic apex of an organization (Mintzberg 1979); it is the executive body most responsible for strategic decision making and, by extension, for such fundamental organizational outcomes as firm strategy, structure, and performance. Third, the interactions among top managers, including power distributions, decision processes and integration, and fragmentation, create outcomes of interest to strategy research.

Fourth, there is clearly some amount of role differentiation in most, if not all, top management groups. For example, Sarbanes-Oxley requires that a chief financial officer, along with the CEO, personally certifies accounting statements prior to sending them to shareholders and filing them with the Securities and Exchange Commission (SEC).¹ Thus, some specific responsibilities of executives other than the CEO have been legally mandated for public companies.

Fifth, and most important, evidence suggests that studying TMTs, rather than CEOs alone, provides better predictions of organizational outcomes (Hage and Dewar 1973; Tushman, Virany, and Romanelli 1985; Finkelstein 1988; Ancona 1990; O’Reilly, Snyder, and Boothe 1993; Tushman and Rosenkopf 1996). For example, in a series of tests of upper-

echelons hypotheses, Finkelstein (1988) reported far stronger results using the TMT, rather than the CEO, as the level of analysis. Other studies have similarly demonstrated that significant variance in organization-level outcomes can be explained by examining the attributes of executives beyond the CEO (Bertrand and Schoar 2003; Reutzler and Cannella 2004; Zhang and Rajagopalan 2004; Bigley and Wiersema 2002).

For these reasons, whether one refers to such groups as dominant coalitions (Cyert and March 1963; Bourgeois 1980), “inner circles” (Thompson 1967; Finkelstein 1992), top management groups (Hambrick 1994), or top management teams² (Bourgeois 1980; Hambrick and Mason 1984; Carpenter, Geletkanycz, and Sanders 2004), there is much to gain from focusing on the relatively small constellation of executives at the top of an organization.

We should acknowledge, however, that the inclination to consider TMTs, rather than just CEOs, is not universal. For example, Hambrick (1994) suggested that many groups of top managers do not act as teams and may interact hardly at all. Similar questions about the examination of teams as an appropriate level of analysis are evident in Carpenter (2002), O’Reilly, Snyder and Boothe (1993), and Simsek, Veiga, Lubatkin, and Dino (2005). Cannella and Holcomb (2005) describe a number of complexities that are introduced when teams are used as the level of analysis in upper-echelons research. Further, Cannella and Holcomb describe several situations in which the team is probably not the appropriate level of analysis. For example, in situations characterized by an autocratic CEO, or a CEO who does not permit open debate and discussion of strategic issues, or situations in which the CEO has a very clear and powerful vision, the team may be relatively unimportant to organizational outcomes. When the influence of the team is muted relative to the CEO, it might be best to simply consider the CEO alone. Perhaps the strongest criticism of focusing on the TMT as the level of analysis in upper-echelons research comes from Dalton and Dalton (2005), who put forth two arguments. First, they believe that the measures and analytical strategies in use at the team level are inadequate, reducing the appeal of the team as the level of analysis. Second, they simply believe that teams are much less important than CEOs and that, absent strong evidence to the contrary, the CEO should be the unit of analysis in upper-echelons research. Despite these doubts and caveats, we believe there is substantial evidence, as noted above, that scholarly attention to TMTs has been and will be fruitful.

Hence, this chapter focuses on TMTs in the context of the strategic decision-making process, and it models the interactions among TMT members as a central construct in that process. Viewed in this way, TMTs present many possible research questions. TMTs are not only a central component in the strategic decision-making process and in postdecision implementation; they may also be viewed as a basic organizational attribute, worthy of exploration in their own right. A dual emphasis, encompassing an interest in both the antecedents and consequences of TMT characteristics, is adopted in this chapter.

We need to note an important matter of scope, however. The strategic decision-making literature is vast and involves numerous sets of relationships among determinants, decision-specific factors, process characteristics, process outcomes, and consequences (Carpenter, Geletkanycz, and Sanders 2004; Eisenhardt and Zbaracki 1992; Rajagopalan, Rasheed, and Datta 1993; Cannella and Holcomb 2005). It is clearly impossible in a single chapter to address each facet of the strategic decision-making process. Rather, our interest is in the role of TMTs in strategic decision making and decision implementation, and more specifically in the nature and effects of social relations among top team members as they develop and implement strategies for their organizations.

The Conceptual Elements of Top Management Teams

Although the term *top management team* is now widely used, it is not uncommon for individual pieces of research to emphasize different aspects of what is, in essence, a multidimensional construct. A top management team has three central conceptual elements: composition, structure, and process. Composition refers to the collective characteristics of top team members, such as their values, cognitive bases, personalities, and experiences. Although these characteristics can be considered in terms of both the central tendency of the team and the heterogeneity of the team, most researchers have focused on the latter.³ In addition, and consistent with [chapters 3 and 4](#), our conceptualization of TMT heterogeneity encompasses both psychological factors (values, beliefs, cognitions) and aspects of executive experiences (age, tenure, functional background, education).

The structure of a top team is defined by the roles of members and the relationships among those roles. Central to this definition is the role interdependence of team members, an important construct that surely has significant consequences for how strategic decisions are made (Michel and Hambrick 1992; Hambrick 1994). We define role interdependence as the degree to which the performance of the firm depends on information- and resource-sharing, as well as other forms of coordination within the TMT. For example, a TMT consisting of heads of functional areas typically has more role interdependence than one made up of heads of autonomous business units. Beyond the nature of executive roles, the actual size of a team is also a fundamental aspect of structure (Merton 1968; Keck 1990).

The third major conceptual element of a TMT is its processes. By processes, we mean the nature of interaction among top managers as they engage in strategic decision making. We limit our focus to two process dimensions: social integration and consensus.⁴ Social integration is defined as “the attraction to the group, satisfaction with other members of the group, and social interaction among the group members” (O’Reilly, Caldwell, and Barnett 1989, 22) and is one of the most studied of process constructs. Consensus within a TMT is “the [extent of] agreement of all parties of a group decision” (Dess and Origer 1987, 313).

All three conceptual elements—composition, structure, and process—are related to the social makeup and interactions of the top team in the process of making strategic decisions. Strategic decisions are not made in a vacuum; rather, they emanate from a group of top managers interacting as social and political creatures. The nature of these interactions and their effects on both strategic decision making and organizational outcomes are of central importance. Beyond the complex set of interactions at the top, strategic decision making is also heavily influenced by activities in the organization and its environment. Hence, we are also interested in the contextual conditions that give rise to particular TMT configurations.

We believe these issues can be best understood by adopting the framework shown in [Figure 5.1](#). At the center of this framework is the TMT, characterized in terms of a set of conceptual constructs: heterogeneity (TMT composition); role interdependence and team size (TMT structure); and social integration and consensus (TMT process). We focus on these constructs, in particular, because they are central to both strategic decision making and social relations within TMTs, and they have been the subject of considerable theoretical interest among scholars for some time. Other aspects of TMTs are certainly important and worthy of study, but the goals of this chapter call for a circumscribed scope.

The framework suggests ways in which each of these facets of TMTs are interrelated. The model also encompasses the effects of contextual conditions on TMTs. These contextual factors include the environment, the organization, and the CEO. Finally, [Figure 5.1](#) shows how TMTs are associated with the strategic decision-making process and the organizational outcomes that arise from this process. A primary goal of this framework is to highlight three

key research questions on TMTs: (1) What is the nature of the interaction within TMTs? (2) How do contextual conditions affect TMTs? (3) What are the consequences of TMTs for both strategic decision making and organizational outcomes? These questions establish the scope of the major sections of this chapter.



Figure 5.1. A Model of Top Management Teams

How the Conceptual Elements of TMTs Are Related

There is a long history of work in social psychology on the composition of groups and the nature of their interactions (Jackson 1992). Much of this research has been conducted on ad hoc “groups” (via lab experiments on college students) or on lower-level employee work groups. However, in recent years, a growing number of studies have directly gauged TMT process constructs using samples of actual TMTs (Glick, Miller, and Huber 1993; Barsade et al. 2001; Athanassiou and Nigh 1999; Bunderson and Sutcliffe 2002; Pitcher and Smith 2001; Chatman and Flynn 2001; O’Reilly, Snyder, and Boothe 1993; Smith et al. 1994; Amason 1996; Amason and Sapienza 1997). Virtually all TMT researchers agree that the dynamics of TMT interaction affect the extent of social integration and consensus, both of which have been conceptually and empirically linked to a wide set of organizational outcomes (e.g., Wiersema and Bantel 1992; Pitcher and Smith 2001; Amason and Sapienza 1997; Amason 1996; Cannella and Holcomb 2005). Unfortunately, team processes are seldom directly measured.⁵ Instead, most researchers simply assume that team demography influences team processes, and that team processes mediate the relationship between team demography and organizational outcomes (Smith et al. 1994; Carpenter 2002; Carpenter and Fredrickson 2001; Richard et al. 2004; Sambharya 1996; Cannella, Park, and Lee 2008).

A large number of potential intervening processes exist between TMT composition and organizational outcomes. For example, the strategic decision-making process has many steps, including generation and evaluation of alternatives, selection, implementation, and evaluation. Before a decision can affect organizational outcomes, it must go through each of these stages⁶—with TMT members interacting throughout the process. A substantial body of work documents linkages between TMT characteristics and outcomes. Our goal in this section is to shed light on some of the intervening processes that define the “black box” in much of this work. We do so by considering interrelationships among TMT composition, structure, and process and by focusing on how these factors affect the strategic decision-making process.

Teams versus Groups

It is at once problematic and self-evident that top management “teams” are really top management “groups.”⁷ It is problematic because virtually all published research on the constellation of executives at the top characterizes these managers as a team, irrespective of whether they are cohesive or cooperative. For example, consider how the executive vice president of marketing in a large firm described the TMT of which he was a member: “Team? How do you define ‘team’? When I think of a team, I think of interaction, a lot of give-and-take, and shared purpose. In our company, we’re a collection of strong players, but hardly a ‘team.’ We rarely meet as a team—rarely see each other, in fact. We don’t particularly share the same views. I wouldn’t say we actually work at cross-purposes, but a lot of self-centered behavior occurs. Where’s the ‘team’ in all this?” (Hambrick 1994, 172).

It is also self-evident that TMTs are really top management groups because virtually all of the underlying theoretical support for proposed relationships on TMTs is based on research on work groups in social psychology. As Jackson notes, “Most of the relevant studies have been conducted by psychologists interested in understanding group processes and group performance. After fifty years of psychological research on groups, a large body of findings has accumulated” (Jackson 1992, 354). Several important conclusions follow: (1) definitions of top management teams or groups need to make clear which executives are included and why; (2) the importance of power dynamics among the group of executives at the top becomes more central; and (3) relationships among different facets of TMTs need to be empirically investigated. We elaborate on each of these points below.

Who Is in the Top Group?

The question of who actually constitutes the TMT⁸ is an interesting and important issue, as evidenced by the surprisingly wide array of operational definitions used in the literature. TMT boundaries take on additional significance, because TMT size is increasingly being examined as a meaningful construct in empirical work (e.g., Haleblian and Finkelstein 1993; Forbes and Milliken 1999; Snow et al. 1996).

The top management team is the relatively small group of executives at the strategic apex of an organization. Hence, a TMT is the group of top executives with “overall responsibility for the organization” (Mintzberg 1979, 24). As simple as this definition appears, there is no consensus among researchers regarding an appropriate operational definition of TMT membership, and definitional concerns have been largely ignored in published research (Roberto 2003; Cannella and Holcomb 2005). Among the different measures used to identify TMT members are: (1) all managers identified by the CEO as belonging to the TMT (e.g., Bantel and Jackson 1989; Glick, Miller, and Huber 1993; O’Reilly, Snyder, and Boothe 1993; Smith et al. 1994; Sutcliffe 1994); (2) inside board members (e.g., Finkelstein and Hambrick 1990; Haleblian and Finkelstein 1993); (3) all managers at the vice-president level and higher (e.g., Wagner, Pfeffer, and O’Reilly 1984; Hambrick and D’Aveni 1992; Michel and Hambrick 1992; Keck and Tushman 1993); (4) the two highest executive levels (e.g., Wiersema and Bantel 1992); (5) all founders of the organization (Eisenhardt and Schoonhoven 1990); and (6) the five highest paid executives (Carpenter, Sanders, and Gregersen 2001; Carpenter, Pollock, and Leary 2003). A few studies have defined the TMT depending on the outcome under study (e.g., Amason 1996; Knight et al. 1999; Smith et al. 1994). (See also Carpenter, Geletkanycz, and Sanders 2004.)

On *an a priori* basis, it is not possible to unequivocally favor one operationalization over another.⁹ Rather, the operationalization used should correspond to the research questions that

guide a particular study¹⁰ (O'Reilly, Snyder, and Boothe 1993; Cannella and Holcomb 2005). For example, it would not be appropriate for most studies to define TMTs in terms of founders, but that might be a suitable definition when studying entrepreneurial firms (Eisenhardt and Schoonhoven 1990; Ruef, Aldrich, and Carter 2003; Watson, Ponthieu, and Critelli 1995).

Also, there is a need to study the sensitivity of findings to different operationalizations of TMTs. The ability to gradually develop more generalizable theory on strategic leadership may be enhanced if results are found to differ systematically according to TMT definition. For example, in a study of TMT demography and organization innovation, Flatt (1992) compared results using alternative definitions of the TMT and found that they differed significantly. (See also Carpenter and Fredrickson 2001; Jensen and Zajac 2004.) Developing varying operationalizations of TMTs in a given data set is often feasible, and thus sensitivity analysis would be possible in many studies. Stronger theory may arise from this type of analysis, for it could enable greater understanding of which executives are influential in a particular setting. Moreover, meta-analysis of research that examines the effects of alternative TMT definitions may be warranted.

The appropriate definition of a TMT may depend on the strategic issue under consideration, with a different set of executives included depending on the issue (Dutton, Fahey, and Narayanan 1983; Roberto 2003; Cannella and Holcomb 2005). Such a "strategic issue processing" perspective assumes that the top decision-making body is not constant (though it may have a handful of stable core members) and implies that the appropriate definition of the relevant group is that set of executives who are most involved in a particular issue (Jackson 1992; Roberto 2003). For example, if we were trying to predict the propensity of a company to increase its investment in R&D, we might consider the relevant decision body to consist of the CEO, CFO, VP of R&D, and VP of marketing, but we would exclude consideration of other executives, such as the VP of human resources and the general counsel. Obviously, such an approach either requires firsthand data about the involvement of various executives in specified decision domains, or it requires some relatively coarse judgments (perhaps aided by expert panels) about the selective involvement of executives in different types of decisions. See Roberto (2003) for a more complete discussion of these issues.

Power Dynamics at the Top

One answer to the question of "Who constitutes the TMT?" is that it consists of those executives with the greatest power to affect the overall strategic direction of an organization. This is precisely the point made by Finkelstein (1992), when he argued that the distribution of power among top executives is usually unequal, and therefore a consideration of power differences may go a long way toward better predictions of TMT effects. Hence, it may make sense to evaluate the power of a wide set of top managers and then focus on the subset that appears most influential. This approach is analogous to Thompson's (1967) concept of the inner circle—the group of individuals with the greatest decision-making influence in an organization.

For example, in a study of 102 companies, Finkelstein (1988) asked top managers to rate the influence of themselves and others within their firms on specific strategic decisions. Using these data, it was possible to gauge the relative power of members of each executive group. Data were collected on a total of 444 top managers, consisting of 283 inside board members and 161 executives who held other top managerial positions but did not sit on the board. The average rating of managerial power for executives who were board members was

13.99,¹¹ while the average score for “nonboard” executives was 9.80, a statistically significant difference ($p < .001$). Even when CEOs were excluded from the analysis (and power scores for other executive board members dropped to 12.00), the difference remained very significant ($p < .001$). Hence, top managers identified a sizable gap between the power of inside board members and other executives, providing support for the use of inside board members as an operational definition of TMT. Since 1992, however, the average number of inside board members has steadily declined, and Sarbanes-Oxley requirements have accelerated this process. Hence, inside board membership is no longer a meaningful criterion to use, but the Finkelstein study highlights more broadly the importance of distinguishing the power differentials within TMTs.

Research on the distribution of power among top managers is important for several reasons. First, and perhaps foremost, power is central to strategic choice (Child 1972; Finkelstein 1992). It is generally well-established that strategic decisions are unstructured and ambiguous (Mintzberg, Raisinghani, and Theoret 1976) and, hence, invite the use of power (Mintzberg 1983b). Numerous examples exist of the important role of power in the strategic decision-making process (Allison 1971; Carter 1971; Pettigrew 1973; Hinings et al. 1974; Bourgeois and Eisenhardt 1988). Second, as we discussed earlier, the distribution of power within TMTs affects which executives are influential and, as a result, the impact of executive experiences and personality on organizational outcomes (Finkelstein 1992; Pitcher and Smith 2001). Finally, studying top managerial power makes clear that TMTs are really groups of individuals—each with their own goals and preferences—and are not necessarily cooperative teams with unitary goals and preferences (Cyert and March 1963).

It is also important to use a broad definition of power and to consider a full range of power sources when measuring the power of TMT members individually. For example, Finkelstein (1992) describes four sources of power: structural, prestige, ownership, and expertise. Of these, structural, prestige, and ownership will tend to be concentrated in the CEO position. For example, when comparing the ownership positions of CEOs and other members of the TMT, both Cannella and Shen (2001) and Reutzler and Cannella (2004) measured the ownership power of heirs apparent and CFOs, respectively. In both cases, ownership power did have significant effects, but the ownership positions of these two very senior executive positions were small relative to those held by CEOs. For these reasons, we expect that expertise power will have the most predictive power among TMT members, though as Bunderson (2003) describes, these effects may be quite complex. Unfortunately, expertise power is more difficult to measure than power deriving from ownership or prestige. Most attempts to examine expertise power have relied on functional backgrounds, as Finkelstein (1992) did, typically by positing an optimal match between functional experiences and strategic contingencies (Carpenter and Wade 2002; Guthrie and Datta 1997; Hambrick 1981a). See Bunderson (2003) for perhaps the most sophisticated measurement strategy.¹²

A study by Pitcher and Smith (2001) focuses on the role of power in affecting the association between TMT attributes and both decision-making processes and organizational outcomes. Using an in-depth case methodology, the authors provide rich insights into the issues of TMT member power and team process. The authors studied the changes in a single organization’s TMT over three eras, with the intent of understanding how TMT heterogeneity influenced both team processes and outcomes. In the first era, the CEO was very participative and held frequent team meetings and open discussions. Members all had some power and influence, and every member’s opinion was sought out. Under these conditions, team member heterogeneity explained intermediate outcomes and organizational performance quite well. In the second era, only the CEO changed, and the new CEO was one of the team

members from the previous era. The new CEO, however, disdained input from TMT members. The only powerful TMT members in the second era were the CEO and his CFO. The new CEO held few team meetings, preferring one-on-one exchanges with executives. TMT members began to avoid visits to headquarters and soon gave up trying to make a difference in strategy, as their opinions and suggestions were ignored or ridiculed. In this second era, *even though the composition of the team was nearly identical to the first era*, the team's heterogeneity did not affect team outcomes or organizational performance. This evidence, though limited, suggests that unless all team members have at least moderate power, team-level heterogeneity will provide few clues to team decisions, intermediate organizational outcomes, or organizational performance.

Another way to interpret Pitcher and Smith would be to assert that the TMT changed considerably in makeup over the first two eras, although the titles and identities of the individuals in senior positions stayed largely the same. In the first era, the team could be described as meeting the basic assumptions of most TMT researchers, as well as Hambrick and Mason's (1984) original conceptualization. That is, the team consisted of a number of senior executives who were influential in determining the strategic direction of the firm. In the second era, however, it could easily be argued that the TMT consisted of only two members—the CEO and his CFO. This interpretation aligns with our discussion of power, but it also illustrates that the CEO may exert a strong influence over who has power among the other executives.

In summary, it seems imperative to consider the relative power of individual executives in the strategic decision-making process (Pitcher and Smith 2001). As Finkelstein has argued:

Power is ... central to research on top management teams. In fact, the choice of unit of analysis in research on top managers and the issue of managerial power are two sides of the same coin. That is, adoption of a unit of analysis rests on an implicit assumption about the distribution of power among top managers. For example, in an organization in which the CEO wields dominant power, studying only the CEO may provide sufficient information with which to test propositions. However, in organizations in which power is less polarized, consideration of a coalition of top managers is necessary to fully capture the range of managerial orientations prevailing. Hence, consideration of the distribution of power among top managers seems an essential ingredient for research on top management teams. (1992, 505)

We now turn our attention to the dynamics of TMT interactions. In particular, we consider how TMT composition, structure, and process are interconnected and how the distribution of power within TMTs affects these important facets of executive interaction. While the first part of our analysis leaves the role of power to the side so we can more easily crystallize the relevant research on TMT composition, structure, and process, this choice in exposition should not be construed as indicating that power can be omitted from conceptual and empirical work on this topic. We return again to this point shortly.

Interactions within TMTs

Figure 5.2 elaborates on Figure 5.1 by depicting relationships among TMT composition, structure, and process. In this section, we develop the rationale for the associations proposed by drawing on work in social psychology, organizational demography, and strategic management. Because much of the relevant research comes from conceptual articles or empirical studies based on samples of people who are not executives, these ideas constitute unfinished business for a research agenda on strategic leadership.

To help understand how senior executives interact as a group, it is useful to carefully consider one of the most studied facets of TMTs—demographic heterogeneity. Referring to the extent to which TMT members have had a wide variety of experiences, demographic heterogeneity is one of the most studied characteristics of TMTs, though it remains among the most ambiguous. Its popularity among researchers is owed to a fair degree to the accessibility, objectivity, and reliability of demographic data (Hambrick and Mason 1984), but critics have questioned the underlying meaning of such data (e.g., Smith et al. 1994; Lawrence 1997; West and Schwenk 1996; Priem, Lyon, and Dess 1999).

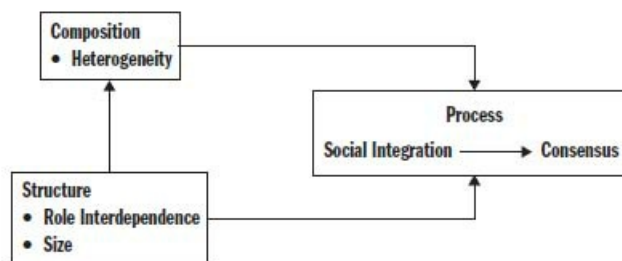


Figure 5.2. Top Management Team Interaction

At one level, demographic heterogeneity may be seen as a proxy for cognitive heterogeneity (Hambrick and Mason 1984), representing innovativeness (Bantel and Jackson 1989; Murray 1989), problem-solving abilities (Nemeth 1986; Hurst, Rush, and White 1989), creativity (Triandis, Hall, and Ewen 1965; Shaw 1981; Wanous and Youtz 1986; Bantel and Jackson 1989), diversity of information sources and perspectives (Jackson 1992; Geletkanycz and Hambrick 1997; Wiersema and Bantel 1992; Sutcliffe 1994; Carpenter 2002; Carpenter and Fredrickson 2001; Sambharya 1996), openness to change (Katz 1982; Dutton and Duncan 1987; Virany, Tushman, and Romanelli 1992; Glick, Miller, and Huber 1993; Bertrand and Schoar 2003), and willingness to challenge and be challenged (Hoffman and Maier 1961; Sorenson 1968; Janis 1972; Gladstein 1984; Eisenhardt and Schoonhoven 1990). Although it is often argued that these positive features lead to superior organizational performance, for now we restrict ourselves to a more limited proposition:

Proposition 5–1A: The greater the demographic heterogeneity within TMTs, the greater the cognitive heterogeneity within TMTs.

Alternatively, there is also considerable support for the idea that demographic heterogeneity has drawbacks for team functioning, reducing social integration within TMTs (and by implication group and organizational performance), increasing conflict (Amason 1996; Amason and Sapienza 1997; Ferrier 2001; Williams and O’Reilly 1998; Simons, Pelled, and Smith 1999; Schmidt 1974; Chatman and Flynn 2001; Reed 1978; Pfeffer 1981a; Deutsch 1985; Nemeth and Staw 1989; O’Reilly, Snyder, and Boothe 1993; Barsade et al. 2001), increasing coordination costs (Pfeffer 1983; Smith et al. 1994), reducing communication frequency (Roberts and O’Reilly 1979; Bunderson and Sutcliffe 2002; McCain, O’Reilly, and Pfeffer 1983; Wagner, Pfeffer, and O’Reilly 1984; O’Reilly, Caldwell, and Barnett 1989; Zenger and Lawrence 1989; Stasser 1993), reducing attentional focus (Bertrand and Schoar 2003; Cho, Hambrick, and Chen 1994), and reducing group

identification and cohesiveness (Lott and Lott 1965; Zander 1977; Ancona and Caldwell 1992; Michel and Hambrick 1992).

Despite these arguments for negative effects from TMT heterogeneity, studies have varied somewhat. For instance, research by O'Reilly and colleagues (1993) is supportive; a study by Glick, Miller, and Huber (1993) reports mixed results; and research by Smith and colleagues (1994) is not supportive. Further, two other issues arise and can be quite important. First, while diversity negatively impacts team process early in the team's life, the negative effects appear to decline over time, as norms for group interaction become established (Chatman and Flynn 2001). Therefore, the life stage of the group under consideration may have important implications for the effects of team heterogeneity on team functioning.

Second, research has been widely inconsistent in how group-level heterogeneity has been conceptualized and measured (Bunderson and Sutcliffe 2002). Future research will need very careful conceptualization and measurement if we are to develop a better understanding of the effects of group-level diversity (Harrison and Klein 2007). (See also Cannella, Park, and Lee 2008; Ferrier 2001; Carpenter, Geletkanycz, and Sanders 2004; Polzer et al. 2006.) Thus, the question of how demographic heterogeneity affects social integration remains an open one. But this is the most promising proposition:

Proposition 5-1B: The greater the demographic heterogeneity within TMTs, the less the degree of social integration within TMTs.

The theory behind cognitive heterogeneity and social integration imply that they should be negatively associated as well. Indeed, social integration is facilitated when group members are more similar (Byrne 1961; Chatman and Flynn 2001; Pfeffer 1981a), while many of the effects of demographic heterogeneity, such as greater diversity of perspectives and willingness to challenge others (Eisenhardt and Schoonhoven 1990; Amason 1996; Barsade et al. 2001; Glick, Miller, and Huber 1993), can create conflict that detracts from team cohesiveness and social integration. Hence, we propose the following:

Proposition 5-1C: The greater the cognitive heterogeneity within TMTs, the less the degree of social integration within TMTs.

Most research that links TMT heterogeneity to factors such as social integration relies upon fixed characteristics of executives, such as race and gender (Chatman and Flynn 2001; Richard et al. 2004; Westphal and Milton 2000), personality (Barsade et al. 2001; Peterson et al. 2003), functional background (Chattopadhyay et al. 1999; Cronin and Weingart 2007), experience (Carpenter and Fredrickson 2001; Sambharya 1996; Richard et al. 2004; Tihanyi et al. 2000; Carpenter, Pollock, and Leary 2003) or co-location (the extent to which the members are physically located near each other) (Cannella, Park, and Lee 2008; see also Carpenter, Geletkanycz, and Sanders 2004; Polzer et al. 2006). However, there are also some sources of heterogeneity that are more time-dependent or context-dependent. For example, as the incumbent CEO nears retirement age, members of the TMT may begin to compete with each other as each strives to be selected as the next CEO (Vancil 1987). The selection of an heir apparent may reduce this competition somewhat (Cannella and Shen 2001); but even in the presence of a clear heir apparent, team members are still likely to compete for favorable positions following the expected change in leadership. Thus, friction among TMT members should be expected in the succession context (Shen and Cannella 2002a), and it seems natural to expect that this friction will spill over into team processes. This remains a fertile area for future research.

Demographic (and cognitive) homogeneity and social integration may increase TMT

consensus. Homogeneous teams develop greater cohesiveness over time (Pfeffer 1983), which promotes greater agreement about the organization and its goals (Tushman and Romanelli 1985). Hence, consensus is formed, as TMT members are able to coalesce around a shared understanding of what the organization seeks to accomplish (Dutton and Duncan 1987; Wiersema and Bantel 1992) and members establish norms of interaction (Chatman and Flynn 2001). To the extent that TMT homogeneity promotes a “dominant logic” (Pahalad and Bettis 1986) among a group of top managers, consensus is more likely (Dess and Keats 1987). Shared understandings are also engendered through cooperation, frequent communication, and group identification, all of which are attributes of socially integrated groups (Lott and Lott 1965; O’Reilly, Caldwell, and Barnett 1989). Finally, TMT heterogeneity may weaken consensus on goals and perceptions (Cyert and March 1963; Bunderson and Sutcliffe 2002; Richard et al. 2004; Snow et al. 1996; Grinyer and Norburn 1975; Bettenhausen and Murnighan 1985; Bourgeois 1985; Priem 1990; Amason and Schweiger 1992). In all, TMT consensus is expected to be positively related to TMT homogeneity and integration.¹³

Proposition 5–1D: The greater the heterogeneity within TMTs, the less the degree of consensus within TMTs.

Proposition 5–1E: The greater the social integration within TMTs, the greater the degree of consensus within TMTs.

The number of individuals within a TMT (its size) is also expected to affect cognitive heterogeneity, social integration, and consensus for many of the same reasons already discussed. To some extent, this may be definitional, because the larger the team, the stronger the likelihood that executives will be demographically heterogeneous (Haleblian and Finkelstein 1993). Nevertheless, we can add two more rationales: (1) larger groups have greater capabilities and resources upon which to rely in the strategy-making process (Hambrick and D’Aveni 1992; Haleblian and Finkelstein 1993), increasing the variety of perspectives that they can bring to a problem and thus promoting greater cognitive heterogeneity but less consensus at the top; and (2) larger groups create coordination and communication problems that smaller groups do not have (Blau 1970; Shaw and Harkey 1976), curtailing member cohesiveness, cooperation (Wagner 1995), social integration (Shaw 1981), and consensus (Shull, Delbecq, and Cummings 1970).

Proposition 5–1F: The larger the size of TMTs, the greater the degree of cognitive heterogeneity within TMTs.

Proposition 5–1G: The larger the size of TMTs, the less the degree of social integration within TMTs.

Proposition 5–1H: The larger the size of TMTs, the less the degree of consensus within TMTs.

Recently, evidence and theory has pointed to the role that TMT tenure can play in team processes. For example, Chatman and Flynn (2001) demonstrated that after a few months of working together, norms of interaction become established, reducing conflict and friction even in very diverse teams. However, while most studies of TMT tenure consider the average tenure across members (Carpenter, Geletkanycz, and Sanders 2004), there are reasons to expect that the tenure of the most recent addition to the team might also be important. Team situations characterized by several long-tenured members and fewer short-term members has

long been known to cause interpersonal friction and conflict (Wagner, Pfeffer, and O'Reilly 1984). Even one or two very short-tenured members might be enough to disrupt team norms of functioning, especially if those members are high-ranking (say the CFO or COO). Future research should consider the implications of adding a single new member to a team (e.g., Tushman and Rosenkopf 1996) and should especially consider the implications of the new member or members for established norms and patterns of interaction. If one new member can disrupt the established norms of interaction (which seems likely), then the tenure of the most recent addition might be much more informative than average team tenure.

Although we draw on research in social psychology to develop propositions on the interrelationships among TMT characteristics, there are important differences between TMTs and other groups. Indeed, one of the problems in interpreting the meaning of TMT heterogeneity is that researchers often tend not to specifically describe how top management groups are different from other groups (upon which much of the supporting literature on TMT heterogeneity typically cited is based).¹⁴ Perhaps of greatest importance is the role of power in TMTs (Keck 1990; Pitcher and Smith 2001; Finkelstein 1992; O'Reilly, Snyder, and Boothe 1993). In contrast to most work groups, one of the major functions of TMTs is to direct the behavior of others, an activity that both generates and uses power for each executive. In addition, top managers are expected to have a functional impact on organizations (Mintzberg 1979); but without the power to make decisions and direct others, they are unable to do so. Hence, it seems particularly important to incorporate power in models of TMT interaction. Nevertheless, such a focus is rare in the literature to date.

One of the most promising efforts along these lines has been the work of Eisenhardt and Bourgeois (1988). Through interviews and surveys, these authors investigated the "politics of strategic decision making" in eight microcomputer companies, developing a series of propositions on power and politics within TMTs. For example, they linked power and politics to TMT centralization, coalition formation, and demography. Unfortunately, their ideas have yet to be formally studied in any large-scale empirical investigation.

We suggest a different perspective on power in TMTs, which builds on research by Finkelstein (1992). He suggested that research on TMTs requires a "recognition of the role of power in strategic choice and a means of incorporating power" if stronger predictions of executive effects are to be found (1992, 532). The basic logic of this approach can be applied to TMT interaction. For example, the effects of TMT heterogeneity on TMT process should be stronger when the relative power of each top manager is taken into consideration. In a typical test of TMT heterogeneity, the dispersion of an attribute among different executives (such as tenure or tolerance for ambiguity) is calculated for the overall group. The impact of each executive on the top team is considered equal to that of any other executive, when in fact this seems unlikely (Mintzberg 1979; Finkelstein 1992; Cannella and Holcomb 2005). Because CEOs are generally more influential than others, an accurate assessment of the real level of heterogeneity in a TMT should take this into consideration. Additionally, the CEO's role in establishing and maintaining team processes seems critical to future research on TMT heterogeneity (Pitcher and Smith 2001; Cannella and Holcomb 2005). Virtually all of the research linking TMT heterogeneity to team process and/or organizational outcomes assumes that the team meets, thinks, and acts like a team. However, as we have noted, this assumption needs to be substantiated. Relatedly, the CEO's leadership style will be very important to team processing. If the CEO does not encourage open debate, is autocratic, or does not tolerate dissent, then TMT heterogeneity would seem largely irrelevant.

Power issues are not limited to CEOs. In many situations, managers with particular expertise, prestige, or ownership position may be more powerful (Finkelstein 1992; Roberto 2003). For example, when decisions regarding financial policy are considered, the CFO's role

(or power) in the decision is likely to be enhanced (Reutzler and Cannella 2004), and similar effects can be expected to the extent that there is role differentiation among TMT members (Cannella and Holcomb 2005; Roberto 2003). Further, as illustrated by Pitcher and Smith (2001), sometimes only one or two TMT members have any real influence. In situations such as these, taking the coefficient of variation of tenure within a TMT and suggesting that this accurately assesses the heterogeneity of that team is potentially misleading. The most powerful managers have the greatest impact on strategic choices (Child 1972), and thus it seems important to factor this into the analysis of TMT interaction.

One way to do this is to measure the relative power of each member of a TMT and adjust the demographic or cognitive makeup of the team by weighting each executive's characteristics by his or her power before computing heterogeneity measures. Such an analysis would yield more precise (and accurate) measures of heterogeneity and would perhaps help establish more consistent and stronger relationships between TMT composition, structure, and process than has been evident in the literature to date. The following proposition is representative:

Proposition 5–1I: The effects of TMT heterogeneity on other characteristics of TMTs are stronger when the relative power of each member of the TMT is factored into the computation of heterogeneity.

The CEO and Team Process

The CEO plays an important role in team processes in several ways. First, as noted above, the CEO sets the stage for the team's interactions. If the CEO encourages open discussion and dispute resolution and treats the TMT as if it is a central component of both strategy formulation and strategy implementation, then team processes will be enhanced. By enhanced, we mean that team processes will approach what are commonly believed to be those that lead to effective functioning—broad consideration of alternatives, widespread information gathering, effective dispute resolution, and the development of strong commitment to the decisions made (Cannella and Holcomb 2005; Pitcher and Smith 2001). Second, if the CEO has a strong vision for the company and communicates that vision effectively to TMT members, then decisions and actions will come to be framed by that vision. In this setting, there will be less comprehensive consideration of strategic issues, and those issues noticed and acted upon are likely to be directly related to the CEO's vision. Additionally, issues raised for reasons peripheral to the vision are likely to be framed in the words and terms of the vision, in order to gain CEO support for action (Cannella and Holcomb 2005). Finally, the CEO's degree of charisma will have an important impact on team functioning (Waldman and Yammarino 1999), as charismatic CEOs are able to secure extraordinary effort and commitment from their followers, especially through direct reports. The research on charisma is highly relevant for scholars who seek to understand TMT dynamics (Klein and House 1995; House, Spangler, and Woycke 1991; Colbert et al. 2008; Ling et al. 2008).

In summary, significant interrelationships exist among the major facets of TMT interaction. Although they are sometimes recognized in the literature, we believe it is important to make these associations explicit. We have suggested several basic propositions that, with a few exceptions, have not been directly tested in an empirical setting. In addition, the idea that power is central to processes within a TMT is generally accepted but has seen only limited application in published research (e.g., Eisenhardt and Bourgeois 1988; Carpenter and Sanders 2002; Pitcher and Smith 2001). Armed with this understanding of the nature of TMT interaction, we are now in a position to analyze both the determinants and

consequences of TMTs. We turn first to the contextual conditions that help explain TMT characteristics.

Determinants of TMT Characteristics

Contextual conditions arising from environmental, organizational, and CEO factors may have pervasive effects on TMTs. In fact, there is a real “need to treat team characteristics as a dependent variable—why do teams look the way they do?” (Pettigrew 1992, 176). Hence, in this section, we develop propositions on how contextual conditions affect TMTs. Although research on the major contextual conditions we focus on is abundant, relatively little of this work has been specifically directed toward TMTs.

Environment

An organization’s environment constrains and shapes activities and behaviors within the boundaries of the firm (Duncan 1972; Aldrich 1979; Dess and Beard 1984). Research has indicated the pervasiveness of environmental effects by showing how they affect such major facets of organizational life as strategy (Porter 1980; Miller, Droge, and Toulouse 1988), structure (Lawrence and Lorsch 1967; Keats and Hitt 1988), organizational processes (Rajagopalan and Finkelstein 1992), and firm performance (Hannan and Freeman 1977). Although few studies have directly examined how TMTs are shaped by environmental influences, such forces likely are important here as well. To help guide our discussion, we consider three fundamental dimensions of the environment: complexity, instability, and munificence (Dess and Beard 1984). Environmental complexity refers to the number of environmental factors that impinge on an organization (Thompson 1967); environmental instability is defined by the rate of change in these factors (Thompson 1967); and environmental munificence refers to the extent to which the environment supports sustained growth (Starbuck 1976). We now consider the effects of each of these dimensions on TMTs.

Environmental Complexity

Organizations in complex environments are typically confronted with conflicting demands from multiple constituencies (Thompson 1967). Managing each of these stakeholders may require a different set of skills or competencies that force organizations to develop greater structural differentiation to cope (Pfeffer and Salancik 1978). As Gupta asserts, by drawing from Lawrence and Lorsch (1967) and Arrow (1974), “The more diverse an organization’s environment, the more necessary it becomes to have a differentiated top management team in order to appropriately monitor the diversity of the environment” (1988, 160). Indeed, environmental complexity has often been operationalized as heterogeneity in the environment (e.g., Dess and Beard 1984; Keats and Hitt 1988).

Although these ideas have been subject to only limited empirical investigation (Wiersema and Bantel 1993), they seem worth pursuing. Firms in complex environments often face ill-defined and novel problem-solving situations, suggesting that larger, more heterogeneous TMTs may be more common under these conditions (Janis 1972). Such teams have a broader range of skills represented among their members (Steiner 1972), are more likely to develop diverse interpretations and perspectives (Wanous and Youtz 1986), and tend to engender more debate and questioning among team members (Hoffman and Maier 1961). In simpler, less complex environments, such heterogeneity is not required and indeed may be dysfunctional to the extent that it engenders poor communication (Zenger and Lawrence 1989) and conflict (Ebadi and Utterback 1984). In addition, as Thompson (1967) has argued,

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to the degree that environmental complexity creates additional challenges for top management, the dominant coalition will be larger. As a result, we offer the following propositions:

Proposition 5–2A: The more complex the environment, the greater the heterogeneity within TMTs.

Proposition 5–2B: The more complex the environment, the larger the size of TMTs.

Sanders and Carpenter (1998) provided evidence in support of [Proposition 5-2B](#). They argued (and provided supporting empirical evidence) that complexity arising from a firm's degree of internationalization leads to such outcomes as larger TMTs and the separation of the CEO and Chair position.

A related argument can be offered for role interdependence. Environmental complexity promotes greater differentiation within the top team and reduces the opportunity for executives to interact, share resources, and operate in a cohesive manner. The greater environmental demands characteristic of this setting force greater task specialization (role differentiation) and make coordination more difficult (Mintzberg 1979). While these circumstances may call for *greater* integration (Lawrence and Lorsch 1967), the demands on top team members from disparate environmental constituencies may make such integration difficult to achieve. As Galbraith (1973) has argued, complexity forces greater specialization and decentralization, reducing opportunities for coordination and increasing both the number of individuals involved in decision making and their decision-making independence.

Proposition 5–2C: The more complex the environment, the less the role interdependence within TMTs.

Finally, environmental complexity is expected to have a direct effect on TMT social integration and consensus. Arguing that environmental complexity requires greater division of labor, which in turn increases differences in interpersonal orientation and time orientation within TMTs (Lawrence and Lorsch 1967), Dess and Origer suggest that “such divergence in perspectives makes consensus on the strategic direction of the firm difficult” (1987, 326). The same logic also suggests that environmental complexity reduces social integration by forcing TMTs to attend to multiple stimuli and demands that highlight differences within the top team. At the same time, the added demands of complex environments also reduce opportunities for team building and cohesion. Consistent with Bourgeois's (1980) contention that complexity promotes conflict, as well as with work by Dess and Origer (1987), we expect the following:

Proposition 5–2D: The more complex the environment, the less the degree of social integration within TMTs.

Proposition 5–2E: The more complex the environment, the less the degree of consensus within TMTs.

Environmental Instability

Environments vary in the degree to which they are characterized by unpredictability and unexpected change (Mintzberg 1979). Such environmental instability can have a dramatic impact on how organizations are structured and operate (Duncan 1972) and, of primary importance here, on the nature of TMT composition, structure, and even process. Environmental instability may refer to the “steady-state” rate of change in environmental

factors affecting organizations (Thompson 1967) or to the extent of discontinuous change in the environment (Tushman and Romanelli 1985). Using either definition, few studies have probed the effects of environmental instability on TMTs. Nevertheless, as we discuss below, important relationships may exist.

In a manner analogous to our argument above on environmental complexity, environmental instability may affect TMT heterogeneity and size. Such environments increase the variation and fragmentation of managerial work (Mintzberg 1973), enlarging the information-processing demands on the top team (Daft, Sormunen, and Parks 1988). As Galbraith argued, “The greater the task uncertainty, the greater the amount of information that must be processed among decision makers during task execution” (1973, 4). The greater information-processing requirements characteristic of unstable environments have two effects on top teams: greater heterogeneity and greater size. Both effects arise from the need for TMTs to increase the quantity and range of (1) information absorbed and recalled, (2) perspectives brought to bear on a problem, and (3) potential solutions considered (Hoffman and Maier 1961; Harrison 1975; Shaw 1981), as environments become more unstable. Hence, the greater information-processing capabilities of larger and more heterogeneous teams (e.g., Steiner 1972) are needed to help firms adapt to the greater information-processing requirements of unstable environments (Haleblian and Finkelstein 1993).

Proposition 5–3A: The more unstable the environments, the greater the heterogeneity within TMTs.

Proposition 5–3B: The more unstable the environment, the larger the size of TMTs.

Environmental instability may affect other aspects of TMTs as well. Challenging environments create large demands on TMT members to cope with external requirements (Pfeffer and Salancik 1978; Hambrick, Finkelstein, and Mooney 2005). As with complex environments, when environmental instability is high, TMTs face greater information-processing and decision-making demands (Kotter 1982) and greater time pressures to reach decisions (Eisenhardt 1989b). The result is less opportunity for role interdependence and, by implication, less social integration. We would also expect TMT consensus to be more difficult to attain, because instability and change promote multiple perspectives (Khandwalla 1977) and uncertainty about both means-ends relationships and outcome preferences (Thompson 1967). The resulting diversity of opinions creates conflict and makes consensus elusive (Amason and Sapienza 1997; Amason 1996). In contrast, higher levels of consensus may be relatively more achievable in stable environments (Priem 1990).

Proposition 5–3C: The more unstable the environment, the less the degree of role interdependence within TMTs.

Proposition 5–3D: The more unstable the environment, the less the degree of social integration within TMTs.

Proposition 5–3E: The more unstable the environment, the less the degree of consensus within TMTs.

These arguments are expected to hold when environments change more dramatically as well. For example, technological discontinuities (Tushman and Anderson 1986; Tushman and Rosenkopf 1996), changing competitive conditions, and regulatory changes are all expected to affect TMTs. As Keck and Tushman noted, “Organizations in jolted environments may require substantially altered executive teams to allow firms to develop the competencies and

internal processes that will make it possible for them to cope with altered competitive requirements” (1993, 1317). For example, Smith and Grimm (1987) found that deregulation caused railroads to alter their TMTs toward younger, shorter-tenured, and more highly educated executives. And Cho and Hambrick (2006) found that top management teams characterized by a greater proportion of output-oriented functional backgrounds and shorter industry tenures emerged in the years after deregulation in the airline industry. In the interests of space, however, we only offer an illustrative proposition for environmental discontinuities, rather than repeating each proposition just presented.

Proposition 5–3F: Environmental discontinuities increase the degree of heterogeneity within TMTs.

Environmental Munificence

Munificent environments help buffer organizations from external threats and enable them to accumulate slack resources (Cyert and March 1963). In addition, munificence confers flexibility and growth opportunities on organizations (Aldrich 1979). This cushion allows TMTs to operate with less constraint than otherwise might exist. As a result, predicting the consequential effects on TMTs is difficult. On the one hand, TMT consensus may be greater in munificent environments, because the generally nonthreatening conditions facilitate agreement and cooperation. On the other hand, because environmental munificence offers TMTs a wider breadth of choices, there may be more diversity of opinion and, hence, disagreement (Dess and Origer 1987).¹⁵

The only proposition we offer here relates to TMT size. As noted, greater organizational slack often accompanies environmental munificence, creating the “problem” of how to use it. Williamson (1963) has suggested that firms with slack resources tend to hire more staff than needed—especially at the executive level. This argument is analogous to a related point by Jensen (1986), who held that top managers with “free cash flow” may have an incentive to engage in such profitdamaging behavior as empire building. In contrast, firms in more challenging contexts often focus on cost containment (Hofer 1980), including by reducing executive and other staff. Hence, environmental munificence may have a direct effect on TMT size (Keats and Hitt 1988; Bantel and Finkelstein 1995).

Proposition 5–4: The more munificent the environment, the larger the size of TMTs.

Organization

Numerous aspects of organizations may affect TMTs. As with environment, however, the empirical work on this question has been quite limited. As a result, we will focus on only two characteristics of organizations—strategy and performance—in developing propositions on the determinants of TMT composition, structure, and process. Firm strategy and performance are emphasized here because they (1) are central to the study of strategic leadership, (2) are fundamental organizational attributes of interest to a wide set of scholars, and (3) appear particularly promising as antecedents to TMTs. This latter concern is important, given our interest in encouraging future investigations of the relationships we discuss.

Strategy

Of all potential antecedents of TMT characteristics, the strategy of a firm may be the most important, yet equivocal, factor. On the one hand, according to the old maxim that “structure follows strategy” (Chandler 1962), organizational characteristics such as the TMT should at least partially be a function of the organization’s strategy. For example, Porter argued that his

“generic strategies [implied] differing organizational arrangements, control procedures, and incentive systems” (1980, 40) all of which affect the TMT. Hence, the effects of strategy on TMTs may be pervasive. On the other hand, as we discussed in [chapter 4](#), organizations and the strategies they follow may be a reflection of their top managers (Hambrick and Mason 1984). Thus, disentangling causal direction in these relationships seems to be a fundamental requirement for future work.

Interestingly, Westphal and Fredrickson (2001) turn the “structure follows strategy” theme on its head, as they illustrate how the board of directors can take actions that lead to both changes in CEOs and changes in strategy. In their study, powerful members of the board of directors, who were CEOs of other firms, initiated succession events and selected successors who tended to initiate strategies similar to those of the outside director’s home firm. While not a central source of CEO successions, the study demonstrates that the preferences and experiences of outside directors can shape company strategies and, indirectly, TMT characteristics.

A firm’s corporate strategy, or the mix of businesses in which the firm competes, may have important implications for TMTs. Michel and Hambrick (1992) tested a series of hypotheses linking corporate strategy with TMT characteristics by developing theory on how the interdependence of diversification postures varies from low to high in the following order: unrelated, related-linked, relatedconstrained, and vertically integrated.

The same logic can be used to make predictions about TMT composition, structure, and process. For example, in firms with highly interdependent diversification postures, such as those that are vertically integrated, “there is need for abundant inter-unit negotiation, compromise, and collaboration. This process is greatly aided if corporate managers have a well-developed rapport and a common outlook and language” (Michel and Hambrick 1992, 17). Similarly, Athanassiou and Nigh (1999) showed that the extent of a multinational firm’s internationalization was directly related to the TMT’s advice network density, and greater interdependence among subunits across national borders increased advice network density. As a result, firms with highly interdependent operations should have TMTs with the following characteristics: low heterogeneity, high social integration, and high consensus. Role interdependence within TMTs is related almost by definition to the interdependence of diversification postures (whether productbased or geographic) as well.

The following propositions summarize this discussion:

Proposition 5–5A: The greater the interdependence of a firm’s diversification posture, the less the heterogeneity within its TMT.

Proposition 5–5B: The greater the interdependence of a firm’s diversification posture, the greater the degree of role interdependence within its TMT.

Proposition 5–5C: The greater the interdependence of a firm’s diversification posture, the greater the degree of social integration within its TMT.

Proposition 5–5D: The greater the interdependence of a firm’s diversification posture, the greater the degree of consensus within its TMT.

One final proposition concerns team size. Managing firms with unrelated diversification postures has been likened to managing a financial portfolio (Berg 1969; Rumelt 1974). Top teams are more concerned with buying and selling businesses than with actively managing the operations of each business. Because the task of operating each business is decentralized to general managers at the individual level, the corporate offices of highly diversified firms

tend to be quite small (Pitts 1976). In contrast, corporate management of firms with more interdependent diversification postures may be larger because they “typically retain responsibility for overall product-market strategy and initiate investment projects (Ackerman 1970)” (Michel and Hambrick 1992, 12). These firms tend to rely on strategic controls instead of financial controls (Hoskisson and Hitt 1988, 1994) and promote coordination among business units by use of specialized incentives based on corporate as well as divisional performance (Hoskisson, Hitt, and Hill 1993). The ability to enact strategic controls and to effectively manage the greater information-processing demands that arise from corporate-based incentives adds complexity and, hence, staffing needs to corporate offices. Therefore, we propose the following:

Proposition 5–5E: The greater the interdependence of the diversification posture, the larger the size of the TMT.

A firm’s competitive, or business, strategy is also likely to affect the composition, structure, and process of its TMT. To help structure our discussion, we contrast how the strategies of Prospector (growth, innovation, and the search for new opportunities) and Defender (cost control, stability, and efficiency) firms call for different TMT characteristics (Miles and Snow 1978).

Compared to Prospectors, the greater stability in Defender firms suggests that they face fewer strategic contingencies (Hambrick 1981a) and do not require larger, more differentiated TMTs. Firms following Defender strategies generally exhibit lower growth, constraining internal labor markets by limiting promotion opportunities for top managers (Pfeffer 1983). Prospectors are not only more growth-oriented, they are also more innovative and forward-looking.

These differences between Prospectors and Defenders have several implications for TMTs. First, it is likely that TMTs of Defenders will be smaller and less heterogeneous, given the importance of maintaining existing domains. As Miles and Snow note, “It is more advantageous for the dominant coalition to know the strengths and capacities of ‘our company’ than it is for them to know the trends and developments in ‘our industry’ ” (1978, 42). Such internally focused TMTs do not require the same breadth and diversity that TMTs with Prospector strategies might need.

Second, top management teams in Prospector firms need to be receptive to change and innovation—searching for new opportunities may require new perspectives and approaches that are more likely to exist when TMTs are heterogeneous (Wiersema and Bantel 1992). In contrast, TMTs in firms with Defender strategies have already coalesced around a specific product market and a narrow range of competitive weapons to defend their firm’s position in that product market. In addition, Defenders face much less uncertainty (Miles and Snow 1978). Hence, TMTs of Defenders are more likely to have similar mind-sets, exhibit greater cohesiveness, and develop congruent beliefs about their firm and how it operates, making it easier for them to reach agreement (Dutton and Duncan 1987). Indeed, both means-ends relationships and desired outcomes are fixed to a much greater extent in these firms.

Proposition 5–6A: Firms pursuing Defender strategies exhibit less TMT heterogeneity than do Prospector firms.

Proposition 5–6B: Firms pursuing Defender strategies have fewer members in their TMTs than do Prospector firms.

Proposition 5–6C: Firms pursuing Defender strategies exhibit more social integration

within their TMTs than do Prospector firms.

Proposition 5–6D: Firms pursuing Defender strategies exhibit more consensus within their TMTs than do Prospector firms.

A final characteristic of a firm's strategy considered here is the extent to which it is relatively constant or changing. Strategic change creates ripple effects throughout an organization, including within the TMT (Wiersema and Bantel 1992; Tushman and Rosenkopf 1996; Keck and Tushman 1993). Changes in firm strategy often disrupt existing ways of doing business, involve shifts to new domains or new tactics within the same domain, and create new power bases within the firm (Starbuck, Greve, and Hedberg 1978; Tushman and Romanelli 1985). These changes have significant implications for the functioning of the TMT. Established communication patterns (Zenger and Lawrence 1989), knowledge structures (Gersick and Hackman 1990), needed competencies and process (Ancona 1990), and patterns of interaction (O'Reilly, Caldwell, and Barnett 1989) all shift. To the extent that the strategic changes are severe, threatening the integrity of the organization or the positions of top managers, constriction of power and control may also result (Staw, Sandelands, and Dutton 1981). Under these conditions, we would expect to see several changes in the TMT: greater heterogeneity and size to try to cope with the changes; less role interdependence as it becomes more difficult for top managers to coordinate activities, at least in the short term; less social integration as a consequence of disrupted patterns of interaction; and greater difficulty in reaching consensus because the rules of the game are in flux.

Proposition 5–7A: The greater the amount of strategic change, the greater the heterogeneity within TMTs.

Proposition 5–7B: The greater the amount of strategic change, the less the degree of role interdependence within TMTs.

Proposition 5–7C: The greater the amount of strategic change, the larger the size of TMTs.

Proposition 5–7D: The greater the amount of strategic change, the less the degree of social integration within TMTs.

Proposition 5–7E: The greater the amount of strategic change, the less the degree of consensus within TMTs.

Organizational Performance

The effects of few organizational attributes are as immediately felt as those of recent performance. These effects are observed by numerous stakeholders, both within and outside an organization, leading one to expect that organizational performance may have important consequences for TMTs as well. Nevertheless, as is the case for the other contextual conditions we have discussed, research on how performance affects TMT configurations is lacking. Hence, in this section, we build on theories of threat rigidity and organizational slack to help develop some testable propositions on how recent organizational performance affects TMTs.

High-performing firms are characterized by excess organizational slack and, by extension, a multitude of strategic options. Organizational slack is defined as “the difference between the resources of the organization and the combination of demands made on it” (Cohen,

March, and Olson 1972, 12). In a sense, performance and slack create additional opportunities that might be foreclosed in firms with less abundant resources. For example, decisions to enter new markets or develop new products are possible only when adequate resources exist. When resource constraints are tighter, fewer options exist, and the organization must be more reactive than proactive in dealing with environmental and strategic contingencies (Pfeffer and Salancik 1978). What is more, when performance is very poor, organizations tend to constrict control at the top, restricting intragroup information flows and promoting dissension (Staw, Sandelands, and Dutton 1981).

These effects have several important consequences for TMTs. Specifically, since high-performing firms have abundant slack and opportunity, while lowperforming firms are constrained and constricted, we expect a curvilinear relationship between organization performance and several attributes of TMTs. For example, TMTs are larger in both the highest performers (because their excess slack facilitates expenditures on staff; Williamson 1963) and lowest performers (because centralized control at the top creates a need for additional senior executives to take over responsibilities that were previously delegated).¹⁶

Proposition 5–8A: Under conditions of very low and very high organization performance, TMT size is larger; when organization performance is at a moderate level, TMTs have fewer members.

The same effects of very high and very low organization performance are expected to affect several other dimensions of TMTs: role interdependence, social integration, and consensus. As we have described, resources are so plentiful in very high-performing firms that TMTs do not have to deal with trade-offs or elaborate coordination. Under these conditions, TMT members need not engage in intensive interchange, because abundant slack allows “the unchecked pursuit of subunit goals” (Bourgeois 1981, 33). Moreover, the TMTs of successful firms may become less interactive and collaborative over time, as the resource constraints that force careful orchestration and collective attention to external contingencies dissipate (Hambrick 1995). Hence, we would expect less emphasis on role interdependence, a breakdown of social integration, and more disagreement on means and ends.

But, at the other extreme, these same TMT effects occur in organizations where performance is dire. A dominant individual or inner circle at the top takes charge, forcing changes without the same degree of collaboration and consultation that may have previously existed (Staw, Sandelands, and Dutton 1981). Time pressures force immediate actions, reducing role interdependence; conflict and self-seeking behavior abound (Bourgeois and Eisenhardt 1988). It is only when firm performance is not at an extreme that social interactions within TMTs can be achieved and sustained. Thus, we offer the following propositions:

Proposition 5–8B: Under conditions of very low and very high organization performance, role interdependence within TMTs is low; when organization performance is at a moderate level, role interdependence is greatest.

Proposition 5–8C: Under conditions of very low and very high organization performance, social integration within TMTs is low; when organization performance is at a moderate level, social integration is greater.

Proposition 5–8D: Under conditions of very low and very high organization performance, consensus within TMTs is low; when organization performance is at a moderate level, consensus is greatest.

CEO

Chief executive officers play a major role in the composition and functioning of TMTs. CEOs are central members of the TMT (Jackson 1992) who have a disproportionate impact on team characteristics and outcomes (Finkelstein 1992). Although the importance of CEO characteristics and behaviors to TMTs seems almost self-evident (Hambrick 1994), studies investigating the nature of this relationship are rare. Thus, it seems important to examine how a CEO's influence permeates TMTs, the topic to which we now turn.

We will consider the impact of CEOs in two related ways. First, extending Hambrick and Mason's (1984) core idea that organizations are a reflection of their senior executives, it seems sensible to consider the degree to which TMT characteristics reflect CEO biases and preferences.¹⁷ Second, CEO power is variable and is likely to affect TMTs (Finkelstein 1992; Hambrick and D'Aveni 1992; Jackson 1992). Research on CEO power or dominance is not plentiful; we are aware of only one study focused on its effects on TMTs (Pitcher and Smith 2001). Thus, there are important reasons to examine how CEO dominance affects TMTs¹⁸ (Cannella and Holcomb 2005).

CEO dominance can take many forms. The traditional view is that CEOs enforce their will through their power (e.g., Finkelstein 1992; Pfeffer 1981b). However, CEO influence can go beyond the common and traditional bases of power (e.g., prestige, expertise, and ownership). For example, CEOs can influence team processes, and through that influence can determine if the TMT has any real influence or not (Pitcher and Smith 2001). Further, through a strong and focused vision, CEOs can influence decision making throughout the firm, as organizational participants must frame their issues in terms of the CEO's vision in order to attract the resources and attention necessary to take action (Cannella and Holcomb 2005). Finally, through charisma, some CEOs can get extra effort and commitment from their employees, especially those who are in direct contact with the leader (Waldman and Yammarino 1999; Klein and House 1995).

Thus, a multitude of CEO characteristics and their effects on TMTs can be considered. In the interests of space, however, we only examine "CEO openness"—a composite of such facets of CEO personality as awareness of multiple perspectives, valuing discourse and debate, and openness to new ideas. CEO openness is a virtual prerequisite for adaptability to changing circumstances, and its absence has been associated with organizational turmoil (Finkelstein and Mooney 2003). Open-minded CEOs are not so committed to a paradigm that alternative perspectives are foreclosed; rather, they are willing to try new approaches (Hambrick and Fukutomi 1991). CEO openness may be gauged by an array of characteristics, including a broad educational background, a higher level of education, newness to the organization, and a high variety of work experience, such as in multiple functional areas and industries. CEOs with this type of background are more likely to value diversity of opinion for the intellectual discourse it promotes as much as for the more varied range of ideas generated.

Some related support exists for these ideas: highly educated CEOs, particularly those with MBAs, promote administrative complexity and sophistication (Hambrick and Mason 1984), as well as innovativeness (Kimberly and Evanisko 1981; Bantel and Jackson 1989)—both of which may lead to inclusion and diversity (Bantel and Jackson 1989). For example, to the extent that large TMTs have greater information-processing and decision-making capabilities than small teams (Eisenhardt and Schoonhoven 1990; Halebian and Finkelstein 1993), a wider set of opinions can be heard.

CEO openness may also be enhanced when the CEO is new to the organization. CEOs selected from outside the firm are not as beholden to the status quo and often bring new

perspectives to the organization (Dalton and Kesner 1985). In addition, outsiders tend to replace more members of the TMT than do CEOs promoted from within (Helmich and Brown 1972; Gabarro 1987; Shen and Cannella 2002b). These changes are consistent with the idea that CEO openness, as gauged by newness to the organization, promotes TMT heterogeneity (Keck and Tushman 1993). Further, it is important to remember that team changes can involve exits of existing members or entries of new members, or both. Entries and exits may be independent events, and may be associated with very different outcomes (Tushman and Rosenkopf 1996).

Proposition 5–9A: The greater the level of CEO openness, the greater the heterogeneity within TMTs.

Proposition 5–9B: The greater the level of CEO openness, the larger the size of TMTs.

The effects of CEO openness are not expected to remain constant over time. Although CEO interest in discussion and debate promotes heterogeneity and inclusiveness, we expect that these effects will dissipate over time. Gradually, CEOs develop routinized procedures (Tushman and Romanelli 1985; Keck and Tushman 1993), stronger opinions on appropriate strategies and how to achieve them (Gabarro 1987), greater interest in perpetuating their power (Pfeffer 1981a; Shen and Cannella 2002a; Finkelstein and Hambrick 1989), and more concern for their legacy (Westphal and Zajac 1995). Whether referred to as “commitment to a paradigm” (Hambrick and Fukutomi 1991), “stale in the saddle” (Miller 1991), or “entrenchment” (Fama and Jensen 1983), long-tenured CEOs become less responsive to diverse perspectives (Katz 1982; Hambrick, Geletkanycz, and Fredrickson 1993). Long tenure not only attenuates the effects of CEO openness, but it also reduces TMT heterogeneity directly because shared understandings about decision making and strategy become progressively more refined and similar over time (Pfeffer and Salancik 1978; Shen and Cannella 2002a; Kiesler and Sproull 1982; Fredrickson and Iaquinto 1989; Keck and Tushman 1993).¹⁹

Proposition 5–9C: The longer a CEO’s tenure, the weaker the relationships between CEO openness and TMT heterogeneity and size.

Proposition 5–9D: The longer a CEO’s tenure, the less the heterogeneity within TMTs.

The second important characteristic of a CEO is his or her power within the TMT. With few exceptions (Hambrick 1981a; Pitcher and Smith 2001; Bourgeois and Eisenhardt 1988; Finkelstein 1992), the distribution of power among senior executives has not been the subject of in-depth investigation. As we argued earlier, however, understanding who has power and who does not within the TMT seems essential for developing more complete models of strategic decision making. Our interest here is how CEO dominance affects TMTs, specifically their heterogeneity and consensus.

Responsibility for selecting a top team generally resides with the CEO (Kotter 1982). Nevertheless, his or her ability to make such selections without constraint depends to some extent on other stakeholders, such as the board of directors (Lorsch and MacIver 1989; West and Schwenk 1996), organizations and individuals on which a firm is dependent (Pfeffer and Salancik 1978), and even other top managers (Finkelstein 1988; Shen and Cannella 2002a). Thus, the more powerful or dominant the CEO, the greater his or her influence on the executive selection process. Dominant CEOs are likely to select top managers who are

similar to themselves.²⁰ This belief is predicated on three related arguments: (1) individuals tend to prefer others who are similar to themselves (Byrne 1971; Boone and de Brabander 1993); (2) individuals may derive self-esteem by belonging to a group of similar individuals (Tsui, Egan, and O Reilly 1992); and (3) by selecting individuals with similar perspectives, CEOs can consolidate power at the top (Westphal and Zajac 1995).

Proposition 5–10A: The greater the CEO dominance, the less the heterogeneity within TMTs.

Although CEO dominance is expected to reduce heterogeneity within the top team, it is likely that the actual size of the team may grow. Several writers have noted the tendency for powerful individuals to add staff and personnel in an attempt to build a protective core around their positions (Williamson 1963; Mintzberg 1983a; Whisler et al. 1967). The more powerful the CEO, the greater the ability to institutionalize power within the organization (Pfeffer 1981b). The net effect of such empire building is a larger TMT.

Proposition 5–10B: The greater the CEO dominance, the larger the size of TMTs.

Finally, CEO dominance may also reduce the degree of consensus achieved in reaching strategic decisions. For example, Eisenhardt and Bourgeois found that power centralization (a notion akin to CEO dominance) was associated with a higher degree of political activity within TMTs. When CEOs were less dominant, there was greater sharing of information, and the decision process was described as “consensus style” (1988, 749). Eisenhardt and Bourgeois’s description of strategic decision making at Alpha, one of the companies they studied, is informative:

The CEO (the president) was described as a “parent” and “benevolent dictator.” His power score was 9.6, tied for highest in our cases. The next most powerful executive at Alpha scored only 5.8. The strategic decision we studied corroborated those data. For example, the VP Sales said of the decision process, “The decision was a Don Rogers edict—not a vote.” The president agreed: “I made the decision myself, despite the objections of everyone. I said ‘the hell with it, let’s go with the PC interface.’” (1988, 748–749)

Proposition 5–10C: The greater the CEO dominance, the less the degree of consensus within TMTs, and the less relevant is consensus to organizational outcomes.

To conclude, this section has elaborated a model of the determinants of TMT characteristics. This model is based on the idea that the context within which a TMT operates significantly influences its composition, structure, and process. We focused on such important antecedents as environment, organization, and the CEO, the central player within the top team. Although our model is not meant to be exhaustive (other factors may also contribute to an explanation of TMTs), it is an important step toward opening up our investigative lenses to the factors that affect how a TMT comes to take on certain characteristics. An emphasis on antecedents is important not only because of the greater understanding of TMTs it affords, but also because of its implications for what TMTs actually do. That is, much of the interest in TMTs apparent in the literature is driven by a desire to learn more about how TMTs are involved in strategic decision making and how this involvement translates into actions that help determine organizational strategy and performance. It is to these issues that we now turn.

Consequences of TMTs' Interaction

Empirical research on TMTs and organizational outcomes has increased dramatically in the past several years. In this section, we review this research to assess what progress has been made and to suggest some new lines of inquiry. Although some studies have examined multiple organizational outcomes, we organize this discussion by the dependent variables of strategic decision-making process, strategic choices and changes, and firm performance.²¹

Consequences of TMTs on Strategic Decision Making

Research on strategic decision making is abundant. Numerous attributes of this process can be studied, including decision speed (Eisenhardt 1989b), comprehensiveness (Fredrickson 1984), analytical techniques (Schweiger, Sandberg, and Rechner 1989), urgency (Pinfield 1986; Bourgeois and Eisenhardt 1988), extent of subunit involvement (see Duhaime and Baird 1987; Pitcher and Smith 2001; Rajagopalan, Rasheed, and Datta 1993), the decision to engage in illegal acts (Daboub et al. 1995), and the handling of cross-cultural issues (Snow et al. 1996; Richard et al. 2004). Here, we develop propositions that relate the major facets of TMTs examined in this chapter with the strategic decision-making process.

The strategic decision-making process is often depicted as a series of stages, beginning with the generation of alternative strategic choices and moving through evaluation of those alternatives, strategic choice, implementation, and finally, evaluation (Ansoff 1965; Hofer and Schendel 1978). Although there are important differences across each stage, strategists have adopted the analytical convention of viewing the process in terms of formulation and implementation (e.g., Andrews 1971). The strategy formulation process involves the generation and evaluation of alternatives, as well as the choice, while strategy implementation encompasses the organizational execution of that choice. While this bifurcation of the strategic decision-making process is somewhat artificial (Mintzberg 1978), it serves a valuable purpose in facilitating the more pointed consideration of potential relationships with TMT dynamics.

Strategy formulation requires an analysis of (1) external threats and opportunities, especially with respect to the competitive environment (Andrews 1971; Porter 1980) and (2) internal strengths and weaknesses within and across functional areas (Prahalad and Hamel 1990). The alternatives that arise from this analysis are assessed and debated before settling on a satisfying solution (Cyert and March 1963). Top management team members are active throughout this process, in part through direct participation and in part by setting agendas (Kotter 1982), by delegating to others (Mintzberg 1983a), and by signaling ideas and preferences (Pfeffer and Salancik 1978; Cannella and Holcomb 2005).

Our review of related research suggests that TMTs with certain characteristics, such as large size and heterogeneity, are likely to generate more alternatives, to evaluate those alternatives along more dimensions, and, as a consequence, to make higher-quality decisions than TMTs without these attributes. As we argued earlier, heterogeneous teams are more innovative, have greater problem-solving skills, and employ multiple perspectives (e.g., Bantel and Jackson 1989), all of which should increase the number and variety of alternatives under consideration. In addition, they can rely on their heterogeneous backgrounds to gather information from different internal and external contacts (Jackson 1992), which is much less likely in homogeneous teams. Moreover, evaluation of alternatives will tend to be comprehensive, given the propensity and willingness of heterogeneous team members to challenge and debate each other (e.g., Gladstein 1984; Schweiger, Sandberg, and Rechner 1989). To the extent that decision quality depends on analytical effectiveness, the resulting

strategic choices may prove superior (Hoffman 1959; Amason 1996; Filley, House, and Kerr 1976; Shaw 1981; McGrath 1984).

In contrast, social integration within TMTs may have the opposite effect. Socially integrated teams value cooperation, are more cohesive, and are motivated by a desire to maintain cordial relations among members (O'Reilly, Caldwell, and Barnett 1989). What is more, highly cohesive groups tend to exert more pressure for conformity than less cohesive groups (Hackman 1976). For example, Lott and Lott (1965) found that cohesiveness was highly correlated with pressures for attitudinal conformity. In TMTs, this emphasis on cooperation and conformity may limit the quality of both alternative generation and evaluation.

Proposition 5–11A: The quality of strategic decisions (as defined by the generation of multiple feasible alternatives and the comprehensive evaluation of those alternatives) is positively associated with TMT heterogeneity and size and negatively associated with social integration within TMTs.

Strategy implementation involves mobilizing the resources needed to ensure that the strategic initiatives selected are appropriately executed. The implementation process typically requires significant integration of people and resources, takes considerable time, and depends on the cooperation of numerous individuals both in and out of the TMT (Galbraith and Kazanjian 1986; Waldman and Yammarino 1999; Cannella and Holcomb 2005). Effectively implementing strategic decisions is challenging because executives who find particular changes threatening or objectionable often have numerous opportunities to disrupt the process (Bardach 1977; Guth and MacMillan 1986). As a result, it becomes important to gain their acceptance and commitment to a strategic decision (Dess 1987; Amason 1996; Nutt 1987), especially in light of evidence that direct intervention, persuasion, and participation tactics are superior to the use of edicts (Nutt 1986b).

The implications of these arguments for TMTs are twofold. First, as we have seen, some evidence suggests that heterogeneous teams engender conflict (O'Reilly, Snyder, and Boothe 1993; Cronin and Weingart 2007). Indeed, many of the positive features of heterogeneous TMTs, such as debate, multiple perspectives, and confrontation, also have negative side effects, including dissatisfaction and dissensus (Schweiger, Sandberg, and Rechner 1989; Priem 1990). These problems are particularly important for implementation because “successful installation ... often depends on obtaining the involvement, cooperation, endorsement, or consent” (Nutt 1989, 145) of managers. When team members disagree with a decision, implementation becomes problematic (Hitt and Tyler 1991). Thus, “the ultimate value of high-quality decisions depends to a great extent on the willingness of managers to cooperate in implementing those decisions (Maier 1970; Guth and MacMillan 1986; Wooldridge and Floyd 1990)” (Korsgaard, Schweiger, and Sapienza 1995, 60).

If heterogeneity is disadvantageous for strategy implementation, social integration and consensus should be beneficial. We have already emphasized that social integration is associated with cooperation, frequent communication, and group identification (O'Reilly, Caldwell, and Barnett 1989), all of which may facilitate the implementation process (Guth and MacMillan 1986). And TMT consensus tends to engender greater feelings of satisfaction with the decision-making process, promoting decision acceptance and commitment (Dess 1987; Bowman and Ambrosini 1997; Fredrickson and Iaquinto 1989; Isabella and Waddock 1994). Hence, we propose:

Proposition 5–11B: The effectiveness of the strategy implementation process is positively associated with social integration and consensus within TMTs and

negatively associated with TMT heterogeneity and size.²²

Consequences of TMTs on Strategy

If TMT composition, structure, and process affect strategic decision making, these factors should also affect the types of strategic choices made. Over the past twenty years, a series of studies on this very point have examined organizational innovativeness, interdependence of diversification posture, and strategic change. Unfortunately, however, the findings reported in these studies generally have been inconsistent.

We will highlight two studies that have been conducted on the associations among demographic heterogeneity,²³ team size, and organizational innovation. Arguing that demographic heterogeneity proxies for cognitive heterogeneity within a TMT, Bantel and Jackson (1989) found that functional heterogeneity was positively associated with administrative innovation in a sample of 199 banks in the midwestern United States. But the heterogeneity of team members along other demographic dimensions, such as age, tenure, and educational specialization, did not significantly predict administrative innovations.

In another study on innovation, O'Reilly and Flatt (1989) used multiple measures of organization innovation (i.e., the score from a *Fortune* magazine survey on innovation and a metric based on articles in *F&S Predicasts*), as well as both age and tenure heterogeneity of TMTs, to test related hypotheses. Of the eight different models tested, three yielded negative and significant results, indicating that homogeneous TMTs were more innovative.

No consistent pattern of results arises across the two studies. Of the sixteen different models tested across articles, one indicated that heterogeneity was a positive predictor of innovation and three suggested the opposite.²⁴ There were significant differences in the methods employed: Bantel and Jackson (1989) defined a TMT in terms of the number of individuals listed by the CEO in a survey, while O'Reilly and Flatt (1989) counted the number of vice presidents. These design choices will have an important impact on measures of heterogeneity. Both studies also used different operationalizations of innovation.²⁵

More recently, Carpenter and Fredrickson (2001) examined the implications of TMT heterogeneity for a firm's global strategic posture (GSP; the degree to which a firm depends on foreign markets for customers and factors of production and the geographical dispersion of these markets and factors) and the moderating effects of environmental uncertainty on that relationship. The authors considered breadth of international work experience, educational heterogeneity, functional background heterogeneity, and tenure heterogeneity as predictive of a firm's GSP. All measures were significant, but two (functional heterogeneity and tenure heterogeneity) had negative coefficients. The authors interpreted this evidence as indicating that heterogeneity on these dimensions detracts from TMT cohesiveness and lessens the firm's global impetus.

Relatedly, Sambharya (1996) examined the foreign experience of TMT members and their association with international diversification strategy. The author predicted that the average number of years of TMT member international experience, the proportion of TMT members with international experience, and TMT heterogeneity of international experience would all be positively associated with international diversification. The authors report some support for all three predictions.

Several other recent studies have investigated the effects of TMTs on global diversification posture of companies (Carpenter, Geletkanycz, and Sanders 2004). For example, Tihanyi, Ellstrand, Daily, and Dalton (2000) examined the association between TMT characteristics and GSP (as did Sanders and Carpenter [1998]). Other studies in this stream include Carpenter, Pollock and Leary (2003), and Carpenter et al. (2001). All of these

studies demonstrate that the characteristics of top management groups are important to the firm's internationalization strategy.

As we discussed in [chapter 4](#), TMT composition may also influence the attentional orientation of the TMT, and through that, strategic choices. For example, Cho and Hambrick (2003) integrated upper-echelons with an attention-based perspective, arguing that TMT demographic composition will affect attentional orientation and, through that mediator, strategic choices. They examined deregulation as a trigger for the shift in attentional orientation, and specifically emphasized a shift from an engineering orientation (emphasis on efficiency, or throughput-oriented) to an entrepreneurial orientation (emphasis on customers and markets, more output-oriented). They predicted that greater recomposition of the TMT would lead to greater shifts in attention from engineering to entrepreneurial concerns. Specifically, they predicted that increases in TMT output function experience, decreases in TMT airline industry tenure, and increases in TMT heterogeneity would all lead to greater shifts in attention. And, greater shifts in attention were expected to result in greater movement toward an entrepreneurial strategy. Put differently, they expected that attention would mediate the relationship between TMT characteristics and strategy outcomes. Evidence from a sample of publicly traded airlines from 1976 to 1986 supported their predictions.

Another recent study provides important insights into the relationship between TMT composition and strategic choices. Ferrier and Lyon (2004) studied the extent to which firm performance derived from the simplicity of competitive repertoires and evaluated TMT heterogeneity as a moderator of that relationship. They concluded that TMT heterogeneity was an important moderator of the relationship between repertoire simplicity and firm performance.

Although there are differences across studies, the inconsistent results apparent in the articles above are troubling. One explanation may be that attempts to relate TMT heterogeneity and strategic choices directly are assuming a connection that is more distant than commonly recognized. In this chapter, we have argued that demographic heterogeneity is associated with cognitive heterogeneity, both of which increase the number of strategic alternatives considered by a TMT and the quality of the evaluation of those alternatives. Rigorous strategy formulation, in turn, is expected to lead to higher quality decisions. Using this logic to predict strategic outcomes is subject to three potential drawbacks.

First—and as is the case for predictions based on the central tendencies of TMTs—there are several logical stages between TMT composition and strategic choice that can disrupt or attenuate expected associations (Cannella and Holcomb 2005). For example, the strategic decision-making process is complex and ambiguous, numerous contextual conditions can affect the process through which strategic choices are selected and implemented, and many of these same contextual factors are often direct determinants of strategic choices as well. Hence, while TMTs undoubtedly affect strategic outcomes, our ability to empirically detect this relationship may be limited.

Second, the logical sequence we outlined above does not link TMT heterogeneity to strategic choices as much as it relates heterogeneity to the quality of strategic decisions. There is a big difference between predicting rigorous strategy formulation and predicting specific strategic outcomes, which suggests that measures of cognitive heterogeneity should not be any better predictors of strategy, since heterogeneity—whether measured demographically or cognitively—is potentially far-removed from specific strategic outcomes.

Finally, there is a point that is seldom noted in the literature but may be quite telling. Logically, a significant difference exists between how TMT heterogeneity and TMT average tendencies are expected to affect strategy. Because the extent to which a TMT is

characterized by a particular compositional attribute defines its orientation or preference set (Finkelstein 1988), this attribute can more easily be translated into specific strategic outcomes than is true for TMT heterogeneity. For example, TMTs dominated by executives with sales and marketing experience will perceive and interpret information in such a way that they will be more likely to prefer such strategies as product innovation and differentiation (Hambrick and Mason 1984). In contrast, and as we have seen, TMT heterogeneity affects the *process* of making strategic decisions much more than it does the *content* of those strategies. Hence, we should not necessarily expect heterogeneity to have a direct impact on strategy content.

These difficulties in studying the strategic effects of TMT heterogeneity are only partially ameliorated in studies of strategic change. However, two studies have employed virtually opposing theoretical rationales. Wiersema and Bantel (1992) argued that demographically heterogeneous TMTs will be more creative and will be able to rely on a wider set of information sources and perspectives during the decision-making process than more homogeneous TMTs. As a result, such teams will be more open to change. In addition, although these authors did not make this argument, it stands to reason that TMT heterogeneity should enhance the variety of strategic alternatives considered and the degree to which they are rigorously evaluated, increasing the likelihood that new strategic initiatives will be suggested. In contrast, O'Reilly, Snyder, and Boothe (1993) argued that TMT homogeneity promotes the cooperation that is needed to implement strategic changes. Hence, Wiersema and Bantel (1992) predicted a positive association and O'Reilly, Snyder, and Boothe (1993) a negative association between TMT heterogeneity and change.

Our analysis of TMTs and strategic decision making produces more equivocal expectations: that is, if TMT heterogeneity increases the breadth of strategy formulation ([Proposition 5-11A](#)) but detracts from the implementation process ([Proposition 5-11B](#)), the resulting effect on strategic change is uncertain.²⁶ The findings of these two studies are consistent with this interpretation. Wiersema and Bantel (1992) reported that one of four demographic measures of heterogeneity (educational specialization) was positively associated with change, while O'Reilly, Snyder, and Boothe (1993) found that TMT tenure heterogeneity was negatively associated with one of two measures of change. O'Reilly, Snyder, and Boothe also reported that a perceptual measure of TMT cooperation or consensus was not associated with organization change but was negatively related to political change.

Beyond heterogeneity, several studies link executive-level social capital to strategic choices. For example, Geletkanycz and Hambrick (1997) studied boundary-spanning relations between TMT members and others from both inside and outside the industry, arguing that strategic choices are affected by social ties. They concluded that social ties (i.e., trade association ties) are weakly linked to strategic conformity to industry averages, although ties to others outside the industry had no effect on strategic conformity. Collins and Clark (2003) examined whether human resource practices directed toward top managers would affect the social networks of the TMT. They documented that network-building practices influenced both external and internal network creation and had important implications for sales growth and stock prices.

In all, the findings we summarize here suggest that direct relationships between TMT heterogeneity and strategic choices are unlikely to be robust. Rather, it may be that TMT heterogeneity and social integration interact during strategic decision making, potentially affecting how the formulation and implementation processes develop. As a result, it seems important to study the relationships among TMT heterogeneity, social integration, and strategic decision making as a first step before attempting to predict strategic outcomes. Further, extending consideration to other aspects of TMT functioning, such as social capital

networks, holds additional promise.

Consequences of TMTs on Firm Performance

Given some of the problems in empirically establishing linkages between TMT interaction processes and strategic choices, it would not be surprising if studies of the association between the distributional properties of TMTs and firm performance were even more problematic. To some extent, this is reflected in the often inconsistent findings that emerge from this work. In contrast to studies of strategic outcomes, however, several of the projects predicting firm performance have also incorporated contingency factors, such as industry change or turbulence, that have the potential to strengthen results. Although this work also has inconsistencies, it offers the potential for redirecting research on the consequences of TMTs on firm performance in the future.

In one of the first studies to examine these issues, Murray (1989) collected longitudinal data on TMT temporal heterogeneity (an index of age and tenure heterogeneity, and mean tenure in the firm [loading negatively]) and “occupational” heterogeneity (an index of two measures of functional heterogeneity) in eighty-four firms in the oil and food industries. He predicted that heterogeneous TMTs would do worse in the short run because they often disrupt established norms and procedures that promote efficiency, but better in the long term because of their superior adaptability. In a series of regressions, Murray (1989) reported that (1) temporal heterogeneity was positively associated with long-term performance (in two of four regressions), while occupational heterogeneity was not, and (2) occupational heterogeneity was negatively associated with short-term performance (in one of four models), while temporal heterogeneity was not.

The pattern of results reported by Murray (1989) provides only the most limited support for the effects of TMT heterogeneity on firm performance. However, this study is commendable for its consideration of multiple industries, independent measures of industry change and rivalry, and multiple measures of firm performance, and especially for its attempt to develop more complex theory that appreciates some of the subtleties of TMTs. Nevertheless, one tentative conclusion that emerges from this work, as well as from four other studies examining related ideas (O’Reilly and Flatt 1989; West and Schwenk 1996; Hambrick and D’Aveni 1992; Glick, Miller, and Huber 1993), is that the distributional properties of TMTs will not be predictive of firm performance in all circumstances.²⁷

Of the other studies published on TMTs and firm performance, contingency factors were incorporated explicitly (Barrick et al. 2007; Michel and Hambrick 1992; Halebian and Finkelstein 1993; Geletkanycz and Hambrick 1997; Keck 1997; Cannella, Park, and Lee 2008) or implicitly (Eisenhardt and Schoonhoven 1990; Smith et al. 1994; Kor 2003). In Michel and Hambrick (1992), the only study in this group to model strategy as a contingency factor, the interdependence of a firm’s diversification posture did not moderate the TMT heterogeneity–firm performance relationship. However, Halebian and Finkelstein’s (1993) study of forty-seven firms in the computer and natural gas distribution industries found that environmental turbulence moderated the association between firm performance and both team size and CEO dominance. Specifically, they found that firms with larger teams and less dominant CEOs did better in turbulent environments, ostensibly because such TMTs had superior information-processing capabilities.

An interesting study that lifts the veil behind team processes sheds light on how top management teams may affect firm performance. Barrick and colleagues (2007) studied the relationship among team cohesion and communication (team mechanisms), interdependence, and both team and firm performance in ninety-four top management teams in credit unions.

They found that the interaction of team mechanisms and team interdependence was positive related to team and firm performance, but in regressions without the interaction the main effects of team mechanisms on the dependent variables were not significant. The implications are important. First, the well-established finding in the small groups literature that interdependence moderates the relationship between cohesion and communication, as well as performance (e.g., Beal et al. 2003; Gully et al. 2002), was also supported in a sample of top management teams. And second, because the main effects were sometimes not related to performance, these results suggest that cohesion and communication may not necessarily be advantageous for top management teams. In the absence of interdependence among senior executives, such cohesion and communication may not play much of a role at all.

Four studies examined TMT characteristics and firm performance in rapidly changing, or “high-velocity,” industries. Arguing that larger and more heterogeneous TMTs engaged in more constructive conflict (Eisenhardt and Schoonhoven 1990) and exhibited less social integration (Smith et al. 1994), two studies found a positive association between several measures of TMT heterogeneity and firm performance. Although not all associations were consistently positive, the overall pattern from these studies quite strongly indicates support for the authors’ ideas.

Keck’s (1997) study reported mixed results. She found that tenure heterogeneity and top management team fluctuation, among other measures, were positively related to firm performance in the turbulent computer industry, but also (unexpectedly) reported a similar result for tenure heterogeneity in the stable cement industry. Taking a somewhat different tack, Kor (2003) studied the relationship between TMT member experiences and the sustained growth of their companies. She concluded that heterogeneity in team, firm, and industry tenure each had important effects on firm-level growth among entrepreneurial firms. She tied her evidence to the notion that there are bundles of experience, and that particular configurations (e.g., bundles) of experiences are important to firm growth.

Cannella, Park, and Lee (2008) used a broad sample of industries that other authors had noted as either relatively certain or relatively uncertain to consider how physical co-location might impact the TMT diversity–firm performance association. Their evidence supported their predictions that when TMT members work at the same physical location, the implications of TMT member diversity for firm performance are positive, and even more positive in uncertain industries. These relationships held across measures of both TMT-level background diversity and TMT member intrapersonal functional diversity.

Finally, the study by Geletkanycz and Hambrick (1997), described above, also considered the implications of strategic conformity (as caused by social ties) for firm performance. They found that conformity was linked to better performance in the turbulent computer industry but not in the less turbulent branded foods industry.

In summary, while an empirical record on the association between TMT heterogeneity and firm performance has been established, it appears from this work that we are unlikely to uncover a strong direct relationship between the heterogeneity of TMTs and the success of the firms they manage.²⁸ Nevertheless, the positive effects of TMT heterogeneity on firm performance in “high velocity” or turbulent environments in several of these studies may help point the way to a clearer understanding of what heterogeneity among top managers really means. Recall our earlier discussion of how TMT heterogeneity promotes a more rigorous strategy formulation process by increasing the number of feasible strategic alternatives under consideration and the quality of their evaluation. In fast-changing, dynamic environments, managerial work becomes more fragmented (Mintzberg 1973), information-processing requirements increase (Hambrick, Finkelstein, and Mooney 2005), and new opportunities and crises necessitate greater adaptive capabilities (Galbraith 1973)—all of which place a higher

premium on the generation of multiple and novel solutions. It is precisely in the most unstable environments that TMT heterogeneity is most valuable.

In contrast, consider Halebian and Finkelstein's (1993) description of stable environments: "Information processing requirements are not as intense in stable environments (Ancona 1990). For example, Kotter found that top managerial information and decision making requirements in stable environments were 'more standardized and routine' than in turbulent environments (1982: 29). Stable environments tend to attenuate learning requirements (Tushman and Keck 1990), making problem solving more systematic than it is in turbulent environments (Eisenhardt 1989b)" (p. 847).

Under conditions of stability, we might expect strategy implementation to be more salient than strategy formulation, because the strategic challenge is less in developing new ideas than it is in preserving established procedures (Tushman and Romanelli 1985). As we discussed earlier, TMT cooperation and stability become more important when environments are more stable (Nutt 1987), suggesting that integrated TMTs may be preferred. Hence, in stable environments, TMT social integration, rather than heterogeneity, may be related to firm performance. The following two propositions summarize these arguments:

Proposition 5–12A: The more unstable the environment, the more positive the relationship between TMT heterogeneity and firm performance.

Proposition 5–12B: The more unstable the environment, the more negative the relationship between TMT social integration and firm performance.

Beyond the moderating role of organizational environments, other contingency factors may help explain how and when TMT heterogeneity affects firm performance. For example, the contextual conditions that give rise to difficult configurations of TMTs may themselves often operate as moderating forces on firm performance. The propositions on environmental instability above are cases in point. Earlier in this chapter, we argued that TMT heterogeneity is greater in unstable environments, to a large extent because such environments impose demands on how organizations should structure their TMTs. An implicit assumption in [Proposition 5-3A](#) was that organizations would respond to these environmental requirements in a variety of ways because these responses would enhance their position and performance. Thus, to the extent that organizations are responsive to environmental demands, firm performance should be greater. Restating this logic in terms of [Proposition 5-3A](#) suggests that firms promoting TMT demographic heterogeneity in unstable environments should do better, a prediction represented by [Proposition 5-12A](#). Hence, an extension of the "fit" or alignment argument implicit in [Proposition 5-3A](#) gives rise to the contingencybased [Proposition 5-12A](#).

Conclusion

This chapter has documented a large and growing body of work on TMTs and has outlined a number of robust conclusions as well as future directions. Still, significant problems remain in the study of TMTs, including how they come to have certain characteristics and what implications they have for firm performance and other outcomes. Robust work in this area will continue to require careful attention to issues such as the identification of TMT boundaries, specification of power relationships, and consideration of TMT processes. While we did not convert each of the propositions predicting TMT characteristics into propositions predicting firm performance, such propositions clearly represent viable and interesting research questions that often have received support in the literature, as we have documented.

There may be other relevant contextual factors worthy of study as well. Several important issues pose particular challenges to TMT researchers and, if resolved, could move the area significantly forward. We discuss these areas briefly below.

First, the boundaries of TMTs need very clear explication and theoretical treatment. At present, there are empirically well-accepted means of identifying TMTs (e.g., Finkelstein 1992; Finkelstein and Hambrick 1990). However, there is a significant heterogeneity in how TMTs are identified, even in the empirical literature. Most frequently, TMTs are identified as the five highest paid officers, all inside directors, and all executives above the rank of executive vice president. Given a particular company, these three approaches might well identify quite different TMTs for that single company. Because we rely so much on processes and demographic heterogeneity, coming to strong agreement about who is in and who is out seems critical. For example, Roberto (2003) has provided a theoretical alternative that has some appeal to the empirical approaches—a stable core and dynamic periphery. It will be important, in future studies, to carefully specify and justify how the TMT is identified.

A second critical issue, mentioned earlier, is how to treat the CEO in the determination of TMT-level measures. Clearly, not all members of the TMT are equal, yet most empirical treatments weight each member as essentially equivalent in calculations of team-level heterogeneity. While we have discussed the moderating effects of team member power and other factors, clearly most prominent in this issue is the CEO, as his or her preferences, biases, habits, and capabilities may have very important effects for team-level functioning. As Cannella and Holcomb (2005) and Pitcher and Smith (2001) have discussed, the CEO is the guardian of TMT processes. Perhaps the notion of “control over process” will direct fruitful study of phenomena such as the CEO’s impact on the TMT and the TMT’s identity separate from the CEO.

A third issue revolves around capturing the heterogeneity of the TMT. Bunderson and Sutcliffe (2002) describe a somewhat unusual but potentially very valuable approach to TMT heterogeneity. The concept of intrapersonal functional heterogeneity, which they describe as the average within-member breadth of functional experience, holds a great deal of promise in our view. Intrapersonal functional diversity is different enough from more traditional forms of diversity to deserve separate treatment, often leading to different hypotheses than would arise from, say, dominant functional diversity among team members (see Bunderson 2003 and Cannella, Park, and Lee 2008 for empirical examples).

In sum, we need more complex frameworks of TMTs that recognize the role of senior executives in strategic decision making, along with the moderating role of such important contextual influences as the environment, the organization, and the CEO. In addition, much more work is needed on such basic aspects of TMTs as their boundaries and determinants. This chapter offers one model of these phenomena that we believe is particularly promising for future research.

6

Changes at the Top

The Antecedents of Executive Turnover and Succession

The replacement of one leader by another has been a matter of fascination and drama through the ages. Executive succession evokes a political picture, with the continuity or disruption of regimes at stake and the creation of clear winners and losers. Turnover at the top instills hope, fear, or simply anxiety in organizational members and other stakeholders. It comes as little surprise, then, that executive succession has been the subject of a huge volume of research, which has grown exponentially along with other research on top executives over the past twenty-five years.

At the core of research on succession has been the goal of answering the “So what?” question: As a practical matter, what are the consequences of executive succession? Some researchers have asked this stark question: Does executive succession help or hurt organizational performance? But even when the question is asked with more subtlety, it quickly becomes clear that one cannot comprehend the consequences of succession in a vacuum. What occurs after new leaders take charge depends on a wide array of factors, including the conditions surrounding the predecessor’s departure, the process by which the successor was named, and, of course, the characteristics and actions of the successor.

In fact, we believe that the effects of executive succession, along with other important phenomena associated with top management turnover, can be framed and best understood by adopting the framework shown in [Figure 6.1](#). At the start of the succession framework is the precipitating context, or the conditions that influence and surround the departure of the predecessor. These contextual factors include (1) the performance of the organization; (2) agency conditions (including ownership and board factors); (3) other organizational characteristics (such as size, structure, or strategy); (4) external conditions; and (5) the characteristics of the predecessor (including background, tenure, power, and personality).

This precipitating context, in turn, affects whether (or when) succession will occur and the process by which it will unfold—the succession event and process. Once the precipitating context of succession processes is understood, we can explain or understand the successor characteristics (e.g., insider versus outsider, knowledge and skill set, and similarity to predecessor).

Finally, one can examine the effects of succession. Here, areas of interest include the successor’s behaviors, organizational changes, organizational performance, and the reactions of stakeholders (including investors).

[Figure 6.1](#) is not only a useful conceptual framework for building specific predictive models of succession phenomena.¹ It also provides a basis for organizing the vast wealth of literature on executive succession according to these overarching questions:

1. Will succession occur?
2. How will it occur? That is, by what process?
3. Who will be selected?

4. What will the consequences be?

These questions form the basis for the major sections of this chapter and the one following it. Because the literature on succession is voluminous, we will treat the antecedents of succession in this chapter; in [chapter 7](#) we will cover the consequences of succession and other related topics. Our focus is primarily on succession of the chief executive, because that position has been the target of almost all research on executive succession. However, many of the concepts and findings also have relevance for succession or turnover in other executive positions, such as chief financial officers (CFOs; e.g., Reutzell and Cannella 2004) and division general managers (e.g., Drazin and Rao 1999). We also include a section in [chapter 7](#) on turnover within top management teams. While succession among top management team members will be explained by some of the same elements that explain CEO succession, we also highlight its own unique characteristics and issues.

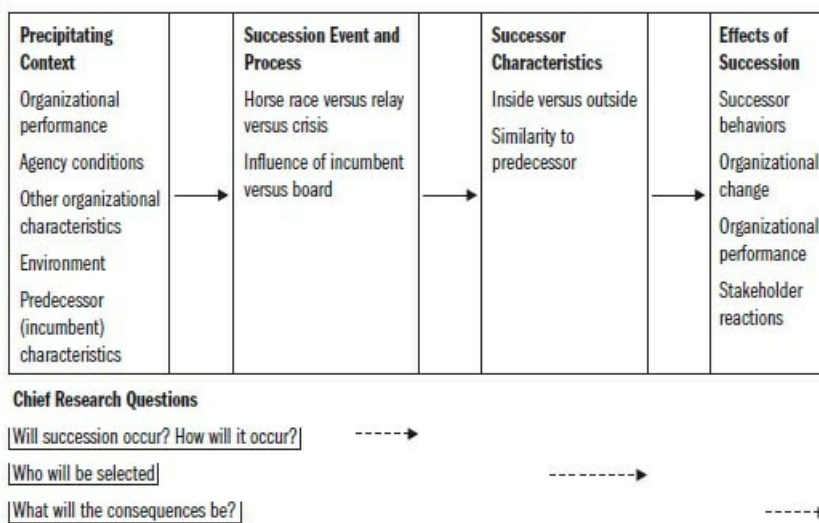


Figure 6.1. Executive Succession: A Conceptual Framework

Will Succession Occur? Determinants of Top Executive Departure

Executive departures come in several forms, including death, illness, mandatory retirement, early retirement for personal reasons, leaving for an executive position in another company, and dismissal. From a theoretical standpoint, these departure routes are not equally interesting. Death and illness are least interesting for organizational scholars because they do not reflect choices and probably account for less than 5 percent of all CEO exits from office (Vancil 1987). Early retirements and departures to join other companies, ostensibly voluntary exits, have not been studied extensively. Such voluntary departures do not occur randomly, and it is important to know whether they tend to occur under certain organizational or environmental circumstances. For instance, as we discuss in the chapter on executive compensation, it may be that executives are inclined to depart voluntarily to the degree that their pay is lower than that of their peers in comparable firms. Executives may leave due to fatigue or stress, perhaps stemming from performance pressures, conflict with large shareholders or board members, or job demands (Hambrick, Finkelstein, and Mooney 2005) such as a highly competitive environment (Jackson and Hambrick 2003). If so, voluntary departure might be predicted by some of the same factors that predict CEO dismissal.

Voluntary departures are probably much more likely among non-CEO executives than among CEOs (e.g., Fee and Hadlock 2003). There are several reasons for this expectation. First, because CEOs have reached the pinnacle of their power and influence within the firm, it seems unlikely that they would seek to improve their positions by moving to another organization. In order to improve, a sitting CEO would have to move to a larger or higher-performing firm. Given the risks associated with bringing in outside successors (Vancil 1987; Wiersema 2002), it is relatively unlikely (though possible) that many CEOs will receive better offers from bigger, more lustrous firms. Should postsuccession performance turn out badly, the directors who hired the new CEO would have to explain why they selected the new leader from a less prestigious organization. On the other hand, non-CEO executives may have both the motivation and the opportunity to find new employers. A particularly fertile setting for examining this possibility would be to examine the departures (and subsequent reemployment) of non-CEO executives after the selection of an heir apparent, or after the ascension of a new person to the CEO position (Fee and Hadlock 2003; Cannella and Shen 2001).

It is important to point out (as our earlier discussion implied) that some “voluntary” departures are not truly voluntary, but rather occur at the strong encouragement or insistence of the board. Moreover, to the extent that a departing CEO or other senior executive is influenced by his or her forecast of the firm’s prospects, it may be that voluntary departures tend to precede significant performance downturns. Cannella, Fraser, Lee, and Semadeni (2002), for example, showed that as the banks they studied moved toward failure, executives were more likely to “jump ship,” moving their employment from one bank to another. Wiesenfeld, Wurthmann, and Hambrick (2008) describe in some detail a process by which corporate failure leads to professional devaluation for individuals—a process with clear negative consequences for those executives who are stigmatized by bankruptcy or other negative events.

The most common circumstance for CEO departure is mandatory retirement. In the United States and many other countries, senior executives are exempt from legislation prohibiting mandatory retirement. On the surface, it would not seem very interesting to study the antecedents of departures occurring under mandatory retirement policies, because these exits are due to institutionalized procedures and not out of volition.

There are at least three reasons, however, to carefully consider mandatory retirement policies. First, they may represent institutional approaches to leadership (and indirectly, strategic) renewal. For example, Weisbach (1995) studied the relationship between mandatory CEO turnover and divestitures of recent acquisitions, observing that the probability of divesting a poorly performing acquisition sharply increased following the exit (mandatory retirement) of the CEO who made the acquisition.

Second, the adoption of a mandatory retirement policy indicates something of the inner workings, power structures, and recent problems confronted by firms. For this reason, attention should be paid to the factors associated with *adoption* of mandatory retirement provisions for senior executives. Not all firms have such policies, and their adoption may stem from very important institutional, agency, and organizational life-cycle forces. In fact, the adoption of mandatory retirement provisions for senior officers could signal a fundamental shift within a firm regarding beliefs about executive entrenchment, staffing, and organizational adaptation.

Third, mandatory retirement provisions are sometimes abrogated when a particularly influential CEO convinces the board that he or she should stay beyond the legislated date. Some visible cases include Roy Vagelos at Merck and Jack Welch at GE. It could be interesting to study the conditions that give rise to such abrupt cancellation of company

strictures, as well as the effects of lingering CEOs—say, on the retention and motivation of other senior executives and on stock market reactions.

The most theoretically interesting type of CEO exit is the dismissal. Dismissals arise from a complex and far-ranging set of organizational factors (Fredrickson, Hambrick, and Baumrin 1988; Shen and Cho 2005). It is not clear how many CEOs are dismissed, but most traditional accounts suggest a range of 10 to 20 percent (Herman 1981; James and Soref 1981; Vancil 1987; Boeker 1992). We say “traditional” because very recent evidence suggests that the incidence of CEO dismissal increased sharply in the 1990s and 2000s, and along with the increased dismissals came sharply increased selection of outsiders as new CEOs (Wiersema 2002; Huson, Parrino, and Starks 2001). We will discuss these issues later in the chapter. The extent of these increases, the factors behind them, and whether the increases are likely to be permanent or temporary provide important opportunities for future research.

Because CEO dismissals have been the explicit or implicit focus of most research on executive departure, our discussion of precipitating factors is primarily oriented toward their explanation. In some places, we depart from the focus on dismissal to reconcile with the phenomena of overall turnover.

The methods for detecting dismissals have varied substantially, especially in the early years of study, reflecting the fact that forced departures are often euphemistically presented to the public.² Some researchers have relied on departure before age sixty-five (the typical mandatory retirement age in large U.S. firms) as signaling dismissal (Vancil 1987; Puffer and Weintrop 1991). Some have relied on press accounts, in some cases triangulating across multiple accounts of a departure (James and Soref 1981; Shen and Cannella 2002a, 2002b). More recently, the tendency has been to consider both the age of the person at exit, coupled with the observation of whether or not he or she retains a seat on the board (Shen and Cannella 2002a; Denis and Serano 1996; Denis and Denis 1995; Denis, Denis, and Sarin 1997; Kim 1996). In fact, Shen and Cannella (2002b) found nearly 100 percent agreement between the “age and board continuity” measure and press reports describing the exit as involuntary. Finally, a quite ingenious and reliable approach to identifying dismissals was Boeker’s (1992) use of the detailed records of two major market research firms in the semiconductor industry to identify CEO dismissals in that industry.

Organizational Performance

Why do CEOs lose their jobs? The most obvious answer is: *because their organizations are performing poorly*. On this matter, the research is abundantly clear; poor organizational performance tends to precede executive departure. Some studies have focused specifically on the CEO and some on a broader set of top executives. Some studies have attempted to identify the effects of performance on dismissals in particular, while some have examined the effects on executive turnover in general, envisioning a combination of dismissals, voluntary “escapes,” and executive fatigue in the face of poor performance. Essentially all the studies have sufficiently arranged the chronology of their data to allow the conclusion that the poor performance *preceded* the departures. As we shall see in [chapter 7](#), this issue of temporal order becomes more problematic when considering research on the *effects* of executive departures.

However, even though a general relationship exists between poor performance and executive departure, the various studies are somewhat disjointed because of their widely differing samples (ranging from large conglomerates to semiconductor firms to baseball teams) and measures of performance. One major series of studies, among the earliest to systematically study succession, found that the won-lost records of sports teams were

associated with general manager turnover (Grusky 1963; Gamson and Scotch 1964; Allen, Panian, and Lotz 1979). Some studies have documented the effects of poor stock returns on executive departure (Benston 1985; Coughlan and Schmidt 1985; Warner, Watts, and Wruck 1988). Others have relied on profitability measures as predictors of executive departure (McEachern 1975; Salancik and Pfeffer 1977a; James and Soref 1981; Wagner, Pfeffer, and O'Reilly 1984; Harrison, Torres, and Kukalis 1988). A growing number have used both types of measures (Denis, Denis, and Sarin 1997; Denis and Serano 1996; Huson, Parrino, and Starks 2001; Shen and Cannella 2002a), sometimes making direct comparisons of the explanatory power of the different measures (e.g., Weisbach 1988; Brickley, Linck, and Coles 1999). In his study of CEO dismissals in semiconductor firms, Boeker (1992) used sales growth as the performance measure because many of the companies in the sample were relatively young and still building their strategic positions; for them, profitability would not have been a relevant indicator (also, since many were privately held, stock return data, which might have been relevant, were not available). And, in an intriguing paper, Puffer and Weintrop (1991) found that CEO dismissal was more tied to the gap between security analysts' expectations and actual company earnings than to the absolute level of stock market or accounting performance of the company.

Overall, the pattern of poor performance preceding CEO executive departure is robust, recurring in sample after sample and across various performance measures. However, the explanatory power of firm performance is not particularly strong; that is, organizational performance, while statistically associated with executive departure, does not explain a great deal of variance in departure. In the above-cited studies, the variance explained by performance was always below 50 percent and typically in the range of 10 to 20 percent. On a more intuitive level, it is relatively easy to think of CEOs who have been dismissed when their organizations were performing well and others who have held onto their jobs through years of poor performance.

To some extent, researchers might explain more variance in executive departure by examining the various forms of disappointing performance. Aside from considering multiple performance metrics (say, profitability, stock returns, and sales growth), researchers should examine each metric from different vantages: its level, its trends, its persistence, and its deviation from expectations. This raises the question: What is most likely to get CEOs fired—low performance, persistently low performance, steadily deteriorating performance, or, as Puffer and Weintrop (1991) found, unexpectedly low performance? Do these associations change over the tenure of the CEO? To begin answering these questions, it would be interesting to assess the relative influence of these various performance shortfalls on executive departure; it might also be useful to develop a summative index of *overall* performance (composed of various elements) as a basis for predicting departure.

Along these lines, Kim (1996) specifically focused on the temporal dynamics of firm performance and its association with CEO turnover, basing his study on Hölmstrom's (1982a) observation that once a CEO's reputation or track record is established, the marginal effect of new performance information is weakened, such that the effects of recent performance will be lesser for longer-tenured executives than for short-tenured ones. Kim's (1996) evidence pointed to two conclusions. First, for his sample, the baseline likelihood of exit (i.e., the performance-independent likelihood) was lower for CEOs early in their tenures and those in office ten years or more (compared to those with intermediate tenure). Second, when the analysis was restricted only to dismissals, the effects of a given year's performance decayed rapidly during the first five years of the CEO's tenure, then leveled off, then decayed further for executives with ten or more years of tenure. Put differently, long-tenured CEOs have typically accumulated such solid track records that recent, or current, performance downturns did not greatly influence the likelihood of their dismissal. Of course, CEO power

might also explain the observed temporal dynamics in linking current firm performance to CEO dismissal.

Different performance measures may have different triggering effects on CEO departure, depending on the context. For example, profits might be the salient performance indicator for large, mature firms, but sales growth might provide the basis for executive retention versus departure in small, growth-oriented firms (Boeker 1992); or profits may be associated with executive departure for one type of ownership configuration, but stock returns may be a stronger determinant of departure under another ownership configuration (Salancik and Pfeffer 1980; Denis, Denis, and Sarin 1997). Finally, for non-CEOs with specific and identifiable responsibilities (e.g., CFOs), Reutzell and Cannella (2004) showed that measures of performance directly linked to those responsibilities are important predictors of exit. As these examples suggest, and as the modest degree of variance explained by performance indicates, the researcher who seeks to accurately predict executive departure will need to look beyond performance to other precipitating factors. Among the more promising of these factors are the agency conditions existing in the firm.

Agency Conditions

Since Berle and Means (1932) documented the increasing separation of ownership and managerial control of large U.S. corporations, theorists have been interested in the implications of varying relationships between owners (or principals) and managers (or agents). Agency theory has many facets (Jensen and Meckling 1976; Eisenhardt 1989a), with clear implications for executive retention versus departure.

One series of studies examined whether CEO tenure depends on the ownership configuration of the firm. McEachern (1975) found that the tenures of owner-managers (those with at least 4 percent of stock) were substantially greater than the tenures of other CEOs. In an elaboration on McEachern's work, Salancik and Pfeffer (1980) sought to determine whether the association between company performance and CEO tenure varied, depending on ownership profile. They found that in owner-managed companies, no association existed between performance and tenure; in "externally controlled" firms in which at least one non-manager held a concentrated amount of stock, a positive association existed between profitability and tenure; and in "management-controlled" firms, in which shares were widely dispersed with no single major owner, stockholder returns were found to be positively associated with tenure. Allen and Panian (1982), in a closely related study, found that in firms in which a family owned 5 percent or more, CEOs who were not members of that family had (1) shorter tenures and (2) tenures more closely tied to performance than did CEOs who were members of the controlling family or where there was no such controlling interest. Thus, across these projects, there is evidence that ownership configuration affects executive tenures, with owner-managers, not surprisingly, somewhat sheltered from the disciplinary consequences of poor performance.

A potential problem arises, however, in focusing on the CEO's tenure as an indicator for whether he or she is buffered from dismissals, as has been the logic in some of the above-cited studies. Tenure represents *all* the years that the CEO has been in office, which in turn is a function of how long he or she is allowed to stay, as well as *how early he or she started the job*. Because owner-managers are relatively likely to have been founders or members of founding families, they probably become CEOs at younger ages than those who are not major owners. Therefore, the long tenures of owner-managers may be due as much to their early starting dates as to their relative immunity from dismissal.

Several studies have examined dismissals specifically, so we have some opportunity to

observe the disciplining of CEOs under differing ownership contexts.

James and Soreff (1981), as noted earlier, found that poor profitability was associated with dismissal. However, contrary to their expectations, they found no significant differences in the effects of poor performance on dismissal under different ownership situations, even with several established ownership classification schemes. Their sample was limited, however (only 16 firings), so their results are only suggestive.

Boeker's (1992) sample was more substantial (67 semiconductor firms over a 22-year period, with 115 CEO dismissals), and his results conform to what would be expected from agency theory. He found that CEOs' stockholdings were negatively related to dismissal in general, as well as in cases of poor performance. Moreover, in cases of poor performance, the more widely dispersed the ownership, the lower the likelihood of CEO dismissal.

More recently, Denis, Denis, and Sarin (1997) examined ownership structure and its impact on the firm performance—departure association. They concluded (and they note agreement with McConnell and Servaes 1990) that executive turnover was negatively associated with the ownership stakes of officers and directors, and positively associated with the presence of at least one large outside block holder. Thus, across various studies, it appears that owner-managers are somewhat buffered from dismissal. Similarly, widely dispersed ownership can also protect the CEO from dismissal, even when performance is poor. A CEO is most vulnerable when he or she owns little stock and someone else owns a lot.

Agency theory also allows predictions of dismissal based on board composition. Here, too, the data provide a fairly consistent picture. Salancik and Pfeffer (1980) established the general finding that the greater the percentage of board members who are insiders—that is, officers largely beholden to the CEO—the longer the tenure of the CEO. Weisbach (1988) similarly found the relationship between performance and executive tenure held only in companies whose boards were dominated by outsiders. And Boeker (1992) found that in situations of low performance, the percentage of insiders on the board was negatively related to dismissal. In a single dissenting study, Denis, Denis, and Sarin (1997) did not find an increased performance-turnover sensitivity for firms with outsider-dominated boards (e.g., boards with more than 50 percent independent outside directors).

Overall, agency conditions—as manifested in ownership profile or board composition—have considerable effects on executive departure. The greater the CEO's control—through his or her own stockholdings, through the absence of a major vigilant owner, or a small contingent of independent outsiders on the board—the lower the likelihood of dismissal, even when performance is poor. Recently, however, several studies have taken a somewhat different tack by examining how external agency pressures, particularly the market for corporate control, can influence executive turnover and dismissal.

Hadlock and Lumer (1997) compared the firm performance–CEO turnover situation in the 1930s and 1940s with more recent times, under the assumption that no market for corporate control existed in the early period. Their evidence indicated that involuntary turnover in the early period was nearly nonexistent and had no connection with shareholder returns. However, they also found that CEO pay was much more closely tied to corporate performance in the early period. The authors concluded that in the more recent period, boards have been spurred to action (CEO dismissal) by the potential threat of takeover.

Walsh and Kosnik (1993) came to similar conclusions in their study of how hostile takeover attempts for one firm in an industry affected the turnover of officers and directors in other firms. The three groups they compared were firms targeted by corporate raiders, their closest competitors, and a control group. The authors found evidence of market discipline only among target firms and their competitors—if those competitors were suffering from sustained poor performance. The authors concluded that disciplinary effects from the market

for corporate control do stimulate some boards to action.

Similarly, Denis and Serrano (1996) studied management turnover following unsuccessful control contests, and noted that 34 percent of the firms in their sample changed top managers within two years. In most of the dismissal instances, outside blockholders arose as a direct result of the control contest. Without the outside blockholders, managers tended to keep their positions (postcontest) despite poor performance. The authors concluded that poorly performing firms without independent blockholders were much less likely to initiate turnover. Additionally, firms with no post-contest turnover were more likely to have experienced contest-related increases in management holdings, rather than increases in independent block holdings. This study suggests that corporate control activity may increase turnover, but the effects are mediated by ownership structure.

Finally, Arthaud-Day, Certo, Dalton, and Dalton (2006) noted that punishment for poor performance goes beyond poor profitability, as they demonstrate that challenges to firm legitimacy in the form of financial restatements also lead to high levels of turnover among CEOs and CFOs. Their study implies that the severity of the legitimacy threat is important to turnover, and that those most likely responsible for the financial restatements suffer the worst consequences (i.e., turnover).

Another stream of research focuses on executive discretion as an influence on dismissal. In an interesting theoretical synthesis, Shen and Cho (2005) outlined a refined way to think about the effects of executive discretion on involuntary executive turnover. They developed the concepts of latitude of objectives (LOO) and latitude of actions (LOA). LOO refers to the freedom that managers have to pursue their own self-serving objectives, a concept that flows from economists' models of discretion (Williamson 1963). A manager under strong performance pressure from large investors would be an example of a low LOO context. LOA refers to the range of alternatives or options open to the manager, following from managerial concepts of discretion (e.g., Hambrick and Finkelstein 1987).

The authors place these two dimensions on a two-by-two matrix and evaluate the theories that are most likely to explain exit under each of the conditions. Under low LOO and low LOA, there is high pressure from shareholders, but there are also few options available to managers. Involuntary turnover in this setting is best explained by scapegoating theory, and the exits will most often involve top-tier executives. Under high LOO coupled with low LOA, there is little pressure from stakeholders, but few strategic options are available. Here, involuntary turnover will be best explained by sociopsychological dynamics among the top management group (e.g., Wagner, Pfeffer, and O'Reilly 1984) and the exits will be largely among executives whose values and perspectives are different from those of top-tier executives.

In situations of low LOO coupled with high LOA, there is high pressure from shareholders to generate profits or growth and a wide array of choices regarding how to proceed. Here, adaptation theory explains best. Involuntary turnover represents an attempt to adapt and occurs mostly under poor performance or environmental change. Turnover will tend to be among those who can no longer contribute because their skills are poor or obsolete. Finally, in situations of high LOO coupled with high LOA, there is little pressure from shareholders, and there are lots of options about how to proceed. Involuntary turnover in this context will follow both from the dynamics in the TMT (Shen and Cannella 2002a) as well as from poor performance. It will also tend to reflect a passive response to deteriorating performance, rather than an active attempt to adapt.

Other Organizational Characteristics

Beyond agency conditions, other characteristics of the organization may also affect the

likelihood of executive succession. Organizational size has particularly been examined in this regard. Grusky (1961) compared the largest twenty-six and the smallest twenty-seven *Fortune* 500 companies in the early 1960s and found that the larger companies experienced more frequent executive successions. Grusky's interpretation was that larger firms are more institutionalized and can experience CEO succession without great disruption; hence, they may be relatively likely to have mandatory retirement provisions to make room for other qualified executives to advance and a willingness to dismiss the CEO if performance falters. It is important to note that Grusky's sample, encompassing the top and bottom of the *Fortune* 500, was very restricted in its range of company sizes. Namely, no truly *small* companies were included.

Attempts to corroborate Grusky's finding have yielded mixed results. James and Soref (1981) found that the larger firms in their sample were more likely to fire their CEOs than were the smaller firms. However, in their studies of CEO dismissals, Puffer and Weintrop (1991) and Boeker (1992) found no effects from organizational size.

Our own interpretation is that size will tend to be positively associated with overall CEO *turnover* rates, but primarily because CEOs in large companies are appointed to their jobs at more advanced ages (Vancil 1987), and because those companies are relatively likely to have mandatory CEO retirement. In line with Grusky's logic, these characteristics exist because of the bureaucratization and institutionalization in large firms. However, it is doubtful that bureaucratization engenders a higher rate of CEO dismissals in large firms.

Recent study has raised additional questions about the implications of firm size for executive departure. Several issues seem prominent. First, smaller firms are more likely to have either large outside blockholders or significant managerial owners. These have opposing effects on the performance-turnover relationship. Samples that do not carefully control for these opposing forces are likely to draw invalid conclusions. Second, smaller firms naturally have fewer insider executives from which to choose in making CEO selection decisions. The well-known tendency of smaller firms to select outsiders (e.g., Dalton and Kesner 1983) is perhaps most easily explained by this reasoning.

Finally, recent research has indicated that family and/or founder ownership is a very important factor not only in developing countries, but in the United States as well (Anderson and Reeb 2002; Rubenson and Gupta 1992; Anderson and Reeb 2003). Since Berle and Means (1932), researchers have tended to overlook family ownership, and when it is noted, to view it negatively (Demsetz and Villalonga 2001; Miller and Le Breton-Miller 2003; Miller et al. 2007). The work cited above implies that family control over U.S. public corporations is much more widespread than has been recognized by prior researchers. Much of the recent work, particularly the research of Anderson and colleagues, implies that the overall health and performance of the firm may be increased, sometimes dramatically, by concentrated ownership and control.³ Clearly, a number of research opportunities exist in fleshing out the implications, costs, and benefits of long-term family control in the public corporation—including its effects on executive turnover.

In short, we do not believe that the final work on organizational size, ownership conditions, and CEO succession has been written. Our best estimate of what will be found is expressed in the propositions below.

Proposition 6–1: Large firms have more frequent CEO turnover than small firms, (due primarily to advanced age at time of appointment and mandatory retirement provisions).

Proposition 6–2: Small firms are more likely to dismiss their CEOs than large firms

(after controlling for performance, ownership profile, and so on).

Proposition 6–3: Relative to non-family-controlled firms, family-controlled firms are more likely to dismiss CEOs who are not family members, and less likely to dismiss CEOs who are family members.

Proposition 6–4: The effects of recent performance on CEO dismissal will be moderated by the CEO's cumulative tenure-long track record. Namely, the greater the cumulative prior performance of the CEO, the less effect that current performance shortfalls will have on his or her dismissal.

One more organizational characteristic not yet examined by researchers may have an important effect on CEO departure rates, including dismissals. We speak of the structure of the firm, particularly whether it consists of divisions (the “M-form” of Williamson 1975) or not. Essentially, a divisional structure creates multiple general management positions that enhance training for, and observation of, potential CEO skills. In contrast to a functionally organized firm, in which no executive other than the CEO has experience in running an entire business, the firm with a divisional structure (which may also have a layer of group executives responsible for multiple divisions) is more likely to have a ready pool of potential internal CEO candidates. We expect that such firms will have relatively high rates of CEO turnover, because their supply of internal talent not only warrants mandatory CEO retirement provisions to make room for advancement of others, but also provides ready replacements for faltering CEOs. Thus:

Proposition 6–5: Firms with a divisional structure have higher CEO turnover rates than do firms that are functionally organized.

Environment

Factors external to the firm, particularly industry characteristics, may also influence rates of CEO succession. One line of thought is that CEO succession rates vary with the industry's age or stage of development. However, the influence of these factors may affect overall executive turnover rates and dismissals in opposing ways. First, firms in young, high-growth industries will tend to have young executives (Harris and Raviv 1979). Therefore, succession due to mandatory retirement, death, and illness should be less frequent in young industries than in mature industries. However, the ambiguity of means-ends relationships is greater in young industries than in more mature ones (Pfeffer and Moore 1980), causing uncertainty and, in turn, strong causal attributions about the effectiveness of organizational leaders (Meindl, Ehrlich, and Dukerich 1985; Hambrick and Finkelstein 1987). When firms in young industries do not perform well, the leader is likely to be seen as the source of the problem and replaced. When firms in more mature industries do not perform well, observers are more likely to attribute the problem to industry conditions, instead of company executives. Therefore:

Proposition 6–6: Dismissals in young, growing industries are more common than in mature industries.

The number of firms in an industry may be another characteristic affecting executive turnover. Fredrickson, Hambrick, and Baumrin (1988) asserted that the larger the number of firms, the greater the potential supply of eligible candidates for a CEO job. Parrino (1997) went one step further, describing how the homogeneity of firms in an industry has two

interdependent effects on executive turnover. First, because the firms in a homogeneous industry are more directly comparable to each other, it is easier for directors to determine whether or not problems derive from the abilities of the CEO. Second, given that the board has identified the CEO as an underperformer, it is relatively easier to find a replacement in a homogeneous industry because skills are directly transferable across member firms.

The initial public offering (IPO) context is an important one for studying how the rapidly changing needs of the firm lead to the need for new CEO skills. Li and Cannella (2007), for example, develop theory to explain the changing skill needs of biotechnology firms, as they approach IPO, conduct the offering, and survive as public companies. Venture capitalists (VCs) were predicted to strongly influence this process. The authors also predict that when VC ownership is high, there will also be a high propensity for technically oriented founders to be replaced by professional managers prior to the IPO. The IPO context offers abundant opportunities to study CEO skills because the evolution of firm needs is quite rapid; the backgrounds of founders seldom prepare them for the full range of firm needs; and the presence of powerful outside owners prompts quick changes in senior leadership.

Environmental discontinuities are another important external factor related to executive succession. Haveman, Russo, and Meyer (2001) studied how organizations responded to discontinuous changes in their environments. The authors argued that dynamic environmental discontinuities often force organizations to change, but the changes are not necessarily immediate. Rather, change most often unfolds over time, because power distributions in organizations are relatively stable and because accrued resources and legitimacy do not disappear immediately, but decline slowly. Indeed, sustained poor performance is often necessary to prompt changes. Following this logic, their results indicated that the rate of CEO change immediately following a discontinuity was unaffected, but then gradually increased over time.

A final environmental factor that could be important to consider in succession research is the effects of fads and fashions (e.g., Abrahamson 1991) or styles (e.g., Ocasio and Kim 1999). As noted earlier, there was a large increase in the rate of CEO dismissal and outside succession in the late 1990s, and the trend continues at this writing. Whether this increase becomes institutionalized or represents a more short-term fluctuation (e.g., a “fad” or a “style”) remains to be seen. Regardless of whether or not the increase is permanent, we should be able to observe its diffusion through the intercorporate network (e.g., Davis 1991; Westphal and Zajac 1995). We believe that excellent research opportunities exist in this realm, as outlined by the propositions below:

Proposition 6–7: Dismissals are more likely when outside directors on the firm’s board have participated in dismissals in other firms where they have served as outside directors.

Proposition 6–8: Outside successions are more likely when directors on the firm’s board have participated in outside successions in other firms where they have served as outside directors. Additionally, when one or more of a firm’s outside directors are themselves outside successors in their home firms, the likelihood of selecting an outside successor is increased.

Proposition 6–9: Because institutional pressures associated with dismissals increased in the late 1990s, the likelihood that firms will describe dismissals in press releases in specific terms, identifying the exit as a dismissal, will be increased. Put differently, the use of euphemistic terms to describe dismissals will be decreased.

Predecessor (Incumbent) Characteristics

Finally, the characteristics of the incumbent CEO must be considered for their possible influence on successions. We have already discussed how the CEO's own stockholdings tend to protect him or her from dismissal, but other forms of power could achieve the same end. These bases of power could include the executive's tenure (Hambrick and Fukutomi 1991; Ocasio 1994), achievement of a patriarchal aura (Vancil 1987), simultaneously holding the board chair and the CEO position (Finkelstein and D'Aveni 1994), as well as other forms of power described in the literature (Finkelstein 1992). In fact, the CEO's power may not only be a basis for avoiding dismissal, but may also be the dominant factor in the waiving of mandatory CEO retirement provisions—which, again, are the biggest driver of CEO departures.

Elements of the CEO's personality also can be expected to affect his or her propensity to stay on, or depart from, the job. In an in-depth analysis of CEO departure patterns, Sonnenfeld (1988) found that some executives cling tenaciously to the job, because they have a "heroic self-concept." Sonnenfeld did not specify the personality constructs that may constitute this syndrome, but narcissism, need for power, and even neurotic delusions of grandeur may be among a psychologist's conceptual explanations (McClelland 1975; Zaleznik and Kets de Vries 1975; Kets de Vries and Miller 1984; House, Spangler, and Woycke 1991).

In sum, the likelihood of CEO succession depends on a wide range of precipitating factors. The organization's performance is clearly a key element in a succession model, but it by no means is the sole factor. The agency conditions in the firm, other organizational characteristics, the external environment, and the characteristics of the incumbent (particularly his or her power and personality) are all needed to achieve strong predictions of executive departures. These same precipitating factors influence the succession process, to which we now turn.

What Will Be the Dynamics of the Succession Process?

Some CEO successions are messy, noisy, and traumatic for the organization and the individual contenders. Other successions seem like non-events, barely noticeable or noteworthy. Unfortunately, little research has been done on succession processes. The explanation for this lack of research is readily apparent. In contrast to more publicly traceable aspects of succession, an examination of processes typically requires access to highly sensitive deliberations and events inside the organization. The most comprehensive analysis of succession processes was undertaken by Richard Vancil (1987), whose book title *Passing the Baton* reveals his own preference for smooth, orderly transitions. However, his research, based on in-depth interviews with CEOs and board members, describes an array of succession profiles.

Types of Successions

At one extreme, and most "healthy" in Vancil's eyes, is the "relay race" (Vancil 1987, 13). With this approach, an heir apparent is selected well before the incumbent's departure, typically elevated to a clear "number two" status in the organizational hierarchy (usually with the title of president or chief operating officer), and readied for the transition to the CEO slot (Figure 6.2). This approach is orderly and emphasizes continuity.

An alternative succession process is the "horse race." With this approach, two or more

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executives are placed in competition with each other for the top job (Figure 6.2). Sometimes a horse race is run very explicitly, with contenders clearly designated and the entire organization and even the media watching intently. Such was the case when Jack Welch at GE placed several executives in a horse race to succeed him—a contest won by Jeffrey Immelt. Sometimes, however, a horse race is more discreet; the contenders are told they are in the race, but no public acknowledgment is made of the contest. In some cases, the contestants may not be told expressly that a race is on or that they are in it. Such ambiguity allows flexibility, perhaps minimizes heated rivalry and acrimony, and even injects into the process a further test of ambition and astuteness.

Sometimes a horse race precedes a relay, with contestants vying for the heir-apparent slot (Figure 6.2). Indeed, it could be argued that until an heir-apparent is designated, an implicit horse race is under way, as ambitious executives vie to improve their chances for later phases of the tournament (Lazear and Rosen 1981).

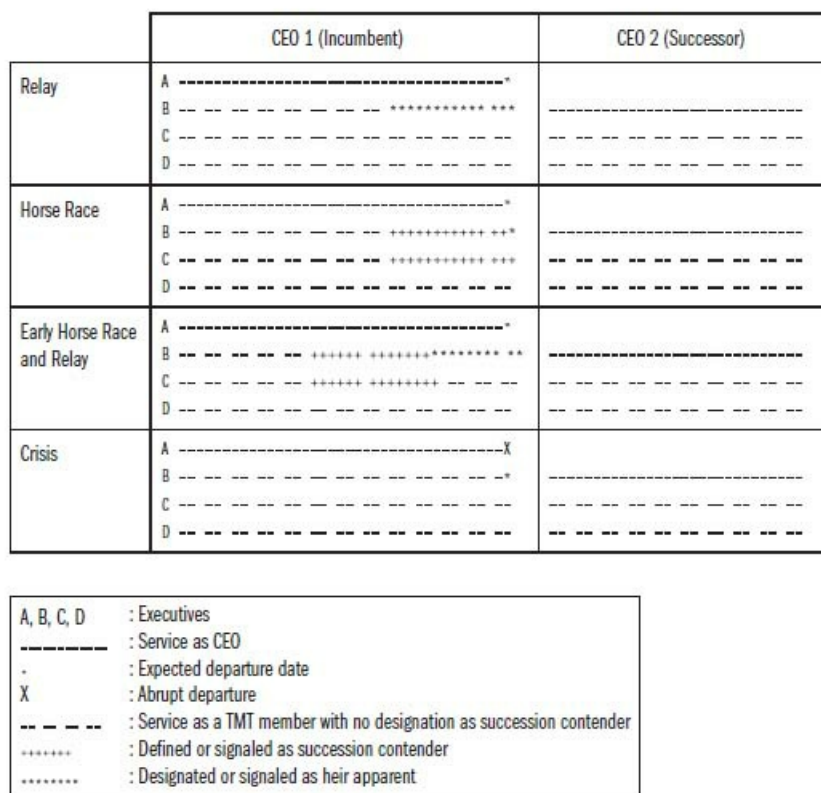


Figure 6.2. Some Major Types of Succession Processes

Third, there are crisis successions in which there is no designated heir-apparent (Figure 6.2). These may include cases of illness or death or, more commonly, the abrupt dismissal of the incumbent. Finally, Shen and Cannella (2002a) outlined a fourth potential succession process—the power contest. Here, one or more top management team members challenge the incumbent’s fitness to serve as leader. If successful, the CEO is replaced with one of the challengers. We will have more to say about this type of succession later in the chapter.

The factors that determine which of these succession processes will occur have recently received a good deal of research attention. Various forces enter in, including, in the case of crisis, essentially stochastic factors. In the section below, we focus specifically on the factors that might give rise to a horse race as opposed to a relay.

First, the horse race requires multiple viable contestants. At the most basic level, it needs

two or more executives who are the “right age,” that is, who could serve at least several years if they won the contest. Executives over sixty years of age are rarely considered as CEO candidates (especially in companies with mandatory executive retirement at age sixty-five), thus limiting the field, or even the potential, for a horse race. Beyond executive age are additional systematic forces that favor one succession mode or another. We expect the following:

Proposition 6–10: A horse race succession process is more likely than a relay if (1) the company has a divisional (M-form) organization with multiple general management positions as CEO proving grounds; (2) the largest operating units are of roughly equal size; and (3) more than one of the largest operating units are relatively high-performing.

These conditions give rise to multiple eligible contenders, all of whom may feel that they should be carefully and thoroughly considered for the CEO job. The likelihood of a horse race also increases if the company does not have an entrenched tradition of a COO position, a typical stepping-stone in a relay (Cannella and Shen 2001). However, Hambrick and Cannella (2004) point out that the COO position is not limited to an heir apparent. Some, perhaps many, COOs are just that—chief operating officers—who have little expectation that they will become CEOs. We will discuss COOs in detail in a later chapter.

Conversely, a relay is most likely in firms that have an institutionalized COO position, that are functionally organized, or have one subunit that exceeds all others in size, strategic centrality, or performance. In such firms, there is a clear stepping-stone for one executive to the top job.

Finally, firms may differ systematically in *how early* they designate their heirs apparent (either via an early horse race or relay hand-off). In conditions of turbulence and instability, there are benefits to delaying the choice of CEO as long as possible, so that the most current criteria can be applied in the selection. Conversely, in more stable situations, the needed qualifications of the next CEO can be anticipated further in advance, and little is gained in postponing the designation. Thus:

Proposition 6–11: The more stable the industry and the more stable the firm’s performance, the earlier an heir apparent will be selected—either through a relay or an early horse race. If the environment or strategic situation is turbulent, decision makers are relatively likely to postpone their choice for a new CEO, so they can be relatively sure of emerging requirements for leadership qualifications.

Several recent studies have provided important evidence on succession processes. Ocasio (1999) studied how boards are influenced by rules of CEO succession, arguing that CEO succession is routinized and conditioned by formal and informal rules. An example of a formal rule is the appointment of an heir-apparent—a public commitment that the successor has been identified and is expected to be promoted in due time. An example of an informal rule is the prevalence of inside versus outside succession among firms in the economy at the time that the incumbent was selected. Following this logic, Ocasio modeled succession (the occurrence of a CEO transition) and selection (whether the successor is an insider or an outsider) as interdependent phenomena. His theory predicted that older firms have more experience and therefore act in more rule-bound ways, especially compared to initial founder successions that occur when the firm has no prior experience to draw upon. His evidence suggested that boards relied on both past precedents and formal internal labor markets for executive succession and selection decisions. Further, he was able to show that reliance on

rules did not derive from rational or adaptive strategies, or from the social ties of outside directors to candidates. For his sample, rules both enabled (e.g., an increased rate of succession when rules were in place) and constrained (e.g., rules were often relied upon even when poor performance, insider ownership, and advanced firm age suggested that the rules should be violated). Finally, Ocasio concluded that rules were not always consistently applied or context free. Put differently, succession rules matter, but their application is not inevitable.

Vancil's (1987) discussion of succession highlighted the importance of heirs apparent, or designated successors, in relay successions. Cannella and Shen (2001) studied the tenures of heirs apparent and the factors that influenced the rates of promotion and exit among them. The study was based on the assumption that decisions about heir-apparent promotion and exit are inherently political and are influenced by the firm's performance profile. The authors' theory (like Vancil's) predicted that CEOs would be conflicted regarding their heirs apparent. On one hand, appointment of an heir is an incumbent's best chance to secure a lasting legacy. On the other hand, an heir represents the intended replacement for the incumbent, thereby symbolizing the incumbent's mortality. Cannella and Shen found that, under conditions of good performance, CEOs attempted to delay promotion of their heirs and sometimes even tried to force heirs out of the firm. Alternatively, under poor performance, CEOs tended to stand behind their heirs, as board challenges to the heir's advancement also amounted to challenges to the incumbent CEO. The distribution of power among the incumbent CEO, outside directors, and the heir apparent importantly influenced the rate of heir apparent promotion as well as exit.

Taking a very different approach to succession, Zhang and Rajagopalan (2004) studied conditions when firms do *not* designate heirs apparent—for example, when firms use horse races, whether explicit or covert. They noted that planning for succession is critical to strategic management, but that relay successions have both advantages and disadvantages. Disadvantages include the tendency toward conformity across CEOs, reduced flexibility around the choice of successor, and demoralization of other executives. The study's evidence, in accord with [Proposition 6-10](#), implied that when there were more internal candidates, the likelihood that the firm would have an heir apparent was lower, and this association was accentuated under poor performance. Poor performance also had a main effect of decreasing the likelihood of heir selection. Additionally, when there were many larger or equal-sized firms in the industry (more prospective outside CEO candidates) the likelihood of selecting an heir apparent was lower. Finally, high strategic conformity to industry norms (again, more prospective outsider candidates) lessened the likelihood of an heir apparent.

Two additional studies imply that while succession processes are important to the functioning of the firm, they are also important to investors. In the first, Harris and Helfat (1998) reinterpreted evidence from Worrell, Nemec, and Davidson (1997), who had noted a negative stock market response when the top officers in their sample held all three top titles (chairman, CEO, and president). They concluded that simultaneously holding these three titles indicates CEO entrenchment, hence the negative response from investors. Harris and Helfat argued that the negative response might also be due to the fact that holding all three titles indicates a lack of succession planning. They explained how Worrell and colleagues' results (a negative investor response for holding all three titles, but no response for combinations of two titles (chairman-CEO and CEO-president) were also consistent with the argument that investors like to see evidence of succession planning.

In the second study, Shen and Cannella (2003) examined investor responses to both the initiation and the outcome of relay successions. Their evidence suggested that investors responded positively to promotion of heirs apparent, but negatively to nonrelay inside succession. Further, investors responded positively to outside succession. The study also

investigated the role of current firm performance in the investor reaction. While investors generally responded favorably to heir promotion, under good performance the response was significantly stronger than under poor performance. Further, for heir exit, the opposite result held: the impact of firm performance on investor reaction to heir exit was negative, implying that when performance was poor, investors preferred the disruption of heir exit to completion of the planned relay succession. The authors interpreted these results as indicating that investors want firms to commit to relay succession planning under good performance, but to drop those plans when firm performance is poor.

Influence of the Incumbent versus the Board

The task of selecting a new CEO is expressly bestowed on the board of directors (Vancil 1987; Lorsch and MacIver 1989), and some theorists have concluded that it is the only task the board can credibly or effectively perform (Mizruchi 1983). Trends in board reform and investor activism in the past several years have probably led to more diligence and thoroughness by boards in selecting CEOs, and may have led to the recent increase in dismissals and outside successions noted earlier. However, it is widely believed that incumbent CEOs still often have a dominant role in the selection of their successors, frequently specifying both the process and the outcome.

In a classic article, Levinson (1974) implored CEOs, “Don’t choose your own successor,” arguing that incumbents lack objectivity about the new talents most needed and the abilities various candidates possess. However, many incumbents have clear favorites among their lieutenants and sometimes make promises, even if implicit, to specific candidates about eventual elevation. At a minimum, most CEOs have the human desire to further extend their impact on the organization through a hand-picked successor. In fact, incumbent CEOs can be expected to influence the succession process to the fullest extent allowed by the board.

Thus, succession processes can be incumbent-driven, board-driven, or somewhere in between (what Vancil 1987 refers to as “partnership”). Zald (1965) provides an in-depth portrayal of such a shared “partnership” succession process in a community service organization. In this particular case, the incumbent executive shaped the process, but the board made the actual choice, picking one of two internal candidates. A careful reading of Zald’s case study makes it clear that the board selected the candidate who was more aligned with the incumbent’s ideology, even though that candidate was initially far less well-known by the board than his rival. It was through shaping the process, particularly by creating forums for extended board exposure to the two candidates, that the incumbent succeeded in turning the long-shot contender into a winner.

Zald (1965) offers a useful inventory of factors that enhanced the influence of the incumbent in the succession process he studied. Drawing on Zald’s factors, but extending them with some additional items, we set forth the following propositions:

Proposition 6–12: The incumbent CEO will have influence in the succession decision to the extent that (1) the organization’s current performance is strong; (2) the incumbent has had a long tenure; (3) the board has had little firsthand exposure to the senior executives who are eligible succession contenders (this could be the case when numerous board members are relatively new, when the succession contenders are relatively new to the company, and when the succession contenders are not board members); (4) agency conditions serve to weaken the influence of the board. Such conditions include (a) widely dispersed shares with no single major owner (other than possibly the incumbent CEO); (b) board members own few shares; (c) the CEO also serves as board chairman; and (d) board members were

selected or appointed by the incumbent CEO.

The proposition above indicates that the same forces that lessen the likelihood that an incumbent CEO will be dismissed (as discussed earlier in this chapter) also buoy the incumbent's influence in the appointment of a successor. It is a matter of CEO power versus board power.

Two recent studies provide new theory and evidence relevant to the issue of board versus incumbent power in the succession context. First, a study by Zajac and Westphal (1996c) demonstrated that outside directors can be highly influential in succession decisions. While we will discuss the study in detail in the section on characteristics of the successor, it is worthwhile to note that for their sample, when performance was poor and/or outside directors were powerful, firms tended to select outside successors, and the characteristics of the outside successors tended to align with those of the directors, not the incumbent CEO. This evidence clearly supports the spirit of [Proposition 6-12](#).

The second study, by Shen and Cannella (2002a), proposed a succession process that had not been widely considered in the literature before. Drawing on the theory of power contestation (Ocasio 1994; Pareto 1964), the authors argued that some successions are not initiated by either the board or the incumbent, but by other top management team members. There are two situations when one or more top management team members might challenge the power of the incumbent CEO. The first is early in a new CEO's tenure, before his or her power is consolidated. Such situations typically involve executives who were passed over for the CEO position: they can sometimes successfully initiate a coup in which they replace the newly appointed CEO. The second is when the incumbent has served for a long time. In this situation, top management team members fear that the board will choose an outside successor, so they work to oust the incumbent and secure promotion of one of their own to CEO. In this situation, fear for their own employment (because outsiders tend to make more executive replacements) brings top management team members together, as they work to remove the incumbent CEO and to avoid an outside successor. The study concluded that CEO succession processes can sometimes be strongly influenced by executives other than the CEO. A follow-up study on performance outcomes (Shen and Cannella 2002b) bolstered the conclusion that power contestation, though not the norm, is not rare, and can lead to improved organizational adaptation.

Who Will Be Selected?

The selection of a new top executive is widely thought to be an important opportunity for the organization to adapt to the shifting requirements of its environment. Research at the aggregate level has found that some correspondence, in fact, exists between external conditions and the characteristics of CEOs. For example, Fligstein (1987) traced the increasing proportion of CEOs with finance backgrounds to U.S. antitrust laws that encouraged corporate diversification—a strategy favoring financial rather than operating competencies. Hambrick, Black, and Fredrickson (1992) found that CEOs in high-technology industries tended to be younger and have shorter tenures, more technical education, and more R&D experience than CEOs in low-technology industries.

Researchers also have found that executive characteristics tend to align with the context created by the organization. For example, Drazin and Kazanjian (1993) found that technology-based firms in the growth phases of their life cycle tended to have CEOs with technology expertise, whereas in later, more mature stages, CEOs with financial, administrative, and marketing backgrounds were more common. Datta and Rajagopalan

(1998) showed that new CEOs tended to match the requirements of their industries. Li and Cannella (2003) argued that venture capitalists would tend to replace technically oriented founders with more managerially oriented executives prior to initial public offering (IPO), and those that do replace technically oriented founders will have more successful IPOs. Pfeffer and Salancik (1978) laid out additional examples of alignments between critical contingencies faced by organizations and the characteristics of their CEOs.

Numerous normative models have been set forth, arguing for the need to match managerial characteristics with the specific demands of the job (Wissema, Van der Pol, and Messer 1980; Szilagyi and Schweiger 1984; Gupta 1986). Executive search firms also have their own frameworks and logics for specifying ideal executive characteristics needed for certain types of situations.

Our interest in this section follows in the same vein, by focusing on the question of who will be selected as the new executive in a given situation. By focusing specifically on succession events, we can improve our understanding of the underlying process by which aggregate covariation patterns, such as those noted above, occur. And by focusing specifically on succession events, we can examine how various precipitating forces give rise to selection outcomes.

The preponderance of empirical research on CEO selection outcomes has focused on explaining when an “outsider” will be chosen as the new leader. We examine this interesting issue in depth, but argue for a new way of conceiving of “outsiderness.” We then posit that the choice of an insider versus outsider as CEO is only one variation of the broader issue of how much continuity is needed or desired in executive staffing.

Insider versus Outsider Selection

The selection of a new CEO from outside an organization, traditionally occurring only in a minority of cases for business firms, has most often been interpreted as a stark indicator that the board of directors wants change (Vancil 1987; Lorsch and MacIver 1989). Conversely, the choice of an insider signals the board’s desire for more continuity and maintenance of current strategic thrusts. While some recent research has challenged this notion (e.g., Shen and Cannella 2002a, 2002b) it is still the dominant view among researchers and practitioners alike. (See also Shen and Cho 2005.) As we will discuss later, there has recently been a sharp increase both in the proportion of succession events that are dismissals and in the proportion of outside successors selected, especially following dismissals (Wiersema 2002; Huson, Parrino, and Starks 2001).

The Role of Performance

The most obvious potential predictor of whether a new CEO will come from the outside is the performance of the organization in the period before the succession. Of the several studies examining this issue, most have found that presuccession performance was lower in cases in which an outsider was appointed than in cases in which an insider was appointed. This pattern has been observed in samples of baseball teams (Allen, Panian, and Lotz 1979) and semiconductor firms (Boeker and Goodstein 1993), and in a cross section of large companies in various industries (Cannella and Lubatkin 1993).

While Dalton and Kesner (1985) found no association between prior performance and selection of an outsider CEO, their sample was appreciably smaller than those in the other studies noted here. Also, unlike the other studies, Dalton and Kesner examined performance (profitability and stock price) without adjusting for industry averages, thus making it difficult to interpret their results. We are quite confident in the conclusion that outsiders tend to be

brought into low performance situations.

However, even in studies in which poor performance and outsider selection were associated, the link was far from complete. The amount of variance explained by performance was less than 20 percent in Boeker and Goodstein's study and less than 10 percent in Cannella and Lubatkin's study. In the Allen, Panian, and Lotz (1979) study, the winning percentages of baseball teams selecting inside versus outside managers differed negligibly (49.6 percent versus 46.6 percent)—graphic evidence that low performance alone does not account for the insider versus outsider choice. Bolstering this conclusion is Huson and colleagues' (2001) comparison of dismissal and outside succession in the 1970s to dismissal in the 1990s. While the authors documented a sharp increase in both outside succession and dismissal, the performance-dismissal association was unchanged and was not particularly strong for either period. Therefore, we must seek other explanations for dismissal and outside succession.

Social and Political Factors

The choice of an outsider as a new CEO is a highly charged decision. It represents a repudiation of the incumbent's strategic direction, or at least of his or her staffing capabilities; it violates implicit deals with potential inside successors; and it stymies other executives whose careers likely would have been advanced with the ascendance of an insider (Cannella and Lubatkin 1993; Shen and Cannella 2002a, 2002b). Since outside succession is an extraordinary event for business firms, additional conditions must exist for the board to turn outside for a new leader. Poor performance alone is not enough.

Several studies have focused on these conditions, particularly political and agency factors, that predict outside succession. Boeker and Goodstein (1993) found, for instance, that the greater the proportion of insiders on the board and the greater the ownership concentration among the board insiders, the less likely a new CEO would come from the outside. Cannella and Lubatkin (1993) found that when the incumbent CEO also was the board chair, the likelihood of outside succession was diminished. Shen and Cannella (2002a) showed that non-CEO executives could coalesce against an incumbent CEO, especially when they were threatened with an outsider succession. These findings clearly signal the role of agency and political factors, including the strength of insiders, in affecting the choice of insider versus outsider succession. Other aspects of agency conditions, such as ownership concentration, percentage of institutional holdings, percentage of the board appointed during the tenure of the incumbent, and the stockholdings of the incumbent, should be included in future studies.

The Common Origins of CEO Dismissal and Outside Succession

Indeed, the decision to hire an outsider CEO emanates largely from the same forces that give rise to CEO dismissal. This is not to say that dismissal always leads to outside appointment; they covary, but not totally (Cannella and Lubatkin 1993; Huson, Parrino, and Starks 2001; Shen and Cannella 2002a). Rather, the two actions depend on essentially the same forces, representing the board's activism in the face of disappointment with the current regime. Thus, with some modification, we would expect that a strong model for predicting dismissal would also be highly apt for predicting outside succession.

Let us draw on the comprehensive framework for predicting dismissals set forth by Fredrickson, Hambrick, and Baumrin (1988), as summarized in [Table 6.1](#). As depicted, poor performance is a precipitating force behind both the CEO dismissal and outsider selection decisions. As discussed earlier in the section on dismissal, a challenge for researchers is to think broadly and carefully about how they conceive of poor performance (level, trend, and persistence; profits, growth, stock price, and analyst expectations; industry norms; and so on). It is likely that the most potent performance metric for predicting dismissal will also have the

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greatest strength for predicting outside CEO selection.

Table 6.1. Commonality in the Major Factors for Predicting CEO Dismissal and Selection of an Outsider

Predictive Construct	CEO Dismissal	Selection of Outsider
<i>Current or Recent Organizational Performance</i>	Poor performance increases the likelihood of dismissal and the appointment of an outsider.	
<i>Board's Expectations and Attributions</i>	If the board has very high performance expectations or considers current management to blame for poor performance, the likelihood of dismissal and outsider selection is increased.	
<i>Board's Allegiances and Values</i>	If the board's allegiances are totally to shareholders and not to incumbent management, the likelihood of dismissal and outsider selection is increased.	
<i>Incumbent CEO's Power</i>	If the incumbent CEO has great power, relative to the board, the likelihood of dismissal and outside selection is diminished.	
<i>Availability of Alternative Candidates</i>	Availability of qualified external candidates increases the likelihood of dismissal and outside selection.	
	Availability of qualified internal candidates increases the likelihood of dismissal.	Availability of qualified internal candidates decreases the likelihood of outside selection.

Adapted from Fredrickson et al. 1988.

Table 6.1 suggests that essentially all the predictive constructs exert similar forces on the dismissal and outside selection decisions. (See Ocasio 1999 for a parallel discussion.) These constructs include the board's expectations and attributions, the board's allegiances and values, the incumbent CEO's power, and the availability of qualified external candidates. The one exception—the one factor that leads to differing predictions—is the availability of internal candidates: existence of qualified insiders may edge a board toward a dismissal, but the internal pool would also facilitate an inside appointment. Evidence from Parrino (1997), indicating that outside succession is relatively likely in industries composed of homogeneous firms, supports this notion.

The central thrust of this portrayal of CEO dismissal and outside selection is that they cohere and are two manifestations of largely the same syndrome: a board or other decision-making body striving to break the organization away from the current leadership regime and, as important, visibly demonstrating to stakeholders that they are doing so. In this regard, it should be clear that both dismissal and outside selection have great symbolic significance: they are cleansing rituals—emphatic demonstrations by the board that the past is past (Gamson and Scotch 1964).

Of course, not all outsider selection decisions rest on political forces, nor do they necessarily require poor performance. Some organizations, by their very nature, have few individuals prepared for or interested in being CEO. These would include universities, hospitals, and sports teams. In such industries, CEO candidates move from other organizations, generally trying to trade up to more prestige or income. The strong norm (or "rule" in the words of Ocasio 1999) in these industries is outside replacement, and insiders are rarely considered.

Some boards select outsiders in anticipation of the need for very different leadership expertise but before performance deteriorates. An example would be the decision in 1994 by

the board of the large pharmaceutical firm Merck to hire Raymond Gilmartin from the outside, in anticipation of the intense competitive pressures that were expected to face drug companies with the consolidation and rationalization of the health industry. Such proactive outside appointments are relatively rare (see, for example, Haveman, Russo, and Meyer 2001); again, an outside appointment is extremely jarring and traumatic. However, it is reasonable to expect that the selection of an outsider CEO is more likely in an industry on the verge of, or in the midst of, a major discontinuity (e.g., deregulation or a major technology shift) than in a more stable one. We encourage an examination of inside versus outside succession patterns in different industries.

An “Outsiderness” Continuum

We believe, however, that the biggest breakthroughs in the study of inside versus outside succession will come from a new conception of “outsiderness.” In many prior studies, inside versus outside succession has been determined in strictly binary terms: the new CEO either was previously employed in the top management ranks of the company or was not.⁴ This is a very limiting approach, at odds with the reality that there are degrees of “outsiderness.” For instance, a new CEO hired directly from outside the company is more of an outsider than a new CEO who has two years of tenure with the company. However, that new CEO with two years’ tenure in the firm is very much an outsider compared to one who has spent twenty-five years with the firm.

Let us step back and consider why we should be interested in inside versus outside succession in the first place. As discussed earlier, an outside succession will occur to the degree that the board seeks a shift away from the prior leadership regime. Specifically, the board may expect that an outsider will be cognitively open-minded, with low commitment to the status quo, able to envision and consider new courses of action, and socially and interpersonally unencumbered, with few attachments to internal executives, and hence able to make major staffing changes. Moreover, the mere act of appointing an outsider is meant to send signals internally that change is coming and externally that the board has taken an extraordinary measure to break with the past. All of these aims can be considered in scalar, continuous terms, with different degrees of outsiderness helping to achieve different amounts of these desired objectives.

Table 6.2 presents a continuum of CEOs from extreme insider to extreme outsider. The extreme insider (with more than fifteen years in the firm) has traditionally been the norm in large business firms (Vancil 1987). Next is the executive with medium tenure in the firm (say, five to fifteen years). Then comes the executive who has long or medium tenure but has recently risen very quickly or is otherwise seen as a “maverick” or a member of the “new generation.” A prominent example of this type would be Jack Welch, whose elevation to CEO of General Electric was preceded by a meteoric rise through several layers and over hundreds of other GE executives (Tichy and Sherman 1993). An appropriate operationalization of the “quick rise” concept might use the number of years the executive has been a company officer as a percentage of his or her company tenure.

Next on the continuum comes the executive with a short tenure (say, one to five years) in the firm (including someone brought in expressly to be the next CEO). Under most prior studies, these executives would be treated as insiders, even though compared to the norm they are quite new to the company. The next gradation is one that seems to be occurring with greater frequency in U.S. business—the appointment of an outside board member to be the new CEO (Lester, Shen, and Cannella 2006). Typically a former CEO at another company, this individual is only a “quasi outsider,” because he or she probably knows many of the company’s senior executives and is knowledgeable about (and has perhaps even ratified) current strategic directions.

The final group is new hires from outside the company. But even here there are gradations. Some new hires come from the same industry and are knowledgeable about that industry but perhaps cognitively wedded to industry conventions or “recipes” (Spender 1989; Hambrick, Geletkanycz, and Fredrickson 1993; Parrino 1997). More “outside” are new hires who come from different but related industries, such as Raymond Gilmartin, who moved from Becton Dickinson (medical products) to Merck (pharmaceuticals). Finally, the most extreme outsider is the executive who comes from an unrelated industry, such as Lewis Gerstner who went from RJR Nabisco (tobacco and food) to IBM (data-processing equipment and services).

Table 6.2 also presents, tentatively, the degree to which the four possible objectives of “going outside” (as noted above) might reasonably be expected from each type of appointment. The closer the new CEO is to the extreme outsider, the more the four expected accompaniments can be expected. However, not all the gradations are equal. For instance, a new CEO with medium tenure (five to fifteen years) in the firm can be expected to have somewhat more social/interpersonal openness to change, as a result of fewer long-standing relationships, than one who has long tenure. However, it is unlikely that the appointment of the mediumtenure executive would send any greater external signal of change.

Table 6.2. A Continuum of New CEO “Outsiderness” and Expected Accompaniments

		Expected Tendencies			
Origin of New CEO		Cognitive Openness to Change	Social/ Interpersonal Openness to Change	Internal Signal of Change	External Signal of Change
Extreme Insider	Long tenure in firm (more than 15 years)	+	+	+	+
	Medium tenure in firm (5 to 15 years)	++	++	++	+
	“Maverick” or quick rise in firm (with long or medium tenure)	+++	+++	+++	+
	Short tenure in firm (1 to 5 years)	+++	+++	++++	++
	Outside director	++++	+++	++++	+++
	New hire from same industry	++++	++++	++++	++++
	New hire from related industry	+++++	+++++	+++++	+++++
Extreme Outsider	New hire from unrelated industry	+++++	+++++	+++++	+++++

The ratings represented by the pluses, and even the specific ordering of the continuum, in Table 6.2 are admittedly speculative. However, the concept of the continuum should clearly signify that researchers will achieve stronger predictions—of who will be selected, as well as of the consequences of different types of appointments—if they develop more fine-grained conceptions of inside versus outside. As important, such subtlety in thinking about “outsiderness” could allow more practical insights for boards, executive search firms, and others involved in executive selection than have been afforded by the dichotomous approaches taken so far.

Recently, several studies have contributed to the concept of “outsiderness.” First, Zajac and Westphal (1996c) question why the selection of an outsider should be considered a more prominent signal of change than the selection of a successor from a different functional background than the incumbent. Functional background dissimilarity between incumbent and successor can indicate a shift in leader attitude and behaviors and can thus provide important clues about postsuccession strategy. The authors’ evidence indicated that under conditions of poor performance and/or in the presence of powerful outside directors, firms tended to select successors (whether from inside or outside) who were similar to outside directors; in selecting outsider successors, firms were drawn to candidates who had experience with strategies similar to the outside directors’ home company strategies. This study points to the conclusion that successor functional background should also be considered, even when the successor comes from outside the firm.

Parrino (1997) studied the association between the level of heterogeneity (or homogeneity) among firms in the industry and the comparative likelihood that insiders,

within-industry outsiders, and outside-industry outsiders would be selected as successors. The evidence implied that turnover, forced turnover, and outside succession were all more likely in industries consisting of similar firms. Further, in industries composed of relatively homogeneous firms, outsiders were more likely to come from the same industry than from a different industry. The author interpreted this evidence as supporting the notion that inadequate CEOs are both easier to identify and less costly to replace when the industry is homogeneous. Poor CEOs are easier to identify because the firms in the industry are relatively comparable, making it easier for boards to attribute firm performance to the CEO. They are cheaper to replace because more replacements are available, and there is less need for firm-specific skills.

Finally, Bailey and Helfat (2001) investigated the skill sets of outside successors, noting that different skills have different implications for organizational performance. Building upon the work of Castainas and Helfat (1991, 1992), the authors classified the skills of outside successors into three categories. Generic skills are fully transferable when an executive moves from one firm to another; industry-specific skills are relatively transferable; and related-industry skills are the least transferable.

The Broader Case of Continuity versus Change

The matter of inside versus outside in CEO selection is a variation of the broader issue of continuity versus change. In general, inertia exerts a great force on executive succession (Ocasio 1999; Haveman, Russo, and Meyer 2001). This inertia can occur because of entrenched power configuration, administrative routines, or organizational culture. For example, some companies have been observed to appoint CEOs, decade after decade after decade, from the same functional area (Pfeffer 1981b). Sameness in successive CEOs is also due to the human tendency for leaders to believe that their successors should be just like them (Kanter 1977; Hambrick, Geletkanycz, and Fredrickson 1993). In general, there is a tendency for new CEOs to resemble their predecessors (Smith and White 1987; Vancil 1987), although the association is not deterministic (Ocasio and Kim 1999; Zajac and Westphal 1996b). Thus, unless there is a countervailing force, not only will successors tend to be insiders, they will also be the insiders who are most similar to the predecessors. The countervailing, inertia-breaking forces could be environmental shifts, strong boards, or poor performance, as some of the studies discussed above have indicated.

The following propositions can be set forth:

Proposition 6–13: The more stable the environment, the more a successor CEO resembles the predecessor in terms of company tenure, industry tenure, functional track, line-of-business experience, and education.

Proposition 6–14: The more powerful the predecessor CEO, the more the successor resembles the predecessor.

Proposition 6–15: The less powerful or less vigilant the board, the more a successor resembles the predecessor.

Proposition 6–16: The higher the recent performance of the organization, the more a successor resembles the predecessor. Conversely, poor performance leads to a CEO who differs from the predecessor.

Not only will poor performance favor the selection of a new CEO who differs from the

incumbent, but also the specific form of the performance shortfall will lead the board toward a new CEO whose credentials and expertise suit the particular challenge confronting the firm.

Proposition 6–17: Specific types of performance shortfalls are associated with specific successor characteristics. For instance: (1) poor growth favors candidates with marketing or sales experience or track records for growing businesses; (2) poor profits, but with satisfactory growth or market share, favor candidates with operations and control experience or track records for consolidating or rationalizing businesses; (3) problems of litigation or apparent ethical misdeeds favor candidates with legal experience.

In a study of 232 CEO successions, Zajac and Westphal (1996b) found support for the general argument just set forth and even for some of the specific propositions. Conceiving of CEO selection as a contest between the incumbent CEO and the board, the authors found that the lower the pre-succession performance (measured both by stock returns and profitability) and the weaker the predecessor's power (as gauged by the predecessor's tenure, whether he or she held both the chairman and CEO posts, and the proportion of outside directors appointed during his or her tenure), the more dissimilar the new CEO was from the predecessor (in terms of functional background, age, type of educational degree, and type of educational institution). Even more intriguing, Zajac and Westphal found that the same factors that caused a new CEO to be dissimilar from the predecessor were strongly associated with the degree of similarity the new person bore to the profile of the average outside director on the board. One might conclude, then, that the CEO and the board engage in a contest to clone themselves. As is true of so much in organizations, the result of a succession event depends on who has the most power.

Westphal and Fredrickson (2001) argued that the strategic changes that follow CEO succession might reflect the influence of boards rather than top executives, because the selection of a new CEO might reflect the board's preferences. In contrast to the more traditional view that outside directors have little influence aside from advice and counsel, and little involvement in strategy or strategic direction, the authors developed theory to explain how boards could initiate strategic change through their influence on the selection of a new CEO. In their model, directors conceived of strategic changes that would better align the focal firm's strategy with the strategies of their own firms, and they then used outside succession to initiate the changes; directors selected CEOs from outside who had experiences relevant to their own prior experience, thus facilitating the implementation of their desired strategies. The authors' evidence provided strong support for their model, and, perhaps even more intriguing, for the conclusion that these actions were not performance-driven. Put differently, directors whose home companies had markedly different corporate strategies than that of the focal firm used CEO succession as a way to alter the firm's strategy to be more similar to their home firm's—regardless of the current performance of the firm.

Additionally, Ocasio and Kim (1999) examined whether the increased incidence of CEOs from finance backgrounds—as Fligstein (1987) documented for the period up to 1980—continued through the rest of the 1980s. Drawing upon White (1992), the study contrasted succession “institutions” with “styles.” Institutions are relatively permanent and frequently have a “taken for granted” status. In contrast, styles are much less permanent and are subject to conflict, contestation, and change. Their study documented contests for control among elites from differing functional groups inside the firm, and it highlighted the obsolescence and contestation of executive power, especially in the succession context. The study provided evidence that the obsolescence of the skills of the group in power (finance CEOs) contributed to that group's replacement. Further, the study documented an important adaptation

mechanism—the selection of successors.

Conclusion

Many potentially fruitful avenues of research remain regarding the antecedents of CEO succession. We note here several issues that we believe are in marked need of further investigation. First, there is tantalizing suggestive evidence that the antecedents of CEO succession have changed sharply in recent years. The study by Hadlock and Lumar (1997) documents how the drivers of succession have changed in recent years relative to many years past, but no careful study has yet documented the changes (if any) observed in the very recent past—say, post-Enron. Because the Sarbanes-Oxley Act requires that public companies both validate and make public a good deal of information, it is likely to have important effects on succession. Further, the suggestive evidence indicates that boards, post-Enron, are less tolerant of performance or other problems, more likely to bring in outsiders, and perhaps more driven by the short-term whims of shareholders. Careful study of the implications of Sarbanes-Oxley on CEO succession processes would seem to be a worthwhile endeavor. Further, to the extent that insider succession is no longer the “norm” in large, public companies, there are likely to be very important implications for executive promotion and retention below the CEO level. Without a high likelihood of insider succession, there is much less reason for lower-level executives to commit large portions of their careers to a single firm. Given the resource-based arguments about firm-specific skills, this outcome is likely to have harmful implications for long-term competitive advantage (Castanias and Helfat 1991).

We are also intrigued by the recent interest in family ownership of large public companies. As we suggested earlier, there is some disagreement about what constitutes a “family” company. For many authors (e.g., Anderson, Mansi, and Reeb 2003; Anderson and Reeb 2003; Villalonga and Amit 2006) the presence of any large owner constitutes a family company. On the other hand, Miller and colleagues’ (2007) study separates large owners into individuals (entrepreneurs) and families. In the latter case, more than one family member must be an owner and active manager or director of the company. In essence, the Miller et al. definition of a family business is one in which a key objective is to pass the business on to subsequent generations. Given this definition, the relevance of succession research among family companies is obvious. However, even in the case of a single large owner with no other family involvement there will be critical issues to be resolved in any succession situation. Recent evidence suggests that both entrepreneur-controlled and family-controlled firms exist in large numbers, even among U.S. public corporations—a fact that has been widely ignored until recently. Though much has been written about succession in family businesses, the focus of this research has tended to be small firms, not large, publicly traded ones (e.g., Handler 1990; Miller 1998; Handler and Kram 1988; Brown and Coverley 1999). Some recent contributions have been made with respect to larger firms (e.g., Lee, Lim, and Lim 2003; Wasserman 2003), but much work remains.

Research on executive succession shows no signs of slowing, and many interesting and challenging questions remain. Our review of the literature has highlighted, for example, that the profile of a new CEO depends primarily on how much change from the status quo the board seeks, as well as the specific nature of the desired change. Boards may look rationally at new or emerging imperatives that call for a new type of CEO expertise, or they may engage in less rational cloning of themselves or a superstitious repudiation of the incumbent’s preferred candidate. In turn, as we shall now discuss, the characteristics of the successor can have a major effect on subsequent strategy, legitimacy, and performance of the firm.

Changes at the Top

The Consequences of Executive Turnover and Succession

We turn now to the topic of implications associated with executive turnover and succession along with a discussion of succession among top management teams. Following [Figure 6.1](#) (introduced in the previous chapter), we consider how succession can affect a number of important organizational outcomes. First, a good deal of research suggests that succession has important implications for successor behaviors. We organize our discussion of this topic into the broad kinds of changes that a succession might engender, how the process of succession can impact the new leader's early survival prospects, and the "going-in mandate" that the new leader enters with. In the second section, we examine the overall performance implications of leader succession, a topic that has garnered a great deal of research over the years. We begin that section with an overview of the sports team studies of Oscar Grusky (1960, 1961, 1963, 1964) and his well-publicized exchange with Gamson and Scotch (1964). Their debates on scapegoating and insider versus outsider succession is still ongoing, though the players have changed identities several times in the forty-some years since it began. We move then to contextual factors such as the stage of organizational life cycle, organization-level changes that accompany the succession event, and institutional factors (such as discontinuous change). We then review the voluminous studies of stakeholder reaction (*shareholder* reaction, really). As before, we provide propositions to help drive future research on succession's consequences.

In sections following the consequences of CEO succession, we turn our attention to turnover beyond the CEO level, considering top management team turnover, as well as turnover in specific organizational positions below the CEO level (e.g., the CFO). Because the research here is not nearly as voluminous as that on CEOs, we consider both the antecedents and consequences of turnover in a single section. In a final section, we cover a variety of issues that are related to succession, but that did not fit neatly into the analytical model outlined in [Figure 6.1](#). These topics include temporary succession, strategic business unit (SBU) leader changes, and postsuccession "settling up" (Fama 1980) among organizational leaders.

What Are the Consequences of Succession?

Perhaps understandably, researchers have devoted more effort to understanding the consequences of succession, or the "So what?" question, than to the other facets of top executive transitions. Unfortunately, this preoccupation with succession effects has often led researchers to ignore some critically important contextual factors, often resulting in weak and contradictory conclusions.

The care that must be brought to any study of the consequences of executive succession is illustrated by the findings of two studies that played a pivotal role in launching contemporary scholarship on executive succession: Gouldner's (1954) study of management succession in a

gypsum plant and Guest's (1962) study in an automobile factory. The new manager of the gypsum plant in Gouldner's study, Peele, succeeded a very popular leader who was socially comfortable with the workforce, to the point of being loose and indulgent. The productivity of the plant had slipped, which was why Peele, an outsider, was brought in. However, other inside managers felt that one of them should have been appointed the new leader; moreover, Peele adopted a stern, disciplinarian management style, meting out punishments liberally. Worker morale and productivity plummeted.

The new head of the automobile plant in Guest's study, Cooley, similarly was brought in from the outside to deal with a low-performance situation. His predecessor, however, had many of Peele's qualities—authoritarian, punitive, abrasive. Members of the organization were happy to be rid of him, and Cooley further rallied their support through a participative management style, laxity in enforcing unpopular company rules, and an approachable demeanor. Worker morale and productivity increased greatly.

These two studies, each of which could be a data point in a statistical study of the effects of managerial succession, illustrate by their contrasting outcomes how difficult it is to arrive at general conclusions. Or, put another way, if a researcher wants to develop general conclusions about the effects of executive succession, the predictive model inevitably must encompass an array of factors. Gordon and Rosen (1981) made the same point in a thoughtful article in which they proposed a succession model with numerous “pre-arrival” and “post-arrival” factors. [Figure 6.1](#), a somewhat more formalized variation of Gordon and Rosen's ideas, indicates our thinking: one cannot make cogent predictions about the effects of succession without considering the factors precipitating the succession, the succession process, and the characteristics of the successor. Moreover, events and actions following the succession affect each other; these include the new leader's behaviors, organization changes, organizational performance, and stakeholder reactions.

The New Executive's Behaviors and Organizational Change

The new executive faces a difficult dilemma that complicates the scholar's ability to predict leader behaviors and organizational activities early in a tenure. On the one hand, the new executive often lacks the information to make prudent decisions. On the other, he or she is under great pressure to demonstrate worthiness for the job and managerial efficacy, generally requiring that *some* early actions be taken.

A new executive, even one internally appointed, enters the position at a disadvantage in terms of knowledge of the task at hand; pertinent facts, contacts, trends, and issues are not yet well understood. This is illustrated by a quote from a new general manager studied by Gabarro: “You go through an early period of first trying like hell to learn about the organization. You're faced with a set of problems that are foreign to you. You have to learn about the people and their capabilities awfully fast and that's the trickiest thing to do. At first you're afraid to do anything for fear of upsetting the apple cart. The problem is you have to keep the business running while you learn about it” (1987, 1).

Accordingly, the new executive devotes a great deal of effort to scanning (Aguilar 1967), immersion (Gabarro 1987), and general learning. Mintzberg (1973) proposed that new managers spend relatively more time on developing contacts and collecting information (“liaison” and “monitor” roles) than in substantive strategic decision making. Other researchers have further emphasized the need for the new executive to develop reliable and constructive relationships with members of the top management team (Gabarro 1987; Greiner and Bhambri 1989).

At the same time, the new executive will feel pressure to show promptly that he or she

was the right choice for the job. One tendency is for the new leader to spend an extraordinary amount of time with higher-ups (say, the board chair or other board members) to seek information and clarification on what needs to be done (Stewart 1967). A related tendency is for the new executive to try to persuade the board to set “realistic” expectations, as did an executive interviewed by Vancil: “I felt that it was very important in that first meeting with them [the board] to calibrate their expectations. I didn’t want them to think that I was arriving with some magical elixir that would solve our problems immediately” (1987, 59).

Constructive and supportive relationships with members of the management team and the board may well be the most important factors for surviving the first two to three years in a new executive position (Gabarro 1987; Vancil 1987; Greiner and Bhambri 1989). But, in general, the casualty or failure rate among new executives is relatively great. A disproportionate number of dismissals occur in the first several years of executives’ tenures (Fredrickson, Hambrick, and Baumrin 1988; Ocasio 1994; Shen and Cannella 2002a). New executives generally do not have as much power as more established ones (Hambrick and Fukutomi 1991; Miller 1993). If new executives are vulnerable and under pressure to demonstrate their efficacy, they cannot only engage in learning and establishing relationships. They must engage in some substantive actions.

The Going-In Mandate

We now turn to the types of strategic actions taken by new executives. While no universal pattern occurs, we can improve our predictions and understanding of actions taken by a new executive if we extend a key point made by Gordon and Rosen: “Newly appointed leaders do not function totally independently of their sponsors and of how those around them expect them to function” (1981, 239). Most new executives have a mandate, even if implicit, stemming from the organization’s current performance and prospects (Vancil 1987), as well as board expectations (Zajac and Westphal 1996b). New executives often are selected because their experiences and credentials align with the mandate, and thus their initial actions also tend to—or should—align with the mandate (Gabarro 1987; Westphal and Fredrickson 2001). Hambrick and Fukutomi illustrated the confluence of organizational situation, mandate, choice of successor, successor credentials, and successor action through a now well-known CEO appointment:

In 1981 General Electric was extremely profitable, but had a very low growth rate and was weighed down with primarily mature businesses. Among several contenders to replace Reginald Jones as CEO, Jack Welch, the person picked by the board, was known for his impatience and track record of innovation and growing businesses. Even his demographic profile lined up with what seemed to be needed: youth, advanced education in technology, and experience in R&D. There seems little question that Welch had a mandate to inject youth and dynamism into GE; he was picked precisely because it was thought that his paradigm ... would make the growth and dynamism occur; he was under pressure to behave in line with such expectations. It was not surprising that Welch immediately sold off numerous low-growth businesses, put major resources into high-growth businesses, and sought technological advantage in industries that had not recently been considered in “technological” terms, such as appliances and lighting. (1991, 722)

The Westphal and Fredrickson (2001) study (discussed earlier) clearly implied that at least some boards of directors are very active in the selection of successors and that their selection decisions reflect their own personal experiences and biases. Further, new CEOs are likely to have been selected with at least some consideration for their skills and how those

skills match the perceived needs of the firm and its context. It follows that a “going-in mandate” is present in many succession settings.

As a broader indication of the same phenomenon, researchers have consistently found that new executives brought in from the outside make more changes in strategy and staffing than do those from the inside (Grusky 1960; Carlson 1962; Helmich and Brown 1972; Kesner and Dalton 1994; Kraatz and Moore 2002). Based on our discussion earlier in the chapter, we may reasonably expect that an outside successor is a mere single indicator of a gestalt: poor performance or environmental shift, the board’s desire to break with the past, and a mandate for major change. However, none of these is binary; all can be considered in scalar, continuous terms. In keeping with our earlier discussion, we propose the following:

Proposition 7–1: The lower the performance of the organization prior to the succession, the greater the strategic and staffing changes made by the successor.

Proposition 7–2: The more dissimilar the successor is from the predecessor, the greater the changes made by the successor.

Proposition 7–3: The more the successor is an extreme outsider (as portrayed in [Table 6.2](#)), the greater the changes made by the successor.

Further, we anticipate that the combination of (1) a “going-in mandate,” (2) the selection of an executive whose credentials align with the mandate, and (3) the new executive’s need to demonstrate early efficacy will serve to bring about early strategic actions that strongly reflect the new executive’s background. Therefore:

Proposition 7–4: The correspondence between an executive’s background characteristics (e.g., insider versus outsider, functional experience, international experience) and the amount and type of strategic actions taken is stronger in the first years of tenure than at any other time in the position.

The Executive’s Early Survival Prospects

Executives are well advised to understand and adhere to their early mandates, as illustrated by a seeming anomaly in Gabarro’s (1987) study. At odds with almost all other studies on the topic, Gabarro found that the few new executives from outside the industry that were in his sample made fewer organizational changes in their first three years than did the insiders. His explanation was that insiders possessed more relevant knowledge and could take informed actions faster than the outsiders who had more of a knowledge deficit. However, as noted, the finding itself departed from other available evidence.

But this unusual result is put in perspective when coupled with another of Gabarro’s findings: a disproportionate number of the few outsiders he studied failed within the first three years. As we have emphasized, outsiders tend to be brought into difficult situations in which the general probability of failure is relatively great, but they are brought in because the board or senior management wants a significant change. If the outsider makes fewer changes than the higher-ups hoped they would get (as seems to be the case in Gabarro’s small sample), then he or she has behaved at odds with the mandate.

A study by Denis and Serano (1996) lends support to the notion of a “going-in mandate” and to the presence of powerful individuals who install the successor in order to achieve specific objectives. These authors studied asset restructurings (announced sales of assets with book value of at least 10 percent of total company assets) following CEO succession. They found that new CEOs selected after unsuccessful control contests were much more likely to

restructure assets relative to incumbent CEOs, and this effect was particularly pronounced when there were independent block holders present in the firm. Further, the authors documented that most of the independent block holders in their sample existed specifically as a result of the control contest and were therefore likely supporters of the need for asset restructuring.

Deviating from one's early mandate increases the likelihood of failure or dismissal for three reasons. First, the executive is probably acting outside the range of his or her primary repertoire, with a relative absence of experience and insight, and misjudgments and missteps may occur. Second, the costs of making a bad CEO selection decision are likely lower when the poor decision is discovered early. Therefore, we expect that directors will be particularly vigilant in the early years of the new CEO's tenure, and they are probably aided by the monitoring activities of the firm's other senior executives (Shen and Cannella 2002a). Finally, when the actions of a new CEO are not consistent with what the board wants, or if an executive embarks in a direction other than the one the board envisions, the slightest misstep will evoke much more scorn and retribution than a similar falter in the agreed-upon direction. Thus, someone with a strong background in product innovation who is brought in to instill innovation is well advised not to turn instead to cost rationalization—at least not at the outset.

Consider a further example. After a long reign as CEO of ITT Corporation, Harold Geneen retired and was replaced by a long-time inside lieutenant, Lyman Hamilton, who promptly started divesting many of Geneen's acquisitions. This was not what the board expected or wanted from this particular successor, and he was soon fired (the fact that Geneen remained on the board did not help Hamilton) (Fredrickson, Hambrick, and Baumrin 1988). Thus, a new CEO's mandate, even if only implicit, restricts his or her discretion (Hambrick and Finkelstein 1987).

We propose:

Proposition 7–5: The greater the correspondence among (1) the new executive's mandate, (2) his or her experiences, and (3) the amount and direction of change initiatives, the greater the likelihood of the executive's survival beyond three years.

Alternatively, there is some evidence that CEO successions, per se, bring about change, regardless of the nature of the succession. For example, Weisbach (1995) examined the relation between CEO turnover and divestitures of prior acquisitions.¹ He hypothesized that the probability of divesting a poorly performing acquisition would rise following the exit of the CEO who made the acquisition, and the evidence supported his argument. However, he found no difference in divestiture rates between normal and forced CEO exits; even planned successions in which a clear heir apparent ascended to the CEO position resulted in divestitures. A study by Ravenscraft and Scherer (1987) came to a similar conclusion. Both studies indicated that even normal, smooth successions permit new leaders to make changes that the prior CEO may have been unwilling or unable to make.

In sum, executives' behaviors entering into their positions vary widely and cannot be universally predicted. However, by incorporating the precipitating context, succession process, and successor characteristics into a predictive model, a greatly improved understanding of early executive actions can be achieved. Now we turn more generally to the issue of the performance implications of executive succession.

Implications for Organizational Performance

Does executive succession help or hurt an organization's performance? There can be no general answer to this question. If succession clearly were salutary, it would become quickly

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known, and organizations would start replacing their executives weekly. If succession were unequivocally harmful, that too would become readily apparent, and organizations would start putting healthy twenty-five-year-olds in top offices and doing everything possible to prolong their lives and connection to the organization, including eliminating mandatory retirement policies for them. As unpromising and naïve as the above question may seem, it was the initial focus of post–World War II research on managerial succession (Grusky 1963). Fortunately, scholars moved on to more fruitful questions, such as When does succession hurt or help the most? We now trace the evolution of this line of research and extract its chief conclusions and implications.

The Sports Team Studies

Large-sample research on the performance implications of succession began with a series of studies on sports teams. This type of organization, while perhaps only marginally like other organizations, provides researchers the important advantages of a well-controlled sampling procedure and, most appealing, undisputable performance measures.

Grusky (1963) launched this stream with evidence from sixteen baseball teams over a twenty-year period. He found that “rates of administrative succession [of field managers] and degree of organizational effectiveness are negatively correlated” (1963, 21). Rather than impute a one-way causal direction, Grusky concluded that a “vicious circle” operates: poor performing teams tend to replace their managers; and new managers are disruptive to team morale and social structure, hence further hurting performance. Grusky further asserted that the “vicious circle” theory (harmful effects of succession) had won out over the “common-sense” theory (that succession brings improved performance).

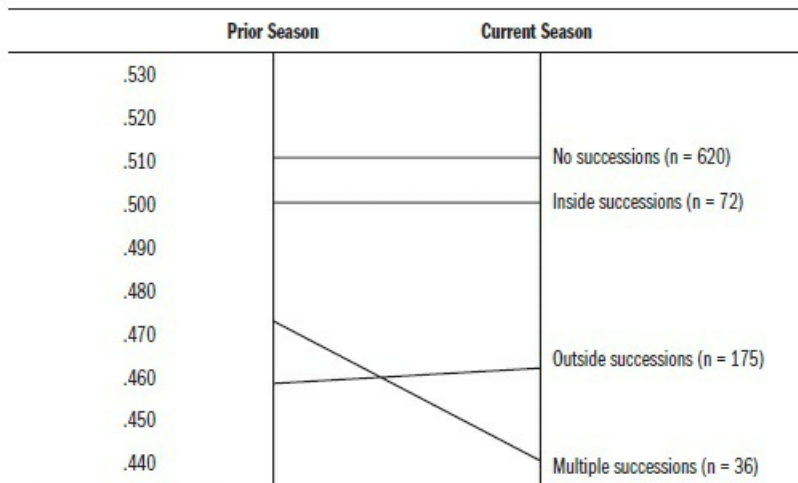
However, Gamson and Scotch (1964) reanalyzed Grusky’s data and concluded that it was not the “vicious circle” theory, but rather the “ritual scapegoating–no effects” theory that was supported. They contended that baseball field managers often are replaced during temporary “slumps”; performance then improves, but not because of the manager; and the improvement is not sustained. By examining a subsample of midseason successions, they indeed found that team performance improved immediately following the succession but was rarely sustained. Gamson and Scotch went on to use an analogy that every student of executive succession should bear in mind: “If we compared average rainfall in the month preceding and the month following the performance of the Hopirain dance, we would find more rain in the period after. The dance is not performed unless there is a drought, so such a comparison would be misleading. Nevertheless, this ‘slump-ending’ effect may help to account for the tenacity of belief in the effectiveness of the ritual” (1964, 71).

In this anecdote, Gamson and Scotch remind us of two things. First, successions occur disproportionately, albeit not exclusively, in low-performance situations. Even some voluntary departures are acts of escape, fatigue, or anticipation of dismissal in the face of poor performance. Second, a very poorly performing organization in one period is likely to be relatively poorly performing in the next period, but, on average, it will improve somewhat because of regression to the mean.

In a rejoinder, Grusky (1964) introduced the distinction between inside and outside succession. He found that teams experiencing inside succession improved in performance, whereas outside succession was associated with slight deterioration of performance. Grusky asserted that “inside successors tend to be less disruptive than outside successors” (1964, 74).

The next two sports team studies we will review represented considerable advances in this stream of research, with possibly important implications for succession in other types of settings. First was a study by Allen, Panian, and Lotz (1979), again on baseball teams. Their important contribution was in introducing careful controls for regression to the mean. In

keeping with the overall thrust of this research stream, they also examined inside and outside successions separately.² Figure 7.1 shows how team performance compared between the prior season and the current one for different types of results that could occur, on average, for these four succession situations in most organizational settings:



NOTE: Successions occurred between seasons or during current season.

Figure 7.1. Winning Percentages for Baseball Teams Studied by Allen, Panian, and Lotz (1979): Prior Season versus Current Season

1. *Organizations with no executive succession:* These were high performing, and in the following year, they were still high performing.
2. *Organizations with inside successions:* These were slightly inferior (below average), and in the following year, they were still slightly inferior.
3. *Organizations with outside successions:* These were very inferior, and in the following year, they improved somewhat, but probably due primarily to regression to the mean.
4. *Organizations with multiple successions:* These were very inferior. Regression to the mean somehow eluded them, and their performance deteriorated even more (no doubt accounting for the multiple successions, or “rain dances”).

Thus, *succession events tend to occur under certain conditions*, which may create the erroneous impression that the successions caused the conditions. But the mere act of succession—particularly when the qualities required of the leader have not changed and there is no reason to believe the new leader is necessarily any better than the old—allows no convincing predictions about new leader effects.

However, executives do vary in their ability, and that was the chief idea explored by the remaining sports team studies we will review. In their analysis of data for twenty-two professional basketball teams over a five-year period, Pfeffer and Davis-Blake (1986) found, as we would expect, that mere coach succession had no effect on subsequent performance (when prior performance was controlled for). However, when the competence of new coaches was included in the analysis, succession did affect subsequent performance. New coaches who had good prior records, or had prior experience coaching in professional basketball, or had led performance improvements in other teams, brought more performance improvement to their new assignments than did new coaches without these qualifications. A study of baseball teams by Cannella and Rowe (1995) came to similar conclusions, but found that the competitiveness of the league also had an important moderating effect. These studies

introduced the commonsense, but long-overlooked, idea that the effects of succession depend, among other things, on the ability of the new executive.

Research on managerial succession in sports teams has had a bumpy but still worthwhile ride. We know more about several aspects of succession, aided by the relatively reliable, uncontroversial measures of performance available for sports teams.

However, two aspects of sports teams have been missed in this research, and they pose considerable limitations on observing any succession effects in such organizations. Specifically, sports teams (particularly in long-established sports) do not face major changes in their environments. Their rules, playing surfaces, ball size, and so on, all remain roughly the same over time. (We are sure baseball aficionados would love to set us straight on this, but even something like the introduction of artificial turf was nothing like deregulation in the airline industry or globalization of the automobile industry.) The repertoires of sports coaches are rarely, if ever, fundamentally obsolesced.

Second, competitive advantage depends greatly on firm-specific factors (Barney 2002). To the extent that all competitors are the same, and all draw from the same pool of input resources (e.g., professional athletes), it is quite difficult to develop firm-specific competitive advantages. Further, firm-specific human capital is central to competitive advantage, because it is very hard for competitors to imitate (Bailey and Helfat 2001). It is very difficult to conceptualize, especially after the advent of free agents, how sports teams can develop much firm-specific human capital. For these reasons, the idea of managerial succession as an adaptive device (Pfeffer and Salancik 1978) has limited relevance in the sports team setting.

It Depends on the Succession Context

When the rules change, when environments shift, when major new strategies have to be developed and implemented—these are conditions in which succession effects may be profound. Here, we will examine projects that have focused on three particular contexts: young companies, turnaround situations, and environmental turbulence.

It is reasonable to expect that executive succession has differing effects, depending on the organization's stage of life. Carroll (1984) pursued this line of thought, arguing that the departure of the company's first chief executive would be extremely disruptive; because of the fragility of relatively young organizations, the likelihood of company failure after the departure would increase. Testing this idea with a sample of newspapers founded over a 150-year period in seven randomly selected cities, Carroll's results supported his premise, revealing three interesting findings: (1) newspapers had disproportionately high failure rates following the departure of their first publisher (essentially, the CEO); (2) the failure rate was highest when the publisher was also the editor, presumably because the executive's personality and values had become even more embodied in the newspaper; and (3) the effect of executive departure on organization mortality was greater in the first two years of the newspaper's existence than in the later years studied (years 3, 6, and 11). Apparently, as the organization becomes more substantial and institutionalized, the departure of the first CEO is not as disruptive. Indeed, with the passing of years and accumulation of resources and legitimacy, CEO succession per se should come to have no general effect on failure rates.

In a similar study of local telephone companies in the early twentieth century, Haveman (1993b) found results similar to Carroll's: presidential exit increased organization mortality. These effects were pronounced in younger organizations but diminished as time passed. Thus, there appear to be organizational conditions under which executive continuity is particularly important to organizational performance and survival.

In a similar vein, writers on corporate turnarounds have consistently emphasized that new leadership is needed for a turnaround to be successful. Based on extensive case data, Hofer

(1980) asserted that a change in leadership is needed if a turnaround is to be successful, because incumbent management has a difficult time making the required changes and has lost too much credibility with key stakeholders. Bibeault (1982) made essentially the same point but also provided some quantitative data on CEO changes in troubled turnaround situations. Of the eighty-two turnaround situations he studied, about three-fourths involved new CEOs. Of those new CEOs, about two-thirds were from the outside, supporting the general portrayal of the need for new perspective, energy, and credibility at the top of troubled firms.

In turnaround situations, these changes of CEOs might amount to little more than ritual scapegoating, or “rain dances.” In fact, neither Bibeault nor other researchers, as far as we know, have provided telling evidence of the *results* that come from different CEO succession patterns in turnaround situations. We believe, in general, that a change of management, particularly bringing in an outsider, provides the best chance for performance improvement in a turnaround.

The institutional context in which the succession takes place is another important factor in the strategic changes that the succession initiates, or fails to initiate. In support of this idea, Sakano and Lewin (1999) investigated the influence of new CEOs on strategic change in Japanese firms. The authors argued that the strong institutional pressures in Japanese firms, coupled with passive capital markets, weak governance structures, and CEO compensation systems would all serve to reduce the ability of new CEOs to implement radical organizational changes in Japanese firms. Their sample of 162 Japanese firms indicated that strategic changes among these firms were quite evolutionary and were relatively independent of CEO succession. Therefore, in some very restrictive institutional contexts, changing leaders may not lead to much change in overall strategy.

The Japanese setting is one of rather extreme inertia in environmental forces. Alternatively, when environments are turbulent, and particularly if there is a major discontinuity, incumbent executive competencies may be rendered obsolete. Under such conditions, executive succession may generally be salutary. Virany, Tushman, and Romanelli (1992) pursued this idea with a sample of companies in the minicomputer industry (1968–1980), an environment of great turbulence and, according to the authors, one in which fresh perspective (or “second-order learning”) was a continuing imperative. The authors found that CEO succession, in general, was associated with profit improvements in the minicomputer industry. The authors also found that performance improved the most through a combination of CEO change, top management team change, and strategic change. But the essential conclusion here is that a turbulent environment tends to favor change at the top.

Tushman and Rosenkopf (1996) distinguished between CEO change, TMT change, and strategic reorientation, arguing that the effects of each are contingent on the organizational context. Large changes that are disruptive in stable contexts are adaptive in turbulent contexts. In the approach developed by the authors, the work of senior executives depends importantly on whether the context demands first-order learning (during convergent periods) or second-order learning (during reorientations). Using this theory, they argued that disruptive successions (CEO change coupled with executive team change, in addition to strategic reorientations) will facilitate second-order learning and will be adaptive in turbulent environments. In more stable contexts, such successions will be harmful to subsequent performance. Turbulence may be due to either environmental or organizational factors, and the two forms call for different remedies. When turbulence arises from the environment, CEO change coupled with executive team change may be called for; but when the turbulence arises from within the organization, such large-scale change may be dysfunctional. The study demonstrated the importance of context to predictions about the effects of CEO and TMT changes, as well as reorientations. Second-order learning can be quite functional in turbulent

contexts and quite dysfunctional in stable ones.

When the institutional context changes dramatically, organizations that are central within the industry are often at a loss in dealing with the change. Here, the migration of leaders from the institutional periphery may be essential to successful adaptation. Pursuing these ideas, Kraatz and Moore (2002) studied how institutions change and what forces lead institutional practices to be altered or abandoned, focusing their efforts on the role of new leadership brought in from the institutional periphery. Their sample of 600 private liberal arts colleges in the United States provided strong evidence that new leaders from the periphery of the organizational field (e.g., from organizations outside the focal college's traditional peer groups) played key roles in initiating changes both in the colleges and at the institutional level. In particular, the study demonstrates how leaders from the margins of the organization's field use knowledge transfer and organizational learning as well as how they introduce new mental models and assumptions.

Interestingly, discontinuous environmental change may not bring about uniform pressures for leadership change among all firms in the industry, especially early in an environmental shift. For example, Haveman, Russo, and Meyer (2001) studied how organizations responded to discontinuous changes by making domain changes and leadership changes, and the performance outcomes associated with these changes. We reviewed their study briefly earlier, in noting how context influences succession. Recall that their study implied that environmental discontinuities increased the rate of managerial succession, but not immediately. Rather, the implications of the discontinuity were felt gradually. However, their study also considered performance implications of succession, and they demonstrated that those firms that proactively changed their CEOs soon after the discontinuity had better performance than those that waited for performance problems (presumably caused by the discontinuity) before making changes.

We earlier derided the idea that a change in CEO per se could have any generalizable effect on performance, though earlier studies have provided evidence that a moderate level of succession is needed for organizational renewal (Weisbach 1995; e.g., Shen and Cannella 2002b). We now offer a line of defense for the conclusion that a moderate level of succession can be beneficial in certain environments. Here, we develop the idea of “fit—drift/shift—refit.” We posit that a board, when selecting a chief executive, strives to appoint a person whose competencies or repertoire align, or fit, with the conditions facing the enterprise at that time and for the foreseeable future. The new executive may not fit perfectly (in fact, we have discussed the inertial and political factors that may make selections depart from the normative ideal), but in general the new executive will tend to be more appropriate than a randomly selected executive and, in many cases, highly appropriate.

The executive embarks on actions, drawing on his or her competencies and perhaps learning new ones. However, with the passing of time, the environment gradually *drifts*, or perhaps radically *shifts*, in a direction that requires competencies and perspectives different from those of the incumbent. The executive who evolves cognitively at the same rate and in the same direction as the environment is exceedingly rare. Thus, the CEO who initially fits the specific contextual requirements will, over time, fit less well.

Whether the executive serves until mandatory retirement or departs in some other way, eventually the board has another opportunity to *refit* executive competencies with the new requirements of the environment and organization. So, on average, new executives will fit current and emerging requirements more than departing executives.

For example, when Reginald Jones was made CEO of General Electric in the early 1970s, the company was experiencing what observers called “profitless growth”—numerous entries into new industries and explosive expansions, but poor returns. Jones brought discipline and

order to GE; by the time of his mandatory retirement in 1981, the company faced essentially the opposite situation: exceedingly high profits but little growth. International opportunities were untapped, new technologies had yet to be exploited, and the service economy was passing the company by. With Jones's departure, the board had an opportunity to refit executive capabilities with the new emerging conditions. It chose to hire Jack Welch, known for his innovation, impatience, and expertise in technology (Aguilar, Hamermesh, and Brainard 1991; Tichy and Sherman 1993).

The “fit—drift/shift—refit” model is not a deterministic view; we are describing tendencies. Not all selection decisions are adaptive; naïve scapegoating, cloning, and careless selection can occur. However, we believe this framework allows a coherent line of thought for explaining the important finding that succession in dynamic environments tends to bring performance improvements.

Some evidence on the “fit—drift/shift—refit” model comes from a study by Datta and Rajagopalan (1998), who investigated the association between industry context and the characteristics of successor CEOs. The authors argued that the best performance outcomes are likely to be observed when new CEOs match the requirements of their industries (Gupta 1988). They focused on three industry characteristics: capital intensity; product differentiability; and growth rate. Predictions were developed to link these three characteristics to successor CEOs' organizational tenure, age, education level, and functional background. They further argued that the extent to which the new CEO fits the industry context would be positively associated with subsequent performance. Using a sample of 134 successions in 119 manufacturing firms over a ten-year window, they provided generally supportive evidence that the fit between the new leader and the industry context led to performance improvement.

Reaction of Shareholders

On the assumption that executive succession events may contain important signaling information, researchers have explored the reactions of shareholders. This has resulted in a quite sizable literature that can be best characterized as inconsistent, both in research designs (measures and model specifications) and correspondingly so in results. (See Warner, Watts and Wruck 1988 and Furtado and Karan 1990 for extensive reviews. Also see these related works: Beatty and Zajac 1987; Friedman and Singh 1989; Lubatkin et al. 1989; Worrell, Davidson, and Glascock 1993.)

One of the major obstacles to interpreting these studies is that they often include succession events that are routine and fully anticipated by investors; thus, they elicit no particular market reaction when the succession is announced or implemented. Perhaps only unexpected deaths of CEOs meet the requirements of an event-study test. Such a study found, on average, no stock market reaction (Johnson et al. 1985).

Doubt has even been expressed about whether most CEO dismissals are sufficiently “surprising” to meet the requirements of a satisfactory event-study test. However, at least two studies have found that firings or “board-initiated” departures of CEOs meet with positive stock market reactions (Friedman and Singh 1989; Worrell, Davidson, and Glascock 1993). Probably occurring disproportionately in troubled firms, these dismissals may give owners some hope that policies will be changed.

An important refinement in this stream of research has been to distinguish analytically between the departure announcement and the successor announcement. While this distinction has added to the complex variety of operationalizations, it has produced one interesting finding in at least three studies: the appointment of an outsider CEO elicits a favorable stock market reaction. But even here, the qualifications of each result diminish the clarity of the

pattern. Reinganum (1985b) found that CEO departure coupled with announcement of an external successor brought positive market response but only for the smaller firms in his sample.³ Worrell, Davidson, and Glascock (1993) found that firings coupled with outsider appointments brought favorable market response (supporting the “change is on the way” theory). But Lubatkin and associates (1989) found that the appointment of outsiders into high-performing firms brought a favorable market response, casting doubt on the simple scapegoating theory. More recently, Huson, Malatesta, and Parrino (2004) concluded that board composition, institutional shareholdings, takeover pressure, and outsider CEOs strongly influenced investor reactions. However, only institutional holdings had important implications for operating ROA. These disparate results are a microcosm of the varying results in this whole research stream.

We offer four suggestions to scholars who are considering their own studies of stock market reactions to executive succession. First, strive to incorporate some of the logics laid out in this chapter and elsewhere in the book: be alert to the concept of executive discretion and include in your model appropriate contextual factors (precipitating context, succession process, predecessor and successor characteristics). Second, only include in your sample those succession events that are near or total surprises to the investment community; otherwise, market reactions cannot be captured. For instance, a CEO’s departure due to mandatory retirement, or the appointment of a long-designated heir apparent, is subtly and gradually factored into stock prices well before the actual event occurs. Third, consider doing very direct replications of some of the better-done prior studies. You might focus on different populations of firms or different time periods, but the aim should be to find out whether a given pattern has any stability or robustness. This stream of research has used an ever-shifting set of variables and models, yielding inconsistent results. A direct replication could allow you to be the first researcher to find the same result that others have found! Fourth, consider comparing the market’s reaction to the succession announcement to the actual performance of the firm over the first two to three years of the executive’s tenure. To what extent are positive (or negative) initial reactions borne out? Indeed, some very prominent strategy researchers have derided the notion that any strategic implications can be drawn from event studies (e.g., Porter 1987). Studies that link investor reactions might allow important insights about executive reputations, the “romance of leadership” (Meindl, Ehrlich, and Dukerich 1985), and investors’ faith in “rain dances.”

Executive Turnover: Beyond the CEO

Turnover in executive ranks, beyond the CEO, may also be reflective or predictive of important organizational phenomena. Although traditionally not studied as much as CEO turnover, the departure of other executives on top management teams has become a prominent topic for research in recent years.

The most consistent predictor of top executive turnover, as with CEOs, is organizational performance. Wagner, Pfeffer, and O’Reilly (1984) found, in a sample of thirty-one large firms, that the correlation between the proportion of the top management group departing (over a five-year period) and the firm’s profitability relative to its industry was $-.44$. Boeker (1992) in his study of semiconductor firms, found a similarly strong association between low performance and executive departures (specifically dismissals). Many of the more recent studies that we will review below report similar conclusions.

Blackwell, Brickley, and Weisbach (1994) provided evidence that division-level performance among bank divisions was an important determinant of division CEO turnover;

but the authors did not gauge how the external market might view the exit, or attempt to link overall firm performance to the departing executive. Further, these authors raise questions about the extent to which overall firm performance can be attributed to division heads.

Building on those issues, Fee and Hadlock (2003) provided a very detailed look at managerial turnover among the top five highest-paid officers, comparing and contrasting CEO and non-CEO executives. They noted higher turnover for non-CEOs (about 15 percent, versus about 9 percent for CEOs) and that non-CEO exit was frequently associated with CEO exit. Fee and Hadlock also noted that CEOs seem to be held more accountable for poor firm performance than lower-level managers. Once they controlled for CEO dismissal, the link between performance and team member exit was weak.

The authors also tried to determine if the departing executives took jobs elsewhere. Through a search of publications and filings of public corporations, they found about 16 percent of the exiting executives. Age was critical in finding new employment. Of those who were under sixty years of age, the authors found that about 27 percent were employed elsewhere; among those who were under fifty, they found about 42 percent employed elsewhere. From press announcements, the authors concluded that when a company announces that the executive is “retiring” it means exactly that. Two-thirds of those executives found at other companies were at public companies, the rest private. On average, the new jobs seemed inferior—they were with smaller firms, at lower hierarchical levels, and at lower salaries. Of the relatively small sample for which they had salary data, 74 percent had taken a pay cut. Interestingly, exit conditions had little apparent influence on reemployment. Executives who were forced out were more likely to be reemployed, but the fact that they were dismissed did not seem to affect the quality of their new jobs. Firm performance at the time of the exit had no effect on the likelihood of reemployment or the quality of the new position. The authors concluded that executives suffered costs from exit, but the costs arose simply from the fact that the exit occurred and were not linked to the reason for the exit, or the conditions surrounding it.

Fee and Hadlock (2003) also studied managerial movement from one firm to another. The study was designed to determine if higher stock prices in the original firm increased demand for the executive in the external labor market, and also to understand the implications of executive retention strategies (e.g., golden handcuffs). The authors used separate samples to examine these two issues. Sample 1 was every outside CEO hired by 2,196 public firms between 1990 and 1998. Using a five-year buy and hold measure, the firms these executives had left (when taking their new CEO positions) were, on average, superior performers, and this effect seemed stronger for higher-ranking executives. Sample 2 was all exits (with reemployment) among 443 large public firms from 1993 to 1998. For this sample, five-year stock returns increased the likelihood of jumping to outside CEO positions. Lateral jumps were not affected by stock price performance. There was no evidence that options or restricted stock had any effect on executive retention. However, promotion opportunities in the original firm did appear to affect retention, as many of the exits (with reemployment) observed were among executives who had recently been passed over for promotion. Finally, hiring grants (i.e., signing bonuses) with the new employer were highly correlated with the options and other awards left on the table at the old firm.

Fee and Hadlock (2000) studied the relationship between product-market competition and management turnover. They argued that theories about the effects of product-market competition on management turnover are ambiguous about the sign of the relationship. Their study documented turnover in six key positions in a sample of newspaper organizations (president, circulation manager, advertising manager, classified advertising manager, managing editor, sports editor) between 1950 and 1993. The authors reported that turnover

increased by about 27 percent under competition (when there was more than one newspaper operating in the region) and the increase was closer to 60 percent for advertising managers. Performance (measured as either circulation or change in circulation) affected turnover among presidents and circulation managers, but not others. Relative performance affected departures only among advertising managers and circulation managers. There was no interaction between competition and performance on turnover. Put differently, the association between performance and turnover did not depend on the level of competition.

The more recent studies indicate several points of difference between turnover of CEOs and turnover of non-CEO executives. First, a wave of executive exits is often prompted by CEO succession, and at least some of the passed-over executives become CEOs at other firms. Thus, a job change for non-CEO executives can clearly lead to promotion. Second, executive exit and re-employment, when the new position is below the CEO level, tends to come at a cost to the executive. That is, the new position is often inferior to the original one (Cannella et al. 2002). Third, performance measures that capture outcomes associated with the specific responsibilities of the executive are perhaps more important determinants of exit than very broad measures of overall firm performance.

As the previous studies indicate, and as we concluded earlier for CEOs, overall performance does not fully explain executive turnover rates. Rather, other factors—including sociopolitical factors—are important as well. First, departure reflects power. In a very intriguing analysis, Boeker (1992) found that in poorly performing firms, highly powerful CEOs (those with large shareholdings and surrounded by a large proportion of inside board members) were not dismissed. However, the dismissal rate of their lieutenants was very high. The powerful CEOs were able to deflect scapegoating and pass it on to their fellow executives. Boeker did not examine which specific executives were dismissed, but we could reasonably expect that their individual power—their own stockholdings, their elite connections, the degree of fit between their competencies and the firm's critical contingencies, and so on (Finkelstein 1992)—would be highly predictive of their own retention versus departure. Evidence discussed below regarding chief financial officers (CFOs) also confirms the importance of executive power (Reutzler and Cannella 2004; Mian 2001). Thus:

Proposition 7–6: The greater an executive's power within a top management group, the less likely he or she is to be dismissed when the firm is performing poorly.

Executive departure may be due to internal social forces as well. As Wagner, Pfeffer, and O'Reilly (1984) found, relational demography of the top management group affected executive turnover. Specifically, the more heterogeneous the group, in terms of tenure in the firm, the higher the departure rate of the executives. And at the individual level, the more distant a given executive is from other members of the group (in terms of age), the greater the likelihood of his or her specific departure. The authors argued, in line with a well-established line of thought in social psychology, that demographic similarity enhances social integration, which in turn aids communication and cohesion. When group members are dissimilar, social bonds are weak, and both voluntary and involuntary departures are greater. Those members most dissimilar from the majority of the group will be most likely to leave. Jackson and associates (1991) found the same result, using additional demographic dimensions. Thus:

Proposition 7–7: The greater the demographic dissimilarity of top management group members, the greater the rate of turnover within the group.

Proposition 7–8: The more dissimilar a specific executive from the demographic

central tendencies of the top management group, the greater the likelihood of his or her departure.

However, an executive's likelihood of departure may be even greater to the extent that he or she is dissimilar from the characteristics of the *most powerful* group members, not simply from the *average* characteristics of all group members. Top management groups often have clear power strata—if only by hierarchical level—and an executive who is very unlike those in the highest strata experiences the combination of social distance described by Wagner, Pfeffer, and O'Reilly (1984) and the vulnerability of being distant from the political center. For example, if the three top-most executives, including the CEO, all have marketing backgrounds, then a vice president with a manufacturing background is relatively likely to depart.

Kim and Cannella (2007), for example, argued that executive social capital can be divided into internal and external dimensions according to its locus and function. The effects of internal social capital (close ties to the CEO or company founder) should be positively associated with the likelihood of promotion when performance is good, but not when performance is poor. Their study implied that socialpsychological factors, such as homophily, can be counterbalanced by performance pressures. Using a large sample of executives in Korean firms, their evidence suggested that when performance was good, executives who had social ties to the powerful people in the firm (i.e., high internal social capital) were promoted, but when performance was poor, executives with ties to powerful organizations in the environment (i.e., high external social capital) were promoted.

Due to a combination of social and political forces, we anticipate:

Proposition 7–9: The more dissimilar a specific executive is from the demographic characteristics of the most powerful executives in the group, the greater the likelihood of his or her departure. This will be a stronger association than the one described in [Proposition 7-8](#).

Although dissimilarity may be a precursor to executive departure, there may be special circumstances when demographic similarity heightens the likelihood of turnover. Here, we speak specifically of the situation in which several executives share many characteristics—and particularly are about the same age—and all aspire to be the next CEO. Too much similarity can create direct rivalries that would not exist if executive characteristics were more dispersed (Vancil 1987). Not only may the rivals act antagonistically toward each other during the succession tournament (heightening chances of friction and departures); but after the succession decision has been made, the winner may engage in retaliatory actions (even unwittingly), and the tournament losers may leave voluntarily.

We consider the implications of CEO succession for the turnover of other executives to be very interesting and potentially important. Beyond the tendency for substantial turnover immediately following a CEO succession (Helmich and Brown 1972; Gabarro 1986; Fee and Hadlock 2003; Blackwell, Brickley, and Weisbach 1994), this general domain has not been studied in detail. It may be that demographic similarity of contenders could affect departure rates, as we suggested above. And the nature of the succession process—whether it is a horse race or relay, how visible the horse race is, how many contenders there are, how close to the incumbent's departure the race is held—may have very strong effects on executive turnover.

The implications of top team turnover (beyond only CEO turnover) for organizational performance have received little attention by scholars. One study in the minicomputer industry, by Virany, Tushman, and Romanelli (1992) found two distinct patterns associated with high performance. The most typical mode was a combination of CEO succession,

sweeping team changes, and strategic reorientation. The authors argued that this is the dramatic combination of events needed to adapt in a turbulent industry such as minicomputers. However, the second and rarer mode involved strategic reorientation and major team changes but continuity in the CEO. These firms, the authors argued, were able to simultaneously inject fresh perspective and learning (through major turnover within the team), while maintaining links to established organizational resources and competencies (through retention of the CEO). Across both modes, however, it becomes apparent that team turnover has implications for performance beyond those from CEO turnover. In this particular industry—turbulent, with frequent discontinuities—top team turnover appears to be beneficial.

The Tushman and Rosenkopf (1996) study discussed earlier showed the importance of context to predictions about the effects of CEO and TMT changes, as well as reorientations. At the TMT level, however, the study provided evidence of a differential performance impact for executive team *exits* relative to executive team *entries*. At the team level, the specific type of turnover (entry vs. exit) was apparently important to adaptation and thus performance. While the authors did not have a theoretical explanation for this finding, it would seem to be a very fruitful arena for future research.

As with CEO turnover, differences in context may cause team turnover to have different effects. Here, a study of failing firms conducted by Hambrick and D'Aveni (1992) is instructive. This study of fifty-seven large bankruptcies and fifty-seven matched survivors examined the top management team characteristics associated with corporate failure. The failing firms showed divergence from survivors on several indicators of TMT composition, for each of the five years before bankruptcy (smaller management teams; shorter tenures; smaller proportions of executives with core function experience, i.e., in marketing or sales, operations, or R&D; and lower executive compensation). Moreover, those differences became more pronounced, at an accelerating rate, over the five-year period. Through cross-lagged analysis of team changes and performance changes, the authors concluded that a two-way causal process, or a “vicious circle,” was at work (Figure 7.2): (1) team deficiencies bring about or aggravate corporate deterioration, either through strategic errors or stakeholder uneasiness with the visibly inadequate team; and (2) corporate deterioration brings about team deterioration, through a combination of voluntary departures (often of the most mobile and able executives), scapegoating, and limited resources for attracting new executive talent. Hambrick and D'Aveni posited that even though there may be ways to arrest this downward spiral, it has a compelling momentum that seriously complicates corporate turnarounds, in a way that turnaround scholars and consultants had not previously considered. Finally, the evidence from Shen and Cannella (2002b), discussed earlier, suggests that new CEOs from inside the firm are likely to make better choices about which insider top management team members should go after a succession event, while after the ascension of outsider successors, top management team exit may do more harm than good.

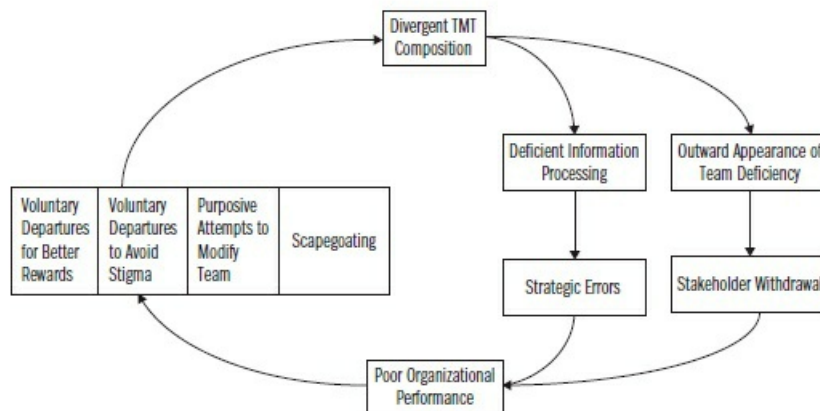


Figure 7.2. The “Vicious Circle” of Top Team Divergence and Poor Performance (Adapted from Hambrick and D’Aveni 1992.)

Building further on the context of company failure, Khanna and Poulsen (1995) attempted to assess managerial culpability for company failure, as well as the consequences of failure for managerial careers. The authors studied managerial decisions for three years prior to company failure and compared a sample of firms that filed for bankruptcy to a matched set that did not experience financial distress. They also studied investor reactions to announcements of decisions made during the downward spiral (decisions included asset sales, plant closings, personnel reductions, equity for debt swaps, and debt restructuring). They concluded that the decisions made by executives were quite similar across the two samples, except that decisions were more frequent in the sample that eventually filed for bankruptcy protection. Market reactions to the announced decisions were also similar across the two samples. The authors concluded that the decisions made by managers of failing firms were not perceived by investors to be value-decreasing. Further, for their sample of failing firms, they found that when managers were blamed for financial distress they were simply being used as scapegoats.

In the turnover part of the study, the evidence suggested that investor reactions to turnover announcements⁴ were significant and negative for both failed and matching samples, and there appeared to be no difference in investor reaction between internal and external replacements. They did find a strong and positive reaction to announcements of downsizings coupled with managerial turnovers for the sample of failing firms. The corresponding reactions were not significant for the matched sample.

The authors concluded, at a broad level, that external labor markets extract a penalty from managers of failed firms, although their evidence pointed clearly toward external factors as the chief causes of failure—the scapegoating explanation.

Another context in which to consider top team turnover—both its causes and its effects—is in corporate acquisitions. Acquisitions are socially disruptive events that provide a crucible for studying turnover phenomena. Often, acquirers have strong preferences—one way or the other—about retaining acquired executives. On one matter, research data are highly consistent: executives in acquired firms depart at an extraordinarily high rate, roughly twice the rate under normal circumstances (Hayes and Hoag 1974; Walsh 1989; Hambrick and Cannella 1993; Krug and Hegarty 1997; Lubatkin, Schweiger, and Weber 1999).

But what are the factors that affect the rate of acquired executive departure? Under an agency perspective, the prior performance of the acquired firm should have a significant effect because the acquirers will want to dismiss the acquired executives if they deem them

inadequate. Indeed, pre-acquisition performance of the acquired firm accounts for some variance in rates of executive departure (Walsh 1989). However, Hambrick and Cannella (1993) argued that departures of acquired executives could be best explained by the relatively robust concept of “relative standing”:

Acquisitions are often surrounded by an aura of conquest (Haspeslagh and Jemison 1991; Hirsch 1986). If the acquirers feel dominant or superior, and they reveal those feelings in their interactions with, and policies toward, the acquired executives (including, but not limited to, outright dismissal), the departure rate of the acquired executives will be affected. Similarly, if the acquired executives feel inferior, stripped of status, or locked in a struggle with the acquirers, they will tend to depart. Obviously, the attitudes and actions of the acquirers and the acquired influence each other. (1993, 735)

They tested these ideas on a sample of ninety-seven acquisitions, with several highly significant results in line with the “relative standing” argument. Not only did pre-acquisition performance of the acquired firm vary inversely with departure rates (as agency theory would predict), but the gap between the acquiring firm’s and the acquired firm’s pre-acquisition performance was an even stronger predictor. As the authors asserted, “perceptions and behaviors of superiority and inferiority are calibrated on the basis of both firm’s performances. Where the gap between them is large, acquired executives are particularly likely to depart, possibly because of a variety of intervening factors: self-doubt about their capabilities and prospects in the combined firm, denigration and status degradation at the hands of the acquiring executives and outright dismissal” (Hambrick and Cannella 1993, 756).

Other indicators of relative standing were also associated with acquired executive departure: friendly mergers led to low departure rates; contested tender offers were followed by high departure rates; the removal of autonomy (imposition of acquirer’s policies) brought about more departure; and executives who were personally granted status in the post-acquisition firm (as officers or directors) were relatively unlikely to depart. Hence, on multiple dimensions, the argument that “relative standing” is a major basis for acquired executive retention or departure was supported.

In another essay, drawing from the same sample, Cannella and Hambrick (1993) sought to test the implications of executive departure for the post-acquisition performance of the acquired entity. Using ratings of pre- and post-acquisition performance from company executives and security analysts (who showed strong consistency in their ratings), the authors explored several hypotheses about the contingency conditions (prior performance, relatedness, and so on) that might moderate any effects between executive departure and performance. However, only a simple and straightforward relationship was found: the higher the rate of executive departure in the first two years after an acquisition, the worse the performance of the acquired entity four years after being acquired. Even among those acquisitions that had the worst pre-acquisition performance, the greatest improvement in performance came to those with the lowest departure rates. The authors concluded that acquisitions are so disruptive—to internal decision-making and social processes, as well as to relationships with stakeholders—that, in general, the departure of senior executives aggravates an already very strained and chaotic situation.

Krug and Hegarty (1997) also studied management turnover following mergers and acquisitions, proposing that foreign (non-U.S.) acquirers would have higher turnover rates when they acquired a U.S. firm than would U.S. acquirers. They studied U.S. targets only, but compared Anglo acquirers (U.S. and U.K.), Japanese acquirers, and non-Anglo, non-

Japanese acquirers. Interestingly, turnover rates for the first three years were virtually identical for all three types of acquisitions. Only in the fourth year, and especially in the fifth year, did Japanese and non-Anglo, non-Japanese acquirers see higher turnover relative to Anglo acquirers.

Krug and Hegarty (2001) followed up their earlier study with one of executive perceptions of merger events, and how those perceptions influenced the decision to stay or go. They found (not surprisingly) that managers who had positive perceptions of the merger announcement were more likely to stay, as were managers who had positive perceptions of the changes implemented post-merger. Interestingly, respondents (executives) who had left gave a variety of reasons for their departure. Thirty-five percent quit to “pursue other opportunities” or “retire on schedule”; 33 percent because of lower job status; 6 percent as a condition of the deal; and 26 percent because they were terminated. Of respondents who had not left, links to family and community tended to be important reasons for staying, even though some were dissatisfied with their positions post-merger.

Lubatkin, Schweiger, and Weber (1999) sought to replicate Hambrick and Cannella’s (1993) relative standing study, but they directly measured perceptions of relative standing, rather than relying on proxies. They hypothesized that acquired executive perceptions of cultural distance between target and acquirer would be positively associated with turnover, and acquired executive perceptions of removal of autonomy would be positively associated with turnover. They found support for both hypotheses during the first year after the acquisition, and for the perceptions of autonomy during the fourth year after the acquisition. Interestingly, as with Hambrick and Cannella (1993) and Walsh (1989), the explanatory power of their model during the second and third years was very weak, raising important questions about what processes are at work during those middle years.

Very, Lubatkin, Calori, and Veiga (1997) studied the post-merger integration of acquisitions made during an acquisition wave that followed the formation of the European Union (EU). Building on Hambrick and Cannella (1993), they focused their efforts on relative standing, directly measuring perceptions of acquired managers. They studied U.S., French, and British firms acquiring French and British firms in a 3×2 design, and they linked relative standing to culture. Their study concluded that post-acquisition performance was positively associated with acquired executives’ perceived attractiveness of the buying firm’s culture, and it was inversely related to the perception of autonomy removal. They also demonstrated a moderating influence of cultural distance on the relationship between perceptions and post-merger performance. Importantly, they concluded that while the theory of relative standing was developed for U.S. acquisitions, it also predicted quite well with their EU sample.

In addition to the studies noted above, there have been a wide variety of other studies that have examined turnover among top management team members in one form or another. For example, Barker, Patterson, and Mueller (2001) studied organization-level factors that were influential in top management team turnover among firms in decline, and the relationship between turnover and changes in strategy. They argued that the tension between inertial forces (firm size, and the length of the convergent period for the firm’s current strategy) and change forces (outsider control of the board and closeness to bankruptcy) would drive turnover among top management team members, and that turnover would be associated with changes in the firm’s business-level strategy, structure and control, and domains of activity. Their sample was small (only twenty-nine firms) but it did provide support for their hypotheses that larger firms and firms with longer convergent periods would have less turnover and less strategic change, and that outsider control would be associated with more turnover and more strategic change. The authors also noted that precipitating events (e.g., a

failed acquisition, a hostile takeover bid, a failed product introduction) seemed critical to top management team turnover, as turnover was greatest immediately following these events. They also described how CEO scapegoating of departed executives can serve a useful purpose, as it changes perceptions of the status quo, helps employees unlearn, and signals the seriousness of the need for change.

Bigley and Wiersema (2002) investigated the role of their apparent experience in a CEO's use of power to initiate strategic refocusing in diversified firms. The authors argued that before strategic change is likely to be observed in a company, the CEO must have both the cognitive orientation and the power to effect change—one or the other, in isolation, is not enough. Their sample was limited to diversified companies in order to observe strategic refocusing, and they found support for their main hypothesis. Additionally, CEOs who served on more outside boards were also more likely to initiate strategic refocusing, although the authors could not test any alternative explanations for this observation. Using parallel logic, Shimizu and Hitt (2005) predicted that the divestiture of a poorly performing acquired subunit is more likely when a new CEO arrives from outside the unit. Their evidence, from a sample of seventy acquired firms, supported this prediction.

Bloom and Michel (2002) argued for, and provided evidence to support, the assertion that pay dispersion among TMT members increased the likelihood of turnover and decreased the average tenure of members.

Mian (2001) studied chief financial officer (CFO) turnover and where departed CFOs went for subsequent employment. Mian's study was designed to determine if and how disciplinary forces work below the level of CEO, and the sample included 2,227 CFO appointments between 1984 and 1999. Mian noted that 50 percent of the new CFOs in the sample were outsiders—much higher than the numbers reported for outside CEOs. Among the departed CFOs, 35 percent quit; 21 percent were reassigned internally; 12 percent were given new appointments; 5 percent were promoted to CEO; and only 11 percent retired. Overall, the evidence suggested that CFO turnovers were disciplinary in nature—that is, they occurred because of poor performance. But the authors found little market reaction to CFO exits. For internal replacements, the response was zero or negative—and negative only when the old CFO quit and the replacement was from inside the firm. CFO turnover was also linked to CEO turnover.

Reutzel and Cannella (2004) developed a model of CFO promotion and exit, predicting that company performance, CEO succession, CFO power, and CFO effectiveness would be important factors in promotion and exit events. Results indicated that firm performance, outsider CEO succession, dividend cuts, and CFO power were all important antecedents to CFO exit. Additionally, firm performance and CFO power were important antecedents to CFO promotion.

As the research reviewed above illustrates, there is ample and important need to focus on executive turnover beyond the CEO. Examining the determinants of executive turnover will allow useful insights into social and political phenomena in organizations. And studying the consequences of team-level turnover, particularly on performance, will allow eventually greater understanding than would be obtained by focusing only on CEO turnover.

In summary, turnover at the top is a reflection of, as well as a cause of, important organizational phenomena. However, an understanding of these patterns and underlying processes can be achieved only if the various elements of executive and top team turnover—the precipitating context, succession events and processes, successor characteristics, and succession outcomes—are treated as an interdependent whole.

Other Interesting Issues for Succession

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In an interesting and provocative ethnography of a temporary CEO succession (a maternity leave taken by a founder), Ashcraft (1999) demonstrated that the originating force behind the succession, in the minds of followers, shaped the responses of followers to the succession itself. Further, the study provided detailed analysis of how followers responded to a temporary change in control (an interim leader). This is an unusual study, in an unusual setting, and it used an unusual methodology. The study also has important implications for leadership styles of women versus men, as the exiting founder was female, and her temporary replacement was male. Additionally, many of those involved in the management of the firm were female.

Drazin and Rao (1999) considered succession beyond the CEO role. Their study contrasted two dimensions of non-CEO executives in a two-by-two matrix: the distance from the apex of the firm; and whether the work was that of generalist or specialist. In Cell 1, there are CEOs (generalists at the top)—power is relative to the board, and consequences of CEO change are significant. In Cell 2 are division managers (generalists at midlevel). Here, performance means division-level. The CEO, rather than the board, evaluates performance. The focal leader must control critical contingencies to gain power, and power is reduced by substitutability. In Cell 3 is the SBU functional manager (specialists at midlevel). Here there is little power to forestall dismissal, and generally high substitutability. Finally, in Cell 4, is the corporate financial officer (specialist at the top). For this group, power arises from the ability to control critical contingencies, and performance evaluation is ambiguous regarding who will do it.

Drazin and Rao's (1999) evidence pointed to several conclusions. First, SBU performance, adjusted for industry, was negatively associated with exit, as was tenure and the interaction of tenure and performance. No other performance interaction was significant. SBU manager power reduced the likelihood of exit. This paper illustrates the importance of studying non-CEO samples, using a fairly comprehensive "performance power succession" model.

Pitcher, Chreim, and Kisfalvi (2000) conducted a meta-analysis of succession studies, and then reported on six qualitative case studies—all in a large, global, financial services firm. Over the eight years of the study, nine successions occurred in the (very independent) subsidiaries or the home office. Their key conclusions included: duality and board structure do not indicate much; we need better measures of board vigilance; major shareholders wield a lot of power in succession (the home office, in this case); in order to initiate a succession, only one or two powerful board members are needed; and it is very difficult to distinguish dismissals from other exits. They also concluded that personality differences were very important, as powerful leaders tended to replicate their personalities through choice of their successors, as well as choices of other leaders in the firm. Finally, like many other studies, they noted that all successions sparked waves of voluntary exits.

Brickley, Linck, and Coles (1999) studied the horizon problem of CEO incentives (the expectation that Fama's (1980) "settling up" will fail in the final years of a CEO's tenure). They studied how CEO post-retirement board service might help to ameliorate the horizon problem. If performance in the final years of CEO tenure is linked to post-retirement outside board service, CEOs will still have important incentives to perform well at the end of their tenures. They examined both retention on the home firm's board and service on other boards as an outside director. Their sample of retired CEOs indicated that those aged sixty-four to sixty-six served on an average of 2.48 boards, and nearly 88 percent of retired CEOs held at least one board seat. The average pay for service on a board as an outside director was \$44,000, plus perks and sometimes pensions. The authors concluded that home company performance in the final years of service as CEO (both stock and accounting performance)

was important to post-retirement board service. In particular, market-based performance was linked to retention on the home firm's board, and accounting performance was associated with outside board service. Their evidence implies that CEO performance in the final years of office has important implications for post-retirement issues like board service.

Conclusion

As our review has indicated, research on non-CEO executive turnover has been rich and variegated in recent years. A good deal of work has attempted to examine the linkage between CEO turnover or executive turnover and organizational performance. However, studies linking CEO succession to organizational performance tend to suffer from a single inescapable fact: organizational performance is a very broad concept and it arises from very complex antecedents. As a result, it is difficult to rigorously link any single organizational antecedent to overall organizational performance. Further, any such study should recognize that its design is, almost by definition, a mediated design. That is, new leaders cannot directly create organizational performance, but must influence performance through the changes they initiate and the actions they take. It is the changes and actions that are associated with organizational performance—and even then the linkage is very complex and embedded in a variety of uncontrollable factors. We believe that a more fruitful approach would be to study the linkage between executive succession and more intermediate organizational outcomes, especially outcomes that theory predicts will be important to organizational performance. For example, a new CEO might influence intermediate organizational outcomes such as competitive response speed (Yu and Cannella 2007), competitive aggressiveness (Yu, Subramaniam, and Cannella 2008), new product development efforts, or corporate-level strategy actions like divestitures (Hoskisson, Johnson, and Moesel 1994). Whether these actions lead to higher performance is an important, but conceptually distinct, issue.

As we have outlined in detail in this chapter, turnover and succession below the CEO level is also a very important issue and one in need of further research attention. An important problem to be resolved in these studies is to identify and capture the actual responsibilities of the executives studied. For certain positions, this problem is fairly easy to address. Titles like COO (Hambrick and Cannella 2004) or CFO (Reutzler and Cannella 2004) tend to have fairly well-identified responsibilities associated with them. However, the most common title in TMT-level research is probably executive vice president. That title clearly indicates high status, but suggests little about what its holder's actual responsibilities are. This fact greatly increases the complexity of studying—and understanding—the implications of succession for holders of that position.

A final issue worthy of mention is the notion of cohorts. Much upper-echelons research implies that when a new CEO takes office, he or she is more or less in charge of structuring the TMT. This suggests a cohort-level analysis of TMT succession and its implications for organizational performance. However, with few exceptions (e.g., Helmich and Brown 1972; Shen and Cannella 2002b), how new CEOs structure their TMTs has not been the focus of much research. This issue would seem to be of primary importance, and is particularly ripe for study in the post-Enron era. If, as we suggested in [chapter 6](#), CEO succession is more frequent in the post-Enron era, it likely has ripple effects through the TMT to lower-level executives. To better our understanding of the implications of succession for organizational outcomes, it is essential that future research consider these issues.

8

Understanding Board Structure, Composition, and Vigilance

All public companies have boards of directors, ostensibly to hire and fire senior executives, to set compensation, to review, approve, and evaluate firm strategy, and to generally act as overseers of company business (American Law Institute 1984). In spite of how seemingly straightforward these directives are, scholars studying boards of directors have raised numerous concerns about this normative model, challenging both its assumptions and its implications. These efforts have produced a set of theoretical perspectives that examine what boards actually do and how they operate.

Resource dependence theorists have argued that boards can be used as a mechanism to reduce environmental uncertainty by co-opting external actors representing critical contingencies for the organization (Pfeffer 1972; Burt 1983). Social class theorists have focused more on managerial elites and board interlocks (Useem 1979; Mizruchi 1996; Mizruchi and Stearns 1988). Some earlier work of a more descriptive nature by management theorists examined what boards actually do, often concluding that boards are more inert than active (Mace 1971; Herman 1981; Vance 1983; Wolfson 1984). Later, agency theorists placed boards at the center of corporate governance by emphasizing their role in monitoring¹ and disciplining top management (Fama and Jensen 1983). In this chapter and the next, we discuss these various perspectives with the purpose of developing a model of boards of directors. We review appropriate research to suggest some new directions to guide future work on corporate governance. A primary goal is to spur further work that informs the study of both strategic leadership and the role of boards in strategic leadership.

Conceptually, boards of directors fulfill two roles in organizations. First, they act as buffers and boundary spanners, linking organizations to critical resources in the environment and to valuable information residing in a network of director interlocks (Price 1963; Pettigrew 1992; Kim 2002; Hillman and Dalziel 2003; McDonald and Westphal 2003; Zald 1969; Pfeffer 1972). Second, they play a role in administration and internal control, putatively (and legally) responsible for setting policy and monitoring management (Zald 1969; Johnson, Daily, and Ellstrand 1996; Fama and Jensen 1983; Dalton et al. 2007). These two roles, the first externally directed and the second internally focused, are implicit in virtually every theoretical formulation involving boards of directors. Nevertheless, alternative theoretical perspectives differ in the importance they place on each role and on the assessment of a board's effectiveness in fulfilling each role.

We consider both externally and internally focused board activities to the extent that each relates to strategic leadership. Our main interest in boards is focused on an understanding of their structure and composition ([chapter 8](#)) and their direct and indirect effects on executive leadership and strategic choice ([chapter 9](#)). Such a treatment is consistent with the theme of this book and facilitates a focused discussion of boards. In addition, the huge volume of work in this area necessitates limiting our scope. Boards influence organizations' strategic choices to the extent that they are involved in strategic decision making or, more commonly, in monitoring top managers as strategic decisions are made.

[Figure 8.1](#) presents a model of boards of directors that highlights how boards fit into executive leadership and strategic choice. The model depicts the major contextual conditions

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that influence board characteristics, such as composition and structure. These contextual conditions include critical contingencies faced by the firm, institutional forces (social class influences and managerial elites), and agency conditions. Board characteristics, in turn, affect board vigilance and behavior—both in terms of monitoring and disciplining top management and of involvement in setting strategy. These board actions have numerous and important consequences, according to our model. The organizational outcomes affected by board vigilance and strategic involvement reflect boards’ dual external and internal roles in organizations and include various strategic outcomes, such as diversification, resource management, and change, as well as internal management activities related to executive succession, compensation, and entrenchment. In addition, our model also illustrates how board vigilance and strategic involvement can affect firm performance. This model is valuable for both its potential to develop a predictive framework of board phenomena and its parsimonious treatment of a wide-ranging literature. It also highlights a key set of research questions on boards of directors of special interest to those who desire to better understand strategic leadership: (1) What are the determinants of board characteristics? (2) What are the determinants of board vigilance and behavior? (3) How do boards affect organizational choices, strategies, and performance? In this chapter, we take up the first two of these questions. [Chapter 9](#) addresses the third question.

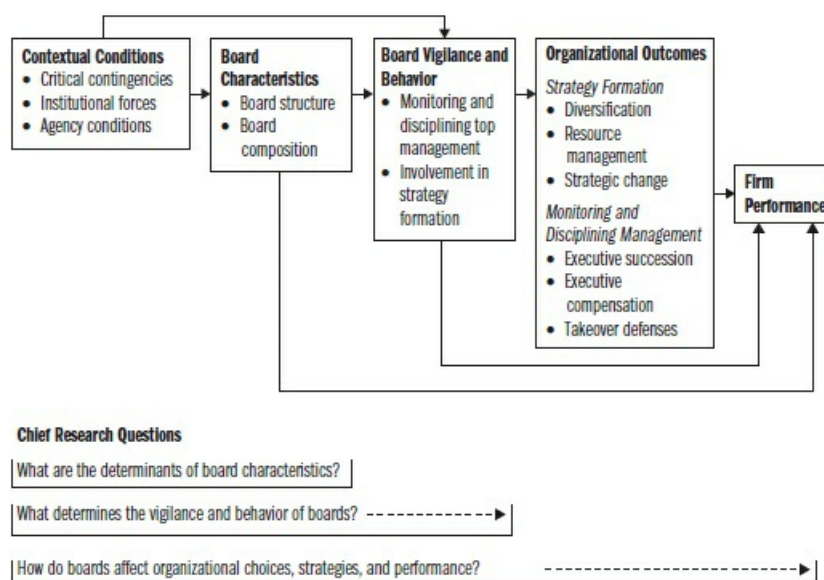


Figure 8.1. A Model of Boards of Directors

Determinants of Board Structure and Composition

A useful starting point is consideration of the characteristics of boards of directors. While it is possible to identify numerous dimensions of boards, our focus is limited to structure and composition for several reasons.² First, board structure and composition are arguably the most fundamental of board dimensions, accounting for the vast majority of research on boards (Zahra and Pearce 1989). Second, both the determinants and consequences of board structure and composition are strongly rooted in strategic leadership, since structure and composition address social, psychological, and economic aspects of strategic choice.

What Do We Mean by Board Structure and Composition?

Board structure refers to the formal organization of the board of directors; its major dimensions are size, the division of labor between the board chair and the CEO, and board committees. The size of a board is straightforward, defined by the number of directors. Board size has been studied for a long time (Zald 1969) and has often been viewed as a key attribute (Pfeffer 1972).³ The second important component of board structure is the formal structure of the chair and CEO positions. CEO duality refers to the situation in which both titles are held by one person, while the separation of chair and CEO positions can simply be called nonduality. CEO duality is one of the most contentious issues in public debates about the role of boards of directors, with most commentators recommending a separation of the top two positions in a firm (e.g., Lorsch and MacIver 1989). However, the duality structure may be advantageous in situations requiring strong leadership (Finkelstein and D'Aveni 1994). Hence, CEO duality is an interesting structural characteristic of boards.

The third attribute of board structure—its committees—has historically not drawn much attention in research, and the relatively small body of work that does exist has tended to use committee membership to study other phenomena. For example, Kesner (1988) and Bilimoria and Piderit (1994) examine board committees to determine if there is evidence of sex-based bias in committee membership. Ferris, Jagannathan, and Pritchard (2003) use committee membership to determine whether outside directors who serve on multiple boards are more prone to shirk their responsibilities. And Luoma and Goodstein (1999) consider whether or not firms establish formal committees to deal with stakeholder concerns (stakeholder committees). All of these studies, while important to knowledge about boards, are outside the scope of our review. In contrast, the few studies on board committees that we do look at, such as O'Reilly, Main, and Crystal (1988), fit more directly into the central broad themes of research on corporate governance.

Despite these reservations, there should be no doubt that board committees can be of consequential interest to strategists and organization theorists. Some years ago, Henke (1986) argued that the board's primary influence on strategy is through its committees, but few rigorous studies have considered this avenue of influence (see Sherman, Kashlak, and Joshi 1998 for an exception). Recently, however, two factors have combined to make board committees potentially much more important. The first is a substantial increase in litigation and other threats against outside directors (see Kaplan and Harrison 1993; Kassinis and Vafeas 2002). This has made it more difficult for firms to secure the services of outside directors (especially independent outside directors) because of their potential exposure to substantial liabilities through shareholder lawsuits that cannot be fully indemnified.

The second recent change is the passage and implementation of the Sarbanes-Oxley Act in 2002, in the wake of a series of large corporate scandals. Sarbanes-Oxley is perhaps the most sweeping change in corporate governance since the Securities and Exchange Commission (SEC) was founded. The act provides, in part, that CEOs and CFOs must personally certify all financial statements and that firms must have audit committees and must state publicly if the audit committee includes a "financial expert." The act further provides for very rapid disclosure of any sales of stock by executives or directors. Paralleling the implementation of Sarbanes-Oxley, the New York Stock Exchange amended its own rules to mandate that the boards of all NYSE firms must include compensation, nominating, and auditing committees made up entirely of "non-executive directors"; that non-executive directors must meet annually without executive directors present; and that the firm must name a lead non-executive director (see *Economist* 2003). As of this writing, the rules are still unfolding, but it seems clear that board committees will be a much more prominent arena of study as events evolve.

In contrast to structure, the composition of a board of directors defines the affiliations of each director, and more recently, the demographic background and expertise that each director brings to the board. At a broad level, a corporate board is composed of the following: (1) top managers of the firm (inside directors); (2) representatives of other organizations that do very little or no business with the firm (independent directors); (3) representatives of other organizations that conduct business with the firm or with key persons within the firm (e.g., lawyers for family owners) or are otherwise affiliated with the firm (affiliated directors);⁴ (4) members of the founding family or relatives of incumbent top managers, who are themselves not officers of the firm (family directors). Although each of these groups may have different motives and hence may behave differently (Van Nuys 1993), most research on board composition has employed the simpler categorization of “insider” and “outsider.” Board composition has been recognized as one of the most significant board dimensions for some time, as witnessed by the overwhelming number of articles in which it is incorporated (Zahra and Pearce 1989).

More recently, an important trend has been to merge the third and fourth categories above into a single “affiliated director” category. Affiliated directors are those with “significant” business dealings with the firm—defined by the SEC (Item 404(a) of the Securities and Exchange Act of 1934) as involving \$60,000 per year or more. Further, the SEC defines “certain business relationships” (Item 404(b) of the SEC act) as significant payments to the firm in return for services or property, significant indebtedness by the firm, legal counseling, investment banking, consulting, former employment by the firm in an executive capacity, and so forth. These individuals can be identified through proxy statements, or there are information services, such as the Investor Responsibility Research Center (IRRC), that maintain lists of affiliated directors.

As noted earlier, board composition can also be studied from a demographic perspective. Hence, composition is also defined by such characteristics as the age, tenure, gender, race, managerial experience, industry experience, and heterogeneity of the members. Interestingly, this implies that it may be possible to extend upper-echelons theory to the board of directors and to study the relationships between various board member characteristics and organizational outcomes. Later, we will review some studies that have been conducted along these lines (e.g., Goodstein, Gautam, and Boeker 1994; Daily, Certo, and Dalton 1999; Hillman, Cannella, and Harris 2002; Hillman and Shropshire 2005).

One final aspect of composition is the shareholdings of each director; it may hold great potential to explain much about boards, such as their relative power. After outside director representation, director equity is the next most studied board characteristic. In many studies, however, the definition of director shareholdings depends on the definition of inside, independent, affiliated, and family directors (see, for example, Villalonga and Amit 2006; Miller, Le Breton-Miller, and Lester 2005; Johnson, Daily, and Ellstrand 1996). Thus, measures of composition and shareholdings are often correlated.

It is also important to study how the characteristics of boards change over time. This is especially relevant because changes in board characteristics are caused by the exit of existing board members, as well as the entry of new ones. Directors leave their positions for numerous reasons: mandatory retirement, illness or death, moving to a more prestigious directorship, insufficient time to perform effectively, ousting by a new CEO, disagreement with other board members or the CEO, or avoidance of the stigma of associating with a poorly performing firm. Nevertheless, in contrast to the large body of work on CEO turnover (discussed in [chapter 6](#)), studies on director turnover and selection are limited.⁵

We now turn to examining the first part of [Figure 8.1](#), outlining the major contextual conditions that influence board characteristics—the impact of critical contingencies,

institutional forces, and agency conditions.

Critical Contingencies

Critical contingencies emanate from multiple sources but find common ground in the challenge they represent for organizations to address the imperatives they impose. Although critical contingencies are sometimes considered solely in terms of environmental exigencies, we also consider imperatives that arise from firm strategy and performance.

A central tenet of resource dependence theory is that firms attempt to reduce the uncertainty associated with their environments (Thompson 1967). This uncertainty derives from the need to acquire critical resources from environmental actors (Pfeffer and Salancik 1978; Miles 1982). Boards of directors can be used to help reduce interorganizational dependencies by establishing interlocking directorates (Dooley 1969; Burt 1980; Pennings 1980; Mintz and Schwartz 1981) or co-optation strategies (Thompson and McEwen 1958; Pfeffer 1972; Burt 1979). Co-optation is “the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence” (Selznick 1949, 13). The implication is that directors are selected for their ability to reduce environmental uncertainty by providing access to resources critical to a firm.

Strong empirical support exists for this perspective. Pfeffer (1972), studying eighty manufacturing companies, found that firms with relatively greater financial needs had more bankers on their boards, more directors, and a greater proportion of outsiders and lawyers. In a follow-up study of fifty-seven hospitals, Pfeffer found that “hospitals operating with relatively more government money ... tended to place more importance on selecting board members for their political connections” (1973, 358). More generally, organizational responsiveness to environmental requirements tends to increase both the size and diversity of boards (Pfeffer 1972, 1973).

Pfeffer’s two studies built on earlier work by sociologists such as Zald (1967), who found that directors of nonprofit organizations were selected on the basis of their ability to raise funds and to deal with environmental threats. The basic logic of the resource dependence approach has been supported in more recent studies as well (Provan 1980; Hillman, Cannella, and Paetzold 2000; Hillman, Cannella, and Harris 2002; Birnbaum 1984; Mizruchi and Stearns 1988; Boeker and Goodstein 1991; Pearce and Zahra 1992; Stearns and Mizruchi 1993; Hillman 2005; Lester et al. 2008).

Although co-optation strategies are generally described as mechanisms to reduce uncertainty (Pfeffer 1972), co-optation may work both ways. For example, a director who represents a bank may encourage a heavier debt load to generate more underwriting work for the director’s firm. Thus, while directors may be appointed to enhance access to needed resources, they may also be fulfilling their own instrumental needs (Aldrich 1979; Lester and Cannella 2005; Lester et al. 2008; Mizruchi 1982; Mizruchi and Stearns 1988).

A second type of critical contingency may derive from the firm’s strategy. Arguing that successful diversification requires (1) skills in portfolio management (Leontiades and Tezel 1981) and acquisition integration (Dundas and Richardson 1982); (2) access to external capital markets (Oster 1990); and (3) knowledge of different technologies (Roberts and Berry 1985), Pearce and Zahra (1992) found that diversification was positively associated with board size and outside director representation. These results are consistent with Baysinger and Zeithaml (1986), who also found differences in demographic characteristics of board members in diversified and nondiversified firms.

Closely related to the concept of strategy is the life-cycle stage of the firm. Lynall,

Golden, and Hillman (2003) described board composition as a function of life-cycle stage and the relative power of the CEO and external financiers. The authors argued, in part, that when the CEO is more powerful than external financiers, board composition will reflect this resource dependence. Alternatively, if external financiers have power, boards will tend to reflect agency (monitoring) or institutional requirements. Interestingly, the authors also noted that most boards are formed about the time of the initial public offering (IPO) and that this initial board often tends to persist. For this reason, the situation in place at IPO will be an important determinant of board composition for some years thereafter.

Firm performance may also affect board structure and composition. Considerable evidence exists that poorly performing firms have higher rates of managerial turnover (Wagner, Pfeffer, and O'Reilly 1984; e.g., McEachern 1975). To the extent that some of this turnover affects inside directors and these insiders are replaced by outsiders on the board (to offer fresh perspectives or to enhance monitoring), poor firm performance should lead to greater outside director representation. In a study of 142 large firms between 1971 and 1983, Hermalin and Weisbach (1988) found that decreasing profits were associated with more outsiders, consistent with the logic above. However, Pearce and Zahra (1992) reported an opposite result for their sample of 119 *Fortune* 500 firms in 1986, as did Hambrick and D'Aveni (1992) in their study of 114 bankrupt and surviving firms. Interestingly, in contrast to Hermalin and Weisbach (1988), Hambrick and D'Aveni showed how outside director turnover was part of a "downward spiral" of top team deterioration, with the departure rate of outsiders increasing as the firm neared bankruptcy (1992, 1464). In another study, however, Gilson (1990) examined 111 distressed firms between 1979 and 1985 and found no relationship between financial distress and outside director representation.

Daily and Dalton (1995) studied CEO and director turnover in failing firms (in the five years leading up to a bankruptcy filing) using both Hambrick and D'Aveni's sample of fifty-seven bankrupt and matched (non-bankrupt) firms, and an additional sample of fifty firms that filed for bankruptcy, coupled with fifty nonbankrupt matching firms. They found that CEO and director turnover did go up, but just weak evidence that duality decreased, and no support at all for the prediction that the proportion of outside directors increased.

These inconsistent findings may be due to differences in performance measures. For example, Hermalin and Weisbach (1988) used market-based measures, Pearce and Zahra (1992) used accounting-based measures, and Hambrick and D'Aveni (1992), Gilson (1990), and Daily and Dalton (1995) identified samples of firms in or near bankruptcy. Additionally, there were important differences in the time periods studied and in model specification: Hermalin and Weisbach (1988) measured both firm performance and outside director representation as changes from the previous year; Pearce and Zahra (1992) lagged firm performance and used an absolute measure of outside director representation; Hambrick and D'Aveni (1992) used several of these approaches; and Gilson (1990) reported simple means over time. Performance as an explanation for director turnover also may derive more from an institutional perspective than from a critical contingencies logic. The following section develops this line of argument.

Institutional Forces

Research on social class theory and managerial elites suggests a different explanation for the composition of boards. According to this stream of work, a capitalist class culture develops from interactions among directors (Useem 1979; Ratcliff 1980; Useem 1984). An individual's power in this so-called business elite depends on his or her position in the social network, which is determined in part by the directorships he or she holds (Warner and Abegglen 1955; Porter 1957; Clement 1975). The directorship is a means of establishing and

maintaining contact with other important people in the business elite (Mariolis and Hones 1982). As Koenig, Gogel, and Sonquist (1979, 177) argued, interlocking directorships allow “business leaders to occupy several influential positions simultaneously so that they can more effectively promote their own and allied interests in both the economic and social spheres.” Often this upper echelon of businesspeople enjoys memberships in the same elite social clubs, business groups, and government policy forums. For them, directorships provide intangible rewards and prestige that are valued in the business elite (Allen 1974; Useem 1979; Mizruchi 1982; Palmer 1983; Davis 1993).

The implication from this work is that directors may be selected to boards because of their personal connections throughout a community of individuals (Mintzberg 1983a).⁶ Although some have argued that boards really are not “old boys’ clubs” anymore (Lorsch and MacIver 1989, 4), persuasive evidence on board interlocks and the business elite continues to accumulate. For example, in a study of directors in the largest U.S. companies, Davis (1993) reported that the number of new boards to which directors were appointed in the 1980s depended on (1) the number of other boards of which they were already members and (2) the network interlock centrality of boards on which they already held directorships. Contrary to agency theory predictions (Fama and Jensen 1983),⁷ directors of better performing firms were not more likely to join new boards than directors of poorer performers, and directors of hostile takeover targets were not less likely than other directors to join new boards. In sum, Davis’s study provided evidence in support of institutional factors, including director prestige and position in the managerial elite, as predictors of director selection but did not support predictions from an agency theory perspective.

Research on director interlocks and social class theory highlights the prestigious nature of a directorship and how it may enhance an individual’s standing in the managerial elite (Allen 1974; Useem 1979). While membership in the managerial elite connotes success, it also implies an obligation to uphold a collective image of winning. Davis (1993) notwithstanding, directors who sit on the board of a poorly performing firm may threaten their own positions in the elite.⁸ This idea is not much different from Fama and Jensen’s (1983) contention that a primary motivation of outside directors is to protect and build their reputations. To the extent that directors are not successful in their fiduciary duties, there may even be an *ex post* “settling up” that exacts a price in terms of director reputation and the consequential rewards that accrue (Fama 1980; Gilson 1990; Kaplan and Reishus 1990; Hambrick and D’Aveni 1992). The logic of this argument suggests several Propositions, only one of which has been tested.⁹

Proposition 8–1: The lower a firm’s performance, the greater the likelihood of director exit.

Hermalin and Weisbach (1988) found no support for this proposition in their study, while Hambrick and D’Aveni’s (1992), Daily and Dalton’s (1995), and Gilson’s (1990) studies of distressed firms and Walsh and Kosnik’s (1993) study of hostile takeovers were supportive.

Proposition 8–2: The greater the number and prestige of a director’s other directorships, the greater the likelihood of that director’s exit in poorly performing firms.

Proposition 8–3: Exit by a director who is a CEO of his or her own firm will be more likely than by other directors when firm performance is low.¹⁰

Note that [Propositions 8-1](#) through [8-3](#) imply that negative firm performance reduces the

value of the directorship to the outside executive, so those with more directorships or with other employment may find the costs of continued service with a poor performing firm to exceed the benefits. By implication, firm and/or director performance should play a role in a director's ability to attain, or maintain, other directorships. For example, Gilson (1990) not only showed that directors of bankrupt firms were more likely to turn over, he also reported that he was unable to find any of the exiting directors at another exchange-listed firm within three years of the bankruptcy. This evidence, though suggestive, implies that outside directors bear a cost when their firms perform poorly.

Since Gilson's (1990) study, several studies have sought to gain a better understanding of the market for corporate directors and how it might function (or not function) to increase governance effectiveness. For example, Brickley, Linck, and Coles (1999) showed that for CEOs, both continued service on the home firm board after retirement and the acquisition of subsequent outside directorships after retirement were importantly impacted by the performance of the home firm in the final years of the CEO's tenure. While retention on the home firm's board was strongly linked to stock performance during CEO tenure, service on subsequent outside boards was better explained by accounting returns. This evidence suggests that performance in an executive role has an important influence on the outside directorship opportunities that arise after that performance becomes public. However, in a recent paper, Westphal and Stern (2007) found that directors who engaged in low levels of monitoring and control behavior actually were more likely to pick up additional board seats in other firms, a result attributed to the norm-breaking nature of the behavior of these directors.

Two other studies have examined visible actions taken by boards and their implications for subsequent board service. In the first, Coles and Hoi (2002) examine how responses to the passage of antitakeover legislation affected subsequent directorship opportunities for those serving at the time of the legislation's passage. They studied Pennsylvania Senate Bill (SB) 1310, which severely restricted takeovers but provided ninety days for existing firms to "opt out" of some or all of the legislation. By "opting out," directors could signal their commitment to strong governance by keeping the door open to takeovers.¹¹ The authors reported that for outsider-dominated boards that "opted out" of some or all of SB 1310's provisions, individual directors were three times as likely as others to gain at least one more board seat in the subsequent three years.

In the second study, Farrell and Whidbee (2000) observe the likelihood of outside director turnover and new directorships among outside directors who forced their CEOs to resign. The evidence suggested that, on average, directors are more likely to exit a board after the CEO is dismissed, but some directors benefited from the dismissal. Directors most likely to leave were those who were closely aligned with the fired CEO. Interestingly, the authors also track the market's response to the replacement decision (the identity of the new CEO). When the market responded positively, they considered those directors as having made a "good" replacement decision. Directors who were not aligned with the outgoing CEO, those with large equity stakes, and those who made "good" replacement decisions were not only more likely to stay on the board of the company that fired the CEO, but to acquire subsequent directorships as well.

Other researchers have moved beyond performance and reputation concerns to study several other factors that influence CEOs and chairs to take seats on outside boards. Booth and Deli (1996) examined the number of outside directorships held by CEOs and chairs as a function of their home firm characteristics and tenures. Their emphasis was on the *supply* of outside directors, as opposed to Kaplan and Reishus (1990) and Gilson (1990) who considered the *demand* for outside directors.¹² The authors proposed that whether or not a CEO or board chair chooses to serve as an outside director will depend on the nature of the

home firm (growth prospects), CEO duality, and CEO tenure. Their logic suggested that CEOs who manage growth companies are rarer and have higher marginal products than those who preside over low-growth firms and therefore are less likely to serve as outside directors because of the high opportunity costs. With respect to duality, they noted that when the CEO and chair positions are separated, the person serving as board chair is probably grooming a successor (Vancil 1987) and should therefore be more willing and able to accept outside directorships. All of these predictions were supported by the evidence. Finally, the number of directorship interlocks between the executive's home firm and other boards was positively associated with the number of outside directorships held by the CEO or board chair. Interestingly, the association between the number of outside directors on the home firm and the number of directorships held by the CEO or chair was also positive and significant. While the authors interpreted this evidence as implying that CEOs are more likely to take on outside directorships when monitoring is strong in their home firm, it might be even more plausible that social comparison or institutional processes were driving this result.

In a somewhat different tack, Westphal and Stern (2006) pointed out that social elite credentials clearly help directors secure their first board seats (e.g., Davis 1993), but many directors, such as women and minorities, achieve board appointments without such credentials. Further, there is little evidence that gains made by women and minorities have come at the expense of social cohesion among directors. The authors proposed that interpersonal influence behavior (ingratiation with their firms' CEOs) may smooth the way to board service for those without elite credentials. Ingratiation behaviors are of three kinds: opinion conformity (public statements of agreement with the target's opinion), flattery, and favor rendering. Fundamentally, the authors argue, ingratiation behavior is an act of submission or deference, and it suggests a certain level (and type) of social fit for board service. The authors show that for managers without board appointments, ingratiation behaviors toward their own CEOs increase board appointments at firms where the CEO serves as an outside director. Additionally, ingratiation behavior may substitute for elite credentials, as the effects are stronger when the person lacks elite credentials, or is a woman or minority. The authors' methodology helped to bolster the argument that the effects observed are mediated by the CEO, as the theory implies. This evidence points to the conclusion that women and minorities (and others who may be perceived as without elite credentials) who achieve board service are more likely to be those who have demonstrated the capacity for ingratiation and are likely to be compliant directors. Supplementary analyses and data indicated that ingratiation behavior toward the home firm's CEO was also linked to ingratiation behavior toward the outside firm's CEO. Therefore, directors who achieve board seats in this way are likely to be compliant, not aggressive, monitors. More generally, investigation of how the characteristics and behaviors of executives and CEOs affect the taking on of board service represents an exciting research opportunity.

Agency Conditions

We use the term *agency conditions* to refer to the distribution of power between a board and its CEO. As might be expected, agency conditions derive from a set of trade-offs between boards and CEOs, and often center on the ability of boards to effectively monitor top management. Although we discuss the issue of monitoring in more detail when we examine board vigilance and involvement in setting strategy later in this chapter, it is important to consider how agency conditions determine board characteristics, which we state in two propositions:

Proposition 8–4: The greater the need for monitoring effectiveness, the greater the

incidence of board characteristics that strengthen the independence of the board.

Proposition 8–5: The greater the relative power of the board, the stronger the relationship between the need for monitoring effectiveness and board characteristics that strengthen the independence of the board.¹³

The first of these propositions has a significant normative element because it implies that boards have the power to strengthen their position relative to the CEO when they need to. Although this may seem at odds with a strict distribution of power perspective, some support for this prediction exists. Harrison, Torres, and Kukalis (1988) found that return on assets was negatively associated with the consolidation of the chair and CEO positions, suggesting that boards in poorly performing firms (presumably in need of monitoring effectiveness) were able to enhance their independence by ensuring a separation of the CEO and chair positions. Of relevance to [Proposition 8-5](#), Finkelstein and D’Aveni (1994) reexamined the CEO duality issue and found that powerful boards were less likely to favor CEO duality when firm performance was poor. Interestingly, both this study and Harrison, Torres, and Kukalis (1988) reported a positive and significant association between outside director representation and CEO duality, ostensibly because CEO duality “contributes to a unity of command at the top that helps ensure the existence or illusion of strong leadership in a firm” (Finkelstein and D’Aveni 1994, 1099–1100).

Worrell, Nemec, and Davidson (1997) study both duality and what they call “plurality”—the situation in which the CEO-chairman also holds the title of president. That is, plurality signified that the CEO holds all of the key titles in the firm—chairman, president, and CEO. They observed that duality exists in about 80 percent of the *Business Week* 1000 largest public companies, and in 15 percent of those cases, the CEO holds all three top titles. In general, the authors concluded that investors respond negatively to both plurality and duality. Interestingly, for outsiders hired directly as CEO, the market reaction was more positive for multiple titles, perhaps because of the signal it sends about the new CEO taking command in an uncertain time (Finkelstein and D’Aveni 1994).

Finally, in a study of board structure and composition in initial public offerings (a context that provides considerable power to principals), Beatty and Zajac (1994) found that both the equity stakes held by top management and the noncash incentive portion of top managers’ compensation (independent variables in their study) were negatively associated with the percentage of outside directors, the percentage of outside director-owners, and CEO duality. Hence, this study supports the logic of [Propositions 8-4](#) and [8-5](#), and it indicates that at least part of the need for board monitoring can be alleviated by alternative incentive alignment mechanisms (compensation plans and equity holdings) (see [chapter 11](#)). Put differently, when alternative incentive systems are in place, boards may not need the same degree of independence as they might otherwise. As pointed out by Beatty and Zajac, these results highlight the trade-off between board monitoring and managerial incentives, suggesting that further studies of board trade-offs may help improve understanding of board structure and composition. Importantly, however, Westphal (1999) provided evidence that incentive compensation weakened the collaboration between CEOs and their boards, and thus the substitution of one governance mechanism for another might involve some important tradeoffs that are often peripheral to monitoring discussions.

In a completely different context, Anderson and Reeb (2004) studied the linkage between family ownership and firm performance. More specifically, the study focused on why family firms outperform nonfamily firms,¹⁴ in particular when family ownership and control are widely predicted to increase agency costs. For example, when a family controls a company’s votes, takeovers are virtually proscribed, and families can divert shareholder assets to their

own uses without concern about the market for corporate control. The study demonstrated, however, that when family owners put independent directors (e.g., not “affiliated” or “pressure sensitive” directors) on their boards, investors responded favorably. Similar to Beatty and Zajac (1994), the authors noted that their evidence also highlights the trade-off between incentives and monitoring.

Although trade-offs between boards and CEOs surely exist, it also seems likely that CEOs have great influence in the selection of directors (Patton and Baker 1987). Because there are usually few legal requirements stipulating who may be selected to a board, its membership may depend on influence and negotiation (Mintzberg 1983a). Some have argued that CEOs are likely to choose allies to sit on their boards (Lorsch and MacIver 1989; Hermalin and Weisbach 1997), and survey and anecdotal evidence provides some support. For example, in a survey by Korn Ferry on how candidates for directorships are identified, “recommendation by the chairman” was the most commonly cited method (Jacobs 1991). Similarly, Anderson and Anthony note, “Although legally the board is elected by shareowners, as a practical matter boards are pretty much self-perpetuating bodies. ... The chairman often dominates the decisions with respect to new board members” (1986, 93). And, in one of the most complete descriptive studies on boards, Lorsch noted that “in most companies, selecting directors has been the responsibility of the CEO, who chose the candidates, then recommended them to the board for approval” (1989, 20). Lorsch quotes a director: “I think CEOs feel, justifiably, that they are entitled to select people of judgment, but who will also feel sympathetic to them” (1989, 22). Although such testimonials are impressive, more recent empirical research on the association between managerial hegemony and director selection tells a somewhat more complex story.

Two studies have directly examined the role of the CEO in new director selection. Shivdasani and Yermack (1999) divided companies into three categories: those in which a nominating committee existed and the CEO served on that committee;¹⁵ those in which no nominating committee existed; and those in which a nominating committee existed but the CEO was not a member of it. In the end, the authors were forced to consolidate the first two categories, comparing them to the third. Their evidence suggested that when the CEO was involved (either as a member of the nominating committee, or because no nominating committee existed), new outside directors were more likely to be affiliated directors than independent directors. Further, investor response was negative when an independent director was selected and the CEO was involved, and weakly positive when the CEO was not involved. Finally, the authors noted that for their sample, the probability that the board was independent (comprised of a majority of independent outside directors) went from 55 percent when the CEO was not involved in director selection to 28 percent when the CEO was involved.

In the other study, Hermalin and Weisbach (1997) developed a theoretical model of director selection in which the balance of power between CEO and outside directors is treated as a bargaining game in which the CEO negotiates wages and director selection. While the authors started with the assumption that CEOs are usually very involved in director selection, rather than immediately concluding that this leads to ineffective governance they considered the market forces that gave rise to the bargaining game. In their model, both the structure of the board and its actions are endogenous.

The model makes five predictions for which existing evidence is already supportive. These are as follows:

1. Poorly performing CEOs are more likely to be replaced than are well performing ones (because a CEO’s bargaining power arises from perceived ability).

2. CEO turnover sensitivity to performance is moderated by board independence (because independent boards have more tolerance for monitoring and will therefore act quicker when performance is low).
3. The probability of independent directors being added to the board increases when performance is poor (because of reduced CEO bargaining power).
4. Board independence declines over a CEO's tenure (because longer tenure implies more CEO ability, increasing the CEO's bargaining power).
5. Accounting measures of performance are better predictors of management turnover than market measures (because earnings reflect current management, and stock price reflects both current management and expectations of future management changes).

The model also makes three predictions for which there is little published evidence. First, board independence will persist over the long term (because changes that strengthen or weaken board independence will tend to change the long-term bargaining power of the board vis-à-vis the CEO). Zajac and Westphal's (1996a) study, discussed below, would seem to support this assertion. Second, stock price reactions to CEO changes will be negative if the firing occurred based on private information, and positive if based on public information, because CEO changes signal information about *both* the CEO and the board. Firing based on private information reveals something about CEO ability relative to replacements, while firing based on public information reveals nothing about the CEO, but is a marker for board independence. Finally, the model predicts that CEO salary will be sensitive to firm performance when past performance is low, but insensitive when past performance is high. This is because as performance increases, the CEO's bargaining power increases, permitting him or her to capture a higher share of current period rents.¹⁶

A different type of challenge to the assertion that CEOs select all outside directors comes from James Westphal and colleagues (Westphal and Milton 2000; Westphal and Zajac 1998; Westphal and Stern 2006; Zajac and Westphal 1996a; Westphal and Stern 2007), who have consistently argued that there are two types or categories of boards—one dominated by the CEO, and the other dominated by outside directors (see also Daily and Schwenk 1996). Further, these play forward into two markets for corporate directors—one for those who have demonstrated the capacity (and willingness) to act in accord with shareholder interests (e.g., “active” directors) and one for those directors who have demonstrated the capacity to support the CEO and not “rock the boat” (e.g., “compliant” directors). For example, Westphal and Zajac (1995) found that (1) in firms where CEOs were relatively powerful, new directors were likely to be demographically similar to the firm's incumbent CEO; and (2) where boards of directors were more powerful relative to CEOs, new directors resembled the existing board, rather than the CEO. These results provide some of the strongest evidence to date for the importance of the distribution of power between boards and CEOs in explaining board characteristics. Further, the existence of a “dual” market for directors—one for directors who are active and one for directors who are compliant—needs to be carefully considered in future board research. For example, while the overwhelming majority of director labor market studies take a purely agency theory view (e.g., Brickley, Linck, and Coles 1999; Gilson 1990; Coles and Hoi 2002), the notion that there is a bifurcated market for directors changes the calculus of Fama's (1980) “settling up” considerably.

We build on this research with first a general proposition and then one that extends the Westphal and Zajac (1995) logic:

Proposition 8–6: The greater the CEO's power, the greater the CEO's involvement in selecting new directors.

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Proposition 8–7: The greater the CEO’s power, the greater the proportion of directors personally or professionally connected to the CEO.

In summary, boards are often strongly influenced by the contextual conditions under which they operate. We demonstrated how critical contingencies, institutional forces, and agency conditions can each affect the structure and composition of boards of directors, as well as changes in structure and composition. Better predictive models of board characteristics will depend on the inclusion of these important contextual conditions. These contextual conditions, as well as characteristics of the board, affect board vigilance and behavior—a subject to which we now turn.

Determinants of Board Vigilance

Our model of boards of directors places board vigilance and behavior in the center of a wide set of determinants and consequences. As [Figure 8.1](#) illustrates, board vigilance and involvement in strategy formation may have potentially significant effects on such organizational outcomes as firm strategy and performance. As a result, gaining a clear understanding of the nature of board vigilance and strategic involvement—and when these are more likely to occur—is critical. We first consider board vigilance. This construct is at the center of agency theory and is defined as the extent to which boards effectively monitor and discipline top managers. Traditionally, board vigilance has been viewed as essentially a power construct. However, more recently, the work of Westphal (1999) and Sundaramurthy and Lewis (2003) has led at least some researchers to recognize that board vigilance is linked to, but goes beyond the power of the board relative to the CEO. We will return to this discussion after developing the traditional view of board vigilance.

Board Vigilance in Monitoring and Disciplining Top Management

The descriptive literature on boards (e.g., Mace 1971) depicts directors as generally ineffective monitors of managerial activity. Agency theorists, however, place boards in the center of corporate governance. For example, Gilson and Kraakman assert that “in the corporate governance debate, all arguments ultimately converge on the role of the board of directors” (1991, 873). For agency theorists, the role of the board is to ratify and monitor the decisions of top management (Fama and Jensen 1983). While there are alternatives to board monitoring, such as the market for corporate control (Jensen and Ruback 1983), competitive forces in capital and product markets (Williamson 1963), corporate law (Baysinger and Butler 1985), and managerial and director labor markets (Fama 1980), the board is considered central to ensuring that managers act in the best interests of shareholders (Fama and Jensen 1983). Boards may accomplish this through various means, including implementing performance-contingent compensation plans, actively appraising and providing feedback to top managers on their performance, and even dismissing CEOs (Fama and Jensen 1983; Mizruchi 1983).

The difference between theory and practice in board vigilance has led many scholars to explore the reasons that some boards appear to be more vigilant than others. To understand why boards are not always vigilant monitors of top management, it is necessary to consider agency theory in some depth.¹⁷ According to agency theory, shareholders and managers have different goals, driven to a large extent by the separation of ownership and control in public corporations and by the different risks that shareholders and managers face in organizations (Jensen and Meckling 1976; Shavell 1979; Holmstrom 1987). So, while shareholders can

diversify their risk by investing in multiple firms, management is tied to a single firm (Fama 1980; Baysinger and Hoskisson 1990). A clear implication of this difference in risk profiles is that top managers have somewhat different incentives than shareholders, potentially leading to inefficient managerial behaviors such as making short-term, risk-averse strategic investments (Lambert and Larcker 1985; Hill, Hitt, and Hoskisson 1988), shirking (Jensen and Meckling 1976), empire building (Amihud and Lev 1981; Myers 1983; Benston 1985), and exploiting managerial perks (Williamson 1985).¹⁸

Faced with this principal-agent problem, the primary responsibility of the board of directors is to ensure that top management actions are consistent with shareholder interests (Alchian and Demsetz 1972; Fama and Jensen 1983). According to this view, the board acts to separate decision management from decision control, keeping for itself the roles of ratification and monitoring (Fama and Jensen 1983). We have already noted, however, that boards are not always effective monitors of top management. The underlying reason, as noted in empirical work (e.g., Kosnik 1987; Main, O'Reilly, and Wade 1994), relates to the distribution of power between boards and top managers (especially CEOs).

Stated somewhat simplistically, when the balance of power favors boards, they will be more vigilant in monitoring and disciplining top management, and to the extent that CEOs are more powerful, boards will be less effective monitors (Westphal and Zajac 1995). As Lorsch has argued: "To govern effectively, directors must have enough power to influence the course of corporate direction, a power that is, at the least, slightly greater than the power of those the directors are to govern—the company's top managers and the employees who report to them" (1989, 13).

Hence, it is fundamental that the distribution of power between boards and top managers be carefully considered in studies of board vigilance.

Proposition 8–8: The greater the relative power of the board over the top management team, the greater its vigilance.

The relationship between power and vigilance is strong because of the myriad ways in which a powerful CEO can affect the functioning of the board. As already discussed, powerful CEOs may be heavily involved in director selection. Choosing his or her own slate, or as much of it as possible, further strengthens a CEO's power base (Pfeffer 1981b) and is often seen as a sign of entrenchment (Fama and Jensen 1983). A powerful CEO may also be able to take the chair position on the board, facilitating control of both the agenda and the debate in board meetings (Finkelstein and D'Aveni 1994; Cannella and Holcomb 2005). Such CEO duality can lead to further entrenchment because board chairs "give outsiders most of the information about the organization" (Mallette and Fowler 1992, 1028). Walsh and Seward (1990) point out a broad set of actions that CEOs may take to entrench themselves, from seeking to attribute poor performance to external influences (Bettman and Weitz 1983; Staw, McKechnie, and Puffer 1983) to redefining relevant performance metrics (Jensen 1984).

More recently, Westphal and his colleagues have added three other mechanisms that CEOs may use to strengthen their hand relative to the board. The first of these is ingratiation behavior on the part of the CEO toward outside board members (e.g., Westphal 1998). The second is social distancing activities (a form of ostracizing) against those directors who engage in activities designed to strengthen the board relative to the CEO (e.g., Westphal and Khanna 2003). Finally, some CEOs engage in preliminary actions that appear to support board vigilance, but ultimately do not follow through with full implementation of those actions (e.g., Westphal and Zajac 1994, 1998, 2001). In effect, the third mechanism represents taking visible actions to falsely signal intentions that do not actually exist. With the exception of ingratiation behavior, all of these entrenchment activities are likely to be

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exacerbated by CEO power.

This logic is implicit in agency theory, at least as this theory has developed from its earliest formulations. While Fama and Jensen (1983) saw the board as the guardian of shareholder interests, scholars conducting empirical work focused on such board characteristics as outside representation (Weisbach 1988) and ownership equity (Morck, Shleifer, and Vishny 1988) as arbiters of board vigilance. Work in strategic management followed a similar path, with studies highlighting the role of such indicators of power as CEO tenure (Singh and Harianto 1989b), CEO ownership equity (Kosnik 1990), and whether the CEO appointed incumbent board members (Main, O'Reilly, and Wade 1994). These studies all recognized that board vigilance is a function of the distribution of power between boards (as representatives of shareholders) and CEOs (as the dominant top manager). Indeed, as Fama and Jensen noted, "the board is not an effective device for decision control unless it limits the decision discretion of individual top managers" (Fama and Jensen 1983, 314).

Fundamentally, then, agency theory is a theory about power. The different goal orientations and risk horizons of boards and CEOs give rise to different incentive structures, creating (in some settings) clear conflicts of interest that are typically resolved through the use of power. Hence, the ability of boards to effectively monitor CEOs depends on board power, while the ability of CEOs to engage in activities that are not profit-maximizing to the firm depends on CEO power. To argue that boards are always effective or ineffective monitors of top management or that CEOs always prefer behaviors that are not profit-maximizing is theoretically unsatisfying because it ignores the fundamental role of power.

It is interesting to compare agency theory to earlier work on power in organizations. For example, Allen noted that "power theory holds that larger firm size and greater profits merely provide larger surpluses within these organizations which managers can allocate, at least in part, to their own compensation" (Allen 1981, 1114–1115). This is not much different from the agency theory arguments that CEOs may "take actions that deviate from the interests of residual claimants" (Fama and Jensen 1983, 304) and that CEO entrenchment can lead to opportunistic and inefficient behavior that reduces shareholder wealth (Jensen and Meckling 1976). The idea that power is central to the functioning of boards (Zald 1969) or that such consequences of board-CEO interactions as executive compensation (Lenski 1966) or CEO succession (Alexander, Fennell, and Halpern 1993) depend on the relative power of top managers is not new to organization theory (Mizruchi 1983). This hardly means that agency theory does not add value to our understanding of strategic leadership, but rather that it is important to identify the distribution of power between boards and CEOs as central to the theory.¹⁹

Given the significance of board vigilance to understanding strategic leadership, it is important to review how this construct has been measured in empirical work. As [Figure 8.1](#) might suggest, with few exceptions (Pearce and Zahra 1991; Judge and Zeithaml 1992; Johnson, Hoskisson, and Hitt 1993), board vigilance has been measured by its determinants, factors like duality, the proportion of outside directors (or *independent* directors) on the board, the ownership equity of outside directors, and the ownership equity of vigilant institutions or individuals who are neither officers nor directors (e.g., Miller, Le Breton-Miller, and Lester 2005; Hoskisson et al. 2002).

Numerous studies have imputed vigilance from nonduality (Young, Stedham, and Beekun 2000) or outside director representation (Kosnik 1987; Sundaramurthy, Mahoney, and Mahoney 1997; Weisbach 1988; Baysinger and Hoskisson 1989; Singh and Harianto 1989b; Wade, O'Reilly, and Chandratat 1990; Davis 1991; Mallette and Fowler 1992; Johnson, Hoskisson, and Hitt 1993; Lambert, Larcker, and Weigelt 1993; Sundaramurthy and Wang 1993; Brickley, Coles, and Terry 1994; Buchholtz and Ribbens 1994; Finkelstein and

D'Aveni 1994; Main, O'Reilly, and Wade 1994). Nevertheless, these studies have not explicitly differentiated between affiliated directors and independent directors (outsiders with no affiliation to the firm), an oversight that may lead to misleading findings. Independent directors, as defined earlier, are expected to be more vigilant because (1) their focus on financial performance is a central component of monitoring (Fama and Jensen 1983; Byrd and Hickman 1992; Johnson, Hoskisson, and Hitt 1993); (2) they are more likely to dismiss CEOs following poor performance (Coughlan and Schmidt 1985; Warner, Watts, and Wruck 1988; Weisbach 1988); (3) they have incentives to monitor in order to protect their personal reputations as directors (Fama and Jensen 1983); and (4) they are likely to exercise greater objectivity because they are not as beholden to CEOs as are inside or affiliated directors (Patton and Baker 1987; Schwenk 1989; Walsh and Seward 1990).

Although outside director representation is a commonly used measure of board vigilance, some have argued that the most effective directors are insiders because they are more informed than outsiders and thus can contribute more effectively to boardroom discussions (Hill and Snell 1988; Shen and Cannella 2002a; Baysinger and Hoskisson 1990; Baysinger, Kosnik, and Turk 1991; Boyd 1994). One of the problems in trying to resolve this debate is that outside representation is an imprecise measure of board vigilance or involvement, leading to inconsistent findings across studies. Our view is that outsiders can enhance board vigilance more than insiders, while insiders have the potential to be more involved in board deliberations than outsiders. Nevertheless, board composition is only one factor influencing board vigilance and involvement. Thus, counts of insiders and outsiders are indirect measures of vigilance and involvement—only one of many determining factors.

Further complicating many of the studies of board vigilance, when vigilance is inferred rather than directly measured, is the fact that very diverse governance mechanisms can substitute for one another (e.g., Walsh and Seward 1990). For example, Rediker and Seth (1995) note that a variety of mechanisms can increase the alignment of manager and shareholder interests, and the level of any one mechanism is likely to be influenced by the levels of others. They examine these substitution effects in a sample of eighty-one bank holding companies after deregulation, and conclude that monitoring by outside directors, monitoring by large outside shareholders, and the incentive effects of managerial shareholdings can all be effective substitutes for one another.

Similarly, Sundaramurthy (1996) demonstrated that observed levels of board vigilance can depend upon governance mechanisms arising from outside the boardroom. Her study of antitakeover amendments adopted by 185 firms between 1984 and 1988 indicated that the adoption depended importantly on whether or not the amendments required a shareholder vote and, if they did require a shareholder vote, the proportion of the firm's shares held by pension funds.²⁰ Poison pills, because they do not require a shareholder vote, are easier for boards to adopt without disruption from institutional investors. The authors modeled actual adoption, not whether an amendment was put forth to shareholders and voted upon. However, it is likely that none of the amendments put forward was voted down. Instead, boards were probably less likely to put such amendments forward in the context of large pension fund ownership.

Substitution among governance mechanisms is not the only challenge to the use of board structure and composition as direct measures of board vigilance. Westphal (1998) showed that CEOs often respond to increases in board structural independence (i.e., increases in independent outsiders, separation of CEO and board chair positions, increased demographic distance between the board and the CEO, and CEO-board friendship ties) with interpersonal influence tactics. Put differently, when faced with a decline in their power relative to the board, CEOs tended to use ingratiation and persuasion behaviors to curry favor with

directors. Westphal examined four such behaviors: opinion conformity; other-enhancing communications (flattery); self-enhancing communications; and favor doing. He gathered primary data on ingratiation and persuasion behaviors by CEOs toward directors, and empirically linked these behaviors to both corporate strategy and CEO compensation. While increases in board structural power did have the expected signs on outcomes like strategy and compensation, interpersonal influence behaviors by CEOs significantly weakened the effects, bolstering the author's conclusion that there are important limits to board structural power.

This discussion indicates that although board composition is often used as a measure of board vigilance, it is an indirect measure based on assumptions about the relationship between vigilance and composition that have not been tested and have been called into question. Hence, we propose the following direct test:

Proposition 8–9: The greater the proportion of independent²¹ directors on the board, the greater the board vigilance.

As noted, board vigilance has also frequently been measured through outside director ownership equity (Salancik and Pfeffer 1980; Gomez-Mejia, Tosi, and Hinkin 1987; Kosnik 1987; Hondholders and Sheehan 1988; Finkelstein and Hambrick 1989; Mallette and Fowler 1992; Johnson, Hoskisson, and Hitt 1993; Lambert, Larcker, and Weigelt 1993; Beatty and Zajac 1994; Finkelstein and D'Aveni 1994; Hoskisson, Johnson, and Moesel 1994). The notion here is that ownership stakes provide outside directors with incentives to monitor CEO behavior (Zald 1969; Alchian and Demsetz 1972; Shleifer and Vishny 1986). Once again, however, board vigilance is being measured by its determinants; direct tests have not been made of whether outsider equity is actually associated with board vigilance.

Proposition 8–10: The greater the percentage of stock owned by outside directors on the board, the greater the board vigilance.

Several other measures of board vigilance appear often in the literature, including (low) director compensation (Vance 1983; Main, O'Reilly, and Wade 1994), number of directors representing block holders (Zald 1969), relative board tenure (Singh and Harianto 1989b; Wade, O'Reilly, and Chandratat 1990; D'Aveni and Kesner 1993; Sundaramurthy and Wang 1993), and whether the CEO was appointed to the board before outside directors or directors serving on the compensation committee (Wade, O'Reilly, and Chandratat 1990; Lambert, Larcker, and Weigelt 1993; Main, O'Reilly, and Wade 1994; Westphal and Zajac 1994). Although there are critics of some of these measures (e.g., Baysinger and Hoskisson 1990; Walsh and Seward 1990; Gilson and Kraakman 1991), all have some merit and have often yielded interesting findings in empirical research. Nevertheless, they are also all removed from the actual actions or behaviors of boards. Without primary data, it is difficult to determine the actual level of board vigilance. Indeed, as we have argued, each of these measures of board vigilance is also a determinant.

Another approach to improving the predictive power of models of board vigilance would be to study various contingency hypotheses predicting the conditions under which boards of directors "predisposed toward vigilance" (those with a majority of independent outsiders, high ownership equity, or some other director characteristic thought to affect vigilance) will be more effective monitors of top management. Such a study would implicitly recognize that most of the time the balance of power between boards and CEOs favors the CEO. Aside from the taboo against directly challenging the CEO except in critical circumstances (Mace 1971), boards are constrained by a lack of time to prepare for meetings and to interact with the CEO, limited information and expertise, and the dominance of the CEO (Lorsch and MacIver 1989;

Finkelstein and Mooney 2003). However, as we will argue in our discussion of board involvement in strategy formation, circumstances exist that may promote board vigilance.

One such circumstance may be when the firm is facing a crisis. For example, several writers have asserted that the likelihood that boards will discipline top managers increases during crises (Mace 1971; Lorsch and MacIver 1989). It may not be clear what constitutes crises,²² but when they occur, they tend to empower boards (Zald 1969). There are a number of recent examples, including Harry Stonecipher at Boeing, Peter Dolan at Bristol-Myers Squibb, Steve Heyer at Starwood, and Dennis Kozlowski at Tyco.

In some ways, these examples are not new. Studies of CEO succession consistently find turnover associated with poor firm performance (e.g., Brown 1982; Coughlan and Schmidt 1985; Warner, Watts, and Wruck 1988). Nevertheless, important questions remain unresolved. Why do some boards act more quickly than others in responding to poor performance (after all, Ford had been losing market share for years)? Does it matter whether boards are dominated by outsiders or have members with large shareholdings in the firm, both traditional measures of board vigilance? Do the experiences of a CEO affect how much time elapses before the board takes action? Are some CEOs, by virtue of their tenure, age, or position in the business elite, given more time to fix whatever is wrong with the firm?

One possibility is what Westphal and Bednar (2005) labeled the Abilene Paradox. They argued that “pluralistic ignorance” could exist among corporate directors, contributing to strategic persistence in the face of poor performance. Pluralistic ignorance is a social-psychological bias. When a given director has concerns about the firm’s strategy, there is a systematic tendency for that director to underestimate the extent to which other directors are also concerned about the strategy. Further, that tendency is exacerbated when directors have weak friendship ties or do not know each other well. The authors theorized that pluralistic ignorance would reduce the likelihood that individual directors would voice concerns about the strategy, therefore leading to persistence in the strategy even in the face of poor performance. Using primary data on outside director perceptions about strategic viability as well as the perceived concerns of other directors, the authors reported strong evidence in support of their theory. The study also has important implications for board diversity, as diverse boards are more likely to suffer from the pluralistic ignorance phenomenon.

Other studies look more closely at actual performance as the key factor. Daily (1995) examined the role of board composition and board leadership structure in bankruptcy outcomes, arguing that the ratio of outside/independent directors should be positively associated with successful reorganization and negatively associated with liquidation (an outcome unfavorable to shareholders). Similarly, nonduality should be positively associated with successful reorganization and negatively associated with liquidation. Her evidence strongly supported the hypothesized effects of independent directors, but provided no support for the hypothesized effects of nonduality.

Boeker and Goodstein (1993) examined the relationship between board composition, ownership structure, and new CEO selection. The authors predicted that successor choice would depend upon prior performance, but the effect would be moderated by board composition and ownership structure. Their evidence suggested, in support of their theory, that poor performance was significantly more likely to lead to outsider selection when there was a high proportion of outsiders on the board, or when ownership was not concentrated in the hands of employees or managers.

The increased vigilance of boards in poorly performing firms is also evident in the Finkelstein and D’Aveni (1994) finding that vigilant boards were associated with CEO duality when firm performance was high but not when it was low. It may be that boards give CEOs the benefit of the doubt, but when they are eventually driven to act, they do so with

some conviction. This conclusion is completely consistent with Mizruchi's (1983) discussion of directors as having "bottom-line" power (i.e., the power to fire the CEO) but not much else. Or perhaps the balance of power between boards and CEOs is fluid, with such factors as firm performance tipping the balance. These questions and issues are important and clearly require further work to resolve.

Competition versus Cooperation in Board-CEO Relations

We cannot leave the topic of agency theory without consideration of an alternative point of view expressed in the work of Westphal (1999), McDonald and Westphal (2003), and McDonald, Khanna, and Westphal (2008). These studies outline a theory of board-CEO collaboration and its implications for governance and firm performance. Their approach to governance clearly provides some challenges to the traditional agency theory explanations for board vigilance. For example, Westphal (1999) reviewed volumes of theory outlining why directors need to be independent from managers in order to be vigilant. We have covered much of the same ground earlier in this chapter. However, he also notes (as did we) that directors both monitor and provide advice and counsel. While independence from the CEO probably increases the effectiveness of board oversight and control, that same independence almost certainly makes the advice and counsel role more difficult to fulfill. For example, failure to seek advice is likely linked to loss of status (i.e., the CEO is ashamed to ask for help), but social ties can mitigate this concern, making it more likely that the CEO will ask for help when help is needed. Further, social ties make it more likely that directors will respond positively to requests for help. For that reason, social independence, though it increases vigilance, at the same time reduces the board's effectiveness in providing advice and counsel to the CEO and other top managers. Westphal hypothesized that social independence between the CEO and directors would increase monitoring but decrease advice and counsel. He further predicted that CEO incentive alignment (linking pay to performance) would motivate the CEO to request more help, because it reduces the costs and enhances the benefits associated with social ties. Westphal predicted direct effects on firm performance suggesting that both monitoring and advice and counsel would (independently) increase performance. Finally, he predicted that CEO incentive alignment would decrease the effect of monitoring on performance, and increase the effect of advice and counsel on firm performance.

To test these hypotheses, Westphal surveyed CEOs and then followed up with a survey of directors to measure both monitoring and advice and counsel. Results did not support the independent board (agency) model. Neither friendship ties nor the number of directors appointed after the CEO took office was related to monitoring. The collaborative model, on the other hand, was supported. Social ties increased advice and counsel, and the moderating effect of CEO incentive alignment was also generally supported. Regarding firm performance, both monitoring and advice and counsel were positively associated with firm performance, but there was no evidence that the effects were increased by CEO incentive alignment. Westphal linked this evidence to the broader issue of how incentives influence social processes (advice and counsel seeking). His study also demonstrated that social ties are especially likely to increase advice and counsel when director expertise is high. His collaborative model is clearly an alternative to the agency approach, and as such warrants much more attention.

McDonald and Westphal (2003) explored a "darker side" to the advice and counsel phenomenon, extending advice and counsel beyond the board of directors. Their study noted that CEOs suffering from relatively low firm performance might seek advice and counsel of a confirmatory nature, rather than advice and counsel that might challenge the status quo or

current strategies. For example, a CEO under performance pressure might seek advice from close friends or similar others (i.e., those more likely to provide confirmatory counsel with respect to the current strategy) and not from acquaintances or dissimilar others (i.e., those more likely to question the current strategy).²³ This would provide one possible explanation for why firms suffering from relatively poor performance often do not seek to make strategic changes. Using a survey methodology, the authors identified CEO advice and counsel networks, and reported strong support for their hypotheses. Specifically, they found that “executives’ social network ties can influence firms’ responses to economic adversity, in particular by inhibiting strategic change in response to relatively poor firm performance” (McDonald and Westphal 2003, 1). Further, the study supported the notion that CEO advice seeking may play an indirect role in organizational decline and downward spirals of poor performance. Additional findings indicate that CEO advice seeking in response to low performance may ultimately have negative consequences for subsequent performance, suggesting how CEOs’ social network ties could play an indirect role in organizational decline. While not all (or even most) of CEOs’ advice and counsel networks are composed of the firm’s outside directors, the study clearly has important implications for board governance.

The third article in this sequence, by McDonald, Khanna, and Westphal (2008), examined whether boards increased the incidence of CEO advice seeking from external, unrelated parties that presumably could provide value-added insight and not just affirming commentary on the firm’s direction. These authors found that several traditional measures of board monitoring—performance-contingent CEO compensation, CEO stock ownership, and actual monitoring behaviors—were related to the incidence of advice seeking by CEOs with external executives who were not friends and did not share similar functional backgrounds. Further, the authors report suggestive evidence that such advice seeking is related to firm performance and may even mediate the main effect results on stock ownership and performance-contingent compensation. Hence, this study, like the previous ones in the series, cleverly integrates agency theory with social networks to yield considerably more nuanced insights than a strictly agency-theory view alone would suggest. In sum, this work points out the interplay between two key challenges for boards—effective monitoring, and the promotion of opportunities for direct, and indirect, advice and counsel.

Conclusion

In this chapter we reviewed work on the determinants of board structure, composition, and vigilance. For many years, questions around these issues have dominated the literature on boards of directors, both in organization theory and strategy on the one hand, and in finance and economics on the other. What unites these different theoretical traditions, as it turns out, is a reliance on many of the same attributes of structure and composition. However, the theoretical lenses remain quite narrowly focused, even when we compare resource dependence with institutional and network forces as explanatory drivers. One place to look for theoretical integration is power. Power and exchange are central to resource dependence theory; power is an important characteristic (and outcome) of organizational networks and the business elite; and power is implicit in much of agency theory.

One topic that also spans the three theories is director selection and exit. In recent years there have been many studies on this topic, but with few exceptions, each has adopted only a single conceptual lens. More broadly, the process of being offered, and accepting, a board appointment is still not well understood. Especially in the post-Enron era, when prospective directors face significant risk to reputation and wealth, who becomes a director is a

fascinating research question.

The other key question we addressed was board vigilance. What makes a board vigilant, and what do vigilant boards do? It is not evident that research has clearly answered this most fundamental of questions. Further, when it comes to specific methods of board monitoring, all but a few studies tend to examine only one such method in isolation. For example, if a board consists of independent outsiders, is there added value in also ensuring that executive pay is tied to firm performance? Or, that the CEO and chair positions remain separate? One can imagine an array of possible monitoring mechanisms at the disposal of boards, but does vigilance require the implementation of all of them, or just some? Especially if we believe there are costs associated with the implementation of some types of monitoring (e.g., less trust between CEO and board; fewer opportunities for boards to fulfill their advice and counsel role for CEOs), this question may be of great importance.

Finally, it is important to recognize that board vigilance, like any organizational process, is not static, or independent of other organizational processes. When boards ratchet up their monitoring, we should expect CEOs to react, sometimes in subtle ways (Westphal 1998; Hambrick, Finkelstein, and Mooney 2005). This suggests that rather than assuming that “more is better” when it comes to board vigilance, perhaps “excessive” vigilance may elicit unintended, and negative, consequences worthy of note.

This latter point brings us to the next chapter. A fundamental implication of work in this area is that board structure and composition, as well as board vigilance, is related to organizational choices, strategies, and performance, a subject to which we now turn.

9

The Consequences of Board Involvement and Vigilance

Boards of directors are of critical importance to the system of corporate governance in place in the United States and around the world. They are expected to be the vigilant overseers of managerial action whose primary responsibility is to the shareholders of the firm. In addition, boards have an important role to play in terms of advice and consent to managers. Hence, boards have huge responsibilities, and when they are not fulfilled, sometimes very poor organizational outcomes ensue. It is because of these key roles of boards that they are important to organizations and to society and thus are important to scholars who are interested in organizations and society.

In this chapter, we turn our attention directly to what it is that boards actually do, and especially their effects on organizational life. We will describe some of the controversy surrounding just how much influence boards have on what goes on in and around organizations, and we will review the quickly expanding body of work on board effects on various outcomes of interest to strategists and organization theorists. We start by reviewing the nature of board involvement in strategy formation, and the conditions that can promote or dampen the influence of boards in this regard. Then, we focus in more detail on the consequences of both board vigilance and involvement on several key organizational outcomes of particular importance to research. While the voluminous nature of the research on these topics makes it impossible to review every article published to date, we do pay attention to key studies, leading indicators, and other work that provides both overview and insight to the effects of boards on organizations.

Board Involvement in Strategy Formation

Several descriptive studies have been conducted on what boards of directors actually do, and this work is instructive for the clear message it sends about board actions (Mace 1971; Mueller 1979; Herman 1981; Vance 1983; Wolfson 1984; Patton and Baker 1987; Whisler 1984). The virtually uniform conclusion that comes out of this research stream is that boards of directors are not deeply involved in strategy formation. As Clark has argued: "It is unrealistic to view directors as making any significant number of basic business policy decisions. Even with respect to the broadest business policies, it is the officers who generally initiate and shape the decisions. The directors simply approve them, and occasionally offer advice and raise questions" (Clark 1986, 108).

As an example, consider the only partly tongue-in-cheek analysis by Whisler (1984; based on interviews with about sixty directors) and the following norms of director conduct he noted:

- Rule I (A) No fighting
- Rule I (B) Support your CEO
- Rule I (C) Serve your apprenticeship
- Rule I (D) No crusades

Rule II (C) We don't manage the company

Rule II (D) We don't set strategy

Rule III (A) Keep your distance from subordinate company executives

A common theme in these norms is that directors should avoid confrontation, stay in the background, and not rock the boat. This profile of director behavior has held in the management literature for some time and is in contrast to work in agency theory that generally posits a central role for boards of directors (Fama and Jensen 1983). Agency theorists, however, focus almost exclusively on the monitoring role of boards (e.g., the board's "most important role is to scrutinize the highest decision makers in the firm"; Fama 1980, 294) and not on the role of boards in strategy formation.¹

In recent years, demand has increased for boards of directors to become more active in strategic decision making (Weidenbaum 1985; Power 1987; Galen 1989). Indeed, as [Table 9.1](#) from the American Law Institute indicates, boards may have the legal authority to make major business decisions and establish corporate strategy (Clark 1986). Concerns about director liability (Galen 1989; Kaplan and Harrison 1993), the influence of pension funds (Dobrzynski 1988; Sundaramurthy 1996), the market for corporate control (Brickley and James 1987; Dalton et al. 2007), and the implementation of the Sarbanes-Oxley Act have all added pressure on boards. Moreover, as Lorsch (1989) reports, many directors want to become more involved in the strategy-making process. Most directors he surveyed stressed the importance of board involvement in strategy formation, and writers such as Kenneth Andrews (1981) are strong advocates for such an arrangement. Nevertheless, the directors in Lorsch's (1989) study also recognized that the board's primary role in the strategy-formation process was in advising and evaluating, rather than initiating, a division of labor driven to some extent by a lack of time and information. Board members may also become co-opted over time to not challenge management, in part because such activity may be demoralizing to managers and in part because there are often strict norms against doing so, as well as penalties for violating those norms (e.g., Westphal and Khanna 2003).

Table 9.1. Responsibilities of Boards of Directors According to the American Law Institute

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1. Elect, evaluate and, where appropriate, dismiss the principal senior executives.
 2. Oversee the conduct of the corporation's business, with a view to evaluation on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with [enhancing shareholder gain, within the law, within ethical considerations, and while directing a reasonable amount of resources to public welfare and humanitarian purposes].
 3. Review and approve corporate plans and actions that the board and principal senior executives consider major and changes in accounting principles that the board or principal senior executives consider material.
 4. Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.
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Adapted from American Law Institute 1984.

Several researchers have focused on the issue of how and when boards are involved in strategy formulation, and have returned with some new insights. For example, McNulty and Pettigrew (1999) interviewed 108 directors of U.K. corporations about their involvement in strategy formulation. Of the 108 subjects, 65 were part-time (i.e., outsiders), including 37 chairmen and 28 non-executive directors, and 43 were full-time (i.e., insiders), including 23

CEOs. They concluded that strategies are rarely initiated by outside directors; when they are, the reason tends to be that executives (inside directors) have little experience in the context (e.g., situations like international expansion or privatization). They describe three levels of involvement in strategic decision making: taking strategic decisions (i.e., approval or disapproval); shaping strategic decisions; and shaping the content, context, and conduct of strategy. McNulty and Pettigrew argued that outside directors take (approve or disapprove) strategic decisions, usually at the end of the decision process. Further, contrary to assertions that boards are rubber stamps, the authors noted that some decisions are not approved when they come before the board.

Shaping is done by a subset of outside directors and occurs in two ways. First (and most common), executives sometimes consult with outside directors during strategy formulation, both inside and outside the boardroom (see also Westphal 1999). Second, without direct contact from executives, non-executive directors can challenge, dissent, and test executives, both inside and outside the boardroom. McNulty and Pettigrew (1999) observed that executives often screened out proposals that they believed the board would have problems with. In this way, outside directors shape strategic decisions without direct consultation.

Finally, in the McNulty and Pettigrew (1999) study, only a few outside directors reported active involvement in strategy formation (i.e., shaping the content, context and conduct of strategy). Instead, outside directors tended to be most frequently involved in shaping the extent to which strategy is deliberate as opposed to emergent. By prompting and questioning executives, outside directors forced executives to think through the issues and be prepared. Alternatively, some outside directors acted to assure that strategic action occurred in a framework of responsibility and accountability by introducing strategic controls (see also Johnson, Hoskisson, and Hitt 1993; Beekun, Stedham, and Young 1998).

Forbes and Milliken (1999) developed theory about the cognitive processes of boards of directors examined as strategic decision-making groups. The authors noted some distinctive features of boards—they confront complex tasks; they tend to be fairly large (larger than the average work group); they function only periodically; and their output is entirely cognitive in nature. The authors also describe four key board processes, and how each impacts effectiveness. First, effort norms refer to director preparation, participation, and analysis. Second, cognitive conflict involves leveraging differences in perspectives but also requires balancing the positive with the negative. Third is the presence and use of knowledge and skills, with the authors noting that presence does not guarantee use. Finally, the board's cohesiveness is linked to task performance, with the authors arguing that the association is likely to be curvilinear. While the authors were sharply critical of demographics in board research, their approach relied fairly heavily on relatively standard psychological measures of group and individual cognitive processes—a concern that will make empirical tests of their theory more difficult.

Golden-Biddle and Rao (1997) reported on a case study of a board in action, focusing on the cultural embeddedness of the board in a nonprofit organization that they call Medlay. The study illustrates how organizational identity—members' shared beliefs about the central, enduring, and distinctive characteristics of their organization—both influenced directors' roles and shaped their interactions with managers. The case illustrated how the board's concerns about Medlay's budget (including some "lavish" travel expenditures) highlighted contradictions in the company's identity and created conflicts for directors. Interestingly, an influential subset of directors and top managers resolved the conflicts through "face-saving" strategies that made directors feel as if they had been vigilant, while at the same time confirming feelings of cooperation. As the authors note, "When actions occur that breach the expected role performance of board members, latent contradictions in the organizational

identity emerge, and directors are faced with the conflict of upholding one dimension of identity while undermining the other” (Golden-Biddle and Rao 1997, 593).

Westphal, Seidel, and Stewart (2001) reviewed a large body of work on the diffusion of technologies, policies, and strategies through social networks. Boards of directors are particularly important in this process (e.g., Davis 1991; Abrahamson and Rosenkopf 1997; Abrahamson 1991). However, the authors noted that second-order imitation (i.e., imitation of an underlying decision process or script) had been largely ignored with respect to boards of directors. Further, for boards of directors, first-order imitation is constrained because directors (by law) must be from outside the focal firm’s industry, so direct imitation is likely to be more limited than second-order imitation. Further, while the *content* of strategic decisions may have problems flowing through network ties, the *processes* of decision making can more easily flow through those ties. The authors considered processes behind three policy outcomes: business strategy; acquisition activity; and compensation. They hypothesized that greater similarity in business strategy, acquisition activity, and executive compensation between tied-to firms and others in their industries would lead to greater similarity in the focal firm relative to its industry. A sample of 433 firms from 31 industries provided support for all of their hypotheses. Separate analyses indicated that companies did not appear to imitate the content of decisions, only the policy that led to the decisions. Additionally, all effects arose from direct ties (none from indirect ties).

Rindova (1999) developed a cognitive theory to describe how directors contribute to strategy in ways similar to those of managers. Viewing outside directors as decision experts, she argued that their contribution is frequently in dealing with the complexity and uncertainty surrounding strategic decisions. Like managers, directors scan the environment, interpret what they notice, and make choices (see also Stiles 2001).

Judge and Dobbins (1995) adopted an original perspective on board involvement by focusing on director awareness, specifically their awareness of the CEO’s decision-making style, and whether such awareness might affect firm performance. They noted that writers such as Mace (1971) have already showed that director awareness is important to board functioning—directors have the potential to get involved, but awareness is very important to whether they choose to do so or not, and directors must be aware to be effective. The authors predicted that awareness would be positively associated with firm performance and negatively associated with firm risk. In arguments somewhat parallel to Shen (2003), they further predicted that directors would be more aware of the CEO’s decision-making style early in his or her tenure, as that is when the CEO typically relies most on the support of the board. Interview data from forty-two CEOs and forty-two outside directors generally supported their hypotheses.

Beekun, Stedham, and Young (1998) studied how board characteristics influenced managerial control systems, and through these control systems, the risk characteristics of corporate strategy in a sample of 167 hospitals (a mix of profit and nonprofit). The theory they developed essentially predicted that the more information the board has with which to evaluate managers, the more it will rely on behavior controls, and the less information that the board has, the more it will rely on outcome controls. They hypothesized that (1) a higher proportion of outsiders would lead to outcome-based controls; (2) board size and diversity would be positively related to outcome-based controls for CEO evaluation; (3) frequency of board-CEO meetings would be negatively related to outcome controls; (4) presence of a strategic planning committee on the board would be negatively related to outcome controls; and (5) more emphasis on outcome controls would lead to more risk-averse strategies. Results did not support the prediction that more outsiders are associated with outcome controls, but the other predictions were supported. The authors concluded that when boards

use outcome-based controls, strategies become more risk-averse.

David, Hitt, and Gimeno (2001) developed theory about how institutions motivate managers to make long-term investments. The authors theorized that institutions must exert pressure (i.e., be politically active in governance) and that passive share ownership is not enough. Activism was defined to include making public announcements as well as initiating shareholder proposals, direct negotiations, and proxy contests. The authors predicted that the effects of activism will be strengthened by the proportion of outside directors. In a cross-lagged panel analysis, they found no support for the argument that independent directors strengthen the effects of institutional activism. Their evidence did link activism to increases in R&D investment (both long- and short-term, and the effect was stronger for proxy-based activism in high-growth settings). However, the level of institutional investment was not an important factor—the level of activism was the main driver. Finally, the study considered the implications of institutional activism for R&D outputs, rather than inputs, and provided evidence to support the assertion that increased inputs to R&D caused by institutional activism correspondingly increased R&D outputs. Therefore, while it might be appealing to believe that institutional pressures on managers are felt through independent outside directors, the evidence in this study did not support that belief.

Johnson, Hoskisson, and Hitt (1993) argued that boards become involved in corporate restructuring when firm performance decreases. This hypothesis was supported in a sample of ninety-two firms between 1985 and 1990, with board involvement measured through a survey instrument where “high scores represent significant board pressure or involvement in the decision to restructure or acquire business units” (1993, 40). The study also found that characteristics of the board itself, such as outside director representation and outside director equity (both indicators of board vigilance), were predictors of involvement. Similarly, Shimizu and Hitt (2005) showed that the divestiture of a poorly performing subunit is made more likely by the arrival of new outside directors. Thus, according to these studies, board characteristics do affect board involvement.

In a study of forty-two firms in four different industries (biotechnology, hospitals, textiles, and “diversified firms”), Judge and Zeithaml (1992) reported several interesting findings. First, in line with the notion that diversified firms face diffuse, and hence less directed, pressure to conform to emerging norms on board involvement, they found a negative association between diversification and board involvement in strategic decision making.² Second, contrary to the expectations of the authors and others who see insiders as contributing valuable insights and information to boardroom discussions (Tashakori and Boulton 1983; Ford 1988; Baysinger and Hoskisson 1990), outside director representation increased board involvement. This result, however, is consistent with a power perspective on board-CEO relations (e.g., Lorsch and MacIver 1989), as discussed earlier. Finally, board size was negatively associated with board involvement.

Westphal and Fredrickson (2001), discussed in some detail in [chapter 6](#), concluded that sometimes outside directors influence strategy through the selection of a new CEO. The authors explained how outside directors may conceptualize strategic changes that align the focal firm’s strategy with the strategies of their own firms, and then select outside successors that alter the firm’s strategy to be more like the strategy of their own firms. Further, as we noted in the last chapter, while the evidence provided strong support for their model, it also pointed to the conclusion that such action by directors was not performance-driven.

The literature on board involvement in strategy formation has expanded greatly in recent years. In two final propositions in this section, we tie this work back to two attributes of board structure and composition: size and diversity.

The huge body of literature on group size generally concludes that larger groups can be

unwieldy (Gladstein 1984), are too diverse to reach consensus (Shaw 1981), and increase conflict (O'Reilly, Caldwell, and Barnett 1989), while smaller groups may be too homogeneous (Jackson et al. 1991) and have limited information-processing capability (Haleblian and Finkelstein 1993). This is corroborated by Clendenin, whose CEO informants told him that “large boards ... are unmanageable” (1972, 62), and by Alexander, Fennell, and Halpern (1993), who reported a positive association between board size and heterogeneity. These studies suggest that the “excess baggage” carried by larger boards reduces their ability to become involved in strategy formation.

Support for a board size–strategy implementation relationship is also evident in Yermack (1996). Yermack studied 452 large U.S. firms between 1984 and 1991 and (using Tobin’s Q as a measure of market valuation) reported an inverse association between board size and firm value after controlling for company size, industry membership, inside stock ownership, growth opportunities, and alternative corporate governance structures. Companies with small boards also had more favorable financial ratios, stronger CEO performance incentives for compensation, and greater threat of CEO dismissal for poor performance.

Proposition 9–1: The larger the board, the less involved it is in strategic decision making.

In a similar vein, the demographic diversity of the board may also hinder strategic involvement. For example, in a study of more than fifteen hundred hospitals between 1980 and 1988, Alexander, Fennell, and Halpern (1993) found that leadership instability (defined as a systematic pattern of frequent succession among top managers) was greater when boards were smaller and more homogeneous. In addition, Goodstein, Gautam, and Boeker (1994) reported that occupationally diverse boards were less likely to make strategic changes than more homogeneous boards. When boards are constructed to reflect the diverse views of various constituencies on which organizations may be dependent, they lose some cohesiveness (Clendenin 1972) and, by implication, power (Lorsch and MacIver 1989). Diversity diffuses board power by promoting differences, while a strong consensus about shared purposes may enhance board power (Hackman 1986). Finally, Westphal and Stern (2006) noted that demographically diverse directors are also likely to be compliant directors (see also Elsass and Graves 1997; Lipton and Lorsch 1992; Westphal and Milton 2000; Westphal and Stern 2007) and therefore are likely to be associated with boards in which the CEO is dominant. Further, Westphal and Bednar (2005) illustrated how pluralistic ignorance is more prominent when the social ties among directors are weak. This evidence suggests that board diversity, on average, may be associated with less strategy involvement.³ If this logic is valid, then we might expect the following:

Proposition 9–2: The greater the homogeneity of board member backgrounds, the more involved are boards in strategic decision making.

Although this bundle of work that touches on board involvement is valuable, it provides only partial evidence on the conditions that give rise to greater board-involvement in strategic decision making—partly because the construct of board involvement is considerably more complex than typically assumed. Consider [Figure 9.1](#). This schematic outlines five stages of strategic decision making, each of which may be subject to greater or lesser board involvement. There is much that we do not know about board involvement. Some questions remain unanswered; for example: Are boards equally involved at each stage? What determines the degree of involvement at each stage? How is involvement at one stage related to involvement at others? Although questions such as these clearly call for empirical

investigation, we offer the following working proposition for study:



Figure 9.1. Board Involvement in the Strategic Decision-Making Process

Proposition 9–3: Board involvement in strategic decision making varies across the various stages of the process. Boards will be involved in the following strategic decision-making stages, in descending order: evaluating strategic alternatives, evaluating strategic results, selecting strategies, generating strategic alternatives, and implementing strategies.

This proposition, while provocative, must also be considered speculative. While other patterns may be possible, the conditions that give rise to alternative patterns remain to be investigated. In the following section, we develop some ideas on potential precipitating conditions. Although we refer to “board involvement” in a general sense, we also suggest, where warranted, how these conditions might differentially affect each stage of board involvement in strategic decision making.

Contextual Conditions Predicting Board Strategic Involvement

In some ways, we are at a crossroads in developing norms for director involvement in strategic decision making. The generally older descriptive studies indicate that boards are largely ineffectual, while newer work suggests that boards can and do become more involved in strategy formation despite the constraints they face. To some extent, these opposing views may simply be reflections of changing norms about board involvement. And, the implications of the Sarbanes-Oxley Act are just now being felt. Our expectation is that boards will become more active in strategy formation, and research will need to keep pace. As a first step toward stronger theory on board involvement in strategy formation, we broadly consider the same contextual conditions discussed earlier, and then we provide suggestive propositions.

Critical Contingencies

We consider two types of critical contingencies, one emanating from the environment and the other deriving from earlier work by Zald (1969) on strategic decision points. In our analysis of the resource dependence perspective, we noted that board members may be selected for their ability to manage interorganizational dependencies. To the extent that this is true, boards of firms facing the greatest environmental uncertainty should be more involved in strategic decision making. These boards might have the appropriate expertise to substantively aid top management. Indeed, several scholars have argued that the strategic role of the board of directors is particularly critical during periods of environmental uncertainty (Boulton 1978; Mintzberg 1983a; Goodstein, Gautam, and Boeker 1994). However, we also noted earlier how board members may be co-opted, an interpretation that implies lesser influence for them.

Complicating matters is the notion that because environmental uncertainty promotes greater ambiguity about means-ends relationships (Thompson 1967), board deliberations on strategy may become politicized, thereby reducing board members' effectiveness and ability to have an impact (Olson 1982). Hence, how environmental uncertainty affects board involvement is not entirely clear, and two alternative propositions are suggested:

Proposition 9–4A: The more uncertain the environment, the more involved are boards in strategic decision making.

Proposition 9–4B: The more uncertain the environment, the less involved are boards in strategic decision making.

Beyond critical contingencies that derive from the environment, we develop a different set of critical contingencies based on a promising theoretical logic first described by Zald (1969) and offer propositions that build on this work. Referring to the extent to which top management found it necessary to be “bound by (the board’s) perspectives and ideas,” Zald noted that it is at “strategic decision points that board power is most likely to be asserted” (p. 107). Strategic decision points, according to Zald, were related to life-cycle problems and choosing a successor.

Several propositions based on these notions can be considered. For example, boards may be more involved in newer organizations because such firms have a greater need for policy formulation and the development of “guidelines for action” (Zald 1969, 107). In the only empirical test of this idea thus far, Judge and Zeithaml (1992) found that board involvement in strategic decision making and organization age were positively related. This unexpected result was attributed to the tendency of a board to develop a broader repertoire of skills over time, making it possible for it to contribute to substantive discussions on strategy formation. Nevertheless, since Judge and Zeithaml (1992) studied hospital boards (which are considerably different from the boards of most businesses; e.g., Alexander, Fennell, and Halpern 1993), the applicability of this finding to other settings is unclear. In addition, although they used multiple measures of board involvement in the decision-making process (“formation” covering roughly the first three stages in Figure 9.1, and “evaluation” representing the final stage), they did not suggest more targeted hypotheses. One such hypothesis might distinguish between board involvement in generating and evaluating strategic alternatives, and selecting strategies (all of which may be more salient for newer firms) from board involvement in evaluating strategic results (which may be a more generalized board activity). Thus, we propose:

Proposition 9–5: The older the organization, the less involved is the board in strategic decision making. Board involvement in generating and evaluating strategic alternatives and selecting strategies is more negatively associated with organization age than board involvement in implementing strategies and evaluating strategic results.

In a similar vein, boards in smaller firms may be more active in strategic decision making. Smaller firms are unlikely to have the same breadth of managerial talent available to larger firms, possibly requiring a larger board role. Indeed, board members are often chosen for their strategic expertise (Vance 1983); it seems even more likely that such a criterion for director selection would be used in smaller firms. Certainly, Zald’s (1969) argument that boards can provide more valued counsel on policy formulation to younger firms should apply to smaller firms as well.

Proposition 9–6: The larger the organization, the less involved is the board in strategic decision making. Board involvement in generating and evaluating strategic alternatives and selecting strategies is more negatively associated with organization size than board involvement in implementing strategies and evaluating strategic results.⁴

Other organizational transitions may also call for greater board involvement. Acquisitions, divestitures, and joint ventures represent important strategic decision points at which a board may be more prominent, and indeed boards are legally required to hold a vote on these decisions. In addition, the acquisition process in particular is time-consuming, absorbing managerial (Hoskisson and Hitt 1994), and likely board, energy along the way. As a result, boards may be more involved throughout the strategy-formation process under these conditions.

Proposition 9–7: The greater the acquisition, divestiture, and joint venture activity of a firm, the more involved is the board in all stages of the strategic decision-making process.

As noted above, selecting a new chief executive is a critical strategic decision point for a firm, and numerous studies have documented the board's role in succession (Brown 1982; Coughlan and Schmidt 1985; Johnson, Hoskisson, and Hitt 1993). Virtually all of these studies, however, tested the relationship between attributes of board structure and composition, and CEO turnover. Missing has been a more direct test of the implications of turnover for board strategic involvement. An important exception is Westphal and Fredrickson (2001), who demonstrated that when boards are powerful, new CEO successors are likely to be demographically similar to directors rather than to the CEO, and are likely to have strategic experiences similar to that of outside directors rather than to the CEO. Further, they showed that these effects were not importantly performance-contingent. Put differently, the effects were not caused by the perception of poor performance on the part of the incumbent CEO.

Proposition 9–8: Appointment of a new CEO increases board involvement in all stages of the strategic decision-making process.

Shen (2003) developed theory to suggest that boards need to focus on CEO leadership development early in a new CEO's tenure, but then move more toward monitoring and control of managerial opportunism later in the CEO's tenure, when the CEO's power base is established and his or her leadership is taken for granted inside the firm. His theory is based on the assertion that boards should act to maximize shareholder interests, not just minimize agency costs. CEOs often need to develop their leadership skills early in their tenures, and may be in precarious positions until those skills are established (e.g., Shen and Cannella 2002a). As CEO tenure increases, so do both leadership capabilities and commitment to a particular strategy. These authors develop three fundamental assertions: (1) manager and shareholder interests may not diverge early in tenure; (2) shareholder interests are enhanced when the new leader is given time to develop leadership; (3) opportunism becomes a problem only after CEOs have proven their leadership and their power has become institutionalized.

Proposition 9–9: CEO tenure decreases board involvement in all stages of the strategic decision-making process.

Institutional Forces

Earlier we described institutional forces as those emanating from the role played by prestigious managerial elites in corporate governance. Membership in the managerial elite provides an independent means through which directors gain power, and as a result, director prestige is a key antecedent to both the selection and turnover of board members. Hence, it is only a slight extension of this same logic to suggest that director prestige may offer board members greater opportunity to participate throughout the strategy-formation process. These prestigious directors are unlikely to serve solely as “rubber stamps” because (1) they may very well have been in a position to select among multiple directorship offers and they likely would not have decided to sit on a board where they would have no impact, and (2) prestige may be accepted as a signal of managerial competence by a firm’s top managers (D’Aveni and Kesner 1993), opening the door to a wider director role in strategy formation.

Proposition 9–10: The more prestigious a board’s directors, the greater its involvement in all stages of the strategic decision-making process.

Friendship Ties among Directors

It is quite likely that friendship ties increase director involvement in the strategic decision-making process. Indirect evidence comes from Westphal and Bednar (2005), who demonstrated that when directors do not know each other well, they are likely to misread each other’s perceptions about the appropriateness of the current strategy. So, while each director may have concerns about the current strategy, each also systematically underestimates the extent to which other directors share those concerns, and for fear of appearing disruptive or out of step, no director speaks up. This “pluralistic ignorance” is much more likely when directors do not know each other well.⁵ Additionally, Westphal (1999) demonstrated that when CEO-director social ties are strong, the board provides much more advice and counsel to the CEO, and the performance of the firm overall is higher. Westphal additionally noted that the increased advice and counsel did not appear to arise from poorer monitoring. Both of these studies imply that more friendship ties among directors and between the directors and the CEO will strengthen the board’s involvement in all phases of the strategic decision-making process.

Proposition 9–11: The more friendship ties among a board’s directors and between the directors and the CEO, the greater its involvement in all stages of the strategic decision-making process.

Agency Conditions

Earlier we suggested that board vigilance depends on the distribution of power between the board and top management. Powerful boards are more vigilant than weak boards. As such, powerful boards should be more involved than weak boards in strategy formation.

Proposition 9–12: The more powerful a board, the greater its involvement in all stages of the strategic decision-making process.

One of the most common circumstances where directors are active is in new firms, especially IPO firms. These directors have more at stake, can add a level of expertise (and prestige for that matter) that is not easily found elsewhere, and perhaps most importantly, have the power to ensure their views are heard. Considerable research is supportive of this idea (e.g., Gompers and Lerner 2003; Jain and Kini 1999).

It is important, when studying board power and its relationship to strategic decision making, to also consider forces outside the board, like family ownership (Miller and Le

Breton-Miller 2005; Miller, Le Breton-Miller, and Lester 2005; Schulze and Lubatkin 2003) or pension fund investments. While David and his colleagues (2001) concluded that the effects of institutional ownership were not felt through outside directors, it seems likely that at least some powerful outside owners will influence the firm by pressuring outside directors.

Hoskisson, Hitt, Johnson, and Grossman (2002) studied the relationship between governance and corporate innovation strategies, concluding that different owners (public pension funds versus professional investment funds) had different preferences for corporate innovation strategies. According to their data, public pension fund managers preferred internal innovation, while professional investment fund managers preferred acquisitions (external innovations). More to our direct interests here, inside directors holding significant equity in the company were associated with internal innovation, while outside directors holding significant equity in the company were associated with external innovation (acquisitions).

The distribution of power between boards and top managers should also act as a moderator of all previously proposed relationships because they are subject to the constraining influence of limited power. Thus, board power should act as both a direct effect on strategy involvement and an indirect effect that accentuates any predisposition boards may have (due to various critical contingencies) to be involved in strategy formation. For example, the first part of [Proposition 9-5](#) asserted that board involvement in strategic decision making will be greater in newer organizations. Considering agency conditions, an additional proposition might predict that the greater the power of the board, the stronger the (negative) association between organizational age and board involvement in strategic decision making. In this way, critical contingencies serve as “precipitating conditions” for board involvement, but the actual extent of such involvement will depend on the distribution of power between boards and top managers. The following proposition is offered as an overarching statement of this relationship:

Proposition 9–13: The greater the power of a board, the stronger the relationship between critical contingencies and board involvement in strategic decision making.

This section suggested possible explanations for board strategic involvement. Other predictors may also be worthy of study. Nevertheless, we may conclude that even though historic norms have reined in board involvement in strategy, the impact of the Sarbanes-Oxley Act and the general business climate are pushing boards toward greater activism. Hence, we should expect boards to play an increasingly greater role in strategy formation, and this impact will depend on various contextual conditions, as well as the power of the board.

Boards and Firm Performance

Although boards do not always use their implicit power to directly affect organizational outcomes, such as strategy, they are influential in a wide range of outcomes related to strategic leadership. Consider how boards can affect top management: they are involved in the selection and succession of CEOs, the determination of compensation systems and levels, and the setting of various takeover defenses and postures, and their vigilance affects how much discretion CEOs have in leading their organizations. So, despite the relatively limited role often ascribed to boards of directors, they may be involved in a broad range of activities that affect how top managers and CEOs do their jobs. These effects are borne out in a review of empirical research on the consequences of board monitoring and strategic involvement.

We begin at the far right of [Figure 8.1](#), which we introduced in the previous chapter, with an examination of the performance consequences of board vigilance and involvement.

Given the various interpretations of the role of boards of directors in the literature, the existence of considerable research raising doubts about the scope of direct board influence in strategy formation, and the rather large gap between board behavior and actual performance outcomes, one might expect to find relatively few studies investigating the direct association between boards and firm performance. However, this relationship appears to be quite enticing for scholars, for dozens of empirical studies have been published over the course of several decades. Researchers have investigated the performance effects of board size (Pfeffer 1973; Dalton et al. 1999; Provan 1980; Chaganti, Mahajan, and Sharma 1985; Zahra and Stanton 1988; Pearce and Zahra 1992), outside director representation (Vance 1955; Daily and Dalton 1994; Wagner, Stimpert, and Fubara 1998; Dalton et al. 1998; Vance 1964; Pfeffer 1972; Schmidt 1977; MacAvoy et al. 1983; Baysinger and Butler 1985; Chaganti, Mahajan, and Sharma 1985; Kesner 1987; Hill and Snell 1988; Morck, Shleifer, and Vishny 1988; Zahra and Stanton 1988; Rosenstein and Wyatt 1990; Hermalin and Weisbach 1991; Hambrick and D'Aveni 1992; Pearce and Zahra 1992), director equity (Kesner 1987; Daily et al. 2002; Morck, Shleifer, and Vishny 1988; Schellenger, Wood, and Tashakori 1989), inside director equity (Vance 1955, 1964; Pfeffer 1972), director and officer equity (Lloyd, Jahera, and Goldstein 1986; Kim, Lee, and Francis 1988; Oswald and Jahera 1991), director background and experiences (Norburn 1986), CEO duality (Berg and Smith 1978; Daily and Dalton 1994; Baliga, Moyer, and Rao 1996; Dalton et al. 1998; Boyd 1995; Chaganti, Mahajan, and Sharma 1985; Rechner and Dalton 1991; Daily and Dalton 1992), board involvement in strategy making (Judge and Zeithaml 1992), board power (Pearce and Zahra 1991), and board attributes (Molz 1988). Inevitably, much of this work has produced mixed results, as an exhaustive review by Zahra and Pearce (1989) indicates.

Zahra and Pearce (1989) point out several reasons that we should not be surprised by inconsistent findings: (1) contextual factors affecting boards, such as industry, organizational life cycle, and corporate strategy have generally been ignored; (2) this research does not effectively consider how board members interact to make decisions; (3) emphasizing univariate analytical approaches, by considering one or two board attributes in isolation, makes comparability and integration across studies difficult; (4) researchers often do not measure board attributes, such as outside director representation, the same way; and (5) many studies use contemporaneous, as opposed to lagged, measures of firm performance, potentially confounding causal direction.⁶ Perhaps most important, board structure and composition likely do not have universal effects on firm performance. There are too many intervening individuals and processes between boards and firm performance, too many potential contingency factors that might affect how boards are related to performance outcomes, and too many other influences on firm performance to expect a strong direct association.

Nevertheless, boards may have an indirect effect on firm performance through the quality of their managerial monitoring or their involvement in strategy formation. Indeed, investigations of how board monitoring and strategy involvement affect nonperformance outcomes may be quite promising. As [Figure 8.1](#) indicates, rather than inducing a second-order effect, such as firm performance, boards may have a stronger impact on such outcomes as executive succession, executive compensation, and takeover defenses, and even on such strategic outcomes as diversification, resource management, and strategic change. We now turn to a consideration of these outcomes.

Board Effects on Strategy

Top managers are generally the most influential organizational actors determining a firm's strategic direction (Hambrick and Mason 1984). However, boards may also play a direct or indirect role in the strategic decision-making process, as [Figure 9.1](#) describes. Boards can directly affect strategy through involvement of their members on committees, recommendations to top management, and oversight of executive decisions. Boards can indirectly affect strategy by reducing interorganizational dependencies and by conveying information about other firms' strategies. Further, through the advice and counsel role (e.g., Hillman and Dalziel 2003), directors can indirectly affect strategy by providing advice and social support to the CEO (see Westphal 1999) and through managing the context in which strategic decisions are made (see McNulty and Pettigrew 1999). Direct board effects have generally been empirically modeled using agency theory and strategic choice perspectives, while indirect board effects rely on resource dependence and institutional theories. This section reviews this research.

A small but important set of published studies examines how strategic outcomes are a direct consequence of board structure and composition. Goodstein, Gautam, and Boeker (1994), studying hospitals, examined whether board size and diversity were associated with strategic change. Arguing that larger boards and more diverse boards have inherently more internal conflict and dissensus, these authors hypothesized a negative association with strategic change. Results indicated that while both coefficients were negative, only board diversity was significantly related to multiple indicators of strategic change. That is, firms with diverse boards were less likely to initiate strategic changes than those with homogeneous boards.⁷

Research subsequent to that of Goodstein, Gautam, and Boeker (1994) provides some insight to the causal mechanism at the heart of their article. For example, Westphal and Bednar (2005) documented that more diverse directors are less likely to speak up in board meetings, even if they have concerns about the viability of the firm's strategy. And Westphal and Milton showed that directors who are demographic minorities relative to the larger board (2000) tend not to speak up in board meetings unless they have friendship ties to other members of the board, or other members of the board have been in minority roles in other boards.

In a different type of study, Cotter, Shivdasani, and Zenner (1997) studied the role of target firms' independent outside directors in responding to takeover attempts (tender offers). They concluded that when the target firm's board was independent, the initial tender offer premium, the bid premium revision, and the target shareholder gains over the entire tender offer period were higher. Further, for independent boards, poison pills and active takeover resistance both led to greater premiums and shareholder gains.

Kassinis and Vafeas (2002) studied why some firms endure very high costs (litigation and fines) because they fail to adhere to environmental laws, while others avoid those costs by following relevant laws and regulations. By comparing the pre-lawsuit profiles of 209 violators to a sample of matched control firms between 1994 and 1998, they concluded that the likelihood of being sued for environmental infractions increased with board size, with the proportion of outside directors from other industrial firms, and with the fraction of inside ownership. The likelihood decreased with the number of directorships held by outside directors. They concluded that corporate boards are central to corporate decisions about environmental policies.

In a similar study, Kesner, Victor, and Lamont (1986) studied the relationship between board composition and the occurrence of illegal corporate acts. However, their evidence

indicated no significant association between the proportion of outsiders and the number of illegal acts committed by the firm. Further, the fact that illegal acts were committed did not appear to lead to any board structural changes (i.e., increases in outsiders). Finally, CEO duality was not associated with the commission of illegal acts.

A different type of argument on how boards affect strategy has been advanced by Baysinger and Hoskisson (1990): Because outsiders tend to emphasize financial controls over strategic controls (i.e., more objective, performance-contingent control mechanisms), thus increasing managerial employment risk, outsider-dominated boards would be associated with greater diversification. Participation in multiple businesses allows top managers to diversify their employment risk by stabilizing the firm's income stream (Amihud and Lev 1981). What is interesting about this idea is that, according to the authors, increased diversification is an indirect consequence of outside director representation and is not due to (indeed, may be contrary to) the presumed vigilance of outsiders. While intriguing, only limited evidence speaks directly to this idea. In a study of ninety-four R&D-intensive *Fortune* 500 firms in 1980, Hill and Snell (1988) found that the ratio of inside to outside directors was negatively associated with diversified scope and positively associated with both the specialization and relatedness ratios, contrary to their agency theory-based expectations but consistent with the Baysinger and Hoskisson (1990) logic. A study of 203 restructuring firms between 1985 and 1990 by Hoskisson, Johnson, and Moesel (1994) found that outside director equity decreased the time spent restructuring and the number of divestitures. However, this study did not find support for the effects of other measures of outsider influence on diversification and restructuring. And a meta-analysis of thirteen samples reporting relationships between the proportion of outsiders on the board and unrelated diversification did not find any significant effect (Deutsch 2005).

Extending their ideas on financial versus strategic controls to R&D activity, Baysinger and Hoskisson (1990) also hypothesized that outside director representation would be associated with lower expenditures on R&D because outsiders' use of financial controls engenders risk aversion among managers. Both of the studies conducted to date on this question have been supportive (Hill and Snell 1988; Baysinger, Kosnik, and Turk 1991). In addition, Deutsch's (2005) meta-analysis of outsiders on the board and R&D expenditures was also supportive. Again, it is worth pointing out that a standard agency-theory interpretation would predict that the enhanced vigilance of outsider-dominated boards ensures that firms limit unrelated diversification and promote R&D activity because such actions are consistent with shareholder interests.⁸ Hence, such a commonly used measure of board vigilance as outside director representation may not be reliable.⁹

Researchers drawing on organization theories have also examined how boards affect such strategic outcomes as corporate borrowing, diversification posture, and acquisition activity. Drawing on resource dependence theory, Mizruchi and Stearns documented how financial representation on boards is associated with corporate borrowing (Stearns and Mizruchi 1993; Mizruchi and Stearns 1994). Studying a group of twenty-two *Fortune* 500 firms over a twenty-eight-year period, they found a consistent pattern of resource acquisition. For example, the presence of a life insurance executive on a board was positively associated with long-term private borrowing but negatively associated with long-term public borrowing. Investment bankers on the board, on the other hand, were more likely to be associated with borrowing from public sources than private sources. In all, these authors provide persuasive evidence that the presence of different types of financial representatives on a board is associated with the use of different types of financing.

Three studies of more recent vintage have also examined how boards affect diversification. Using an institutional theory framework in a study of the adoption of the

multidivisional organizational form by firms between 1963 and 1968, Palmer, Jennings, and Zhou (1993) tested the notions that (1) director interlocks provide information on strategic innovations in use in other firms and (2) the greater the number of interlocks with other firms that had already adopted the multidivisional form, the higher the likelihood of adoption by the focal firm. Surprisingly, results were mixed, with directional interlocks unexpectedly decreasing and nondirectional interlocks¹⁰ increasing the likelihood of adoption; the results were attributed to different patterns of information dissemination associated with these interlocks. Nevertheless, the findings of this study were still generally supportive of an institutional theory story on how boards affect strategy.

These authors also tested board hypotheses based on political theory but found no significant results. Nevertheless, Palmer, Jennings, and Zhou's (1993) study is noteworthy for the multiple interpretations applied to board characteristics. This study highlights a general condition about research on boards: a reliance on objective characteristics of boards must start with strong theory because these characteristics are subject to multiple interpretations.

Tihanyi, Johnson, Hoskisson, and Hitt (2003) considered the role of institutional investors in firm strategies (international diversification) and the moderating effects of board composition and technological opportunities. Their study focused on two types of institutional investors: public pension funds and professional investment funds.¹¹ Because professional investment funds turn over their portfolios very quickly, they tend to take a short-term view. In contrast, public pension funds tend to be very long-term investors. The authors predict that both types of owners will respond favorably to international diversification.

The differences between the two types of institutional investors were fleshed out with moderators—board composition and technological opportunities. The authors argued that international diversification offers benefits, but may exacerbate agency problems. Professional investment funds were predicted to support international diversification more when independent outside directors are present, especially those with experience in international diversification. In contrast, pension fund investors were expected to support international diversification more when there are more inside directors. Because of their focus on the long-term, pension funds were also expected to prefer international diversification in industries with high technological opportunities (the extent to which a firm's market or industry demands or accepts product innovation). The authors' sample of 197 Standard & Poor's (S&P) 1500 firms provided support for all of these predictions.

Ellstrand, Tihanyi, and Johnson (2002) studied how board composition and CEO duality influenced the average political risk of a firm's portfolio of international manufacturing operations. Building on earlier work in international strategies (e.g., Sherman, Kashlak, and Joshi 1998; Sanders and Carpenter 1998), they argued that insiders would prefer lower-risk portfolios, and outsiders would prefer higher-risk portfolios. Further, inside directors should be able to persuade affiliated directors to support their desire for lower risk. They also predicted that CEO duality would be associated with lower-risk portfolios. While the evidence was weak, two of their three hypotheses (the exception being the alignment of insiders and affiliated directors) were supported.

In a pair of studies that also examined boards from a social network perspective, Haunschild (1993, 1994) reported results that were strongly supportive. In the first study, she examined whether board interlocks were associated with acquisition activity in a sample of 327 medium and large firms between 1981 and 1990. Arguing that "director interlocks are an important source of personal contacts among those managers with the power to affect organizational merger and acquisition activity" (1993, 568), Haunschild found that focal firm acquisition activity was positively associated with the number of acquisitions made by firms

that were tied to the focal firm through directorships. An inverted-U relationship was also found. These results held for different types of mergers and, after controlling for several alternative explanations, for acquisition activity as well.

The second study focused on the size of acquisition premiums, arguing that the size of prior premiums paid by firms tied to an acquiring firm through director ties should be a significant predictor (Haunschild 1994). This expectation was borne out in a sample of 240 acquisitions completed between 1986 and 1993. Taken together, the two Haunschild studies provide strong support for an institutional theory perspective on the relationship between boards of directors and strategy formation.

In a theoretical paper, Certo (2003) noted that for IPO firms, board characteristics should influence legitimacy and thus market performance. In the IPO setting, one key role of the board is to signal the value of the firm to prospective investors, who seldom understand the nuances of the technology or business plan. Certo (2003) suggested that investor perceptions of IPO prestige would derive from the board's aggregate social and human capital, and that board prestige would be a stronger signal of firm value as investor prestige increased.

There is some empirical evidence on this question. Higgins and Gulati (2003) tested whether "upper echelons affiliations" among biotech start-ups increased the prestige of the investment bank underwriting the start-up's IPO, and reported mostly supportive results. The idea that prestige begets prestige (Merton 1973) has been demonstrated for some time in all sorts of contexts (Podolny 1994), although this study was one of the first to establish the principle for boards. A similar result was found for computer software firms going public between 1994 and 1996 (Pollock et al. 2007), in this case with IPO valuations as the dependent variable.

IPO boards not only bring prestige to the table; their actual skill sets may also be advantageous. In particular, top management teams that have worked together in the start-up, and hence have accumulated a degree of shared knowledge about the young firm, enable boards to add value because of their relevant expertise. This is precisely the finding of Kroll, Walters, and Le (2007), who investigated the role of original top management teams on IPO firm performance in 524 entrepreneurial firms. These authors also found that stock ownership by team members was associated with firm performance as well.

Carpenter and Westphal (2001) studied boards and their influence on strategy, framed around two questions: Do directors have suitable knowledge or information to contribute meaningfully to strategy? What factors influence the knowledge-contribution association? The authors took a sociocognitive perspective, arguing that experience on other boards is very likely to be critical. They considered stable and unstable environments, noting that in stable environments, strategy implementation is more important than strategy development. Directors can help in implementation when their ties are to strategically related firms—that is, companies that follow similar strategies and operate in similar product market or international market contexts. These kinds of social connections lead to more highly developed knowledge structures, those that include both more information and more structured information. The authors hypothesized that in stable environments, the appointment of a director to the boards of other firms that are strategically related to the focal firm would increase the director's perceived ability to contribute to board discussions of strategic issues. They made parallel predictions for board monitoring and for advice interactions surrounding strategic issues.

In contrast, in unstable environments, heterogeneity is likely to be more beneficial than strategic similarity, but too much heterogeneity hampers social interaction. The authors hypothesized that in unstable environments, the extent to which a director's board appointments to other firms complemented the appointments of other directors in their

strategic relatedness to the focal firm, the greater the director's perceived ability to contribute to board discussions of strategic issues. Parallel predictions were made for monitoring of strategic decision making and for the level of board advice interactions on strategic issues.

The authors sampled 600 firms from the *Fortune* 1000 and surveyed one outside director and the CEO of each.¹² All the hypotheses were supported. They concluded that it was not just social structural context that was important, as predicted by the interlocking directorates literature. Instead, social structural context was moderated by strategic context. Evidence also suggested that outside directors were more influenced by their home company's strategy than by the strategies of other boards in which they served as outside directors.

Gulati and Westphal (1999) studied how social influence networks (board interlocks) affect strategic alliance formation. They noted that in theory, interlocks are central to an embeddedness perspective and should influence policy and strategic decisions. However, there is an important need to specify the content of the ties, and they argued that indirect ties can strongly influence or "condition" the effects of direct ties. Their study focused on joint ventures, and predicted direct effects of heterogeneous social processes (board-CEO relations), as well as moderating effects of indirect ties, on joint venture formation.

Board interlocks (and other network ties) are commonly seen as resolving uncertainty—both in forming alliances and in selecting alliance partners. Gulati and Westphal (1999) hypothesized that a direct tie would increase the likelihood of an alliance between the two tied firms. However, they also predicted that this effect would be weakened to the extent that the board exerted control over the CEO (i.e., the extent to which the board was independent). They classified CEO-board relationships into three categories (see also Westphal 1999): independent monitoring and control, close cooperation, and inaction. Advice and counsel usually comes at the CEO's request, and is therefore likely to develop into a strong cooperative and working relationship. This cooperation can affect alliance formation several ways—trust, positive affect, confidence in each other. Finally, they hypothesized that greater cooperation between CEO and board would increase the likelihood of alliance formation. Each of these predictions was supported in their sample of large firms.

The role of indirect ties was an important part of the study because indirect ties can influence the level of trust in direct ties. Burt and Knez (1995, 1996) argued that third party relations will tend to amplify both trust and distrust. In this way, indirect ties influence the intensity, but not the direction, of direct ties. The authors sampled 600 *Fortune/Forbes* companies and surveyed them to identify CEO-board cooperation, measuring levels of trust, control, and cooperation. Survey items were strongly correlated with archival measures of control (.42) and cooperation (.34). The first hypothesis was rejected—simply having a person on the board did not influence the likelihood of an alliance with his or her firm. All other hypotheses were supported. In supplementary analyses, the authors showed that trust mediates the effects of control and cooperation, not the other way around. A key contribution of this study was to show that board interlock ties can have both positive and negative effects. Further, the evidence generally supported the notion that independent board control tends to politicize the CEO-board relationship.

When considered in its entirety, considerable research energy has been directed to the question of how boards affect strategy, especially in recent years. This is a break from the more historic view that boards have little influence on what really goes on in the firms they govern, but is in line with broad institutional-level changes that continue to ratchet up the pressure on boards to be proactive in fulfilling their fiduciary duties to shareholders.

Another conclusion that emerges is that board structure and composition are both causes and consequences of various organizational outcomes. Consider the following two examples that come out of our evaluation of the relevant literature:

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1. What is the relationship between boards and diversification? On the one hand, limited evidence exists that diversified firms tend to bring more outsiders to the board for information and expertise (Pearce and Zahra 1992). On the other, theory and some evidence has accumulated that outside directors, by focusing on financial controls, tend to be associated with greater firm diversification as CEOs seek to diversify their employment risk (Hill and Snell 1988; Baysinger and Hoskisson 1990).
2. What is the relationship between boards and corporate borrowing? Directors from the banking community may be appointed to the board because firms wish to ensure adequate capital resources (Pfeffer 1972), while corporate borrowing may be higher in firms with more banking representatives on the board (Mizuchi and Stearns 1994). Hence, it is difficult to disentangle what is really happening in such relationships. As we noted earlier, co-optation works both ways, with banking directors and firms both having something to gain from mutual interaction.

There are two key implications for research on boards and strategy that emerge from this analysis: (1) investigators must consider alternative explanations for their results that derive from the multiple theoretical perspectives bearing on boards; and (2) conceptually and analytically, researchers must explicitly take into consideration the possibility of a reverse causal direction to that posited.

Boards as Supra-Top Management Teams

Future research could extend upper-echelons theory to boards of directors.¹³ Few studies have explicitly tested upper-echelons hypotheses to a large extent because of the limited decision-making ability of most boards and the relatively greater role of top managers in effecting such organizational outcomes as strategy and firm performance. Nevertheless, there may be instances when board discretion is quite high, and in those cases, it is sensible to test upper-echelons hypotheses. For example, in a study of hospital boards referred to earlier, Goodstein, Gautam, and Boeker (1994) found that larger boards were associated with less reorganization of hospital services. Although these authors did not formally posit an upper-echelons framework for their hypotheses, the logic they used to support hypotheses and their subsequent findings are clearly consistent (Hambrick and Mason 1984).

If boards are seen as decision-making units operating analogously to top management teams, perhaps the upper-echelons perspective can be extended in this way. If so, then two important refinements to upper-echelons theory are especially relevant to boards—the moderating roles of discretion and power (Finkelstein 1988). As we have argued, boards of directors are not always able to directly affect organizational outcomes; they have limited discretion. They are constrained by their own power relative to the CEO and other top managers, and their choices, as well as their ability to make choices, are constrained by many of the same environmental, organizational, and individual factors that limit executives. And they are subject to the influence of friendship ties that complicate their potential role as decision-making bodies (Westphal 1999). Hence, because many of the same forces may be at work, upper-echelons propositions must take these constraints into account.¹⁴

If boards of directors are supra-TMTs, research on the power of individual board members with respect to other board members will be particularly important. Although numerous studies have examined the distribution of power between boards and top managers, with a lesser number on the distribution of power within top management teams, empirical research is only beginning to investigate the distribution of power among board members. For example, several studies have shown that independent outside directors are more influential

than affiliated outside directors (Byrd and Hickman 1992; Anderson and Reeb 2004; Cotter, Shivdasani, and Zenner 1997; Shivdasani and Yermack 1999), and Westphal and his colleagues have shown that diverse directors (defined at least two different ways) tend to be less involved in board meetings (Westphal and Bednar 2005; Westphal and Milton 2000; Westphal and Stern 2006).

To the extent that boards affect organizational outcomes, further and more in-depth analyses may help improve explained variance and offer a potentially exciting line of inquiry. In addition, it would be interesting to develop a typology of director power and compare this with related work on top management teams (Finkelstein 1992). It is important, however, in any power-related study, that the researcher be able to specify the preferences of the powerful parties (Lane, Cannella, and Lubatkin 1998; e.g., Golden and Zajac 2001).

We might add that this perspective also opens the door to studies of various attributes of boards that have for the most part been studied only for executives. In [chapter 11](#), for example, we review work on the consequences of executive compensation on a whole range of outcomes of interest to strategists and organization theorists, and to the extent that theory and empirical data can support a “boards as supra-TMTs” perspective, one can imagine how board compensation might also be efficacious in an analogous manner. Indeed, a recent study by Deutch, Keil, and Laamanen (2007) does precisely this, finding that stock and stock option pay of outside directors were significantly related to the rate at which their firms made acquisitions in an inverted U-shaped pattern.

If boards are supra-TMTs, many of the same phenomena that drive power relations among top managers may also be relevant for board members. Consider the four major power types identified by Finkelstein (1992): structural, ownership, expertise, and prestige. Each of these power types appears to be operative among board members. Structural power arises from formal hierarchical relations within the board, such as whether the CEO position is structurally separate from the board chair position. Ownership power emanates from shareholdings in the firm and family relations, both of which are important drivers of board power. Expertise power is defined by the ability of board members to reduce uncertainty arising from critical contingencies, something that has long been considered a central task of boards (Pfeffer 1972). Prestige power is a major component of the influence structure of top managers and has been used as an indicator of board power (D’Aveni and Kesner 1993). Nevertheless, boards of directors have several unique characteristics that may require a more complex model of the power distribution, chief among them being that both insiders and outsiders are members. It is not clear which director type will necessarily be more powerful, so development of these ideas requires special consideration of such differences. Further, the work we have reviewed on friendship ties suggests this may be a fifth potential source of power for board members.

If boards are supra-TMTs, it is possible to suggest numerous propositions that build on the original upper-echelons ideas. Below, we offer two as examples.

Boards and Functional Tracks

Several studies have investigated the idea that a manager’s functional background will be related to the strategies the firm employs (e.g., Hitt and Tyler 1991). As Hambrick and Mason argued, “this functional-track orientation may not dominate the strategic choices an executive makes, but it can be expected to exert some influence” (1984, 199). Extending this line of thought to the board level suggests the following proposition:

Proposition 9–14: The firm’s resource allocation among different functions is positively associated with the extent to which these functions are reflected in the backgrounds of board members.

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Some support for this proposition can be found in the work of Westphal and Fredrickson (2001) and Zajac and Westphal (1996c), who demonstrated that the primary source of power in a firm (i.e., the CEO or the board) is an important determinant of successor CEO functional backgrounds. Westphal and Fredrickson (2001) carry this analysis through to the successor's strategy. Also, Golden and Zajac (2001), discussed below, develop a model to link demographic profiles to preferences for change versus stability.

A different result emerges, however, from Jensen and Zajac (2004). These authors studied three different agency contexts (CEOs, outside directors, and non-CEO TMT members) and their influence on corporate strategies such as diversification and acquisitions. They noted that while demography is usually seen as impacting preferences, agency theory perceives position to be a much more important factor than demography. For example, agency theory predicts that outside directors, regardless of their demography, will prefer less diversification. Results indicated that finance CEOs preferred higher levels of diversification and made more acquisitions, but that functional background made no difference for non-CEO TMT members or outside directors.¹⁵ This study is an important qualifier for any supra-TMT approach, because the roles of directors may alter or negate the effects of individual demography.

Boards and Tenures

Perhaps the most studied of all demographic characteristics is the duration of service, or tenure. As we discussed in [chapter 4](#), long tenures are associated with strategic persistence to a course of action (Finkelstein and Hambrick 1990). Hence, at the board level, we propose:

Proposition 9–15: The longer the tenures of board members, the less strategic change in the organization.

Golden and Zajac (2001) studied the demography of boards of directors in hospital organizations, with the intent of demonstrating linkages between demographic profiles and preference toward change. The authors described how longer board tenure implies more commitment to the status quo and persistence, but greater experiences also increase communication and some group-level functioning. The authors developed predictions to link board tenure, average director age, occupational heterogeneity, and some specific occupations (e.g., business and law will favor change; community leaders will favor the status quo) to strategic change. Finally, they argued that the relationship between the board's inclination toward change and subsequent change would be stronger when boards were more powerful. They also considered monitoring activities and predicted that boards with more comprehensive CEO evaluation processes would also be associated with more strategic change. All of these predictions were supported with evidence from a sample of 3,198 hospitals.

In keeping with our discussion earlier on how discretion and power represent key refinements to the upper-echelons logic, it is important to underscore how propositions such as those presented above are subject to moderating influences. We offer two generic propositions to address this issue:

Proposition 9–16: The greater the discretion of the board, the stronger the association between board demographic characteristics and organizational outcomes.

Proposition 9–17: The association between board demographic characteristics and organizational outcomes is moderated by the relative distribution of power among board members.

The Golden and Zajac (2001) study, described above, provided evidence in support of these ideas. Other support can be found in the studies by Westphal and Fredrickson (2001) and Zajac and Westphal (1996b). As noted earlier, however, it is important to specify the preferences of powerful groups before linking power to organizational outcomes.

In sum, our purpose here is simply to suggest some testable propositions on the relationship between boards of directors and strategy formation, and not to formally develop theory that extends the upper-echelons perspective to boards. Nevertheless, abundant research opportunities are apparent.

Board Monitoring and Disciplinary Behavior

The idea that boards fulfill a monitoring role in organizations is more widely held than the notion that boards are actively involved in strategic decision making. Research has investigated several different outcomes attributed to boards, including executive succession, the setting of managerial pay, and the adoption of takeover defenses. In [chapter 6](#), we examined CEO selection and succession, and we thus do not review this literature here. Nevertheless, it is important to reiterate a point made in [chapter 6](#): CEOs do not get hired and fired without boards of directors playing a central role in these actions. Indeed, of all the activities in which boards of directors are engaged, the hiring and firing of CEOs are the most representative of their ultimate responsibility to discipline top management (Zald 1969; Mizruchi 1983).

Before reviewing research on the actual consequences of board monitoring and disciplining, it is important to consider the operative mechanisms through which boards may have this effect. Empirical studies seldom specify these mechanisms. Rather, hypotheses often argue that outside directors (or other measures of board vigilance) are associated with various organizational outcomes. An implicit assumption is that outsiders pressure top managers to behave in a manner consistent with shareholder interests. What is unclear is how vigilant boards do so.¹⁶ In particular, do top managers work harder, or better, when boards are vigilant? How do vigilant boards actually influence top management to “do the right thing”? Although scholars have raised such questions in the past (e.g., Perrow 1986; Finkelstein and Hambrick 1988; Barkema 1993; Davis and Thompson 1994), very few studies have empirically specified, measured, and tested how board monitoring actually affects organizational outcomes (but see Westphal 1999 for an exception). We believe that such a research program is in order. Nevertheless, in spite of this omission, considerable research has been conducted on the consequences of board monitoring, which we now review.

Boards and Executive Compensation

Boards have long been considered to play an important role in the establishment of executive pay (Fama and Jensen 1983). While agency theorists tend to portray the board’s role in aligning managerial and shareholder interests as primary, researchers working from an organizational perspective are beginning to accumulate evidence suggesting a different role for boards in the compensation-setting process.

In one of the earliest and still most persuasive studies, O’Reilly, Main, and Crystal (1988) found that CEO compensation was positively associated with the pay levels of compensation committee members and outside directors. Drawing on social comparison theory, this article suggests that the composition of board committees contains potentially valuable information

on how boards and CEOs interact and that boards may not necessarily act as true principals in a principal-agent relationship. These notions were further supported in a more elaborate follow-up study (Main, O'Reilly, and Wade 1994).¹⁷

Importantly, and presaging the rather mixed record on the effects of traditional measures of board structure on executive compensation, two more recent studies found no effect of compensation committee structure on CEO compensation. Daily, Johnson, Ellstrand, and Dalton (1998) studied 200 firms from the 1992 *Fortune* 500, and Conyon and Peck (1998) focused on the *Financial Times* 100—the United Kingdom's 100 largest firms—between 1991 and 1994, and both reported weak to nonexistent results. The Conyon and Peck (1998) article also reported that, consistent with U.S. studies (Westphal and Zajac 1995; Finkelstein and Hambrick 1989; Core, Holthausen, and Larcker 1999; Lambert, Larcker, and Weigelt 1993), pay and performance did not become more aligned as the proportion of outside directors increased. In combination with O'Reilly, Main, and Crystal (1988), these nonfindings point out how the “classic” indicators—used by agency theorists and managerial researchers alike—may be less important predictors of compensation than measures targeted toward uncovering behavioral insights.

One way to think about how an organizational and behavioral perspective on compensation can be reconciled with agency theory is to explicitly model agency theory in terms of power. Indeed, this approach has been adopted in several studies, although almost always by relying on the same indicators of power that agency theorists focus on. For example, in a study of 218 large industrial firms in 1975, Allen (1981) tested whether various measures of director equity (an indicator of board power or vigilance) were associated with CEO compensation. Results were not clearly supportive, as was the case in other studies testing similar relationships (Finkelstein and Hambrick 1989; Lambert, Larcker, and Weigelt 1993). On the other hand, outside director representation was positively associated with compensation in two other studies (Lambert, Larcker, and Weigelt 1993; Main, O'Reilly, and Wade 1994), although no significant effects were found for total pay (Kerr and Kren 1992) or the adoption of long-term incentive plans (Westphal and Zajac 1994). When we add in Deutsch's meta-analysis findings (2005), it seems clear that the proportion of outsiders¹⁸ on the board is not a particularly robust predictor of CEO compensation.

Several studies using a more robust measure of CEO power—the percentage of outsiders appointed to the board by the CEO—have reported positive relationships with CEO compensation (Lambert, Larcker, and Weigelt 1993; Main, O'Reilly, and Wade 1994; Westphal and Zajac 1994). CEO duality, another indicator of CEO power over a board, was a significant predictor of executive compensation in two studies (Main, O'Reilly, and Wade 1994; Westphal and Zajac 1994), although others have questioned the importance of duality in understanding boards (Baliga, Moyer, and Rao 1996; Daily and Dalton 1997). And in a study testing the effects of board control (a composite variable encompassing several of the indicators just noted) on CEO cash compensation, Boyd (1994) reported results consistent with an inverse expectation. This study, however, found that it was insiders, rather than outsiders, that limited CEO pay. In this respect, a meta-analysis of thirty-eight studies involving some sixty-nine samples by Deutsch (2005) provides perhaps surprising corroboration—the proportion of outside directors was negatively associated with CEO incentive pay.

These mixed studies have prompted researchers to adopt somewhat more nuanced conceptual lenses. One such example is an article by Westphal (1998) that studied how CEOs respond to increased levels of board independence—specifically structural independence, defined as increases in the ratio of outsiders to insiders, CEO/chair split, decreased CEO-board friendship ties, and increased demographic distance between the CEO and outside

directors. Existing evidence indicates that increased structural independence does not universally lead to improved performance (e.g., Baliga, Moyer, and Rao 1996; Walsh and Seward 1990; Hermalin and Weisbach 1991; Davis 1991; Buchholtz and Ribbens 1994; Kesner, Victor, and Lamont 1986; Baysinger and Hoskisson 1990). The author suggests that one reason such a connection has not been found is that CEOs have options in dealing with board structural independence, specifically the use of interpersonal influence tactics—persuasion and ingratiation. Persuasion is using reason or logic to convince others. Ingratiation is a set of tactics designed to make the person more attractive to another or others. To our point here, Westphal (1998) argued that CEO ingratiation and persuasion behaviors would increase the level of compensation, but lower the contingent portion of compensation. The empirical evidence presented supported these predictions. Note that this study was done in the context of increased board structural independence, and CEOs were observed responding to increased independence of their boards.

In sum, despite the problems of measurement that plague this research, the research record is sufficiently robust to suggest that the distribution of power between boards and CEOs is an important determinant of executive compensation. Some boards' ability to effectively monitor top management through the use of compensation contracts is severely restricted by their limited power. As such, this research represents relatively strong support for our earlier conceptualization of agency theory as a theory of power. What is more, the few studies that have considered interpersonal issues (e.g., Westphal 1998) raise the intriguing notion that board power may be more endogenous than typically thought.

Boards and Monitoring Behaviors

Beyond compensation arrangements, boards play a potentially large role in spearheading a firm's response to takeover. This response need not await an actual takeover attempt, as boards can institute numerous antitakeover amendments or actions to reduce the chances of a successful takeover. Doing so is generally not considered to be an enhancement of shareholder value because actions that reduce the probability of takeover have the effect of insulating top managers from the market for corporate control and reduce the opportunity for shareholders to capitalize on the returns that often accrue to target-firm owners (Jensen and Ruback 1983; Coles and Hoi 2002; Sundaramurthy 1996, 2001; Sundaramurthy, Mahoney, and Mahoney 1997; Sundaramurthy, Rechner, and Wang 1996; Sundaramurthy and Wang 1993; Kosnik 1987; Mallette and Fowler 1992). Researchers have examined how boards influence the adoption of golden parachutes,¹⁹ poison pills,²⁰ classified board provisions,²¹ and antitakeover amendments in general, as well as the paying of greenmail,²² and takeover resistance.

This work constitutes a significant research stream on corporate governance. Driven largely by an agency theory logic, these studies have grown in importance because takeover defenses exemplify the boards' exercise of fiduciary responsibility. To the extent that boards adopt various mechanisms that protect top managers at the expense of shareholder interests, there is clear evidence of a breakdown of the principal-agent relationship. And in almost every case where such breakdown is observed, it is driven by a distribution of power that favors top managers over boards. Hence, the major contribution of this work is the identification of the distribution of power between boards and top managers as the key driving force in the agency relationship.

Several studies have examined the association between boards of directors and the granting of golden parachutes. In the first study of this type, Cochran, Wood, and Jones (1985) hypothesized that because insiders were more likely beholden to the CEO than

outsiders, the incidence of golden parachutes would be greater in firms with more insiders on the board. They tested this idea on a sample of 406 *Fortune* 500 firms in 1982 and found that the percentage of insiders on the board was actually negatively associated with the incidence of golden parachutes. Singh and Harianto (1989b) reported similar results in a different sample of firms over a longer period. These authors also noted that managerial shareholdings were negatively associated with golden parachutes, suggesting that stock ownership may substitute for takeover-contingent compensation. Other board attributes were not significantly associated with golden parachutes, including director equity (Cochran, Wood, and Jones 1985), and board size and relative board tenure (Singh and Harianto 1989b; Wade, O'Reilly, and Chandratat 1990), although CEO tenure on the board was a negative predictor (Wade, O'Reilly, and Chandratat 1990). In addition, Singh and Harianto (1989a) reported that the percentage of insiders on the compensation committee was negatively associated with the number of executives covered by golden parachutes in a firm, and relative managerial tenure (positive) and board size (negative) were significant predictors of the magnitude of golden parachute contracts.

A number of studies have examined board effects on the adoption of poison pills. A comparison of two of these studies in particular is instructive, because the firms and time periods sampled overlapped significantly. Although the models tested and the analytical techniques employed were different, the reported results had important similarities. Both Davis (1991) and Mallette and Fowler (1992) found inside director equity to be negatively associated, but inside or outside director representation not associated, with the adoption of poison pills.²³ In addition, Mallette and Fowler (1992) reported that such characteristics of outside directors as their equity and tenure were unrelated to poison pill adoption. However, these authors also found CEO duality to be positively related to poison pill adoption.²⁴

Sundaramurthy (1996) considered the adoption of antitakeover provisions and distinguished between poison pills (which do not require shareholder approval) and all others. Her key finding was that institutional ownership is important to the adoption of antitakeover provisions, but only when a vote is needed. Poison pills, because they do not require a shareholder vote, are quite different from other antitakeover provisions.

Sundaramurthy, Mahoney, and Mahoney (1997) noted that investors often react negatively to the adoption of antitakeover provisions, and they studied how other governance mechanisms influenced shareholder responses to antitakeover provisions. They considered two board structural attributes: composition (mix of insiders and outsiders) and duality, arguing that both would moderate investor reaction. Their evidence suggested that investors reacted more negatively when there were more outsiders on the board (opposite to hypothesis), and more negatively under CEO duality (as hypothesized).²⁵

Sundaramurthy, Rechner, and Wang (1996) examined classified boards as an entrenchment device and studied what factors enabled the adoption of classified boards.²⁶ The authors hypothesized that more outsiders would be positively linked to adoption; more loyal outsiders (appointed during the CEO's tenure) would be positively linked to adoption; board tenure would have a U-shaped relationship to adoption (because more senior directors are likely to be more independent); duality would reduce adoption; and more outside directors who identify with the CEO (those who are CEOs themselves) would increase adoption. Finally, they argued that institutional ownership and CEO ownership would reduce adoption

Their methodology tracked 192 firms from the S&P 500 from 1978 to 1988, during which time 104 firms adopted classified boards and 88 did not. Using an event history model, they provided marginal support for the hypotheses that the proportion of outsiders would be positively associated with adoption and that institutional ownership would be negatively

associated with adoption. All other hypotheses were rejected.

In another study related to antitakeover amendments, Sundaramurthy and Wang (1993) found that board size was negatively associated with the adoption of classified board provisions. Yet, outside director representation, CEO duality, and the ratio of outside director tenure to CEO tenure were not significant predictors. In addition, earlier work by Brickley, Lease, and Smith (1988) found that director and officer equity was positively associated with the percentage of affirmative votes cast for management-sponsored antitakeover amendments.

Some of the earliest work in this research stream was conducted by Kosnik (1987). In a study designed to test the effect of board characteristics on resistance to paying greenmail, Kosnik (1987) found that outside director representation, but not outside director equity, was positively related to resistance. In a follow-up study, Kosnik (1990) reported that a refined measure designed to assess the incentives outside board members face (the ratio of an outside director's equity to his or her compensation) was also unrelated to greenmail resistance. The interaction of this measure with a similar one constructed for top managers was positive and significant, although the main effect for "management's equity ratio" lost significance when the interaction term was added to the regression. Both of these studies developed interesting measures relating to the distribution of power between boards and managers, and the 1990 article also tested the effects of various measures of board demography.

Finally, two studies have examined the role of boards during takeover attempts. Adopting multiple theoretical perspectives, D'Aveni and Kesner (1993) argued that firms were more likely to resist tender offers when their top managers were more powerful than board members. Using a variety of measures of relative managerial power, these authors did not find support for this hypothesis. Instead, results indicated support for the notion that relatively powerful managers were more likely to cooperate with bidders. In contrast, a study by Buchholtz and Ribbens (1994) with a larger sample of firms subject to tender offer found that director equity was negatively associated with takeover resistance. However, outside director representation was not at all related to takeover resistance. Both of these studies are interesting in that they were carefully done yet yielded mostly counterintuitive findings.

Our review of the literature on how boards are associated with organizational outcomes shows a strong reliance on an agency theory–power perspective. While some refer to managerial hegemony theory (e.g., Mallette and Fowler 1992) or more loosely connected ideas on managerial power (e.g., Allen 1981), rather than agency theory, virtually all consistently highlight the distribution of power between boards and CEOs as a central theoretical idea that drives this research stream. As such, empirical research is reflective of our earlier conceptualization of agency theory as a theory of power.

A second conclusion that emerges from this review is that, in spite of the generally consistent theoretical rationale across articles, results are far from uniform. One source of this confusion, the measurement of board vigilance, deserves greater emphasis in this research. Using such proxies for board vigilance as outside director representation or outside director equity may be part of the problem. Outside directors may not have sufficient information or independence to enforce shareholder interests on a potentially entrenched top management. However, most studies testing the efficacy of board governance rely on such data. More direct measures of board vigilance—ideally derived from field and survey data—are needed that can more accurately assess the true extent of board power. The work of James Westphal and colleagues (Westphal 1998, 1999; Westphal and Bednar 2005; Westphal and Khanna 2003; Westphal and Milton 2000; Westphal, Seidel, and Stewart 2001; Westphal and Stern 2006; Westphal and Zajac 1995, 1998; McDonald and Westphal 2003) and Tosi and Gomez-Mejia (1989) are all examples of research that seeks to go beyond the "classic" model of

agency and power. Studies of this sort make it possible to consider whether commonly used board vigilance proxies are related to more direct measures of board vigilance and whether these more direct measures are related to organizational outcomes. The study by Jensen and Zajac (2004) also reminds us that demographic proxies may have important context dependencies. One approach that has seemed to bear fruit, but does not carry the onerous burden of primary data collection, would be to abandon the traditional insider/outsider dichotomy and instead separate outsiders into independent and affiliated categories, as discussed earlier.

Developing valid and reliable field- and survey-based measures of board vigilance clearly is no easy task; the potential benefit of such an undertaking, however, would appear to be large. Researchers should expand the relatively narrow set of objective measures of board characteristics typically studied. For example, Eisenhardt notes such operational measures of board monitoring as “frequency of board meetings, number of board subcommittees, number of board members with long tenure, number of board members with managerial and industry experience, and number of board members representing specific ownership groups” (1989a, 65). These characteristics are consistent with our earlier conceptualization of board structure and composition; yet few of these attributes have been used in empirical research.

Another reason may account for the inconsistent results reported in previous work. In each study, authors selected a dependent variable and a set of independent variables, but no consideration was given to the interaction among different dependent variables and among different independent variables. For example, firms adopting poison pills may feel no need to also adopt classified board provisions. This suggests that different dependent variables may be substitutes for one another and that different measures of board vigilance may also be substitutes for one another. That researchers usually do not examine interrelationships among multiple outcomes of board monitoring or the substitutability of alternative measures of board vigilance²⁷ may explain why many studies report inconsistent results. This line of argument suggests the following illustrative proposition:

Proposition 9–18: Boards that have adopted antitakeover provisions in the past are less likely to adopt subsequent antitakeover provisions.²⁸

Relatedly, shareholders can rely on alternative monitoring and disciplining mechanisms, not all of which need be operative at any one time. For example, boards have several different internal monitoring and disciplinary mechanisms at their disposal, including compensation contracts, direct board monitoring, and dismissal (Walsh and Seward 1990). In addition, there are several external monitoring mechanisms on which shareholders may rely. However, with few exceptions (e.g., Morck, Shleifer, and Vishny 1989; Beatty and Zajac 1994; Rediker and Seth 1995; Westphal 1999), research has proceeded without consideration of alternative methods to keep top managers in line (Williamson 1983).

To the extent that agency costs can be minimized in a variety of ways, studies that model multiple monitoring mechanisms simultaneously are more likely to accurately assess how managerial behavior is constrained by such monitoring. Consider this simple example. Suppose a firm made extensive use of performance-contingent compensation, but the board of directors was dominated by insiders. Research that relies on a standard measure of board vigilance such as outside director representation may be misleading, because the tight link between pay and performance in this firm suggests that managers may actually be focused on shareholder interests.

Thus, it seems important that research on corporate governance adopt a more sophisticated approach that explicitly models the possibility that alternative monitoring mechanisms are substitutes. For example, we propose:

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Proposition 9–19: Alternative monitoring mechanisms (e.g., direct board monitoring, CEO compensation, the market for corporate control, market competition) act as substitutes for one another.

Finally, it is important to note that while the majority of research on board consequences is based on agency theory, several studies have adopted alternative theoretical approaches. One of the most promising of these approaches views boards as part of a social network (e.g., Galaskiewicz and Wasserman 1981) and is embodied in work by Davis (1991), Haunschild (1994), and Westphal (1999), among others. As Davis and Thompson argue:

The corporate elite forms an identifiable category of actors connected by extensive formal and informal social ties. Of most interest for corporate governance is the interlock network formed by overlapping membership on boards of directors. Most large corporations are linked into a single network by sharing directors with other firms. This network ... can serve as a basis for cohesion and collective action among professional managers (Useem 1984) as well as a latent structure for spreading techniques for expanding corporate control. Because the board has ultimate authority within the firm in matters of governance, sharing directors provides a mechanism for innovations in governance to spread from board to board. (1994, 163)

Hence, research that relies solely on an agency theory perspective to explain board behavior may be neglecting important alternative theories, one consequence of which may be the inconsistent results reported in the literature.

Conclusion

Our goal in these last chapters was to develop an integrative model of boards of directors that depicted the board as a central player in strategic leadership—sometimes a monitor of top management, other times a confidant to the CEO, and occasionally even a supra-top management team. Consideration of the contextual conditions that give rise to board structure and composition, as well as the organizational outcomes that result from board vigilance and strategic involvement, allowed for an integrated treatment of the role of boards at the apex of organizations. These chapters also suggested numerous testable propositions to focus research on boards of directors as important strategic leaders and advocated a broader theoretical understanding of how boards affect, and are affected by, internal and external forces.

In the previous chapter we reviewed theory and empirical work on the determinants of board structure and composition, the two most commonly studied attributes of boards typically associated with vigilance in the literature. Further, we also considered the central role of power in board vigilance. One of our key conclusions was that structure and composition are less attributes of board vigilance as much as they are potential determinants. Unfortunately, this remains a problem when we turn our attention to the consequences of board vigilance, as we have seen in this chapter as well. Indeed, the vast majority of research has tested relationships between board structure and composition, and various organizational outcomes, under the assumption that these board attributes are actually representative of board vigilance.

In effect, what much of the literature has done is create a “black box” around board vigilance, so that it is usually not measured but inferred from more general and, as we have seen, somewhat questionable factors. This state of affairs has created a tremendous research

opportunity for scholars who have focused on what it is that boards actually do, and whether and how those things they do have any effect on organizational outcomes of interest to strategists and organization theorists. It may well be that the greatest research breakthroughs will come from studies that adopt qualitative methodologies with potential to identify real behaviors that boards engage in, as well as their effects. And survey methods have proven useful as well. Scholars in the organizational sciences are particularly well-suited for this challenge, both for their methodological training and because the few studies that have examined actual board behaviors have identified a range of board conduct that goes far beyond the rather limiting views of agency theory. Rather than just acting as careful representatives of shareholders, board members may engage in the full array of perceptions, actions, and non-actions that have already been documented for senior executives. By focusing more closely on these actual behaviors, and not the generalized proxies that have dominated much of the literature to date, there is a great opportunity to expand our understanding of what boards do and their effects on organizational outcomes.

The Determinants of Executive Compensation

Few topics on strategic leadership generate the same degree of controversy as executive compensation. This debate spans academic, managerial, governance, and legislative audiences, and tends to focus on a single question: What is the logic behind CEO pay? Academics generally try to answer this query with economic explanations that focus on incentives and principal-agent relations. CEOs and boards of directors, however, confront a broader array of forces that govern their behavior and frequently lead to conflicting goals in the compensation-setting process, including comparability, equity, power, discretion, and performance. Meanwhile, governmental agencies, taking a different tack, advocate greater disclosure of executive compensation or propose limits on certain compensation practices in response to pressure from various stakeholders.

Our goal in this chapter and the next is to first develop a framework that captures the complexity of executive compensation and then suggest a research agenda to guide further work on this topic. While such a framework cannot encompass every stream of work on executive compensation (because of the broad range of disciplines represented), we attempt to offer a parsimonious yet integrative structure. This framework is based on three dimensions that characterize the assumptions often implicit in empirical research on executive compensation: (1) the direction of causality, (2) the theoretical perspective adopted, and (3) the unit of analysis. The following section describes these dimensions.¹

Organizing Dimensions for a Framework of Executive Compensation

Direction of Causality

Executive compensation can be considered as a dependent variable (i.e., something to be explained) or an independent variable (i.e., for explaining something else). Scholarly and popular interest in understanding why some CEOs are paid more than others has focused on compensation as a dependent variable. Thus, the prevailing research has been on the determinants of pay. Perhaps of greater interest for strategic choice and firm performance, however, are the consequences of executive compensation—an area that is garnering more interest from scholars in recent years. Modeling executive compensation as an independent variable directs attention not only to firm performance, but also to a potentially wide set of strategic choices, organizational characteristics, and stakeholder reactions that may be responsive to executive compensation plans.

Theoretical Perspectives

Research on executive compensation has historically been driven by economic theory: for example, Berle and Means (1932), in one of the earliest and still most influential published works on corporate ownership structure, documented the increasing separation of ownership and control in modern organizations. This work led other economists to focus on the

consequences of this separation, including the observation that “executive salaries appear to be more closely associated with the scale of operations than with its, the firm’s, profitability” (Baumol 1967). Consequently, early empirical research on executive compensation was dominated by economists’ concerns about the relative importance of firm size and profitability as determinants of pay. Over the past twenty-five years, this work has come to be guided by agency theory, which is essentially a more sophisticated version of the same argument. More recently, some of this work has been extended by insights on risk, and especially the idea that for executives, risk aversion is actually loss aversion (Wiseman and Gomez-Mejia 1998). Hence, economics-based theory has traditionally been the dominant influence on executive compensation research.

In spite of the prevalence of economic approaches to executive compensation, alternative perspectives based on social-psychological and political theories of organizations are becoming more common. The social-psychology perspective argues that the setting of executive compensation is a social phenomena (Barnard 1938; Hicks 1963) and, hence, is influenced by the actions of other individuals both within and outside of the organization. The political perspective suggests that executive compensation and executive power are closely related (Finkelstein and Hambrick 1988). Taken together, then, scholars interested in studying executive compensation can select from economic, social-psychological, and political theoretical perspectives. Predictably, most research has focused on only one of these theories, but each can offer valuable insights to the compensation puzzle. In addition, research that seeks to combine theoretical perspectives may be particularly valuable because it can lead to critical tests that help distinguish the conditions under which various theories are applicable and the conditions under which they are not (Platt 1964).

Unit of Analysis

The question of unit of analysis is seldom explicitly considered in research on executive compensation. Most work focuses on either the pay of the CEO or the aggregate pay of a larger set of top managers. Less common, but potentially very informative, is research on pay patterns within top management groups—such as pay dispersion and differentials—to understand both its determinants and consequences. Although research on pay at the group level is common for nonmanagers (Hirsch 1982), it is only in recent years that work on this topic has been directed toward senior executives.

When direction of causality, theoretical perspective, and unit of analysis are all considered together, a complex but analytically useful framework for the study of executive compensation emerges. The value of such a framework is twofold: (1) it provides a broad view of research on executive compensation that helps match pieces of a complex puzzle, and (2) it enables identification of research opportunities along multiple combinations of underlying dimensions. When all three possible dimensions are brought together in a two-by-two-by-three framework, as in [Table 10.1](#), twelve possible conditions emerge. As will become apparent, however, the volume of work in each of these areas varies widely.

To organize our presentation of this research, we focus in this chapter on the determinants of executive compensation, still the area of research that has dominated other questions. We also review work on the compensation of business unit general managers. In the next chapter, we take on a dual focus: we examine the consequences of executive compensation and, because research on the determinants and consequences of group-level executive pay often draws on the same theoretical insights for support, we review both directions of causality at the group level concurrently. Doing so allows an integrated discussion of pay distributions within top management teams that avoids repetition. Hence, we consider all three dimensions of executive compensation in a parsimonious yet integrated fashion across these two

chapters.

The remainder of this chapter is divided into four sections, examining economic, social, and political explanations for individual executive compensation, as well as the determinants and consequences of compensation for business unit general managers. Our goal in each section is to outline the key issues and research questions, major research findings, and unresolved or unanswered questions, and to recommend future research.

Table 10.1. A Framework to Study Executive Compensation

Perspective	Individual Unit of Analysis Direction of Causality		Group Unit of Analysis Direction of Causality	
	Determinants	Consequences	Determinants	Consequences
<i>Economic</i>	Managerial versus neoclassical economics Human capital Marginal product Managerial labor markets	Managerial risk acceptance and acceptance of longer time horizons Firm performance	Tournament model and pay differentials	Tournament model and turnover Tournament model and firm performance
<i>Social-Psychological</i>	Mimetic and normative isomorphism Social comparison	Equity and turnover	Social comparison and pay dispersion	Pay inequality and turnover Pay inequality and firm performance
<i>Political</i>	Managerial power versus board power	Managerial manipulation of incentive systems Unintended consequences of pay	Distribution of power within top management teams	Politics as a contingency between pay inequality and firm performance Pay inequality and top management team politics Relative managerial pay and internal labor markets

Economic Explanations for Executive Compensation

The economic determinants of executive compensation have been a major focus of research for some time. As we noted above, for many years economists have been interested in the relative importance of sales and profits in explaining compensation. The underlying theories, though not always explicit in some studies, can be described from both the managerial and neoclassical perspectives.

Research from the Managerialist and Neoclassical Traditions

According to the managerialist perspective, CEOs seek to maximize firm size because (1) size is more controllable than profits, (2) bigger firms have greater ability to pay more than smaller firms (Agarwal 1981), and (3) bigger firms offer larger nonpecuniary benefits, such as prestige, to managers (Baumol 1967; Marris 1964; Williamson 1985). The managerialist view leads naturally to a “corporate growth hypothesis”; namely, that firm size (sales or assets) will be positively associated with executive compensation (Ciscel and Carroll 1980). It is also possible to argue that maximizing firm size is a worthy goal for which CEOs should be rewarded because larger firms may have greater market power and access to more resources and, hence, managerial jobs in such settings involve more complex and demanding responsibilities (Henderson and Fredrickson 1993; Ungson and Steers 1984; Hambrick, Finkelstein, and Mooney 2005). Nevertheless, if a CEO is rewarded for increasing firm size and if bigger firms tend to pay more than smaller firms, an association between size and pay is mutually reinforcing: CEOs are paid more to manage a large firm, so they increase the size of the firm in order to be paid more (Lenski 1966). Perhaps for this reason, significant empirical support for the managerialist perspective exists, spanning several decades (Benston 1985; Ciscel 1974; Cosh 1975; Kerr and Bettis 1987; Marris 1964; McGuire, Chiu, and Elbing 1975; Meeks and Whittington 1975; Rajagopalan and Prescott 1990; Roberts 1959; Schmidt and Fowler 1990; Tosi et al. 2000). A very strong association exists between organization size and CEO pay.

Neoclassical economists support the “profit maximization hypothesis,” which translates in the compensation arena to an expectation that executive pay will be significantly related to firm profitability (Ciscel and Carroll 1980). According to this perspective, because corporations, through the decisions of management, seek to maximize profitability, profits should “have a strong and persistent influence on executive rewards” (Lewellen and Huntsman 1970, 718). Until recent years, the idea that pay and firm performance are related has been promulgated by agency theorists (Holmstrom 1979; Jensen and Meckling 1976). Rather than only assuming that managerial interests are aligned with shareholder interests, however, agency theorists emphasize the importance of incentives in promoting this alignment (Smith and Watts 1982). Hence, traditional empirical work from the agency theory perspective hypothesizes a significant association between managerial pay and firm performance—generally under the assumption that effective incentives are included in compensation contracts (Raviv 1985).

Although conceptual support for agency theory is strong, Jensen and Murphy (1990b), in a widely noted empirical examination of the effectiveness of incentives in compensation contracts, found these incentives to be particularly small. For example, these authors demonstrated that a \$1,000 change in corporate value corresponded to a 6.7 cents change in CEO salary and bonus, hardly an incentive at all. More recently, a meta-analysis involving some 137 published articles that analyzed CEO pay and either firm size or performance (or both) was only a little more optimistic (Tosi et al. 2000). These authors concluded that a \$1,000 increase in shareholder wealth returns about \$3.25 to the executive. Finally, in an intriguing paper by Aggarwal and Samwick (1999b), the observed link between pay and performance was somewhat stronger, though still relatively small. Despite the inclusion of a variety of measures of risk, CEO wealth change among low-performance variation firms in their sample was \$27.60 per \$1,000 change in shareholder wealth, while at the median performance variation it was \$14.52 per \$1,000. While both were significant, neither association seems strong enough to provide “high-powered” incentives.

Thus, while agency theory clearly has strong appeal as a theory, the evidence (at least for CEO compensation) is quite consistent. There is little direct association between pay and performance (Hall and Liebman 1998; Gerhart and Milkovich 1990). In part as a response to these disappointing findings, even prominent agency theorists have suggested that social-psychological and political factors may play roles in determining executive compensation (Baker, Jensen, and Murphy 1988).²

While it is possible for scholars to continue asking the same two questions (size vs. profitability) by identifying increasingly minor nuances that might shift the relative balance at the margin, much more productive is the question of the conditions or characteristics under which size and profits determine compensation. And indeed, there has been some recent progress in developing explanations for the varying relationship between firm profits and executive compensation, with studies examining corporate control (e.g., Finkelstein and Hambrick 1989; Gomez-Mejia, Tosi, and Hinkin 1987; Hambrick and Abrahamson 1995; McEachern 1975; Gomez-Mejia, Larraza-Kintana, and Makri 2003), firm risk (Aggarwal and Samwick 1999b; Bloom and Milkovich 1998; Stroh et al. 1996; Miller, Wiseman, and Gomez-Mejia 2002; Gray and Cannella 1997), and managerial discretion (Kerr and Kren 1992; Rajagopalan and Finkelstein 1992; Finkelstein and Boyd 1998). In the following sections, we review this work.

Moderators of the Pay-Performance Relationship

Both the managerialist and neoclassical schools are implicit in virtually all studies of the determinants of executive compensation. Although agency theory has modernized the

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neoclassical perspective, it remains at the heart of most work on compensation. In fact, the agency perspective has become almost paradigmatic in research on the determinants of executive compensation.³ In a similar vein, the managerialist perspective has become more sophisticated over time as well as scholars have clarified and expanded the role of power that is at the heart of this perspective (Hambrick and Abrahamson 1995; Hill and Phan 1991). Nevertheless, this work has also helped make clear that the managerialist view is really a political perspective that provides a clear counterpoint to an economic perspective.

Corporate Control

Research on corporate control has probably come closest to developing these opposing theoretical perspectives on executive compensation. This work differentiates externally controlled firms (where a single nonmanager owns a significant portion of the stock) from managerially controlled firms (where no single party is a significant shareholder) (Gomez-Mejia, Tosi, and Hinkin 1987; Hambrick and Finkelstein 1995; McEachern 1975). When externally controlled and managerially controlled firms are compared directly, the underlying logic behind the neoclassical and managerialist schools becomes clear. Table 10.2 presents such a comparison. The underlying theory in explaining executive compensation in externally controlled firms is agency theory (neoclassical). The locus of corporate control in agency theory rests with the board of directors, who try to ensure that shareholder and CEO objectives are aligned (Fama and Jensen 1983). Hence, externally controlled firms seek to reward performance while simultaneously minimizing CEO pay (i.e., to limit the upper bound of compensation within the firm and to reduce overall compensation). The key driving forces in the setting of executive compensation are supply and demand, concerns for managerial product, and maximizing firm profits.

Table 10.2. Externally Controlled versus Managerially Controlled Firms

	External Control	Managerial Control
<i>Underlying Theories</i>	Neoclassical Agency theory	Managerialist Managerial hegemony theory
<i>Locus of Corporate Control</i>	Board of directors	CEO
<i>Competence Depends On</i>	Alignment of shareholders' and CEO's objectives	Dominance of CEO preferences
<i>Guidelines in Setting Compensation</i>	Reward performance Minimize CEO pay	Legitimize process Maximize CEO pay
<i>Key Driving Forces</i>	Profit maximization Supply and demand Marginal product	Sociopolitical forces Institutional norms Bureaucracy

In the managerially controlled firm, on the other hand, the underlying theory invoked to explain compensation is managerial hegemony (managerialist) theory. According to this perspective, the locus of corporate control is the CEO because the board lacks the motivating influence of a large shareholder (Shleifer and Vishny 1986). Without this countervailing pressure, compensation is based on CEO preferences, leading to higher CEO pay subject only to a need to ensure that the process appears legitimate to stakeholders. The managerialist view thus is driven by sociopolitical factors increasing pay, and bureaucratic and institutional pressures legitimizing pay.

These alternative perspectives were examined in a study by Hambrick and Finkelstein (1995). Sampling 188 firms in seven industries between 1978 and 1982, they found dramatic differences in CEO compensation patterns in externally controlled and managerially

controlled firms. As Table 10.3 illustrates, consistent with our depiction of differences in pay patterns across ownership categories, annual changes in sales had a big impact on CEO pay raises in managerially controlled firms but a nonsignificant effect in externally controlled firms.

Some of the most interesting findings came from an examination of the effects of changes in firm performance (return on equity [ROE]): “Our results suggest that CEOs of [managerially controlled firms install] asymmetric incentive plans which yield substantial pay increases when profits go up, but no change in pay when profits go down. As Crystal (1988, 76) cynically surmised, ‘... pay for performance, see?’ This is a graphic indication of how CEOs in management-controlled firms strive to maximize their pay while appearing to abide by the basic convention of contemporary business practice” (Hambrick and Finkelstein 1995, 31).

In externally controlled firms, CEO pay increased marginally (and nonsignificantly) when ROE improved but decreased by 0.51 percent for every 1 percent decline in ROE. These results indicate that externally controlled firms also create asymmetric pay plans but in a direction very much different from the pattern apparent in managerially controlled firms. This finding is not consistent with the idea that externally controlled firms seek to align shareholder and CEO interests. Hambrick and Finkelstein (1995, 189) suggest these results may reflect the attributions of major owners: “When the firm performs well, the owner’s interpretation is that the managers have done nothing exceptional; they have done their jobs. They have fulfilled their responsibilities as stewards of the inherently valuable assets of the firm. However, when performance is poor, at odds with expectations about the worth of the firm, management is seen as the problem.”⁴

Table 10.3. Some Key Drivers of Change in CEO Pay (Cash and Stock Options)

Predictor	Externally Controlled	Managerially Controlled
<i>Change in Sales</i>	No effect	Big effect
<i>Change in ROE</i>	Minor upward effect for ROE increases	No downward effect for ROE declines
<i>Change in CEO Pay in Industry</i>	Moderate effect	Big effect

In a related study, Werner and Tosi (1995) considered the implications of ownership on compensation strategy across a wide range of hierarchical levels. The authors developed arguments to predict that ownership structure will have important effects on both compensation levels across the hierarchy as well as pay differentiation within level. It is well-known that powerful CEOs can extract extra compensation from shareholders (Gomez-Mejia, Tosi, and Hinkin 1987; McEachern 1975), but not as well-known how this impacts pay at lower hierarchical levels.⁵ The authors compare owner-managed firms, manager-controlled firms, and owner-controlled firms, predicting that manager-controlled firms will exhibit higher pay across the hierarchy, and that pay will be linked to performance in owner-controlled and owner-managed firms, but to growth in management-controlled firms. Further, they predict that the proportion of managers eligible for long-term incentives and bonuses will be higher in owner-controlled and owner-managed firms, and that bonuses will be a higher percentage of pay in owner-controlled and owner-managed firms, relative to manager-controlled firms. Using a very large database of some 200,000 managers across twelve hierarchical levels, they found good support for only the first prediction—that pay levels will be higher across the hierarchy in management-controlled firms, and even there, the evidence was not uniformly strong. Firm growth was not connected to compensation regardless of ownership structure, while change in firm performance was related to change in pay only for

owner-controlled firms. There was partial support for the prediction that owner-managed firms had a higher proportion of managers eligible for long-term pay plans. Finally, and opposite to the authors' predictions, manager-controlled firms actually had the highest levels of bonus eligibility across the hierarchy, as well as the highest bonus-to-base pay ratio of any ownership structure.

Werner, Tosi, and Gomez-Mejia (2005) built on the earlier work by Werner and Tosi (1995) to examine how governance impacts compensation strategy. While Baker, Jensen, and Murphy (1988) suggest that pay-performance relationships should weaken as we move down the hierarchy, the authors develop the opposite argument—that there are reasons to believe that the compensation strategy observed at senior executive levels will cascade through the hierarchy. Specifically, Werner et al. predict that (1) linking compensation to growth lowers risk for all managers; (2) the need to attract employees for a growing company may require pay that is higher; and (3) it is easier to justify more pay at the top because of the need to maintain “appropriate” differentials across the hierarchy. Their study provided evidence that (across hierarchical levels) change in pay level is linked to change in performance in owner-controlled firms but not management-controlled firms, and that change in pay level is linked to change in firm size in management-controlled firms but not in owner-controlled firms. However, variance explained was quite modest (see also Rousseau and Shperling 2003).

There has also been some work on the role of institutional investors. Such outside investors are the classic “external-controllers,” at least in theory, because they meet the criteria typically defined in this stream of work—a dominant outsider stockholder. However, as we noted in [chapter 8](#), institutional owners are not created equally because many have business relationships with the firm. Building on earlier work (e.g., Brickley, Lease, and Smith 1988), David, Kochhar, and Levitas (1998) separated institutional investors into “pressure sensitive” (e.g., banks, insurance companies, nonbank trusts) and “pressure resistant” (e.g., public pension funds, mutual funds, endowments, foundations),⁶ and predicted that the extent of ownership by pressure-resistant institutional investors would be positively associated with the extent to which pay is performance-contingent, and negatively related to the level of CEO pay. However, their sample of 125 *Fortune* compensation survey companies (1990–1994) only supported the latter prediction about CEO pay.

Recent theory and evidence suggests that a third aspect of corporate control—family control—may have very important implications for executive compensation. Work by Anderson and colleagues (Anderson and Reeb 2003, 2004), Villalonga and Amit (2006), and Miller and colleagues (Miller, Le Breton-Miller, and Lester 2005) have established two key conclusions.⁷ First, family ownership is a very important influence, even among large public corporations in the United States. Second, family ownership has important implications for firm performance and risk taking. Naturally, this influence should extend to CEO compensation.

In the most complete study to date of family ownership and executive compensation, Gomez-Mejia, Larraza-Kintana, and Makri (2003) started by noting that CEOs of family companies tend to have high employment security because of emotional ties to family members. They are bonded to their firms, and unlikely to seek employment elsewhere. For these reasons, Gomez-Mejia and colleagues (2003) then predicted that family-firm CEOs will be paid less than CEOs of nonfamily firms. The authors' empirical analysis led them to several conclusions. First, regarding pay for performance, the authors noted that among nonfamily firms, CEOs earned nearly four times more when their firm's performance was in the top quartile than when it was in the bottom quartile. However, for family-firm CEOs, the situation was reversed. Whether this pattern is influenced by succession, tenure, and stock ownership is unclear, however, and warrants further work. In addition, Gomez-Mejia et al.

(2003) found that family-firm CEOs in the top performance quartile earned about one-quarter as much as nonfamily CEOs in the same performance quartile. Clearly, family ownership and control is an important factor in CEO compensation and turnover.

In sum, corporate control plays a key role in the setting of executive compensation. These studies make clear that differences between neoclassical and managerialist perspectives on executive compensation are fundamental and can be understood much more clearly when critical contingency factors such as corporate control are taken into consideration.

Risk

Risk is a central component of agency theory (Eisenhardt 1989a), and one that has figured prominently in studies of executive compensation. Particularly influential has been work by Holmström (1987), who argued that because shareholders are risk-neutral and managers are not, managerial pay cannot be tightly linked to performance without inducing risk aversion. This “risk problem” effectively rules out any perfect solution to the divergence of interests between managers and shareholders. Not surprisingly, then, empirical work has focused on exploring the trade-off between incentives and risk-sharing.

Beatty and Zajac (1994) found a negative association between the risk that top managers bear in firms going through initial public offerings and (1) the use of stock options and (2) the level of noncash incentives in compensation plans. Because top managers in riskier firms already face considerable uncertainty, pay packages tend to de-emphasize risky components, such as stock options and noncash incentives.

Taking this trade-off between incentives and risk-sharing as their starting point, Gray and Cannella (1997) described three dimensions of compensation relevant to CEO risk-sharing—total compensation, compensation risk, and compensation time horizon. They predicted that when managers were asked to bear more risk, they would be compensated with higher overall pay. Further, as the unsystematic risk confronted by the firm increases, the risk-based portion of overall compensation was predicted to decrease. Finally, the authors predicted that as strategic risk increased, the proportion of long-term incentive pay would decrease. Their evidence, from a sample of 100 *Fortune* 1000 firms followed from 1980 to 1989, supported all of these predictions.

Bloom and Milkovich (1998) examined the role of risk in the structure of compensation (their sample included managers at a number of levels, not just CEOs), and concluded that short-term incentives are de-emphasized when business risk is high. This was expected, as business risk increases risk aversion on the part of managers, and if short-term incentives were emphasized, this would accentuate the risks borne by managers, leading to even more risk aversion in decision making.

Stroh, Brett, Baumann, and Reilly (1996) studied agency theory’s predictions about variable pay compensation schemes in the context of firm risk. They considered three variables closely linked to agency theory: task programmability; risk; and the length of the principal-agent relationship. The authors proposed a competing risk premium hypothesis related to total cash compensation, predicting that managers in programmable jobs would receive a lower proportion of their compensation in the form of variable pay (bonus). For the relationship between turbulence and pay, they developed competing hypotheses—one predicting that under turbulence, managers will bear more risk (in contrast to agency theory) and one predicting the opposite (the agency-theory prediction). Finally, they predicted that managers in more turbulent organizations will be paid more to compensate them for the increased risk, and managers with longer-term employment relationships will bear less risk in their compensation.

In contrast to Gray and Cannella (1997), Stroh and colleagues’ (1996) analysis provided

no support for the agency-theory prediction that under risky conditions managers are paid more. In fact, their evidence suggested the opposite. However, high task programmability was linked to less variable pay (as predicted by agency theory), and under environmental turbulence there was more variable pay (that is, organizations tended to shift risk to managers as company risk increased). Finally, long-term relationships decreased variable pay. While their study was focused on middle managers and not CEOs, their evidence raises some important concerns. They concluded that agency theory predicts compensation arrangements much better in stable environments than in turbulent ones, a point that much more broadly echoes the importance of environmental context in explaining a number of strategic leadership relationships discussed in previous chapters.

Miller, Wiseman, and Gomez-Mejia (2002) considered the fit between compensation design and firm risk. In developing their conceptual framework, the authors evaluated when it would be efficient to use contingent pay, and identified three factors germane to that question: degree of control the agent can exert; availability of information on agent behavior; and the total cost of compensation (because with higher levels of risk, agents can demand higher total pay). Consideration of these factors led them to predict a curvilinear relation, such that with more uncertainty, contingent pay should decrease. While several studies (cited above) support the idea that performance-contingent compensation becomes less efficient as uncertainty increases, these authors emphasized that instrumentality is also likely to be highest at moderate risk. Finally, these authors hypothesized that the effects described above should be stronger for systematic risk because CEO effort is dissociated with systematic risk. Their empirical analysis provided support for all of the above predictions.

This research on risk and incentives is also related to board-monitoring activities. While we explored this topic in the last chapter, here we simply make the point that studies of incentives and risk-sharing need to consider the balance of costs associated with incentive compensation and monitoring. For example, Zajac and Westphal (1994) argued that firm risk increases the costs of incentives (CEO ownership and incentive compensation) and that when this is the case, monitoring by the board of directors can provide a more cost-effective governance system than incentives. However, strategic complexity has the reverse effect, making monitoring more costly than incentives. Evidence from their sample—the *Fortune* 500 between 1987 and 1991—provided strong support for these arguments.

In a related study, Parks and Conlon (1995) explored, through lab experiments with MBA students, conditions under which employers offer and employees accept contingent pay schemes. Their approach contrasted agency theory and collaboration theory (Davis, Schoorman, and Donaldson 1997). Like others (e.g., Rediker and Seth 1995) they noted that monitoring and incentive alignment can be substitutes, but their contribution rests on the consideration of the level of collaboration between principal and agent. They predicted that monitoring, under conditions of munificence, can encourage principal-agent collaboration—a view not considered by agency theory. Under scarcity, because of the mutual threat, collaborative arrangements should encourage risk-sharing. Their evidence was in alignment with these predictions. Further, the authors concluded that agency theory effectively predicts compensation arrangements under munificence, but fails under scarcity.

Finally, Wright, Kroll, and Elenkov (2002) argued that executives might pursue acquisitions largely for pay increases (see also Morck, Shleifer, and Vishny 1990), but that any such activity will be hampered by monitoring. Their study considered three types of external monitors: security analysts, independent directors, and institutional investors. They predicted that with stronger monitoring, the returns from acquisitions would importantly impact executive compensation, but with weaker monitoring, sales growth would have a large impact on executive compensation. Their evidence supported these hypotheses for both stock

returns and return on equity.

Taken together, the research on the role of risk in executive compensation leads to some interesting conclusions. While risk clearly raises concerns for a tight pay-performance relationship, other factors, like task programmability or instrumentality, also need to be considered. As the board's ability to link overall performance outcomes to the CEO's actions decreases, the agent's ability to hide mistakes, misjudgments and even self-interested behavior increases. As Holmström's (1979) analysis showed some years ago, there is no single compensation arrangement that resolves all the problems inherent in principal-agent relationships.

Managerial Discretion

In [chapter 2](#) we reviewed work on managerial discretion that provided evidence for its effects on overall compensation and the use of incentive compensation. Here, we reiterate and extend that review by noting a few related studies of relevance to executive compensation. The key point remains the same: managerial discretion is a potentially powerful predictor of the extent to which pay and performance are related. Stated simply, the greater the level of managerial discretion, the greater the potential impact of managers on organizational outcomes and the more important it is to ensure that their pay is tied to performance (Hambrick and Finkelstein 1987).

It is in this vein that Henderson and Fredrickson (1996) argued that CEO compensation is a function of the extent to which they are required to process complex information. The authors developed theory to support the notion that coping with information processing is a key part of any CEO's job, and that it is easier and more observable to link pay to information processing requirements because other contributions to marginal product are harder to observe or assess. They suggested that three firm-level factors exert significant influence on information processing demands: (1) number and interdependence of business activities; (2) technologies employed; and (3) management structures. Evidence from their *Fortune* 500 sample between 1985 and 1990 provided general support for these predictions.⁸

Sanders and Carpenter (1998) studied internationalization and its implications for compensation, top management team (TMT) composition, and board structure. Building on Henderson and Fredrickson (1996), they describe how the complexity of internationalization makes board monitoring more difficult and costly, so firms respond in part by linking CEO pay to long-term outcomes and by increasing levels of pay. These basic propositions were supported by the evidence from their Standard and Poor's (S&P) 500 sample. They further observed that information processing demands led to governance structures designed to handle the increased complexity. So, like Zajac and Westphal (1994) and others (e.g., Parks and Conlon 1995; Rediker and Seth 1995), the trade-off between monitoring and incentives is consequential. In addition, the Sanders and Carpenter (1998) study, as well as Henderson and Fredrickson (1996), are interesting in their depiction of complexity as a relevant construct in explaining executive compensation. To the extent that complexity taps into managerial discretion, future research might also look into the role of such other correlates or indicators of discretion as slack, resource availability, and size, to name a few.

Balkin, Markman, and Gomez-Mejia (2000) studied how incentives in high-technology firms were related to innovation. The authors argued that CEOs are paid more for innovation than for financial performance in high discretion environments, and reported that between 15 percent and 23 percent of variance in CEO compensation was explained by innovation among high-tech firms versus virtually no variance explained in their control sample of non-high-tech firms.

Boyd and Salamin (2001) argued that discretion is important to the design of

compensation systems, and those systems need to be aligned with strategic orientation (e.g., “orientation toward change”) to be effective. They predicted that base salary and bonus and pay mix would be positively associated with strategic orientation and hierarchical level. Their sample from two large Swiss financial institutions involved some 917 employees at a variety of hierarchical levels. The base salary predictions were universally supported, while bonus and pay mix predictions were supported for higher-level managers. Overall, this study is consistent with the conclusion that discretion is important to pay, and its effects extend well below the higher hierarchical levels.

Finally, in a study of pay changes among deregulated firms that harkens back to work by Rajagopalan and Finkelstein (1992), Cho and Shen (2007) reported greater pay levels and tighter pay-performance linkages in their sample of top management teams in the airline industry. Interestingly, these authors additionally note that these same effects were also boosted by top team turnover.

In sum, if we put the discussion of managerial discretion into a broader context of explanations for the pay-performance relationship, it holds great potential to move this work forward. Indeed, as we noted in [chapter 2](#), discretion has been used to inform our understanding of compensation for some time (Rajagopalan and Finkelstein 1992). Hence, although the traditional neoclassical-versus-managerialist debate in executive compensation may seem old, a new focus on contingency variables and managerial discretion may give rise to fresh ideas on the pay-for-performance question. We summarize this discussion with the following propositions:

Proposition 10–1: The association between CEO compensation and firm performance is not a direct one. Rather, the nature of the pay-performance relationship depends on such contingency factors as corporate control, firm risk, and managerial discretion.

Proposition 10–1A: The greater the level of external control, the stronger the relationship between CEO compensation and firm performance.⁹

Proposition 10–1B: The greater the level of firm risk, the weaker the relationship between CEO compensation and firm performance.

Proposition 10–1C: The greater the level of managerial discretion, the stronger the relationship between CEO compensation and firm performance.

Human Capital

Several other economics-based theories have been used to explain executive compensation, including human capital (Becker 1975), marginal product (Frank 1984), and the managerial labor market (Fama 1980; Fama and Jensen 1983). Although these theories are often invoked to explain compensation, it is only recently that they have begun to be formally operationalized in empirical research on executive pay. In light of our discussion in [chapter 4](#) on the resource-based view of executive experiences, we focus predominantly on the human capital perspective.

Human capital derives from the experiences and background of a manager, and it is an important source of compensation to the extent that it is recognized and valued in a firm. Examples of relevant human factors are managerial experience, education, and tenure (Hogan and McPheters 1980). Historically, there have been only a smattering of studies in this vein that occasionally report significant results. For example, Finkelstein and Hambrick (1989)

found that CEO general management experience was related to CEO bonuses (but not total cash compensation or salaries), and Agarwal (1981) reported a significant association between job-related experience and executive compensation. Fisher and Govindarajan (1992) also reported that the compensation of business unit heads was positively associated with years of education. Several studies have also investigated the effects of CEO tenure from a human capital perspective, typically yielding insignificant results (Deckop 1988; O'Reilly, Main, and Crystal 1988; Rajagopalan and Prescott 1990).

With the increase in popularity of RBV theory, several more recent studies have revisited the human capital question. In this vein, Harris and Helfat (1997) studied the linkage between CEO compensation and three types of skills: firm specific, industry specific, and generic.¹⁰ Three key factors related to skill specificity affect compensation: risk and return to human capital, market power, and adverse selection. For outside CEO candidates, the lack of firm-specific human capital suggests that they must be compensated for the previous employer-specific human capital they give up to make the move. Outside successors also bear greater risk and therefore may demand an additional risk premium for taking the job. Firm performance also plays a role—when poor, both inside and outside successors may demand premiums up front. They predicted that external CEO successors will receive greater initial noncontingent pay than internal successors, and external successors who have only generic skills will receive greater initial noncontingent pay than those with industry-specific skills. They identified 305 successors from the *Forbes* compensation survey (1978–1987) including some 35 outsiders. Their evidence showed external successors received a 30 percent premium in salary and bonus. Further, within-industry successors received salaries and bonuses of 23 percent more than insiders, and outside-industry successors received 36 percent more. These results are in line with a series of earlier studies that reported similar findings (Gilson and Vetsuypens 1992; Joskow, Rose, and Shepard 1993; Hambrick and Finkelstein 1995).

Carpenter, Sanders, and Gregersen (2001) studied the human capital implications of international experience for CEOs. They described (via the resource-based and dynamic capabilities views) how intangible and socially complex resources like human capital are most likely to yield benefits when bundled with complementary resources. For this reason, their theory implies that some characteristics of multinational corporations (MNCs) will have implications for the CEO international experience–firm performance relationship, and they considered whether or not CEOs were able use their compensation arrangements to capture some of the additional rents that are presumably generated for their firms. Their sample included any *Fortune* 500 firms that were MNCs, defined as operating in at least three foreign countries (n = 245). There was no support for the main effect of international experience, but the interaction between CEO international experience and the breadth of the firm's global strategic posture was strongly significant. Firms with broad global strategic posture tended to pay CEOs with international experience more.

Combs and Skill (2003) contrasted managerial and human capital approaches to pay premiums, noting that managerialism implies that entrenchment leads to high pay while human capital theory argues that unique skills lead to high pay. In contrast to traditional work on managerialism, these authors point out that firm size does not necessarily imply managerial entrenchment; rather, managerial pay relative to contextual expectations (pay premiums) is a much better indicator. Therefore, managerialism predicts that shareholders will respond positively to the sudden death of a key entrenched executive. In contrast, human capital theory implies that pay premiums result from unique skills and knowledge (Fisher and Govindarajan 1992), so shareholder response to the sudden death of a pay-premium executive should be negative.

A contingency perspective brings these two theoretical streams together. As an

executive's power increases, shareholders are more likely to view pay premiums as excessive, and hence, will see the sudden death of an executive as potentially value-creating. As governance strength increases, pay premiums connote returns to human capital, and so investor reaction to key executive sudden death will be more negative. Using abnormal returns, the authors' sample of seventy-seven sudden executive deaths (CEOs, presidents, board chairs) between 1978 and 1994 weakly supported the power moderation prediction, but strongly supported the governance moderation prediction. Despite some measurement oddities (power was measured as board tenure and founder status, perhaps not the first two indicators one might consider; the same can be said for the two governance indicators—percentage of outsiders and presence of a nominating committee), this is an interesting work for two reasons. First, it points out that studies of human capital need to be very careful about accurately interpreting the indicators of managerial experience (e.g., skills vs. entrenchment), and second, it incorporates governance and power as central constructs. The organizational context in which executives behave, and especially the power dynamics they face, are absolutely critical components of any theory of executive compensation.

In all, the work on human capital has not yet produced a robust set of results. While it may be that certain human capital is advantageous in reaching the top echelons of a firm (Leonard 1990) or in being selected as an outsider to run a company, theory has been a little less clear on how this translates more directly into higher pay. In some ways, this is surprising, because at an intuitive level it is perfectly evident that some executives are paid more than others in part due to differences in skill sets. The problem may be the occasional disconnect between the primary research idea being investigated and the relative lack of sophistication in effectively testing that idea. If executive experiences are valuable, boards should be willing to reward executives for such experience. That makes sense, and the finding of Carpenter, Sanders, and Gregersen (2001) noted above is one example. The challenge is to identify what is "valuable."

We addressed this topic in [chapter 4](#), where we made the point that executive experiences must fit a particular context to have value, and that is where the real research opportunity may be for studies of human capital and compensation. In fact, most of the contingency propositions we suggested in that chapter can be refitted into compensation propositions. For example, [Proposition 4-19](#) suggests the following new propositions on compensation:

Proposition 10-2: Output function experience among executives in firms pursuing Prospector strategies is more strongly related to executive compensation than output function experience among executives in firms pursuing Defender strategies.

Proposition 10-3: Throughput function experience among executives in firms pursuing Defender strategies is more strongly related to executive compensation than throughput function experience among executives in firms pursuing Prospector strategies.

There is another way to think about context and executive compensation. Firms that pay their executives effectively will be more likely to retain those executives, and may even perform better. This is a different version of the same fit story. So, when a particular type of human capital is valued (because it helps address environmental contingencies, or a firm's strategy), those firms that pay more for it will likely attract and retain executives with the best portfolio of that human capital. Here are two representative propositions:

Proposition 10-4: The greater the compensation for executives with throughput

function experience in firms pursuing Defender strategies, the less likely they will exit the firm.

Proposition 10–5: The greater the compensation for executives with throughput function experience in firms pursuing Defender strategies, the greater the firm performance.

Finally, the mix of pay may also be an important consideration in studies of human capital. For example, to the extent that some executive experiences are associated with risk acceptance (Gupta and Govindarajan 1984), human capital factors may be related to the use of contingent and long-term compensation. These experiences may affect managerial preferences for different types of compensation (contingent versus fixed, short-term versus long-term), since some managers are more comfortable with risk than others. Hence, if a top manager has some control over the setting of his or her pay (as most CEOs do), executive compensation can be tailored to managerial risk preferences, thus representing one way in which human capital (i.e., experiences with risk) may be related to executive compensation.

Marginal Product and the Managerial Labor Market

Beyond human capital, while it seems likely that an executive's compensation depends in part on his or her marginal product (Finkelstein and Hambrick 1988; Frank 1984) and the workings of the managerial labor market (Fama 1980; Jensen and Murphy 1990b), no empirical work has attempted to directly measure an executive's marginal product or model the managerial labor market. On the other hand, several factors that have been found to determine executive compensation—managerial job complexity, degree of regulation, firm size, and firm performance, for example—may be indirect proxies for manager's marginal product. For example, complex managerial jobs tend to offer managers more choices, which increase their discretion (Finkelstein and Peteraf 2007) and, hence, their potential contribution to a firm. In this vein, evidence that (1) CEOs in regulated firms earn substantially less than CEOs in unregulated firms, and (2) the association between pay and performance is weaker in regulated than in unregulated firms (Joskow, Rose, and Shepard 1993) is consistent with the notion that managerial discretion is lower in regulated firms (Hambrick and Finkelstein 1987; Rajagopalan and Finkelstein 1992). To the extent that these findings are a reflection of the marginal products of CEOs, we offer the following proposition:

Proposition 10–6: The greater the marginal product of a CEO, the greater his or her compensation.

Unfortunately, the effects of the managerial labor market are somewhat more intractable to gauge because the market's boundaries are so diffuse. At any point in time, it is unclear how many "eligible" candidates exist for available positions. Perhaps for this reason, consideration of managerial labor markets in empirical work on executive compensation has been limited (Fama 1980). We cite only two studies here. In the first, Harris (1986) examined executive reputations in the managerial labor market and found that reputation moderated the relationship between performance and compensation during an executive's external succession. Specifically, the relationship between pay and performance was stronger for new outsider CEOs with greater standing in the managerial labor market.

The second study by Ezzamel and Watson (1998) studied how market comparisons affect executive compensation. If one believes in an information-efficient labor market, there is no reason to expect that there will be a strong pay-performance link because compensation

committees must pay the going rate. Because non-executive directors and compensation committee members tend to be similar to CEOs and are often subject to social influence from CEOs, they will tend to be quicker to respond to situations in which their CEO is underpaid relative to the market than to situations in which their CEO is overpaid. Therefore, the sensitivity of cash pay should be greater for underpayment anomalies than for overpayment anomalies.¹¹ Further, pay consultants also tend to increase the upward bias because they focus on the upper half of the pay distribution. The authors predicted that pay change would be driven by a desire to reduce anomalies and that pay anomalies would explain the observed “bidding up” of executive pay between 1992 and 1995.

For their sample of U.K. firms, adding pay anomalies to the models greatly increased the explained variance. The addition of a quadratic term was especially important, suggesting that large anomalies were particularly influential. However, while the evidence clearly showed that responses to overpayment and underpayment anomalies have an important influence on CEO compensation, the overall prediction that responses to underpayment would be larger than responses to overpayment was not supported.

In sum, as is evident from our review and commentary, research on the determinants of executive compensation from a generally economics-based perspective is abundant. Certainly, work of this type accounts for the vast majority of research conducted over the years on executive pay. Despite all this, however, it is apparent that there remain opportunities for researchers to dig deeper in several domains. In particular, we would encourage additional work on the conditions that give rise to tighter, or weaker, pay-performance relationships, as well as on human capital explanations for pay. In the following sections we go beyond the traditional economic orientation of work on executive pay to explore how social and political theories have informed, and can continue to inform, research in this area. We turn to this topic next.

Social Explanations for Executive Compensation

While labor economists view the managerial labor market as a fundamental attribute of the economics of an industry, it is interesting to point out that labor markets are socially constructed in the sense that supply and demand gain meaning in the context of a *group* of firms and CEOs. The Ezzamel and Watson (1998) study is as much a study of pay equity as it is an analysis of the CEO labor market. So, while much work has been done on the economic determinants of executive compensation and the effects of social factors have received less attention, the potential contributions from such an approach are sizable.

One need go no further than to explore how executive compensation is actually determined to see why a social explanation for pay is so vital. First let us consider the often pervasive influence of compensation consultants (Baker, Jensen, and Murphy 1988; Crystal 1991; Bebchuk and Fried 2003). Compensation consultants are employed by most firms to assist in the setting of executive pay (Bizjak, Lemmon, and Naveen 2007 reported that some 65 percent of firms in their sample used compensation consultants). In fact, Wade, Porac, and Pollock (1997) pointed out that CEOs often cite the use of compensation consultants when justifying their own compensation. These authors also developed a theory of social comparison in which consultants tend to focus on comparability, leading to more homogenization of CEO pay than would exist if CEOs were compensated according to their own marginal products (Finkelstein and Hambrick 1988).

Canyon, Peck, and Sadler (2006) conducted one of the most rigorous studies to date of the association between the use of compensation consultants and CEO pay. They tested several

assertions. First, if compensation consultants are indeed responsible for the observed increases in CEO compensation, then CEOs whose firms use compensation consultants should be paid more than CEOs whose firms do not. Additionally, CEOs who use compensation consultants should be paid more when the consultants provide other services to the firm, as that would lead to additional power (influence) for the CEO. Finally, drawing on social comparison theory, they argued that when a CEO uses a compensation consultant, his or her compensation should be similar to that of CEOs in other firms that use the same consultant. Their evidence provided support for all three of these predictions among publicly traded U.K. firms, although a CEO's reliance on compensation consultants was only weakly associated with that CEO's pay level.

Beyond the actions of consultants, several additional factors promote a social explanation. First, the publication annually in corporate proxy statements of information on executive compensation in publicly held firms removes secrecy and facilitates comparisons; indeed, research on pay secrecy suggests that open information about pay typically promotes social comparison pressures (Leventhal, Michaels, and Sanford 1972; Pfeffer and Davis-Blake 1990). Second, extensive reporting on compensation by the national business media further facilitates pay comparisons both across and within firms (Lawler and Jenkins 1992). Third, the wide availability of data on executive pay enhances its value as a scorecard of professional status and attainment, and thus may motivate top managers to keep track of their relative standing (Crystal 1991; Lawler 1966; Patton 1961).

An interesting research question that arises from all this is whether greater disclosure and other changes that make it easier for CEOs to compare their pay actually lead to higher pay. We believe they do, and a study specifically designed to test this hypothesis would be relevant from a research and public policy perspective as well. As disclosure laws in other countries become more liberal (in line with trends in the United States), there is a real opportunity for scholars to take advantage of these "natural experiments."

Proposition 10–7: New laws, regulations, or customs designed to expand disclosure of executive compensation to stakeholders in a country increases, rather than decreases, the magnitude of executive pay in that country.

In sum, the notion of comparability leads naturally to an emphasis on social processes and the setting of pay in accordance with "social norms." In the remainder of this section, we develop ideas that may provide fruitful directions for research on the role of social factors in the setting of managerial pay, along three related themes: institutionally driven isomorphic pressures, social comparison processes, and social capital.

Isomorphism of Executive Compensation

Isomorphic pressures to conform to "pay norms" are evident in many studies of executive compensation. If we consider an industry as a working definition of an organizational field (Fligstein 1990), the results of several studies documenting strong industry effects on pay gain added meaning (Deckop 1988; Eaton and Rosen 1983; Ely 1991; O'Reilly, Main, and Crystal 1988; Rajagopalan and Prescott 1990). For example, Rajagopalan and Prescott (1990) highlighted how the determinants of compensation varied systematically across industries, and Hambrick and Finkelstein (1995) found that changes in industry pay patterns were significantly associated with changes in CEO pay. However, most of the studies listed above did not rely on isomorphism as an explanation for industry differences in compensation; indeed, while most research has modeled industry as a control variable and has used dummy variables or single industry samples (Finkelstein and Hambrick 1989), other studies have

considered industry as a reflection of structural economic characteristics (O'Reilly, Main, and Crystal 1988; Rajagopalan and Prescott 1990).

Thus, the idea that executive compensation differs by industry because of isomorphic pressures for conformity has yet to be fully tested. Unfortunately, such a hypothesis may not be amenable to empirical investigation because this explanation only predicts that differences across industries will exist and does not offer guidance on why CEO pay in one industry may be greater than CEO pay in another. In addition, there are explanations other than social ones for why compensation would vary across industries (for example, in addition to structural economic characteristics, managerial discretion—which varies by industry—also affects compensation). In this vein, Finkelstein and Boyd (1998) found that discretion from the task environment was positively associated with overall pay. And Rajagopalan and Finkelstein (1992) relied on a similar logic in their study of executive compensation in the electric utility industry (reviewed in more detail in [chapter 2](#)).

Rather, the effect of “industry norms” may be observed most directly in terms of the variability of CEO compensation within an industry. Industries with particularly strong isomorphic pressures toward conformity will have more homogeneous pay patterns than those that are less constrained in this way. In addition, managerial discretion increases the potential marginal product of a CEO and creates greater outcome uncertainty in an industry (Rajagopalan and Finkelstein 1992), accentuating differences in CEO compensation across firms. These ideas give rise to the following propositions:

Proposition 10–8: The greater the level of managerial discretion in an industry, the greater the variation in CEO compensation within that industry.

Proposition 10–9: The greater the isomorphic pressures in an industry, the lesser the variation in CEO compensation within that industry.

Although work on isomorphic pressures on executive pay is not highly advanced, it is a promising area of inquiry, with data often readily available from proxy statements. Over the past ten years or so, there have been a handful of studies on how various institutionalization processes play out in the context of executive compensation. For example, Rajagopalan and Datta (1996) examined the role of mimetic and normative isomorphism on the adoption of contingent executive compensation plans. The main hypothesis in this study suggested that the adoption of performance-contingent compensation plans would be a function of the proportion of firms in an industry that have previously adopted that plan (mimetic isomorphism). To understand the driving forces for imitative behavior, the effects on adoption rates of CEO pay patterns in other firms with which board members were affiliated were also examined. Preliminary results indicated that firms were more likely to adopt particular pay plans when board members already had knowledge and experience with those plans, suggesting that normative isomorphic pressures arising from judgments about “appropriate” compensation plans may govern executive pay. Hence, it seems reasonable to expect that isomorphic pressures toward imitation operate in executive compensation in a manner similar to their operation for other administrative innovations (Burns and Wholey 1993; Teece 1980), and that further exploration of such effects may be fruitful. Work by Conlon and Parks (1990), discussed earlier, is also important to this debate. Their evidence, from a lab setting, implied that tradition (i.e., what has been done between the principal and the agent in the past) has a very strong effect on compensation arrangements. The following propositions summarize this line of argument:

Proposition 10–10: The greater the proportion of other firms within an industry that

have already adopted performance-contingent compensation plans, the greater the likelihood of subsequent adoption by a focal firm.

Proposition 10–11: The greater the affiliation of board members with other firms that have already adopted performance-contingent compensation plans, the greater the likelihood of subsequent adoption by a focal firm.

The setting of executive compensation, like other administrative processes, takes place in a social context, where legitimacy matters. Just as Meyer and colleagues (Meyer and Rowan 1977; Meyer, Scott, and Strang 1987) established some time ago that some environmental mandates are adopted largely to secure institutional legitimacy, and are not actively engaged, so too should we expect the same pattern in the compensation arena.

One of the ways in which concerns for legitimacy play out is in the adoption of incentive compensation structures. In a study of the explanations provided in proxy statements for long-term incentive pay (LTIP) packages, Zajac and Westphal (1995) described a tension between economic efficiency and political reality that recognizes the role of symbolism in the adoption of compensation plans. The authors suggest that explanations for LTIP adoption will reflect (1) the dominant beliefs about social legitimacy, and (2) the beliefs of corporate leaders (either boards or CEOs, depending upon which is more powerful). They examine alternative explanations for adoption that rely on agency (the plan is adopted in order to provide effective motivation of executives) or human resource (the plan is adopted in order to attract, develop, and retain high quality managers) rationales. The authors analyzed every LTIP adoption of Forbes 500 companies between 1976 and 1990. The evidence suggested that powerful CEOs relied more on human resource explanations, while powerful boards relied more on agency explanations. Further, the later the adoption (and the more diffuse the existence of LTIP plans) the more firms used agency explanations to legitimate them.

In a related study, Westphal and Zajac (1994) examined whether the plan adopted was ever actually implemented (funded by the firm). They argued that powerful CEOs, who are not interested in the risks associated with an LTIP plan, may adopt them for purely symbolic purposes. The authors reported that a large number of firms did exactly that—adopt but not fund an LTIP plan. Symbolic adopters tended to be firms with powerful CEOs and those exhibiting poor performance.

Staw and Epstein (2000) studied the adoption of popular management techniques (PMTs) and their implications for (among other things) CEO compensation. Like Zajac and Westphal, these authors build on the notion that innovations can be adopted for social as well as economic reasons. Additionally, Abrahamson (1996) described the emergence and adoption of PMTs as fashion cycles. That is, at any given time, older practices tend to be viewed as deficient and newer practices tend to be viewed as better. Institutionalization theory predicts that adoption of PMTs will be motivated more by a need for legitimacy than a desire for efficiency. The authors strive to measure the implications of PMT adoption on organizational legitimacy (as well as performance). Studying the 100 largest *Fortune* firms in 1995, they gauged PMT usage through news articles on the sample firms. Their evidence showed that adoption of PMTs had no impact whatsoever on firm performance (regardless of the effectiveness of implementation).¹² Further, CEOs of firms that adopt PMTs tend to be paid more, regardless of whether or not the adoption was linked to firm performance. Finally, the authors show that when press reports highlight PMT adoption, CEOs tend to be paid more, again regardless of the firm's performance or the effectiveness of the actual implementation of the PMTs. They add that the effects show up in short-term compensation, and their analyses clearly link the compensation effects to the adoption of PMTs, not to reputation increases or effective implementation.

Finally, Sanders and Tuschke (2007) studied the adoption of stock option plans in Germany, a country with an institutional climate that is generally hostile to executive wealth accumulation. Drawing on institutionalization theory, these authors argue and find that German firms tied into U.S. business milieu—specifically those firms with American Depositary Receipts—were more likely to be early adopters of stock option plans in that country. Other significant results were related to the role of experience, board interlocks, and regulatory barriers. Overall, this is an interesting study for its focus on institutional forces affecting executive compensation—in this case, the adoption of stock option plans.

In all, these studies point out how social legitimacy considerations influence the adoption of administrative innovations, like compensation plans. Rather than being a straightforward economic calculation, compensation in general and performance-contingent incentive plans in particular are subject to complex forces that are still relatively unexplored.

Social Comparison Processes in the Setting of Executive Pay

Our discussion of isomorphism is closely related to ideas on how social comparison processes can affect executive compensation. According to Festinger, individuals have a need to evaluate their own opinions, attributes, and abilities, and select for comparison others who are seen as similar in some way (Goodman 1974). This is the argument invoked by O'Reilly, Main, and Crystal (1988), in a study we discussed in [chapter 8](#). Specifically, these authors argued that social comparison processes lead compensation committee members to rely on their own experiences and those of similar others (CEOs). In their study of 105 large firms in 1984, they found that compensation committee members' pay in their own firms was highly related to compensation levels for sample CEOs. Nevertheless, while this result is supportive of a social comparison explanation, it may also reflect that “the largest corporations are headed by the most able, and ... offer the most prestigious and highest-paying directorships” (Lazear 1991, 94).¹³

The importance of social comparison processes to the setting of executive compensation is beginning to permeate work in economics, as evidenced by research incorporating ideas from psychology and sociology in an attempt to refine traditional notions of efficient wages. For example, several writers have discussed the possibility that social comparisons do take place among employees and that this process of comparison can affect productivity (e.g., Akerlof and Yellen 1985; Lazear 1989, 1991) as well as interfirm rivalry (e.g., Aggarwal and Samwick 1999a, 1999b).

The two studies by Aggarwal and Samwick (1999a; 1999b) are particularly interesting for their direct connection of relative performance evaluation (RPE; i.e., when a CEO's pay is specifically tied to the performance of competitor firms, as well as that of his or her own firm) to interfirm rivalry. In the first study, Aggarwal and Samwick (1999b) emphasize a key prediction of agency theory, relatively untested, that pay-performance sensitivities will decrease with the variance in firm performance (to better protect managers from the risk of firm operations). Further, studies that do not account for the effects of performance variation are biased toward finding no pay-performance association. The logic behind RPE arises from the notion that pay should be based not only on firm performance, but on any measure that provides unique information about managerial actions (Holmstrom 1979, 1982b; Holmstrom and Milgrom 1987). Demonstrating some average level of own-firm and rival-firm pay-performance sensitivity is not a clear test of the RPE prediction because it does not take into consideration performance variation (risk). However, like several others (e.g., Garen 1994; Lambert and Larcker 1987; Janakiraman, Lambert, and Larcker 1992), they find little support for the RPE model, whether risk is controlled for or not. They suggest that the nonsupport might be explained by the notion that RPE can sharpen rivalry among firms that are similar

enough to warrant RPE.

This prediction is tested in Aggarwal and Samwick (1999b), which starts with the assertion that when an industry suffers random shocks, and those shocks are correlated across firms (in that industry), then RPE (i.e., relative to others in the industry) will (according to agency theory) be a good way to structure executive compensation. This arises from the fact that when shocks are correlated across firms, multiple executives confront similar situations (shocks), so these executives provide important information on the performance of any one of them who is under scrutiny. However, this theory ignores any strategic interactions among firms. RPE positively weights the firm's performance and negatively weights the performance of competitors, which provides incentives for the executive to lower industry returns.

Aggarwal and Samwick's evidence supported this notion, in that they showed that the use of RPE is significantly lower in more competitive industries, and they attributed this outcome to the need to soften product-market competition in industries with intense rivalry. The authors model competition in terms of strategic complements and strategic substitutes. When products are complements, RPE lowers returns because it leads to aggressive price-cutting. In settings like this, the level of compensation increases with own- and rival-firm performance. In more competitive industries, there are weaker incentives to maximize own-firm performance and more incentives to maximize the value of all firms in the industry. In settings where competitors are strategic complements, the ratio of own-firm pay-performance sensitivity to rival-firm pay-performance sensitivity is a decreasing function of the level of competition in the industry. In contrast, in settings where competitors offer strategic substitutes, the level of compensation should increase with own-firm performance and decrease with rival-firm performance. Pay should also be sensitive to competition, especially in high-rivalry industries. Their study of *Fortune* 1500 firms in 1992 provided strong support for these ideas.

While this perspective is compelling because (according to this theory) social comparisons are prevalent, several questions arise in testing these notions. First, because social comparisons are made by all top managers, as well as the board, disentangling the relevant comparisons can be confusing. The CEO evaluates his or her own pay, as does the board, and this theory provides little guidance on which actor to emphasize. (As we discuss later, a political model does just this, suggesting the value of a multidisciplinary approach.)

Second, executives may consider the trade-off between, say, level of pay and prestige of position in evaluating their compensation. This point suggests that compensation may be only one type of reward a manager receives, and evaluation of its worth may vary dramatically across individuals. Along these lines, Finkelstein and Hambrick argued that financial compensation is only one of a variety of incentives available to CEOs and that "prestige, challenge, and power might rival or even greatly surpass pay in their importance to executives" (1988, 543). The value that executives attach to alternative rewards is likely to depend on a wide set of factors, including personal wealth and career experiences, firm size and profitability, and even industry conditions. For example, we might hypothesize that the opportunity to ascend to the CEO position, or the challenge of leading a cutting-edge, high-profile company, may be more important than immediate financial rewards. Hence, financial and nonfinancial incentives may be substitutes for each other. As long as the entire package of inducements is sufficient to ensure appropriate contributions, executives will remain on the job (March and Simon 1958). It could even be argued that the tournament model (discussed in detail later in this chapter), which postulates that top managers will accept lower pay in exchange for the opportunity to be promoted to the next hierarchical level, is a manifestation of this phenomenon. Hence, we offer the following:

Proposition 10–12: Financial incentives are negatively associated with nonfinancial incentives.

Third, it is not clear what reference groups are used when individuals make comparisons. For example, do CEOs compare their compensation to other CEOs, CEOs in firms of similar size, CEOs in the same industry, or some other reference group? The potential comparisons that board members make may be more complex, because they also include comparisons to their own firms, to other firms on whose boards they sit, and perhaps even to the experiences of other directors at other firms with whom they interact. Nevertheless, when these complex interactions are examined together, the process of social comparison begins to resemble the engine that may drive isomorphic pressures toward compensation conformity. In spite of some of these conceptual difficulties, further work is needed to understand how social comparison processes affect compensation patterns in organizations.

Social Capital

Belliveau, O Reilly, and Wade (1996) investigated social capital and its effect on CEO compensation. Their approach compared CEOs to other CEOs as well as to their compensation-committee chairs. These committee chairs are seen as particularly important because the compensation-setting process involves relatively few people in deliberations and decision making, elevating their role.

They propose five hypotheses: (1) social similarity between CEO and compensation committee chair will lead to higher pay; (2) CEO social status will be associated with higher pay; (3) compensation committee chair status will be negatively associated with CEO pay; (4) CEOs of higher status than their compensation committee chairs will receive higher pay; and (5) CEOs of higher status than other CEOs and with compensation-committee chairs of lower status than other compensation-committee chairs will be paid more. Their sample included some sixty-one CEOs and compensation committee chairs. Social capital was measured relative to all other CEOs in the sample. The first two hypotheses were not supported, but all the others were. Perhaps their strongest conclusion was that social capital is more important than social similarity.

The study makes several important contributions. First, it is one of very few studies of social capital and income attainment. Second, the authors were able to show that social capital was of more value than human capital in setting CEO compensation. Third, the study is one of the first to consider comparative social capital (i.e., social capital relative to nearby others). Finally, the study provided evidence that relative social capital is more important than absolute social capital—suggesting that social capital works through a direct social-influence process.

There are five other studies that followed a somewhat similar logic. The first is an article by Westphal and Zajac (1995) discussed in [chapter 9](#) that is also relevant here. These authors found that the similarity of the CEO to the board along several human capital dimensions was positively associated with CEO pay and negatively related to contingent compensation. This is much the same hypothesis that was not supported in Belliveau et al. (1996).

The second article examined executive compensation in German firms (Fiss 2006). The interesting insight in this study is the author's comparison of relative versus absolute differences in managerial characteristics, a dichotomy that gets to the heart of a tough challenge in research on social capital—how to differentiate findings from a straight power hypothesis. In this case, Fiss (2006) found that in firms where CEOs were more educated and longer tenured than board chairs, average TMT compensation was higher.¹⁴ This higher status—a form of power—accounted for results. Interestingly, there was no effect for the

absolute measures of similarity (i.e., measures that pay no attention to directionality), which arguably tap into social similarity more than they do power.

Two articles in this set looked at the effects of CEO certification (in *Financial World's* annual “CEO of the Year” award) on CEO and top management team compensation. Wade, Porac, Pollock, and Graffin (2006) reported a positive association between CEO certification and CEO pay, an indicator of the importance of prestige and status in the setting of pay. Interestingly, being anointed as a “star” cuts both ways—when subsequent performance increased, CEO pay increased, but when subsequent performance actually declined, so did the CEO’s compensation. While any significant degree of coupling between pay and performance is noteworthy, the authors do point out that the inflection point was only at the 11th percentile of performance, meaning that the bar for “performance improvements” was set quite low.

The other study of CEO certifications, by these same authors, found a degree of “status leakage” whereby a CEO’s star status also translated into greater pay for other top managers (Graffin et al. 2007). And once again, high expectations accompanied firms led by star CEOs, such that high subsequent firm performance accentuated the positive benefits of status leakage, while low subsequent firm performance was negatively related to average top executive pay. Note, however, that this latter result was only partially supported in the analysis, and in any event, star CEO pay was four times more sensitive to subsequent performance than was the pay of other top managers.¹⁵

Finally, Geletkanycz, Boyd, and Finkelstein (2001) studied how CEO external directorate networks impact compensation. In their view, social capital is less a source of power than a source of valuable inputs to the firm, and they argued that when a CEO’s external directorships are valuable to their firms, that value should be reflected in compensation. Hence, this is another version of the fit hypothesis that we discussed earlier in this chapter.

While most research considers managerial resources to be important, the view of such resources has usually been limited to experience, knowledge, skills, and judgment. Director networks (social capital) are also likely to be important because they reduce uncertainty, provide access to information and opportunities, and bring legitimacy and status to the organization. As a result, a CEO’s network will likely be more beneficial to some firms than to others. Geletkanycz, Boyd, and Finkelstein (2001) suggest it is the degree of firm diversification that is the determining factor in affecting the value of such networks. Diversified firms have greater information-processing requirements and a greater need for diverse resources. Directorship linkages aid both of these needs. Building on that logic, the authors predict that diversification will strengthen the association between CEO external directorate networks and compensation. Using a sample of 460 *Fortune* 1000 firms and measuring seven dimensions of directorate networks (see also Freeman 1979), they concluded that CEO pay was weakly associated with CEO directorate networks. However, the moderating effects of diversification were very strong, suggesting that as diversification increases, the value of CEO external directorate networks is enhanced. Generalizing from this result, we might expect that as the value of a CEO’s social capital (e.g., directorate networks) increases, so too does the CEO’s compensation. Determining value is the key research challenge, and while Geletkanycz, Boyd, and Finkelstein (2001) studied diversification, it may well be that other contextual conditions are also important. We offer the following suggestive propositions in this regard:

Proposition 10–13: Social capital will be positively associated with executive compensation to the extent that environmental or strategic contextual conditions require such social capital.

Proposition 10–13A: Social capital directed toward governmental and institutional actors will be associated with executive compensation in more highly regulated firms than in other firms.

Proposition 10–13B: Social capital directed toward supply-chain and distribution-chain actors will be associated with executive compensation in firms with more alliances and in firms with less structural autonomy than in other firms.

Political Explanations for Executive Compensation

Power, an important factor in explaining behavior in top management teams, plays a central role in the strategic decision-making process (Bourgeois and Eisenhardt 1988; Finkelstein 1992). Hence, it would not be surprising to find that managerial power is a critical determinant of pay. Indeed, some have even argued that executive compensation is an indicator of power (Finkelstein 1992; Halebian and Finkelstein 1993; Hambrick and D’Aveni 1992). While several studies have used power-based explanations for compensation, virtually none has attempted to develop and test a complete model of the effects of power on compensation.¹⁶

At the heart of a political model of executive compensation is the realization that the board of directors—acting as monitors of managerial behavior—and top managers are fundamentally in conflict (Jensen and Meckling 1976). Boards have a fiduciary responsibility to maximize shareholder value, while top managers are more concerned with maximizing their own utility.¹⁷ As a result, the setting of executive compensation brings together boards and managers with different interests that are often resolved through political means.¹⁸ For example, the studies by Westphal and Zajac (1994) and Zajac and Westphal (1995) on LTIP adoption found that CEO power was significantly associated with LTIP use. That is, firms with powerful CEOs were more likely to put in place long-term incentive plans, ostensibly to mollify shareholder pressures for performance-based pay, but were less likely to actually implement (i.e., fund) these plans because they raised CEOs’ compensation risk.¹⁹ These authors argued that while compensation plans may be set up for symbolic reasons, the real test of how closely compensation is tied to performance is whether these plans are operative. Hence, these findings suggest that the compensation-setting process is highly political.

We note two other recent articles here. In the first, Pollock, Fischer and Wade (2002) studied how CEO power affects the repricing of executive stock options. The framework these authors put forth involves CEO power, outside owner power, and company visibility. Repricing usually occurs after a sharp decline in share prices (typically blamed on the industry) leaves options underwater. Repricing after such a stock decline often elicits protests from investors and tends to be justified with agency theory arguments about realigning managerial interests with those of shareholders. Several studies have investigated these justifications, but none have supported them as explanations for repricing (e.g., Brenner, Sundaram, and Yermack 2000; Chance, Kumar, and Todd 2000; Carter and Lynch 2001). Pollock et al. (2002) predicted that the relationship between option spread (the difference between the strike price and the current stock price) and the likelihood of repricing is stronger when the CEO is powerful, outside owners are weak, and the firm is less visible. Evidence from their sample of 136 software companies in the latter six months of 1998 provided some support for this prediction. We should also note that in contrast to most other studies on boards and compensation, Pollock and colleagues (Pollock, Fischer, and Wade 2002) relied, in part, on Finkelstein’s (1992) model of power to measure the construct, a topic we will

return to later in this section.

The second article is different, but intriguing. Responding to a rule requiring peer group comparisons in justifying CEO compensation (implemented by the Securities and Exchange Commission in 1993), Porac, Wade, and Pollock (1999) examined how 280 firms reacted to the rule change in terms of the peers they selected and reported on in their proxy statements. The authors concluded, in part, that while the rule was designed to make the compensation-setting process more transparent, its actual effect was to provide opportunities for firms to politicize it.

The consequence of conceptualizing the compensation-setting process through a political lens is that the key predictor of executive pay becomes the relative power of a manager (typically the CEO in empirical work) versus the board. An implicit assumption here is that managerial power will be associated with greater levels of compensation. However, consistent with our earlier description of compensation setting in managerially controlled firms, power allows individual managerial preferences for type and mix, as well as amount, of compensation to affect pay determination. While some research has incorporated managerial preferences (Finkelstein and Hambrick 1988; Hambrick and Snow 1989; Mahoney 1964; Westphal and Zajac 1994; Zajac 1992), none has attempted to directly model how preferences affect compensation. Thus, a model that considers the interaction of power and preferences in the determination of pay is needed.

Proposition 10–14: CEO preferences for pay determine the amount, mix, and type of CEO compensation.

Proposition 10–15: The more powerful the CEO, the stronger the relationship between CEO preferences for pay and the amount, mix, and type of CEO compensation.

Consideration of the role of preferences raises another question: Could CEO power and compensation be self-reinforcing, such that powerful CEOs are paid more, which allows them to gain additional power through equity ownership in the firm? In this way, compensation systems may help promote the institutionalization of CEO power in a firm, the consequences of which may be far-reaching with respect to corporate governance. If this is the case, it suggests a dual causal structure between power and compensation that has not been investigated. Doing so will require time series data to help disentangle causal direction.

Despite the intuition on the importance of power and politics in the setting of executive compensation, our review of research in [chapter 9](#) on this topic indicated that results were not always as strong as would be expected. A big part of the reason is that most work of this type relies on board structural indicators to measure power; as we discussed in [chapter 9](#), these indicators are fraught with difficulties. Here are just a few examples of how power has been operationalized in studies of executive compensation: CEO tenure (Finkelstein and Hambrick 1989; Hill and Phan 1991; Wade, O'Reilly, and Chandratat 1990; Westphal and Zajac 1994; Barkema and Pennings 1998), relative CEO tenure (Singh and Harianto 1989a; Wade, O'Reilly, and Chandratat 1990), CEO duality (Boyd, Dess, and Rasheed 1993; Main, O'Reilly, and Wade 1994; Westphal and Zajac 1994), CEO board directorships (Wade, O'Reilly, and Chandratat 1990), outsider director representation (Lambert, Larcker, and Weigelt 1993; Main, O'Reilly, and Wade 1994), CEO influence in appointing outside directors or compensation-committee chairs (Lambert, Larcker, and Weigelt 1993; Main, O'Reilly, and Wade 1994; Wade, O'Reilly, and Chandratat 1990), CEO shareholdings (Allen 1981; Finkelstein and Hambrick 1989; Lambert, Larcker, and Weigelt 1993; Barkema and Pennings 1998), CEO family shareholdings (Allen 1981; Finkelstein and Hambrick 1989),

outsider shareholdings (Finkelstein and Hambrick 1989; Gomez-Mejia, Tosi, and Hinkin 1987; Hambrick and Finkelstein 1995; Lambert, Larcker, and Weigelt 1993; McEachern 1975), and with survey measures (Tosi and Gomez-Mejia 1989).

A review of this work reveals that, while different measures of power have been used, the link between measurement and construct has yet to be fully developed. While a plausible case can be made for all of the measures used, there are really no theoretically based reasons that one measure should be preferred to another. In some cases, one can even raise questions as to whether the measures employed are really appropriate. For example, tenure can be taken as a measure of power or, as we discussed earlier, of human capital. While CEO shareholdings may signify power, some researchers have taken shareholdings to indicate alignment with owners' interests (Jensen and Murphy 1990a).

A broader conceptualization of power is needed in the context of executive compensation. Power is a multidimensional, complex construct (Finkelstein 1992; March 1966; Pfeffer 1981a), a consequence of which is the potential instability of results across studies that use different measures of power without grounding in a clear theory of board-CEO power. Such a model would need to (1) develop a conceptualization of board-CEO power grounded in theory, (2) use this grounding to identify appropriate dimensions of the construct, and (3) create a measurement methodology that adequately captures the multiple dimensions of board-CEO power. Although Finkelstein's (1992) model may be used as part of this process, it was based on the relative power of the CEO versus the rest of the top team (and not versus the board). This problem is analogous to our discussion of board vigilance in [chapter 9](#). As we argued in that chapter, the distribution of power between CEOs and boards is at the heart of agency theory and, hence, of central importance in understanding the compensation-setting process. In sum, research on boards of directors, and on executive compensation, calls out for a new approach to measuring power, and despite all the work done on these topics in the past fifteen years, this remains a central challenge for research in these areas.²⁰

Compensation for Business Unit General Managers: Determinants and Consequences

To this point, we have focused on the determinants of corporate top executive compensation. As we noted at the beginning of this chapter, however, there is a related stream of compensation research on business unit general managers (GMs), to which we now turn our attention. A review of this work suggests that this research stream has not been an abundant one. Much of it has focused on the implications of corporate strategy on divisional GM pay (Berg 1973; Hoskisson and Hitt 1994; Lorsch and Allen 1973; Merchant 1989; Salter 1973), with some conceptual and empirical support for the idea that reward systems for GMs in highly diversified firms, with few strategic interdependencies, tend to emphasize performance-based pay, objective criteria, and relatively higher incentive pay than reward systems for GMs in less diversified firms (Kerr 1985; Napier and Smith 1987; Pitts 1974). The underlying logic is that compensation systems must fit the strategic context to ensure appropriate managerial motivation and performance (Hambrick and Snow 1989).

Herein, we focus on the unanswered or unresolved issues relating to business unit GM pay. Multiple theoretical perspectives, for the most part, have not been employed to study business unit GM pay, and most of the work has focused solely on the determinants of GM pay. Thus, we address three basic questions about business unit GM pay: (1) What is different about business unit GM pay? (2) What are the determinants of GM compensation? (3) What are the consequences of GM compensation?

GM Compensation versus CEO Compensation

The administration of business unit GM compensation differs from CEO compensation in several ways. First, divisional GMs are generally subject to greater constraint than CEOs by virtue of being in middle management and thus having less direct influence in the setting of their pay. Nevertheless, it is incorrect to disregard the role of power in business unit GM pay because the level of compensation earned by general managers may be influenced by top managers' perceptions of GMs' upward mobility. A second difference between business unit GM pay and CEO pay is that the latter's pay is formally set by the board of directors, while general manager pay is based on internal evaluations. Future work may build on this observation by modeling agency relationships within firms, with the CEO acting as principal and the business unit general manager as agent (see, for example, Galbraith and Merrill 1991). Third, pay may be less of a motivator for CEOs than for business unit GMs because CEOs generally have greater wealth and may be motivated by other factors, such as power and prestige (Fisher and Govindarajan 1992). Thus, business unit GMs may be more responsive to financial incentives than are CEOs. Finally, for researchers, the measurement of managerial performance is even more difficult for business unit GMs than it is for CEOs. Although there is controversy over appropriate measurement (Antle and Smith 1986), CEO performance can generally be measured by outside observers in several ways, including stockholder returns.²¹ In contrast, business unit performance is difficult to capture with publicly available measures, whether accounting or market-based (Fisher and Govindarajan 1992).

The Determinants of GM Compensation

Although the work cited earlier on the determinants of divisional reward systems has been informative, little research has been done on the determinants of the actual level of GM pay. In a study that relied on data collected by compensation consultants, however, Fisher and Govindarajan tested a model of business unit GM pay. Their model applied findings on CEO pay (Finkelstein and Hambrick 1988; O'Reilly, Main, and Crystal 1988) to the profit center manager and found that such variables as firm size, profit center size, firm performance, and the human capital of the GM were significant predictors. As these authors acknowledge, they were unable to test the association between business unit profitability and business unit GM pay because of measurement difficulties. Although this study is informative, it still raises the question: If the business unit GM job is different from the job of the CEO, should we not be able to develop a model of business unit GM compensation that does not depend on arguments originally ascribed to CEO pay? Indeed, Fisher and Govindarajan note that "the results from studies on CEO pay cannot be directly transferred" to the business unit level (1992, 205).

CEO pay may be an important driver of GM pay. As we discussed earlier, research by Graffin, Wade, Porac, and McNamee (2007) found that high-status CEOs shared their good fortune with subordinates. Further, as we note in the next chapter, patterns of CEO overpayment and underpayment tend to cascade down the hierarchy to other top managers (Wade, O'Reilly, and Pollock 2006). More broadly, some of the other work we will review in the next chapter on pay differentials may have implications for GM pay as well.

Different contexts and settings may also play into the setting of GM pay. For example, Hambrick and Cannella (1993) describe how acquired managers are treated in the post-acquisition firm, and the resulting implications for their retention. This argument could easily be extended to the compensation of acquired GMs. Further, some acquired executives are founders²² of their companies, and this would also seem to have important implications for

their pay.

Research on foreign subsidiary compensation is also relevant when one considers that the relationship between headquarters and a subsidiary is akin to that between the corporate office and a business unit. We look at one study in particular that may offer insights on GM compensation. Roth and O'Donnell (1996) argued that three factors are critical to potential agency costs in the headquarters-subsidiary relationship: cultural distance, the role of the subsidiary, and the psychological attachment of headquarters to the subsidiary (see also Golden and Ma 2003; Yu and Cannella 2007). Cultural distance directly increases agency costs, and calls for incentives to correct the problem. By "role of the subsidiary" the authors contrast global strategies with transnational strategies. Under global rationalization, the headquarters dominates and in a transnational strategy (lateral centralization) the reverse holds. Therefore, with transnational strategies, decisions are not programmable and monitoring is difficult. Psychological attachment refers to the headquarters' commitment to subsidiaries. The authors take these ideas and examine four components of foreign subsidiary compensation strategy: (1) headquarters senior management pay mix; (2) market positioning; (3) subsidiary pay mix (for the entire subsidiary, not just the leaders); and (4) adjustment criteria (performance criteria).

Roth and O'Donnell (1996) predicted that cultural distance and lateral centralization would be positively associated with incentives, while parent commitment would be negatively associated with incentives (because with more parent commitment, more socialization is used to align incentives). With respect to pay levels, they predicted that cultural distance, lateral centralization, and psychological commitment would all increase subsidiary manager pay. Finally, with respect to pay mix, cultural distance and lateral centralization were expected to be positively associated with the proportion of incentives in subsidiary manager pay, while psychological commitment would be negatively associated with the proportion of incentives.

Noting that the motivation behind incentives is to reduce monitoring costs, the authors predicted that cultural distance and lateral centralization would both increase the degree to which regional and corporate performance are used as incentives, while psychological commitment would have the opposite effect. Finally, the authors predicted that incentive alignment would be positively associated with perceived subsidiary effectiveness.

Roth and O'Donnell (1996) gathered data from the scientific measuring instruments and surgical and medical instruments industries, surveying 100 subsidiaries of 73 parents. Their evidence suggested that (1) the percentage of senior management incentive compensation increased with lateral centralization and psychological commitment; (2) the level of compensation increased (relative to competitors) with lateral centralization (transnational strategies); (3) the percentage of incentive compensation increased with cultural distance; (4) more weight was given to regional and corporate performance criteria with lower psychological commitment; and (5) the perceived effectiveness of compensation strategy increased when subsidiary manager pay was designed to align incentives with those of headquarters. Future research might extend these findings into other domains of GM compensation.

The Consequences of GM Compensation

Many of the same questions that arose in our discussion of CEO compensation may also be relevant for business unit GMs. For example, do general managers compare their compensation with each other, and does this affect their motivation to stay in the organization? The answer is not obvious because business unit GM pay is seldom publicly

available, and organizations often have a norm of pay secrecy. Beyond this, much of the work on business unit GM compensation adopts a contingency framework that implies certain outcomes in response to strategy-reward system alignment or misalignment (Balkin and Gomez-Mejia 1990; Fisher and Govindarajan 1992; Galbraith and Kazanjian 1986; Govindarajan and Fisher 1990; Kerr 1985; Napier and Smith 1987). Nevertheless, no direct empirical tests have been made of such a hypothesis. We might expect however, that, all things being equal, the closer the alignment between corporate diversification and performance-based pay for business unit general managers, the greater the firm performance.²³ Additionally, whether the firm uses strategic or financial control systems (e.g., Hill, Hitt, and Hoskisson 1992) would seem to have important implications for GM pay, since financial controls might generate a closer link between GM pay and subsidiary performance, while with strategic controls pay would be much more complex and depend on subsidiary interrelationships and probably overall corporate performance.

Proposition 10–16: The more diversified the firm, the stronger the relationship between performance-contingent compensation and firm performance.

Hambrick and Snow (1989) also developed a set of prescriptions that differentiated between emerging and established general managers, arguing that each group has its own needs, desires, and values, and, hence, may respond to different reward systems. Emerging GMs are “in the 35–50 age range, often have less than ten years tenure with the firm, and, while part of the general management ranks, tend to preside over smaller, lower-level units than their more seasoned counterparts” (Hambrick and Snow 1989, 350). Established GMs are older, have longer company tenures, and “have largely achieved the positions of power and responsibility that their younger counterparts seek” (Hambrick and Snow 1989, 350). As [Table 10.4](#) illustrates, these differences extend to the type and amount of incentives, payment criteria, and incentive administration. For example, established GMs tend to prefer a combination of cash and deferred compensation, while emerging GMs favor cash compensation. The implication of this logic is that firm performance depends in part on the degree to which reward systems and GMs’ characteristics are aligned. Each of the cells in [Table 10.4](#) represents hypotheses on business unit GM pay that require empirical tests. Hence, firm performance should be greater to the extent that emerging and established general managers are rewarded through the pattern of incentives, criteria for receipt, and administration described for each in [Table 10.4](#).

Table 10.4. Incentive Systems for Different Managerial Contexts

	Incentive Types and Amounts	Criteria for Receipt	Incentive Administration
<i>Emerging General Managers</i>	Promotion and advancement of paramount importance Pay emphasis on cash, reliable base salary, high incentive leverage and hurdles	Emphasis on unit performance Emphasis on quantitative, "objective" indicators	Explicit and unambiguous incentives
<i>Established General Managers</i>	Perquisites and recognition of primary importance Blend of cash and deferred stock compensation, competitively average base salary, moderate incentive leverage and low hurdles	Balanced emphasis on unit and corporate performance Balanced emphasis on quantitative and qualitative measures	Somewhat implicit, flexible, and ambiguous incentives

Conclusion

Countless articles have attempted to test the relationship between pay and performance, with inconclusive results. Indeed, one of the most perplexing problems in agency theory is why the association between pay and performance is not more robust (Jensen and Murphy 1990b). Our review of social and political factors strongly suggests that a prime reason for the often weak reported association between pay and performance is that the "agent" in the principal-agent framework is not necessarily a fully "rational," risk-averse, self-interested optimizer, but rather an individual whose complex motivations and interests cannot be scripted. Coupled with breakdowns in the vigilance of the "principal" (as [chapter 9](#) documents), it is not hard to see why the pay and performance relationship is not simple and straightforward.

The implications of these arguments are fundamental: (1) pay and performance are not always related, and (2) the relationship between pay and performance is contingency-driven, depending on an assessment of such factors as principal (board of directors) effectiveness, agent (managerial) preferences for different types and amounts of compensation, existence of alternative monitoring devices, firm risk, and the nature of top managerial work and discretion in different contexts. A focus on social and political, as well as economic, factors is needed to not only develop more complete understanding of compensation, but also to begin to resolve such fundamental dilemmas as the pay-performance relationship.

In sum, while research on the determinants of executive compensation has a long history in several different academic disciplines, in the end what is most important is to develop appropriate conceptual logics that are explanatory and compelling. This means going beyond economic logic to encompass social and political ideas on pay that open new doors to understanding.

The study of the determinants of executive pay is only one-half of the story when it comes to reviewing this topic. Compensation has an impact on people, and on organizations. In addition, organizations are social organisms, and executives are surrounded by other executives in a firm. These simple insights give rise to a whole other arena of research on compensation—the consequences of pay, and the nature of TMT pay patterns. In the following chapter we turn our attention to these questions.

11

Executive Compensation Consequences and Distributions

In the previous chapter we examined research on the determinants of individual-level executive compensation using the framework in [Table 10.1](#) as a guide. In this chapter we turn our attention to the burgeoning research on the consequences of pay, and the explanation and meaning of pay distributions within top management teams (TMTs). These topics have captured the interest of scholars in recent years, especially as theorists have expanded their conceptualizations of agency theory to include a behavioral dimension, and empirical researchers have become more adept at integrating social and political perspectives with economic ones. The chapter is organized into two major sections, the first on the consequences of executive compensation and the second on the distribution of pay within top management teams.

Consequences of Executive Compensation

The topic of executive compensation is of compelling interest to many people, not only because we become fascinated with the huge sums of money that CEOs and other top managers earn, but also because the pay that an executive receives for performing his or her job may have many consequences for that manager, the top management team, the organization, and stakeholders in the organization. While research on the consequences of executive compensation is not as extensive, or as long-lived, as work on the determinants of executive pay, in some ways it is even more central to the concerns of organizational and strategy scholars. In fact, top executive pay may potentially impact firm performance, strategic decision making, strategy processes, and managerial motivation, turnover, and behavior. The following sections review existing research and suggest new avenues to explore, once again by organizing work into economic, social, and political considerations.

Economic Explanations for the Consequences of Executive Compensation

Agency theorists have for some time taken the lead in investigating the consequences of different compensation arrangements. This is not surprising, given that a primary focus of normative agency theory is to specify optimal incentive contracts that yield desired outcomes (e.g., minimize managerial shirking, induce strong effort and performance, avoid entrenchment) (Harris and Raviv 1979; Holmstrom 1987; Holmstrom and Milgrom 1990; Ross 1973). Indeed, a basic assumption of agency theory is that compensation contracts can be written to provide incentives for top managers to maximize firm performance, hence aligning managerial interests with shareholder interests (Alchian and Demsetz 1972; Fama and Jensen 1983; Raviv 1985; Barkema and Gomez-Mejia 1998).

Along these lines, empirical work has been directed toward demonstrating that long-term incentive compensation contracts¹ (most frequently observed in the form of bonuses or stock-option plans) promote greater risk acceptance and longer time horizons for CEOs, outcomes

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presumed to be consistent with shareholder interests because they help direct risk-averse CEOs toward attractive but risky business opportunities (Lambert 1986). In this vein, a study testing the impact of bonus schemes on discretionary expenditures in banks by Larcker (1984) found that managers of banks adopting bonuses tended to make fewer nonpecuniary expenditures (such as disbursements for offices, furniture, and employee salaries) than managers of banks without bonuses. Similarly, Lambert and Larcker (1985) found that the adoption of stock option plans tended to increase the variability of equity returns (taken as evidence of managers' greater propensity to undertake risky investments that may have longer time horizons but also the potential to increase shareholder wealth). More recently, Wright, Kroll, Krug, and Pettus (2007) took a somewhat different tack by testing the effects of salary and stock incentives (and stock options) on the standard deviation of accounting and market returns (measures of risk). While they found support for these hypotheses, using the volatility of returns as the dependent variable (as in Lambert and Larcker 1985 as well) is prone to considerably more measurement error than relying on actual strategic actions that entail risk.

This point brings us to Larcker (1983). In a widely cited study, he found that the adoption of long-term performance plans was associated with increases in capital expenditures (but only for an average of one year following adoption),² outcomes that were consistent with shareholder interests. Increases in capital expenditures tend to entail some risk, take longer to pay off than some other investments, and are seen as consistent with shareholder interests, according to agency theorists (Hoskisson and Hitt 1988). In three studies examining R&D expenditures, which are presumed to have a positive long-term effect on shareholder wealth (Baysinger and Hoskisson 1990), Rappaport (1978) reported a positive correlation with long-term contingent pay, while Waagelein (1983) and Hoskisson, Hitt, and Hill (1993) reported negative associations with short-term bonus plan adoption and division financial incentives, respectively. Finally, Schotter and Weigelt (1992), in a lab experiment using college students, found that bonus schemes induced longer decision-making horizons among subjects. However, with the exception of lab studies (which have obvious problems of external validity), alternative explanations for managerial behavior in these studies cannot be ruled out (Lambert and Larcker 1987).

One more point on incentive pay and risk. While the typical study in this area examines the effects of incentives on strategically directed managerial behavior (i.e., R&D expenditures), O'Connor, Priem, and Coombs (2006) looked at fraudulent financial reporting as their dependent variable. One way to look at this issue would be to say that this is an example of managers accepting too much risk. Interestingly, however, these authors did not argue that stock options promote risk acceptance (the classic agency-theory hypothesis discussed in this section). Rather, options were hypothesized to help align shareholder and managerial interests, leading to less fraudulent financial reporting. In their study of 130 firms in a matched pair design, they found support for this hypothesis.³ In addition, they also reported a complex set of interactions that suggest that stock options actually *increased* fraudulent reporting when (1) the CEO was also board chair and the board did not earn stock options itself, and (2) the CEO was not board chair but the board did have stock options. While various interpretations are possible for these unusual results, we would note just two things: the complementarity of different monitoring mechanisms remains an understudied phenomenon; and the idea that the effects of stock options depends on other monitoring mechanisms suggests that more complex models to those typically used in empirical research may be called for.

A stronger test of the effects of incentives would examine the proposition that "an incentive system that ameliorates the principal-agent problem creates greater incentives for

executives to maximize profits, and so increases profit” (Leonard 1990). Such a test has numerous problems, however, including ambiguity about casual direction between profits and compensation, as well as the possibility of manipulation by executives through aligning the payment of contingent compensation awards with expected periods of high performance.⁴ So, in one of the few studies to empirically examine the relationship of executive compensation to return on equity, Leonard (1990) reported an ambiguous U-shaped association, with executive pay highest for the most successful and unsuccessful firms in his sample.⁵ Leonard acknowledged that this result was inconsistent with assumptions that pay is an incentive device and speculated that compensation was high in firms with very poor performance because “failing firms may need to pay a compensating differential to attract and retain skilled managers” (Leonard 1990, 23-S). This result also highlights the difficulty in establishing any direct, nonmediated, nonmoderated connection between executives and performance, something we addressed in [chapter 4](#) as well. Incentives that work perfectly well might induce particular managerial behaviors, but the translation of those behaviors into performance depends on numerous intervening mechanisms.

Some have argued that the problem of casual direction may be resolved by using event studies (Lambert and Larcker 1987), but the evidence here is also mixed. While Tehranian and Waegelein (1985), in studying bonuses, and Larcker (1983) and Brickley, Bhagat, and Lease (1985), in studying long-term compensation, all reported positive abnormal returns following adoption of these compensation schemes, Gaver, Gaver, and Battistel (1992) found no such evidence in a sample of firms adopting performance plans. In trying to reconcile these findings, the Gaver et al. study (1992) notes three differences: (1) some of the earlier studies relied on small sample sizes (Larcker studied twenty-one firms and Tehranian and Waegelin examined forty-two); (2) there is a considerable uncertainty pinpointing the precise event date because information about compensation plans is available at various times (the Securities and Exchange Commission [SEC] stamp date, the board meeting date, and the proxy statement date); and (3) there appears to be a generalized “annual meeting effect” associated with positive abnormal returns independent of the content of the meeting (Brickley 1986).

A more recent study adopts a different viewpoint by factoring in the performance context in which incentives are provided, as well as the incentive effects themselves as mediators. Carpenter (2000) tested the assertion that CEO pay changes will be associated with changes in strategy. The author proposed that changes in pay should lead to changes in strategy (gauged as deviation from industry norms), but only when performance is poor. When performance is good, executives should display high degrees of strategic persistence. The study (involving 314 S&P 500 firms between 1991 and 1998) supported the prediction that increases in long-term pay and pay structure (the mix of fixed and incentive components) are positively associated with strategic change. Additionally, Carpenter (2000) reported that the positive relationship turned negative for the top performing 35 percent of firms in his sample, indicating that higher pay did not induce greater strategic change among high performers.

Several points are worth making in assessing this research stream. First, the association between incentive compensation plans and abnormal market returns are subject to two alternative explanations in addition to the caveats put forth by Gaver, Gaver, and Battistel (1992): (1) compensation plans may be adopted to minimize the joint tax liability of a firm and its managers (Hite and Long 1982), and (2) compensation plans may be adopted when top managers expect profitability to be favorable in the future (Jensen and Zimmerman 1985).⁶ This latter point may help explain why firms adopt performance plans even after a stock option plan is in place, because it is unclear how an additional, and similar, long-term compensation plan will be motivational at the margin (Gaver, Gaver, and Battistel 1992).

Second, long-term compensation systems are used by virtually all large firms today (Leonard 1990; Sloan 1991), but few observers are prepared to argue that the principal-agent problem has been ameliorated. Hence, while some evidence exists that incentive compensation is associated with “good” CEO behavior, it is not at all clear that compensation contracts can effectively align shareholder and managerial interests. Indeed, Holmstrom (1987) reminds us that true incentive alignment between managers and shareholders is not possible in the modern corporation. Put differently, there is no combination of governance structures that leaves executives with identical preferences to shareholders.

This is true at almost a philosophical level—which may be Holmstrom’s (1987) point—but it is also true at a very practical level. For example, evidence indicates that a large proportion of options that are exercised are immediately converted to cash and not retained as part of a manager’s equity holdings (Ofek and Yermack 2000; McGuire and Matta 2003). Not only does such action put an immediate end to the incentive effect, it also reveals something of the risk-averse managerial mindset. We should also further note that Westphal and Zajac (1994; 1998) found that at least some CEO incentive compensation systems are adopted for symbolic reasons rather than substantive ones.

Third, it is questionable whether compensation is really a motivator for top managers. We have already noted the complexity of a top manager’s motivations; it is simplistic to assume that executives will work harder or better if they are paid more (Barkema 1993; Finkelstein and Hambrick 1988). Thus, when agency theorists posit a direct association between incentive compensation and value-maximizing managerial behavior, they are basing it on a clear assumption about top managerial motivations (Fama and Jensen 1983; Holmstrom 1979). We believe that this assumption is generally false and argue that it leads to confusion regarding why incentives do not always yield anticipated results (or why firm performance explains little variance in pay levels) (Baker, Jensen, and Murphy 1988; Lawler 1971).

In one of the few studies that attempted to probe executive motivation, Donaldson and Lorsch interviewed top managers at twelve large companies. One of their major conclusions was that “contrary to conventional wisdom and most economic theory ... top managers are [not] motivated by financial incentives” (Donaldson and Lorsch 1983, 20). Rather, top managers are driven by a desire to excel, to do better than their peers in similar firms. The portrait these authors draw of executive motivation raises doubts about the implicit assumption made in agency theory about the incentive effects of compensation contracts and suggests that an alternative perspective based on social and political factors may be useful. This notion is also in line with an argument made by Chester Barnard about seventy years ago: “The real value of differences of money reward lies in the recognition or distinction assumed to be conferred thereby” (Barnard 1938).

Rather than a generalized incentive effect of executive compensation, it may be that certain circumstances boost the salience of incentive pay. Carpenter’s (2000) finding discussed above indicated that poor firm performance acted as just such a booster, accounting for the incentive pay–strategic change association he reported. Other moderating factors might be low CEO tenure (i.e., the CEO is more open to change), high managerial discretion (i.e., the CEO has the discretion to enact change), and high competitive intensity (i.e., the CEO is immersed in a dynamic context), to name a few. In each case, however, empirical analysis will have to establish that the interaction of a moderator with incentive pay explains variance in strategic changes beyond that explained by the main effects alone. Here are three illustrative propositions:

Proposition 11–1: The lower a CEO’s tenure in the job, the more positive the relationship between incentive compensation and strategic change.

Proposition 11–2: The relationship between incentive compensation and strategic change is more positive in high discretion contexts than in low discretion contexts.

Proposition 11–3: The greater a firm’s competitive intensity, the more positive the relationship between incentive compensation and strategic change.

Analogous to some of the work on fit that was reviewed in [chapter 4](#), there is a broader question of fit between compensation plans and firm strategy in all this—to the extent that compensation design is consistent with strategy (or perhaps other critical contingencies), firm performance will be higher. Very much along these lines, Gomez-Mejia (1992) argued that compensation strategy should match diversification strategy, and that when such a match exists, it should be associated with higher performance. He described two major patterns of compensation in firms. The algorithmic pattern implies heavy reliance on job evaluation procedures, seniority, minimal learning, internal equity, and hierarchical position. The experiential pattern is flexible and adaptive, where personal skills and attributes, performance (not tenure), risk sharing, and sensitivity to market forces are important. Some years ago, Berg (1969; 1973) concluded that experiential pay schemes were more prominent among conglomerates, and Lorsch and Allen (1973) found that algorithmic pay schemes were common in vertically integrated companies. Gomez-Mejia (1992) also predicted that single business firms will tend to rely on experiential compensation schemes, largely because they are more entrepreneurial. Algorithmic schemes facilitate direct control and monitoring, thus reducing transactions costs in related diversification settings. The more asset specificity that exists within business units, the more experiential pay becomes appropriate. His evidence supported the predictions that experiential pay schemes were positively associated with performance for single business firms (but not for conglomerates), and that algorithmic pay schemes were positively associated with performance for dominant product firms and related product firms.

Gomez-Mejia (1992) also studied the association between compensation strategy and the process of diversification (internal growth or acquisitive growth), providing evidence that algorithmic pay schemes were positively associated with performance in steady-state (internal growth) firms and experiential pay schemes were positively associated with performance in evolutionary (acquisitive growth) firms. Overall, the author concluded that firm performance is partially a function of the degree to which compensation strategy reinforces or matches with corporate strategy. We summarize and extend in a general sense this discussion with the following:⁷

Proposition 11–4: The greater the match between compensation strategy and firm strategy, the greater the firm performance.

Proposition 11–5: The greater the match between compensation strategy and a firm’s life cycle, the greater the firm performance.

Proposition 11–6: The greater the match between compensation strategy and a firm’s environmental contingencies, the greater the firm performance.

The fourth observation we would make is that executive compensation arrangements can elicit both intended and unintended consequences (from the point of view of the principal). These unintended consequences may include perception-shaping behaviors that March (1984) called the “management of accounts and reputations.” Rather than respond to incentives by adjusting strategic behavior (as agency theorists intended), CEOs may choose to manipulate measures of their performance. For example, Healey (1985) found that managers manipulated

accounting choices to increase the value of their bonuses. Similarly, CEOs may attempt to shape board perceptions of their behavior through such image-management techniques as courting the media to receive flattering treatment or working long hours to demonstrate their commitment to their jobs (Finkelstein and Hambrick 1988; Walsh and Seward 1990). The net effects of such activities in response to incentives may be far afield from, even opposite to, those envisioned by agency theorists.

Finally, most studies of compensation adopt inferential methods that do not directly examine the extent to which boards actually monitor the compensation-setting process. However, in one study that did ask the most senior compensation officer in a firm to assess the level of board monitoring of CEO compensation, the “higher monitoring of CEO pay processes [was] positively related to firm performance, but the effects of monitoring on firm performance [were] weaker at higher levels of monitoring” (Tosi and Gomez-Mejia 1994, 1009). This finding of diminishing returns to monitoring was consistent with notions that CEO abilities to affect performance are necessarily limited when performance is already high (Holmstrom 1979) and that high levels of monitoring may induce CEOs to be overly cautious in making strategic decisions (Baysinger and Hoskisson 1990). Although there are questions concerning the reliability of subjective assessments of monitoring, this work holds promise for its ability to enter the “black box” of monitoring processes.

In sum, a significant gap seems to exist between traditional economic predictions of the consequences of executive compensation and actual empirical results (see also Devers, Cannella, Reilly, and Yoder 2007). In addition, considerable problems arise in interpreting the results of this work. To a sizable extent, these problems are due to the overly simplistic assumptions about managerial motivations. The following sections focus on alternative theoretical conceptualizations, starting with consideration of the behavioral agency theory.

Behavioral Agency Theory

Wiseman and Gomez-Mejia (1998) provide a detailed discussion and development of a behavioral agency model of managerial risk-taking, especially as it pertains to executive compensation. The discussion in this section draws heavily on their contribution. As we elaborate below, the behavioral agency approach raises four key challenges to traditional agency-theory depictions of risk. First, relative to behavioral agency theory, the concept of risk is underdeveloped in traditional agency theory, which treats any behavior not labeled as “risk averse” as a special case or as uninteresting. At the same time, however, the behavioral literature is replete with studies of risk-taking behavior, grounded in observation of actual decision behavior, and the picture that arises is quite different from that provided by agency theory (see Kahneman and Tversky 1979; March and Shapira 1987). Second, agency theory assumes stable risk preferences, while behavioral approaches emphasize that perceptions of risk (and thus, risk-taking behavior) depend importantly on context. Third, despite a huge body of research in agency theory, the precise linkage between governance structure and agent risk choice remains unclear. Without consideration of context, a precise understanding is not possible. Finally, most agency-theory treatments of risk are linear and recursive, while behavioral decision theory describes a more complex association between performance and risk choice, including a role for such factors as current wealth and prior success with risky alternatives.

Behavioral agency theory predicts that risk-taking behavior changes with problem framing (in contrast to agency theory’s depiction of stable risk preferences). In behavioral decision theory, managers compare problems to some reference point, and perceive (i.e., “frame”) outcomes in terms of gains or losses relative to that reference point (Kahneman and Tversky 1979; March and Shapira 1987). While agency theory views risk aversion as the

motivating force behind decision making, behavioral approaches view loss aversion as the motivating force. And in fact, there is considerable evidence supporting the behavioral decision theory prediction that managers actually take on *more* risk to avoid a loss than to generate a gain (Gomez-Mejia et al. 2006). Further, while agency theory assumes that risk bearing increases risk aversion, behavioral agency sees risk bearing as partially mediating the influence of problem framing on risk taking (Sitkin and Pablo 1992; Sitkin and Weingart 1995). Put differently, to the extent that executive wealth is impacted by firm performance, executives are likely to perceive more risk to personal wealth under conditions of gain, but less risk under conditions of loss. This leads to the prediction that positively framed problems will increase perceived risk bearing, and risk bearing will exhibit a negative influence on risk taking.

Another important aspect of decision context is performance history. Agency theory assumes that past gains and losses are simply historical—that is, “sunk” and therefore irrelevant to current decisions (Lambert 1986). Prospect theory, because of its emphasis on reference points and framing, views past performance as central to current risk perceptions (Bromiley 1991; Thaler 1980). For example, Wiseman and Gomez-Mejia (1998) predict that rising firm performance will increase agent aspirations for future firm performance and therefore decrease the likelihood that executives will perceive a decision situation as a prospective gain.

In evaluating the implications of incentive alignment on risk-taking behavior, there are four issues to be considered: (1) allocation of compensation between base salary and incentive components; (2) design of incentive pay; (3) setting performance targets for awarding incentive pay; and (4) selection of performance measures (see also Gomez-Mejia 1994). While agency theory emphasizes the relative importance of incentives and risk bearing, the fact that failure to reach targets affects employment risk is also important (Holmstrom 1987). Behavioral agency theory asserts that executives perceive base and contingent compensation very differently. Contingent pay is more uncertain, so base pay is viewed by executives as an annuity or endowment (see Larraza-Kintana, Wiseman, Gomez-Mejia, and Welbourne 2007). Therefore, if a change in compensation is designed to change the reference point in decision making, it is much more likely to do so when it involves a change in base pay. Executives perceive risks to future base pay as significant threats, but losses to contingent pay are viewed as less severe. Behavioral agency, since it assumes executives are more loss averse than risk averse, concludes that agents are indifferent toward uncertainty but hold clear (and negative) preferences with respect to losses. Therefore, compensation risk affects behavior largely through perceived threats to base pay (Wiseman and Gomez-Mejia 1998). Further, the contrast between risk aversion and loss aversion may be fairly sharp, so simply adding more contingent pay may not increase risk bearing.

In support of these ideas, an empirical study of initial public offering (IPO) firms by Larraza-Kintana, Wiseman, Gomez-Mejia, and Welbourne (2007) found that the variability in what they called “essential” compensation was positively related to CEO risk taking, while the downside risk of this pay was negatively associated with CEO risk taking. In addition, employment risk was positive related to risk taking.

In discussing stock option design, Wiseman and Gomez-Mejia (1998) build on the concept of “instant endowment” (Thaler 1980), arguing that stock options may actually increase risk bearing and thus risk aversion (Larraza-Kintana et al. 2007 found support for this prediction). This would especially be the case for in-the-money stock options (see also Sanders and Hambrick 2006). If the downside risk of options is perceived to be zero, risk aversion may not result. Further, target attainability is a critical factor. Agency theory has nothing to say about attainability, while behavioral theory predicts that high targets will

increasing risk taking, and lower targets will reduce risk taking, because targets influence framing (Kahneman and Tversky 1979; March 1988; March and Shapira 1987).

Regarding performance measures, Wiseman and Gomez-Mejia (1998) contrast accounting-based measures versus market-based measures and discuss both the motivational differences and the informational differences between the two types. Agency theory emphasizes the informational properties of measures and implies that any “noise” increases agent risk bearing (Lambert and Larcker 1987). Some agency-based discussions also emphasize the motivational properties of accounting versus market-based measures (Jensen and Murphy 1990b; Rappaport 1986). As noted, however, behavioral theory replaces risk aversion with loss aversion. In the behavioral decision theory view, executives likely prefer accounting measures because they are easier to control, while principals prefer the opposite (on this point, agency theory and behavioral decision theory agree). However, using accounting measures also likely increases the perceived likelihood that targets will be reached, and thus leads to higher forecasted performance levels, reducing managerial risk perceptions. Therefore, both behavioral and traditional agency theory predict the same outcome, but for different reasons. In behavioral theory, the influence is indirect—through framing.

Finally, monitoring is another mechanism for promoting incentive alignment. Monitoring is basically *ex post* “settling up” (Fama 1980) and relies on behavioral criteria and direct supervision (Eisenhardt 1989a). Wiseman and Gomez-Mejia (1998) argue that the agency theory treatments of monitoring have confounded the mechanism of control (supervision) with the criteria of evaluation. Management theory suggests that direct supervision will include the setting and communication of performance standards (Griffin 2006) and that these standards will be linked to the preferences of the monitors (see also Tosi, Katz, and Gomez-Mejia 1997; Zajac and Westphal 1994). In behavioral agency theory, however, the vigilance of monitoring also is highly likely to influence the targets set (more vigilant monitors will set higher performance targets); this will influence managerial reference points and, through the reference points, managerial decision behavior.

Some approaches to monitoring involve behavioral evaluation criteria rather than outcome-based criteria (Makri, Lane, and Gomez-Mejia 2006). Wiseman and Gomez-Mejia (1998) argue that any ambiguity in criteria increases agent risk bearing and reduces risk taking. In addition, behavioral criteria may not be specifiable in advance, increasing the problem. Finally, monitoring is often a collective effort, and consensus must be reached among the monitors. This also enhances the risk of loss in the mind of the manager, especially when the group doing the evaluating changes in membership. All of these forces lead to more uncertainty in monitoring and lower actual risk taking by the executive.

Clearly, stock options form a very large part of the executive compensation picture and are an aspect of pay that is quite amenable to the application of behavioral decision theory. However, most research focused on stock options emphasizes the adoption of stock option plans (antecedents of compensation) and not the implications that stock options have for executives, decision making, and organizational outcomes (consequences of compensation). Further, the traditional treatment of stock options in the literature is to treat them as equivalent to equity ownership. However, behavioral agency theory provides a strong theoretical framework for predicting how the incentives provided by stock options differ from those from equity ownership. In perhaps the most in-depth treatment of the issue, Sanders (2001) argued that equity and options have different properties because option risks are asymmetric—that is, both equity and options benefit from rising stock prices, but only equity can lead to losses of real wealth. Therefore, while both stock and options provide incentives for risk-taking, behavioral agency theory leads to the prediction that the downside risk of

equity may make executives more risk averse. In making acquisitions, for example, executives with large equity positions should be more reluctant to proceed, as they have more to lose. In contrast, holders of stock options tend to benefit from increases in the variance of firm returns, rather than increases in firm returns per se.

This logic led Sanders (2001) to argue that there should be a negative association between equity ownership and acquisition activity, and a positive association between option holdings and acquisition activity.⁸ Regarding divestitures, equity ownership does not lead to a clear prediction, but stock options are likely to result in increased divestitures once again because executives have little to lose and much to gain (see also Tuschke and Sanders 2003).

Two moderating hypotheses were also considered in this study. First, CEO tenure—presumed to reflect individual-level risk aversion—was expected to attenuate the main effects. Second, firm performance was expected to have a similar effect. Specifically, because poor performance leads to negative framing of a decision—there is relatively less downside—positive opportunities are emphasized. Good performance, on the other hand, triggers the loss aversion reaction among executives. Therefore, Sanders (2001) argued that firm performance, like CEO tenure, will negatively moderate the predicted associations of equity and option ownership on acquisitions and divestitures.

Sanders (2001) sampled 250 Standard and Poor's (S&P) 500 firms between 1991 and 1995, and found significant support for hypotheses. The main effects for acquisitions (positive for options and negative for equity) were supported. Further, equity ownership was negatively related, and stock options positively related, to divestitures. Both moderating effects (for tenure and firm performance) were supported for options (risk seeking), but not for equity (risk avoiding). Overall, however, the study is an important one because of the empirical support it provides for the asymmetric risk properties of equity and options.

Building on the behavioral agency theory foundation laid by Wiseman and Gomez-Mejia (1998) and Sanders (2001), Sanders and Hambrick (2007) developed a robust model of the effects of stock options on managerial risk taking. While agency theory predicts that large returns require large risks to be taken, it is ambiguous about what is meant by “risk,” especially from the manager's standpoint. Accordingly, Sanders and Hambrick outlined three key elements of managerial risk-taking: (1) the size of the outlay; (2) the extremeness of the potential outcomes (the “odds”); and (3) the likelihood of a large loss (downside risk). They then developed theory to predict how stock options might be expected to affect strategic behavior and performance. Abundant stock option grants may induce significant risk seeking among executives, perhaps more risk than shareholders desire because executives are focused only on positive outcomes and hardly at all on losses.

Sanders and Hambrick predicted that stock options would increase the size of the bets and will also be associated with extremeness in firm performance. They argued that large bets coupled with long-odds bets will lead to even more extreme outcomes—more than can be explained by the magnitude of the long-term investments. They also posited that the interaction between CEO stock options and the magnitude of long-term investments will be positively related to performance extremeness.

In developing theory about how risk taking will affect company performance, Sanders and Hambrick noted that investor reaction to stock option plans seemed to suggest that investors perceived options to have favorable performance effects (e.g., Seward and Walsh 1996; Zajac and Westphal 1995). Managers may tend to overemphasize downside risk, but options reverse that inclination. Hence, the authors predicted that when stock options constitute a large part of CEO pay, large losses (in company performance) would be more prevalent than large gains.

Using a sample of S&P 500 Mid-Cap and Small-Cap firms in 1993, Sanders and

Hambrick's evidence supported the prediction that stock options tended to lead to larger magnitude of long-term investments. Additionally, they observed that the higher the proportion of options in CEO compensation, the more extreme the firm's subsequent performance. Results also indicated that the relationship between CEO stock options and total shareholder return was partially mediated (as predicted), but this association did not hold for return on assets. Therefore, stock options do bring about extreme performance, but largely through ways other than higher levels of investment. The interaction between CEO stock options and the magnitude of long-term investments was positively associated with performance extremeness, but again, only for shareholder return, not for ROA. The authors also reported that the combination of CEO stock options and high investment spending produced extreme performance outcomes.

Sanders and Hambrick concluded by noting the concern that payoff horizons differ among R&D, capital investment, and acquisitions. Acquisitions are much quicker in terms of payoff. For acquisitions, the long-odds nature of the investment outweighs the discrete size of the investment. The prescriptions of agency theory, taken to extremes, may not even be beneficial for shareholders. Moderation in stock option awards would seem to be the key. Both equity ownership and option holdings generated large investments; they differed in the performance extremes they yielded.

Two studies published around the same time as Sanders and Hambrick (2007) also reported results with a similar flavor. Zhang, Bartol, Smith, Pfarrer, and Khanin (2008) tested whether executives with out-of-the-money stock options were more inclined to engage in earnings manipulation than were executives with in-the-money stock options. In line with prospect theory, the latter executives, these authors argued, had more to lose by taking excessive risks. For the out-of-the-money executives facing long odds, the implicit incentives were reversed. Zhang and colleagues (2008) examined these ideas in a large database from Execucomp and found significant support. Interestingly, these authors also reported that stock ownership (as opposed to stock options) decreased the likelihood of earnings manipulation.

In the other study, Harris and Bromiley (2007) used a match-sample of 434 misrepresenting and 434 control firms to examine the effects of CEO compensation on accounting irregularities. In line with other work discussed in this section, they found that the proportion of CEO pay from stock options was positively associated with the likelihood of accounting misrepresentation in the firms they led. Also of note in this study is that the authors did not find bonuses to elicit the same nefarious motives, perhaps lending further credence to the view that stock options represent pay of a different kind.

Hence, Sanders and Hambrick (2007), Zhang et al. (2008), and Harris and Bromiley (2007) all provide evidence that stock options have powerful incentive effects on executives, but not always in a manner intended by the boards that created them. That their findings are reminiscent of the classic Kerr (1975) article "On The Folly of Rewarding A, While Hoping for B" is noteworthy, and indicative of the risks that researchers take in blindly accepting traditional agency-theory assumptions about managerial incentives.

Other research on stock options raises questions about the long-term role of option awards in executive equity holdings. For example, McGuire and Matta (2003) studied how the exercise of CEO stock options influenced firm ownership structure and subsequent performance. They noted that across firms in the United States, stock options account for about twice the equity actually held by officers. Building on the work of Sanders (2001), the authors noted that option exercise is not a routine decision, and may signal expectations about future firm performance. Additionally, the average firm has about 14 percent of its equity represented by options (Morgeson 1998). The available evidence suggests that when executives exercise options, most of the resulting equity is sold, so the implications of option

exercise on firm ownership structure tend to be minimal (e.g., Ofek and Yermack 2000). Using a sample of 580 firms with stock options outstanding, they provide evidence that option exercise tends to increase executive equity ownership (i.e., not all options exercised are sold immediately). However, equity ownership moderated the association between option exercise and equity ownership change (with lower levels of equity, more of the exercised options were retained rather than sold), and option exercise was marginally positively associated with subsequent performance. Finally, the influence of equity ownership on the option exercise–firm performance association was evident (as equity ownership increased, the marginally positive association between option exercise and subsequent performance was eroded). In sum, option exercise had little impact on equity ownership, and very little support was found for the notion that exercise signals poorer future performance. While reductions in CEO equity were linked to poorer future firm performance, option exercise was not, a finding congruent with Sanders (2001). The authors concluded that their study provided little support overall for the argument that stock options promote incentive alignment.

Carpenter and Remmers (2001) also studied stock option exercise and its relationship to subsequent performance, with the intent of determining if executives use private information to time stock option exercise. Prior to May 1991, shares from option exercise had to be held for six months before any sales could occur. In that time period, option exercise was significantly associated with positive abnormal stock performance, suggesting that executives did use inside information to time option exercise. However, since 1991, the authors reported no significant association between option exercise and subsequent firm performance, except for small firms where a small negative association was observed.

Devers and colleagues (2006) directly contrasted agency-theory predictions with behavioral decision theory predictions in the context of acquisition behavior and long-term incentive pay (LTIP). The authors used agency theory to develop the prediction that the performance implications (i.e., shareholder returns) associated with LTIP will be mediated through risk-taking behavior, gauged through acquisitions. Then, drawing on the behavioral decision theory idea that loss aversion is the key risk perceived by executives (Wiseman and Gomez-Mejia 1998), they developed the competing prediction that managerial perceptions of risk and return will be negatively associated in the minds of executives, not positively associated as predicted by agency theory. They specifically predicted that the indirect effect of team-level LTIP on firm performance (through acquisition behavior) would be negative, in contrast to the agency-theory prediction. Using a large sample of S&P 500 firms, they found strong support for the behavioral decision theory prediction that shareholder return would be negatively associated with LTIP at the TMT level. They concluded that LTIPs provide incentives for managers to take high risks, but also to take bad risks.

In sum, this new work on behavioral agency theory holds great potential to shed new light on traditional agency-theory views of executive compensation. Further, as researchers continue to incorporate behavioral ideas in empirical analysis of executive compensation, we would expect greater visibility into managerial risk orientation, motivation, and behavior, which in many ways are the most fundamental questions in this entire research stream.

Social Explanations for the Consequences of Executive Compensation

Reviewing work on behavioral agency theory is a natural segue into the role of social psychology in explaining the consequences of executive compensation. Indeed, one of the most studied areas in organizational behavior is the relationship between rewards and outcomes (Baron and Cook 1992). The outcomes most commonly investigated include performance, satisfaction, absenteeism, and turnover. While this literature is clearly too massive to review here and is based almost entirely on lower-level individuals in

organizations, we focus on the two outcomes that have the most relevance to strategic leadership, namely, performance and turnover, and only consider them as they pertain to top managers.

Central to this discussion is the issue of top managerial motivation. Research on equity theory in the organizational behavior literature may offer one promising avenue in this regard. According to equity theory (Adams 1963; 1965), “the presence of an inequitable state of affairs motivates behavior aimed at returning exchange participants to their formerly equitable conditions” (Greenberg 1982, 391). With respect to compensation, equity theory suggests that individuals compare their pay and productivity to referent others and adjust their behavior in response to this comparison. The adjustment of behaviors that equity theory suggests will come from over- or underpayment, however, such as working harder or working less hard (Greenberg 1982), seem not to be very applicable to top managers.⁹ As we noted earlier, managers have strong incentives to perform well in their jobs, and these incentives may not necessarily be monetarily based. For example, Donaldson and Lorsch note that the “desire to win or excel takes the form of an almost personal comparison with peers and friends who are the CEOs of other companies” (1983, 23). Hence, it is important to recognize that compensation may have its greatest motivational impact as a symbolic reward (Lawler 1966). Pay is a primary scorecard for managerial success; hence, top managers may not work harder in response to higher pay, but they probably will be highly dissatisfied with lower pay.

If equity theory allows only weak predictions about firm performance, perhaps it has more relevance for executive turnover. The association between compensation and turnover is predicated on the idea that underpaid executives will experience inequity and leave the organization. Of course, if the “underpaid” executive is an ineffective manager, he or she may not find the managerial labor market particularly welcoming. But in general, we would expect that executives who are paid less than their performance level would seem to warrant, as compared to their peers, would seek jobs elsewhere. Investigating this question raises thorny methodological issues, such as identifying the appropriate referent group, assessing labor market conditions, and considering countervailing nonpecuniary inducements (e.g., access to a company jet or a huge office with large staff) that may keep top managers on the job even though they are “underpaid.”¹⁰

Proposition 11–7: The greater the compensation of executives relative to peer groups, the lower their turnover.¹¹

It is also important to recognize the implications of expectancy theory for executive compensation. Expectancy theory suggests that motivation is a function of employee perceptions of (1) the clarity of the association between effort and performance, (2) the clarity of the association between performance and reward, and (3) the value of that reward (Lawler 1971). Because one of the implications of installing contingent compensation plans is the increased likelihood that a reward will follow performance, employee efforts should increase. The idea that pay and performance should be related is also central to agency theory.¹² From an expectancy theory point of view, however, it becomes clear why incentives may not yield the anticipated outcomes for top managers that they might for lower-level employees. First, the ambiguity of the top management task (March 1984; Mintzberg 1973) weakens managerial expectations that effort will result in performance. Executives have little control over numerous factors that might influence a company’s performance, such as industry conditions, the economy, regulatory actions, and even luck. Further, among executives, observed pay inevitably includes a mix of base and incentive components. This clouds the evaluative picture, making it somewhat more challenging to predict what the

comparison to referent others will yield. Hence, expectancy theory leads one to conclude that all top managerial incentives have a necessarily limited motivational impact because of the inherent uncertainty of executive leadership. Second, the marginal value of additional compensation for highly paid top managers may not be that great (Finkelstein and Hambrick 1988).¹³ For top managers already earning millions of dollars, the motivational value of an increment in pay is not likely to be large. This points to the importance of distinguishing between the motivational impact of incremental pay and the natural desire to be paid as much as possible. Because executive compensation has great symbolic value as a scorecard of managerial status and success, we would not expect an executive to refuse a raise—yet the additional compensation may not necessarily be motivational.

Political Explanations for the Consequences of Executive Compensation

Political explanations for the consequences of executive compensation focus on how compensation plans may provoke unintended behaviors from stakeholders (as well as managers) seeking to maximize their own self-interest. Fundamental to a political explanation for the consequences of executive compensation is the idea that CEO power and CEO compensation are closely related. We consider these ideas in this section.

As noted earlier, compensation, especially contingent compensation, is subject to manipulation by CEOs (March 1984). Rather than responding to a long-term bonus by, say, evaluating investment decisions over long-time horizons, CEOs may attempt to make accounting choices that are most favorable to them. Indeed, it could be argued that the use of incentive schemes triggers political activity in a firm. Other than a small number of studies (e.g., Healey 1985; Zajac and Westphal 1995; Westphal and Zajac 1994), however, little research has been conducted on managerial manipulation of incentive systems. In light of the stock option backdating scandal widely reported in 2006–2007, research of this type seems especially important.

The amount of compensation that top managers earn may also trigger political activity. In fact, behavioral agency theory would suggest that the more a top manager is paid, the more he or she will become risk averse because there is more to lose if the firm does poorly (Wiseman and Gomez-Mejia 1998). This idea is contrary to traditional agency theory expectations that large guaranteed compensation is required to ensure that CEOs will be willing to make risky but appropriate long-term investments (Eisenhardt 1989a). Top managers would be expected to engage in much “management of accounts and reputations” under these circumstances—a further example of how incentive compensation systems may have unintended consequences. Thus, we propose:

Proposition 11–8: The greater the level of executive compensation, the greater the degree of political behavior by executives (self-interested attempts to manipulate accounting systems or personal reputations).

Proposition 11–9: The adoption of performance-contingent compensation plans increases the degree of political behavior by executives (self-interested attempts to manipulate accounting systems or personal reputations).

Executive compensation may also provoke behaviors from a wide range of stakeholders. Beyond the stock market reactions and incentive effects for top managers already discussed, compensation may also affect boards of directors, employees, suppliers, customers, competitors, and regulatory agencies (Finkelstein and Hambrick 1988). For example, Beatty and Zajac (1994) report that firm-monitoring activities are more intense when top managers

receive less incentive compensation. In addition, because compensation awards or plans may convey information about an organization's health and intentions, stakeholders may monitor company proxies and announcements for information content. For example, there is considerable anecdotal evidence that the compensation sections of corporate proxies often obfuscate factual data (Crystal 1991; Porac, Wade, and Pollock 1999)—lending credence to the idea that various stakeholders attempt to interpret information on compensation in various ways.

The recent changes in SEC proxy reporting requirements that direct firms to identify a “peer group” for purposes of performance comparisons open an interesting window to incorporate impression management.¹⁴ While it is possible to imagine various decision rules used in the selection of a peer group (same industry, same firm size), Murphy (1994) reported that firms select peer groups that enhance their perceived relative performance. Thus, not only are stakeholders receptive to such information, firms may also actively manage compensation reporting to send “appropriate” signals to stakeholders. In evaluating this idea, Porac, Wade and Pollock (1999) studied the selection of peer firms and concluded, in part, that while new SEC rules were designed to make the compensation-setting process more transparent, the actual effect was to provide opportunities for firms to politicize it.

A very important setting for considering compensation as a signal is in initial public offerings (IPOs), where there is high uncertainty about the technical and market-related aspects of the firm. In this setting, compensation structure sends a strong signal about who is in control and what their motivation might be. For example, Certo, Daily, Cannella, and Dalton (2003) considered how stock options and equity ownership might send different signals about future risk taking. The authors argued that investors will view options more favorably when the executives also have equity stakes (with the accompanying downside risks). The authors predicted that not only would stock options be positively associated with firm valuation at IPO, but that they will interact with equity to have an even more positive effect on firm valuation. Their sample of 193 IPO firms between 1996 and 1997 provided weak support for the prediction that stock options increase firm valuation, but strong support for the argument that stock options interact with equity to increase firm valuation. In some respects, these results are not surprising, since stock options may increase the volatility of returns, an outcome that does not engender investor enthusiasm (Sanders and Hambrick, 2007).

Sometimes the signals that are broadcast by compensation plans have negative consequences for the firm. For example, large pay increases for CEOs may elicit objections from unions and lower-level employees, whose compensation is considerably less generous (Finkelstein and Hambrick 1988). Certainly the trend in recent years for more and more substantial exit packages for CEOs, payable whether or not exit was due to dismissal, has produced a firestorm of criticism (Dash 2007).

In addition, “high pay may signify potential organizational slack, which a supplier may interpret as an exploitable opportunity to raise prices without fear of significant opposition. Similarly, competitors may learn about the financial health of business units by studying year-end bonuses. Regulatory officials may also read into pay levels something of an industry's financial health” (Finkelstein and Hambrick 1988, 553). Hence, executive compensation is open to multiple interpretations by a variety of stakeholders, each of whom may potentially find political advantage in this knowledge.

Distribution of Compensation within Top Management Teams

Up to this point, we have generally limited our discussion to the compensation of CEOs. Considering pay at a “group” level of analysis, however, has important implications for theory. Implicit in this treatment is the recognition that individual managerial compensation is not assigned in a vacuum and that senior management reward systems affect the pay of individual executives within a firm. The notion that the compensation of a group of top managers is of interest is implicit in such questions as, Why do some managers make so much more than others within the same firm? While alternative classifications may be possible, a review of research on compensation within top management teams highlights two central, and related, issues that will be reviewed in this section: (1) What accounts for, and what are the consequences of, the magnitude of pay differentials between CEOs and other top executives in a company? (2) What are the determinants and consequences of pay dispersion among all the executives within a top team?

Pay Differentials between CEOs and Other Executives in the Firm

Perhaps the most developed theoretical perspective on pay differentials within top teams is the tournament model (Lazear and Rosen 1981; Rosen 1986). Based on work in economics, this perspective suggests that when monitoring is unreliable or costly, compensation systems based on rank rather than absolute individual performance are more efficient (Becker and Huselid 1992; Conyon, Peck, and Sadler 2001). For top managers, this translates into an expectation that marked differences in levels of pay characterize different hierarchical levels (i.e., executive vice president, president, CEO). An underlying assumption of this theory is that top managers are motivated to work hard and perform well because they wish to win each successive tournament (for promotion to the next hierarchical position) and the accompanying increase in compensation that is the prize. Because the tournament for the position of CEO is the final one in which a top manager will be involved in any one organization, a particularly large pay increment is provided as incentive for that job (Rosen 1986). The resulting compensation structure within top management teams is thus defined by higher pay for successive positions and a particularly large gap in pay from the CEO to the second-highest position.

Two questions arise in considering the tournament model. First, has the core logic for the model been supported in empirical work at the top management team level? And second, what are the implications of a tournament model for such organizational outcomes as firm performance and managerial turnover?

Several empirical studies have focused on the core logic of the tournament model in the context of top managers, but results have not been consistent. On the one hand, evidence supports the assertion that compensation differentials between hierarchical levels increase as one moves up the organization (Lambert, Larcker, and Weigelt 1993; Leonard 1990; Main, O’Reilly, and Wade 1993; Conyon, Peck, and Sadler 2001). For example Lambert, Larcker, and Weigelt found that “the difference in compensation level for the CEO relative to the next lower position in the organizational hierarchy [was] ‘extraordinarily’ large” (Lambert, Larcker, and Weigelt 1993, 453). Further, Main, O’Reilly, and Wade found the number of vice presidents (a measure of the number of contestants in the tournament and, hence, an indicator of the scale of the tournament) to be positively associated with CEO compensation (although they concluded that “promotion brings a raise, but not immediately on the order that would be expected if a ... tournament were operating”) (1993, 625). And Conyon and colleagues (2001) reported a similar result, at least for cash compensation (though not for incentive compensation).¹⁵

On the other hand, O’Reilly, Main, and Crystal (1988) reported that the number of vice presidents was negatively associated with CEO compensation, a result that is opposite to the

tournament expectation and one that implies that conditions designed to support a tournament actually reduce the gap between CEO pay and the average pay of vice presidents. This nonresult for the core tournament hypotheses was further substantiated in a study by Henderson and Fredrickson (2001) that reported a negative association between the number of vice presidents in a firm and the CEO pay gap.

These mixed results on the core logic of the tournament model may reflect that there are alternative explanations for pay differentials that have little to do with the existence of a “tournament.” To the extent that executive compensation carries symbolic meaning as a scorecard for managerial success (Lawler 1966), pay differentials among senior managers may actually signal the distribution of power within the top team. This may be especially true when these differentials are not based on hierarchical position, which as an “objective” sign of structure can be discounted as an indicator of real power. It may be possible to learn much about internal labor markets—promotions, fast tracks, deadwood—by studying pay patterns at the top. For example, relative compensation can be used as a predictor of subsequent promotion under the assumption that relatively higher-paid managers are being singled out as promising and induced to stay with the company. While such work may have its greatest predictive value for middle- to upper-level management, such signaling undoubtedly takes place at the top management team level.

Proposition 11–10: The relative power of top managers determines the magnitude of pay differentials among them.

Proposition 11–11: The greater the compensation of an executive relative to other top managers at the same hierarchical level within the same firm, the greater the probability of his or her promotion to a higher position.

Second, differences in compensation levels across hierarchical levels may be due to the need to demarcate a firm’s organizational structure (Simon 1957). The increasing magnitude of compensation differentials in the higher ranks may be a reflection of different levels of structural power. In this respect, the “extraordinary” gap between CEO pay and the next lower position may also be due to the relatively unconstrained power a CEO holds relative to other top managers, an idea very much in line with [Proposition 11-10](#) above. Relatedly, the magnitude of the differential between a CEO’s pay and the compensation of the next highest executive may be an indicator of CEO autocracy, reflecting “the gap between the CEO’s assessment of his own worth to the firm and his assessment of others’ worth” (Hambrick and D’Aveni 1992, 1452).

Third, there are at least two conflicting sociopolitical explanations for CEO pay differentials in organizations. Wide pay gaps may be characteristic of firms that need not cooperate much across levels (e.g., unrelated diversified firms with business unit general managers one level below the most senior top management; Michel and Hambrick 1992) because the incentive effects of tournament structures may promote excessive political activity, which disrupts the ability of top managers to work together. Hence, pay differentials may depend on the extent to which cooperation and interdependence characterize top managerial work. Alternatively, pay differentials based on rank are exactly what one would expect because of the relative status of formal positions in an organization (Berger, Cohen, and Zelditch 1972; Berger et al. 1983). According to status-value theory, the need for status consistency drives compensation differences across hierarchical levels (Cook and Hegtvedt 1983).

The Henderson and Fredrickson (2001) study noted earlier also sheds light on the first of these explanations. Comparing predictions in line with our arguments above on cooperation

and coordination with that from tournament theory, they found partial support for the tournament model. Specifically, these authors found that while relatedness had no effect on the CEO pay gap, the other indicators of the need for coordination they tested—number of businesses, R&D investment, capital investment, and firm size—were positively related to the CEO pay gap. The authors interpreted these results as generally supportive of tournament theory because monitoring challenges are greater in firms with complex coordination needs and strategies (Carpenter and Seo 2007; Finkelstein and Peteraf 2007), calling for larger pay gaps to help keep managers in line. (The counter hypothesis predicted a negative association between indicators of coordination needs and pay gaps.) These findings are interesting, though subsequent work may want to more precisely and uniquely match organizational characteristics to each of the two theoretical perspectives.¹⁶

Henderson and Fredrickson's study (2001) gives rise to some interesting follow-up investigations. What they point out is that in some organizations there is a simultaneous need for coordination and for monitoring, an important insight. To the extent that this is true, it suggests that subsequent work should measure need for monitoring independent of need for coordination to provide a cleaner test of the two theoretical perspectives. Further, there are alternative coordination and monitoring mechanisms available to organizations that go beyond CEO pay gaps. For example, coordination can be supported with low pay differentials, but also by promoting trust among executives, by building more homogeneous top management teams, or by supporting greater behavioral integration at the top. Large pay gaps may help motivate executives to do the right thing, but so could performance-contingent compensation and a vigilant board. Hence, there is an opportunity to design a study that separates out the coordination and monitoring explanations for CEO pay gaps to construct a much tighter test of tournament theory and sociopolitical theories.

Fourth, and more generally, the tournament model, like other economically based models of executive compensation, tends to overemphasize the need for externally driven incentive structures and to underestimate the degree to which most top managers are self-driven (Donaldson and Lorsch 1983; Finkelstein and Hambrick 1988). CEOs, in particular, are highly motivated because of the challenging nature of the job (Patton 1971; Roche 1975), the intrinsic value of the job (Barnard 1938; Patton 1961), a need for security (Patton 1961), a need to achieve (Kraus 1976; McClelland 1972), a need for power (Ungson and Steers 1984; Zaleznik and Kets de Vries 1975), and a desire to build a successful reputation in the managerial labor market (Fama 1980; Patton 1961).

A fifth reason that tournament results have not been robust is that one can imagine a reverse causal logic at work: firms (or industries) that retain a large gap in pay between the CEO and other top managers make it easier to retain a larger cadre of senior executives all focused on the same goal—replacing their boss. It is true that the size of the top management team is subject to many other influences, some of which we discussed in [chapter 5](#), but to the extent that large pay gaps become standard in a firm (or industry), they may play a role.

Finally, it is typically the CEO, and not the board, who hires the people who report directly to him or her (Lorsch and MacIver 1989). What incentive does the CEO have to set up a tournament in which the prize is his or her job? According to this logic, a wide pay gap between a CEO and a firm's vice presidents is less likely to represent the existence of a tournament than to reflect CEO power (Shen et al. 2003). Thus, much more work is needed to understand the implications of a tournament model for top managers. This work should focus not only on examining the original ideas of Rosen and colleagues (Lazear and Rosen 1981; Rosen 1986), but also on disentangling potentially confounding explanations for pay differentials based on political and social theories of organizations. While some qualitative evidence exists that promotion tournaments occur in organizations (Vancil 1987), when they

occur and their implications for compensation structures among top managers remain important, and unresolved, research questions.

Despite the existence of alternative theories and the mostly mixed empirical results reported to date on the core logic of tournament theory, there has been a small set of studies tackling the even more difficult question of how pay differentials affect managerial turnover and firm performance. We might expect that if top managers recognize a tournament is in operation, there almost certainly will be (1) some self-selection either into or out of organizations with such structures (this is the reverse causality issue discussed above), and (2) among those remaining, turnover is likely to occur in a step function, triggered by promotion decisions that define winners and losers at each stage. In other words, executives who are bypassed for promotion may be more likely to leave at each stage of the promotion ladder. This implies that, except when promotion decisions are made, top managerial turnover will be lower in firms that structure compensation on the basis of a tournament because executives may be less interested in leaving an organization while they are still in the running for a promotion.

Some of these ideas have been subject to empirical examination. For example, although their study was focused on university management departments and not business organizations, Cable and Murray (1999) found that the tournament model better described university hiring decisions than a sponsored mobility model (i.e., where promotion decisions are made on the basis of advocacy of certain candidates by established others). However, there remain several unanswered questions, the first of which is whether in fact tournament-like pay structures succeed in retaining managers longer than in other organizations:

Proposition 11–12: In firms whose compensation systems are structured as a tournament, executive turnover will be lower than in other firms.

We can go a step further by considering *when* it is that turnover might occur in such firms, using the step-function logic suggested above:

Proposition 11–13: In firms whose compensation systems are structured as a tournament, executive turnover will be more likely to occur around the time of promotion decisions and less likely in the absence of promotion decisions.

Proposition 11–14: In firms whose compensation systems are structured as a tournament, the promotion of other executives to higher hierarchical positions increases executive turnover.

Beyond top managerial turnover, because tournaments are designed to provide incentives, the theory suggests that companies with such systems should perform better than firms that do not have tournament structures. While there is some evidence in non-organizational settings (auto racing and golf) that individual performance may be affected by tournaments and that the magnitude of the spread between winners and losers is especially informative (Becker and Huselid 1992; Ehrenberg and Bognanno 1990), these ideas have hardly been studied for top managers in organizations.

One study that focused on pay differentials between top managers and lower-level employees is worth mentioning. Cowherd and Levine (1992) used equity theory (Adams 1965; Homans 1961) and distributive justice theory (Kulik and Ambrose 1992; Andrews and Henry 1963; Martin and Murray 1983) to evaluate the implications of interclass pay equity (pay dispersion across hierarchical levels) on product quality at the business unit level. The study showed that small pay differentials between lower-level employees and upper-echelon

managers are associated with higher product quality because they tend to increase lower-level employees' commitment to top-management goals, effort, and cooperation (though the authors did not measure these mediating effects). The authors compare the pay of hourly workers and lower-level managers to those of senior executives, noting that product quality is likely to be particularly sensitive to the perception of inequity among lower-level employees. Their results strongly and consistently supported the argument that pay inequity was associated with lower product quality.

There is one recent study, however, that is particularly instructive for its examination of the effects of CEO pay gaps. In line with our ideas on cooperation and coordination, Wright, Kroll, Lado, and Elenkov (2005) argued and found that salary gaps were motivational to managers in diversified firms, but not in more focused firms. Option gaps, however, were uniformly positively related to firm performance. One intriguing aspect to this study is the additional focus on intrarank pay gaps—differences in pay between senior managers at roughly the same level in the hierarchy. Intrarank pay gaps—whether in terms of salary, options, or both—were negatively related to firm performance, ostensibly because the signaling effect of “overpaying” one executive relative to his or her peers creates motivational problems for the bypassed executives. While intrarank pay gaps may say more about equity theory than tournament theory, one can imagine several interesting research questions worth exploring.¹⁷ For example, where do intrarank pay gaps arise in the first place? It may well be that the distributional properties of top managers may play a role:

Proposition 11–15: Top management team heterogeneity (in tenures and functional background) is positively related to intrarank pay gaps.

CEO and executive tenure patterns may also be important. Given the pay premiums that outsiders tend to receive (Harris and Helfat, 1997), we might expect greater pay disparities in firms with more outsiders.

Proposition 11–16: The greater the proportion of top management team members who enter the team as outsiders to the firm, the higher the intrarank pay gap.

Over time, as CEOs become more entrenched in their jobs, they tend to prefer stability over change (Hambrick and Fukutomi 1991), leading to a natural constriction of pay among senior executives who are expected to stay committed to the status quo.

Proposition 11–17: CEO tenure in the position is negatively related to intrarank pay gaps.

Managerial discretion creates opportunities for managers to have a significant impact on strategy and performance. As noted in previous chapters, boards tend to pay for discretion because they are aware of the potential effect of high-impact performers (Hambrick and Finkelstein, 1987), so overall pay is higher in high-discretion firms and industries (Rajagopalan and Finkelstein, 1992; Finkelstein and Boyd, 1998). However, still unexplored is whether discretion also contributes to managerial pay gaps because of the greater use of incentive pay—not all of which will pay off equally for each top manager.

Proposition 11–18: Managerial discretion is positively related to intrarank pay gaps.

Lastly, to the extent that Wright and colleagues (2005) are correct in their suggestion that intrarank pay gaps can be demotivational to managers who are aware that they have been bypassed by peers, we would also expect greater turnover within the team.

Proposition 11–19: Intrarank pay gaps are more strongly related to executive turnover than interranks pay gaps.

In our final set of comments on tournament theory, we note that while the tournament model has taken hold in research on executive pay differentials, there is a much longer and richer research stream on equity theory and inequality that can also inform this discussion. Part of our argument on the importance of cooperation is in line with this tradition. Rather than pay differentials providing incentives, as tournament theory holds (Rosen 1986), pay differentials within the top group may be disruptive and dysfunctional. In acknowledging this possibility, Lazear (1989), an original proponent of tournament theory (Gordon and Rosen 1981), suggests that pay compression may be preferred to pay inequality across ranks because unequal pay promotes disruptive political activity in organizations.

In this regard, there have been two recent studies on pay gaps that warrant attention. In a study that we discussed in [chapter 10](#) in the context of social capital–based explanations for executive compensation, Wade and colleagues (2006) also developed theory on how the certification of CEOs as stars affects the gap in pay between the CEO and other top managers. They argued and found that immediate status attainment by a CEO was positively related to pay differentials between that CEO and the rest of the top team. These authors found that star CEOs “share the wealth” with other top managers, but in concert with this result, a star CEO may spread the wealth while ensuring that he or she still gets an increasing piece of the pie. Wade and colleagues (2006) characterized this as a “winner take most” story, and that seems as good a summary as any of their results.

Another recent paper brings equity theory to a central place in the analysis of executive compensation. Wade, Porac, Pollock, and Graffin (2006) tested a series of hypotheses all based on the idea that the overpayment or underpayment of CEOs has consequences for the compensation of other managers (not just top managers) and the turnover of these other managers. They found that CEO overpayment and underpayment were generally related to the overpayment and underpayment of subordinates, and that underpayment relative to the CEO was at least marginally associated with managerial turnover in one-half of the reported regressions.

Overall, this study provided mixed support for equity theory predictions, perhaps in part because of methodological challenges. In fact, the great difficulty in research of this type is to accurately assess what represents “overpayment” or “underpayment”; Wade et al. (2006) relied on a residual model approach that attempts to remove the effects of other pay determinants that are likely viewed as appropriate or fair. The most important of these other pay determinants in the context of equity theory is almost certainly managerial performance, but in the absence of data at the individual level, researchers must fall back on firm performance measures. Clearly, this creates a significant bias, both because firm performance does not fully capture individual performance, even for CEOs,¹⁸ and because (at least in this study) firm performance was used to proxy for individual performance for all managers. This is a problem for all research of this type, and not an easy one to resolve, but perhaps it may represent a research opportunity looking forward. When individual-level managerial performance is not available, alternative indicators worth considering might be the manager’s human capital and hierarchical level (Wade et al. 2006 did collect data on these indicators), the speed at which a manager has been promoted up the organizational hierarchy (i.e., the ratio of a manager’s number of jobs in the firm to firm tenure), average pay raise over time, or number of outside boards. Supplementing these objective measures with survey or other qualitative data might be the best solution of all, despite the inherent costs and difficulties in doing so.

Pay Dispersion within Top Management Teams

While the tournament model focuses on pay differentials, considering social comparison processes at the top management team level gives rise to a focus on pay dispersion. While pay differentials and pay dispersion are both conceptually and empirically related, research on pay dispersion is broader in scope, in part because it need not be constrained by the dominance of the tournament perspective as an explanatory theory. In fact, pay dispersion, defined as the variance in pay within top management teams, is a critical element of executive compensation for two reasons. First, the distribution of compensation within a top team may have important substantive consequences for how the team functions as a group. Second, studying pay dispersion may be one of the best ways to assess the importance of social factors in the setting of executive compensation because social comparisons occur at a group level; hence, they can be easily overlooked by researchers who focus on the compensation of an individual, such as the CEO.

Two basic research questions must be considered: Why is there great variance in pay among top management team members in some firms but not in others? What are the organizational consequences of pay dispersion within top management teams? In line with our earlier comments on cooperation and coordination in tournament theory, a social-psychological perspective might suggest that in organizations where cooperation, coordination, and social integration among top management team members are critical to the success of the firm, pay dispersion will be reduced (Finkelstein 1995). This may be expected because some of the consequences of pay dispersion, such as political infighting (Lazear 1989), conflict (Frank 1984; Leventhal 1976), and low trust and information sharing (Whyte 1955), tend to be disruptive in organizations where coordination and integration are important. As Deutsch (1985) has argued, pay dispersion signifies that some group members are not as valuable to the group as others.

One of the challenges in attempting to test these ideas at the top team level is to specify the conditions under which the potentially negative consequences of pay dispersion will be most detrimental to the functioning of management. While research is generally limited on the nature of interaction within top management teams, more is known about diversification. The literature on differences in managerial work among firms with different diversification postures indicates that the degree of interdependence and social integration is greater in less-diversified firms (Galbraith and Kazanjian 1986; Vancil 1979). In contrast, in highly diversified firms, “corporate managers exist as discrete technical resources rather than as a coordinative entity” (Michel and Hambrick 1992, 17). Hence, our expectation would be that pay dispersion is more likely in highly diversified firms than in less diversified ones; accordingly, some evidence suggests that firms consider these issues in setting compensation. Top executives in broadly diversified firms tend to be compensated on the basis of their own unit’s performance, rather than the performance of the overall organization (Kerr and Slocum 1987; Pitts 1974). To the extent that the performance of a firm’s divisions varies, as seems likely, such policies will tend to increase pay dispersion in broadly diversified firms and decrease pay dispersion in more focused ones. In less diversified firms, pay is based more on overall firm performance to promote cooperation among the separate businesses to achieve synergy (Hoskisson and Hitt 1994).

Proposition 11–20: The more diversified the firm, the greater the pay dispersion within the top management team.

Proposition 11–21: The less diversified the firm, the stronger the negative association between pay dispersion and firm performance within the top management team.

The group level of analysis not only lends itself to a consideration of social determinants of compensation, it also leads quite naturally to a focus on power. Power is essentially a relative concept, meaningful only to the extent that the object or application of one's power is specified (Blau 1964; Emerson 1962). Hence, a basic proposition to consider is, analogous to [Proposition 11-10](#):

Proposition 11-22: The greater the dispersion of power among top management team members, the greater the pay dispersion within the team.

As straightforward as this proposition appears, little research has directly offered an empirical test. The importance of behavioral factors (social and political) in explaining executive pay is being increasingly recognized, quite often by scholars who have traditionally adopted an economic orientation in their work (Baker, Jensen, and Murphy 1988; Jensen and Murphy 1990a; Lazear 1989). What remains for researchers interested in executive compensation is to develop an integrated and balanced perspective on how economic, social, and political factors affect top managerial pay. To some extent, this has occurred at the individual level of analysis; scholars have a great opportunity to develop new directions in research on executive compensation that hold the potential for deeper understanding.

In contrast to research that attempts to account for pay dispersion, a relatively large body of literature on the social consequences of reward allocations in organizations focuses primarily on groups (Greenberg 1982; Homans 1961; Martin 1981). This work argues that the social consequences of various reward allocations depends on the distribution rules adopted (Cook and Hegtvedt 1983). Although several different distribution rules are possible (Eckhoff 1974), most work has focused on the consequences of pay distributions based on equity. Typically, research indicates that inequity leads to such negative consequences as higher turnover and lower performance (Cook and Hegtvedt 1983; Greenberg 1987). An alternative distribution rule, that of equality, has not been studied as often, even though it appears particularly relevant for top managers. Hence, the remainder of this section focuses on the consequences of equal and unequal pay allocations in top management teams.

There is often significant pressure to reduce pay differentials within groups (Leventhal 1976); individuals from unionized workers (Hirsch 1982) to automobile salespersons (Frank 1984) to university faculty (Pfeffer and Langton 1993) all tend to prefer relatively equal pay within their work groups. These preferences for equality are generally assumed to derive from a process of social comparison (Festinger 1954), with pay compression valued because of the group social integration and the stability that it promotes (Deutsch 1975; Leventhal 1976; Sampson 1975). In contrast, unequal pay can engender conflict, reduce commitment, and discourage group cooperation (Lawler and Jenkins 1992; Leventhal, Michaels, and Sanford 1972; Rhodes and Steers 1981).¹⁹ Considerable research indicates that rewards based on group performance tend to elicit more collaborative behavior than rewards based on individual performance (Harder 1992; Miller and Hamblin 1963; Mitchell and Silver 1990). To the extent that compensation based on group performance leads to more equal distribution of rewards than compensation based on individual performance, this research provides additional support for the notion that individuals prefer more equal pay within their work groups. The net effect of this research is to suggest that pay inequality is positively associated with turnover and negatively related to performance (Adams 1965; Pfeffer and Davis-Blake 1992).

How might this research at the group level translate to top management teams? Several characteristics of top management teams suggest that the negative consequences of pay inequality may be operative at this level as well. As already noted, research indicates that pay differences within groups become more compressed when successful completion of a group's

task requires interaction and cooperation (Cook and Hegtvedt 1983; Greenberg 1982). High levels of contact among group members increase the likelihood that social comparisons will occur (Deutsch 1975) and that such comparisons will create pressure toward pay compression (Deutsch 1985; Pfeffer and Langton 1988). Further, preferences for equal pay tend to be enhanced when a group is involved in a stable, long-term relationship because individuals are more likely to perceive themselves as a team that shares a “common fate” (Cook and Hegtvedt 1983; Deutsch 1985; Leventhal, Michaels, and Sanford 1972). In addition, the negative consequences of unequal pay tend to be more severe when the degree of group interaction is more intense (Frank 1984). Hence, to the extent that top management teams are characterized by interaction, cooperation, and stability, pay inequality may promote higher turnover and lower firm performance. Relatedly, because political activity reflects and promotes conflict (Pfeffer 1981a), top management teams that are less politicized may perform best when pay is relatively compressed.

In recent years, a number of studies have considered this question. One of the first is the study by Main, O’Reilly, and Wade (1993) discussed earlier. In addition to testing the tournament hypothesis (recall they found weak support in favor of the core logic hypothesis), these authors also found that pay dispersion was positively related to ROA, but not stock market returns. Further, they found no relationship between the interaction of pay inequality and a measure of top management team interdependence on either indicator of firm performance.

Bloom (1999), with a sample of major league baseball teams, found that compressed pay structures (not pay dispersion) were associated with higher performance. A competing hypothesis—that compensation tied to hierarchical level boosted individual performance²⁰—was not supported. However, the author did find support for the moderating hypothesis that those higher in the hierarchy were likely to respond well to the hierarchical approach, while those lower in the hierarchy would not. In a related study, Bloom and Michel (2002) found that pay dispersion significantly increased managerial turnover and shortened managerial tenures.

Shaw, Gupta, and Delery (2002) considered some diverse non-executive samples, but their study has important implications for how pay dispersion impacts coordination and cooperation, and so it is discussed here. Like Henderson and Fredrickson (2001), Shaw and colleagues directly contrasted economic and behavioral theories, but Shaw and colleagues considered horizontal pay dispersion (e.g., within group) and not vertical pay dispersion (e.g., between groups). Specifically, they argued that pay dispersion without individual incentives may be harmful, but that pay dispersion among independent employees is likely to be beneficial. Their sample was comprised of two disparate groups: truck drivers (independent workers) and production workers (interdependent employees). Results indicated that pay dispersion was beneficial for the independent truck drivers, but not for the interdependent production workers.

In another recent study, Siegel and Hambrick (2005) draw on two literatures—task interdependence and group rewards—to argue that technological intensiveness is an important contingency factor in team-level pay distributions because it imposes information processing and collaboration requirements on team members. Hence, the greater the technological intensity, the more harmful the effects of pay disparities. In contrast to almost all previous work (but see Main et al. 1993 for an exception), these authors examine how both pay differentials (vertical pay disparities) and pay dispersion (horizontal pay disparities) affect firm performance.

Vertical pay disparities arise from two sources: (1) tournaments, and (2) great social distances in the hierarchy—perhaps from an autocratic CEO. These create both perceptual

and substantive barriers between levels that reduce information processing and coordination. The authors predict that the more technology-intensive the industry, the more negative the relationship between vertical pay disparity among top managers and subsequent organizational performance.

Horizontal pay disparities also arise from two sources. First, executives within each level may be perceived to have widely different economic value, inevitably leading to social comparisons and lower collaboration. Second, individual performance may be valued over group performance. This also impairs collaboration and turns effort toward individual factors and away from group or collective factors. The result is that the more technology intensive the industry, the more negative the relationship between top management team horizontal pay disparity and subsequent organizational performance.

Siegel and Hambrick (2005) predicted no main effects for either pay disparity type, but only effects contingent on industry. Using a proprietary database of single-business firms, and measuring firm performance in terms of shareholder returns and market-to-book ratio, they found considerable support for their predictions.

Devers, Holcomb, Holmes, and Cannella (2006) considered whether pay dispersion affects the incentive alignment properties of TMT long-term incentive pay. The authors predicted, in part, that the association between the level of LTIP and risk-taking behavior will be moderated by TMT pay dispersion—when there is high dispersion, the relationship was predicted to weaken. This occurs because pay dispersion decreases information sharing and trust (Whyte 1955) and increases conflict (Cyert and March 1963), power struggles (Lazear 1989), and competition among TMT members (Lambert, Larcker, and Weigelt 1993). Evidence from a large sample of S&P 500 firms supported this prediction.

In considering this work on pay dispersion in the context of the broader set of studies on pay distributions in top management teams, it seems clear that the variation of pay among senior executives affects motivation, risk taking, and even firm performance. For the most part, some assessment of top managerial interdependence or cooperation has been identified as a key contingency factor, but there are no doubt other important influences that remain to be investigated. More generally, the idea that the distribution of pay affects how executives and organizations act represents a huge leap in the complexity of our conceptual models of executive compensation, and clearly warrants further research attention.

TMT and CEO Compensation Patterns

The social composition of top management teams may affect the distribution of rewards at the top in other ways. Research on senior executives is increasingly focused on social dimensions driven to a large extent by the recognition that top management teams are really groups and that much can be learned from a group perspective (Hambrick 1994). Three studies we report below have important implications for the group perspective on compensation, but are less about horizontal or vertical pay differences than they are about TMT and CEO pay patterns. Each of these studies is relatively recent, and seems a natural extension of work on pay that goes beyond traditional conceptual treatments.

First, Carpenter and Sanders (2002) examined how CEO pay, shareholder interests (external alignment), and fairness (internal alignment) are reflected in TMT pay, and how that pay affects subsequent firm performance (considering both total pay and incentive pay). The authors argued that TMT pay and CEO pay should be similar, but will not be perfectly correlated because internal factors may lead to differences (internal factors include subunit-specific incentives, the gap between the CEO and the TMT, and CEO hubris). Additionally,

they argued that to the extent that TMT pay is aligned internally and externally, performance will be higher. By external alignment, the authors mean aligned with shareholder interests (i.e., a higher proportion of incentives). The authors offered three predictions: (1) CEO and TMT pay (total and LTIP) will be positively, but imperfectly, correlated; (2) external alignment of TMT pay (LTIP) will be positively associated with performance; (3) internal alignment of TMT pay will be positively associated with performance. Using a sample of 250 S&P 500 firms, they provided support for all three predictions, but also noted that, in particular, the effects of CEO pay on firm performance were completely mediated by TMT pay.

This study raises several interesting issues. First, to the extent that external alignment is much the same as adoption and use of LTIPs, work we reviewed earlier in this chapter on the consequences of executive compensation seems relevant. In particular, we should be alert to hypotheses positing a direct link between any attribute of executives (such as compensation) and firm performance because it ignores all sorts of intervening mechanisms—capital expenditures (Larcker 1983), R&D (Rappaport 1978) and strategic change (Carpenter 2000) in the case of executive compensation; and discretion, power, implementation, and fit in the more general case. Second, and despite this concern, a focus on external and internal alignment is a clever way to study the fit question in the context of compensation. Finally—and this will harken back to a point we made in [chapter 4](#) in a very different context—it is rare to see a study examine mediating effects, and this is one of the nice features of Carpenter and Sanders (2002).

A second study by Carpenter and Sanders (2004) examined the performance implications of team-level compensation in multinational companies (MNCs). Their core argument is that managing MNCs is complex work that requires significant human capital and managerial motivation. To the extent that compensation and incentive pay, like LTIPs, signal superior talent (attracted by pay) and motivation (via incentive alignment), firm performance should be higher. Results were supportive of this idea, though we can imagine a subsequent study more fully testing the complexity hypothesis by varying the sample to include both high- and low-complexity firms. If pay and LTIPs are not beneficial in less complex firms, the theory would be more strongly supported. Carpenter and Sanders (2004) also tested and found that larger CEO-TMTs pay gaps were associated with lower firm performance, ostensibly because of greater TMT fragmentation (Hambrick 1995), although the authors did not actually measure such fragmentation.

This latter idea on fragmentation brings to mind some of the work on pay differentials and pay dispersion reviewed earlier in this chapter. Many of the studies in this vein tend to assume that pay differentials and pay dispersion lead to “bad” social outcomes, and while some implicitly test whether they do by examining the effects of such pay differences on firm performance (as in Carpenter and Sanders 2004), none actually measures these social effects. Hence, we propose the following:

Proposition 11–23: The greater the gap in pay between the CEO and the rest of the TMT, the greater the TMT fragmentation and the lower the behavioral integration of the TMT.

Proposition 11–24: The greater the TMT pay dispersion, the greater the TMT fragmentation and the lower the behavioral integration of the TMT.

We might go a step further with the following additional propositions:

Proposition 11–25: The relationship between the gap in pay between the CEO and the

rest of the team, and firm performance, is mediated by TMT fragmentation/behavioral integration.

Proposition 11–26: The relationship between TMT pay dispersion and firm performance is mediated by TMT fragmentation/behavioral integration.

Finally, Carpenter and Wade (2002) studied the compensation of non-CEO executives, and how their human capital and opportunity structures influenced their pay. Their multilevel framework was designed to shed light on how resource allocation decisions associated with strategy impact non-CEO executive pay, as well as the CEO's influence on non-CEO executive pay. Noting that firm strategy may be viewed as a pattern in a stream of resource allocation decisions (Child 1972), and that such allocations reflect in part the functional dependencies in a firm, the authors predicted that executives with functional backgrounds associated with functional areas in the firm receiving higher resource allocations will receive higher cash compensation. Additionally, executives with backgrounds similar to that of the CEO should receive higher pay. Finally, they predicted that the link between background similarity with the CEO should be stronger among higher-ranking executives. The authors tested these predictions with a panel survey from 1981 to 1985 involving only the top four levels of executives (all above vice president). Evidence was somewhat mixed, but generally supportive of predictions.

As is evident from this review of research on pay differential, pay dispersion, and CEO-TMT pay patterns, there is considerable consistency in the underlying theoretical formulations at work. For the most part, these theories derive from the original social psychology research on equality and equity, the essence of which we reviewed earlier in the chapter. Perhaps because of these consistencies, however, research has not been as analytical or as precise as possible, suggesting new research opportunities. In this concluding section, we summarize some of these ideas.

In organizing the work in this area for purposes of exposition, we settled on three central constructs—pay differentials, pay dispersion, and CEO-TMT pay gap. Nevertheless, theoretical rationales sometimes overlapped across constructs, suggesting that researchers have not fine-tuned their theories to each construct. The challenge for scholars interested in extending work of this type is to focus more directly on what vertical (pay differentials and CEO-TMT pay gaps) and horizontal (pay dispersion) patterns in executive compensation really signify. In addition, research on “intra-rank” pay gaps (Wright et al. 2005) further complicates the unit of analysis question. Other than obvious empirical differences, very few studies (see Siegel and Hambrick, 2005 for an exception) have clarified why it is that vertical, or horizontal, pay patterns, and not the other, is the subject of study.

A second consideration is the role of TMT behavioral integration. We suggested several propositions to bring this key construct into theoretical formulations on TMT pay patterns, but more may be possible. Further, we believe it is important to specify a clear causal chain in research in strategic leadership, and certainly on executive compensation. Can it be that a particular pattern of TMT compensation is so efficacious that it actually influences firm performance directly? We are aware that several studies have reported precisely such a relationship, but there is a significant research opportunity open to scholars who can more carefully conceptually specify, and empirically measure, the key intervening mechanisms between top executive pay and firm performance. Some studies often make liberal use of implicit logic to link executives to performance, but in the absence of overt consideration of intervening mechanisms, such findings may be due to a variety of other factors—omitted variables bias, sample selection bias, or other design breakdowns. Some of the mixed results reported to date may well be due to this problem.

We are most encouraged by those studies that have modeled key contingency variables as intervening or moderating factors in the effects of TMT pay patterns on firm performance. Research has found complexity, internal and external alignment, diversification, and technological intensity, among others, to be promising in this regard. There is room for further elaboration. For example, one argument for the importance of complexity might focus on how complex industries, firms, or strategies (this too has not been well-specified) create a need for incentive alignment because behavior-based controls are more difficult to install when means-ends linkages are unclear and managers have high discretion. Boards will rely on outcome-based controls, such as incentive compensation, to align managerial actions with shareholder interests under these conditions, and this effort will tend to increase pay dispersion and pay differentials. Another argument might suggest that complex situations place a premium on talented and motivated managers, pushing boards to increase pay and incentive pay. Again, pay differentials and pay dispersion may also be higher as a result. And a third argument might suggest that complex organizations benefit from coordinated managerial attention to key problems; if true, complexity would attenuate pay differential and pay dispersion. Finally, each argument also lends itself to a fit-type hypothesis on firm performance, such that the relationship between pay patterns and firm performance will be affected by the level of complexity.²¹

These approaches represent three different arguments, with different implications for TMT pay patterns and firm performance. On the one hand, this illustration suggests that researchers need to carefully consider just why it is that complexity (or diversification, etc.) affects pay patterns and to make those conceptual arguments as clear as possible. On the other hand, to the extent that complexity (as one example) plays out in these ways suggests that further research is needed to distinguish among alternative theoretical rationales. Doing so may well require different types of data—data that can get at the underlying logic via surveys, qualitative methods, and even experimentation—but it seems a particularly promising route to greater conceptual clarity in this research stream.

Conclusion

The growing body of research on executive compensation profiled in this chapter and the previous one is exciting and robust. The direction of this work is clearly toward more complex theoretical formulations, elaborations on behavioral agency theory, deeper understanding of social and political forces in pay, and a focus on other top managers and especially the top management team as a unit. The one thing that all studies—regardless of theoretical or empirical grounding—require, however, is excellent data. More so than in other areas of organizational research, the availability of publicly available data and databases has been a powerful catalyst for work on executive compensation. The danger for researchers lies in getting caught up with the data and not taking appropriate care in developing compelling theoretical narratives that guide collection and analysis of these data.

A second concern is in measurement. While years ago most studies of executive compensation reported only salary and bonus data, for a number of years now the dominant research design has involved collecting data on various stock and incentive plans. This is all to the good, but we should not forget that there are vulnerabilities. Some of these vulnerabilities present research opportunities—the choice of peer groups in reported executive pay in proxy statements, for example, is a wonderful opportunity to explore social comparisons and symbolic behavior.

Other data vulnerabilities are more troubling; perhaps because they have been around for

a long time, they have lost currency as a legitimate concern. For example, although some version of the Black-Scholes model is typically used to value stock options, “the ultimate proceeds from a stock option grant ... depends on the firm’s stock price performance after the employee’s risk preferences ... and changes in the tax law” (Lambert, Larcker, and Weigelt 1993, 444), considerations that are not part of the Black-Scholes computation. In addition, the assumptions of Black-Scholes are not precisely met with executive stock options (Kerr and Kren 1992). Further, managers often place valuations on their stock options that are less than the Black-Scholes valuations, a difference that might have conceptual as well as empirical import (Hall and Murphy 2002; Devers, Wiseman, and Holmes 2007). There may be even greater uncertainty in valuing other types of long-term contingent compensation (Antle and Smith 1986). These problems have yet to be resolved in the literature (Lambert, Larcker, and Verrecchia 1991), leading to variety in how executive compensation is measured in empirical studies.

Beyond problems in valuation, it is also worth remembering that several studies on different aspects of compensation indicate that results are appreciably the same whether or not long-term pay is included in the measure of executive compensation (Benston 1985; Ely 1991; Hambrick and Finkelstein 1995; Lambert, Larcker, and Weigelt 1993; Lewellen and Huntsman 1970; Lambert, Larcker, and Verrecchia 1991). As a result, while the inclusion of long-term contingent compensation does provide additional information on executive pay, the marginal gain in information may be offset by potentially unreliable measurement.

Finally, we might add a new concern—the backdating of stock options. However, in this instance, while such backdating actually distorts the “true” measure of an executive’s pay, the fact that such distortion has occurred is itself interesting from a research point of view. Backdating is a particularly visible example of apparent manipulation of executive compensation arrangements, and as such would be interesting to study. While explaining which firms were more likely to backdate than others is an obvious—though still relevant—research question, the implications of backdating on organizational outcomes would be particularly interesting to investigate.

In sum, there is a wide set of potential consequences of executive compensation—functional and dysfunctional, intended and unintended. We have highlighted many of these consequences by adopting a multitheoretical perspective. There are inconsistencies and conflicts among perspectives, given the differences in underlying assumptions. However, from a research point of view, they present great opportunities for theory testing and comparative analysis. Research on executive compensation has traditionally focused on its determinants, at an individual unit of analysis; this chapter has focused on synthesizing work on the consequences of executive pay and pay distributions, with an eye toward illustrating its research potential.

Notes

CHAPTER 2

1. Locus of control derives from the extent to which individuals believe that they can control their environment. Internals believe that they have great influence over their environment, while externals believe that their environment largely controls them.

CHAPTER 3

1. It is important to note that some information restriction is due to social structures and organizational characteristics, not merely to the executive's own human limits; the context may not be inclined to provide an executive with all potentially pertinent information. To address this issue would entail a discussion more of organizational design than of executive behavior. In line with our theory, we expect that executives would seek to modify information flows as a function of their own biases and dispositions.

2. One of the first and best-known references to "selective perception" was by Dearborn and Simon (1958). However, they used the term to refer to the interpretive act, the third phase in our sequential information-processing model. "Selective perception" is an expression that seems apt for conveying incomplete noticing, a concept not considered by Dearborn and Simon.

3. See Dutton, Fahey, and Narayanan (1983) for a thoughtful discussion of iterative information processing by strategists.

4. See Corner, Kinicki, and Keats (1994) for a sequential information processing model analogous to ours. Their stages are attention, encoding, storage/retrieval, decision, and action.

5. This section is adapted from Chatterjee and Hambrick 2007.

CHAPTER 4

1. Executive age has also been the subject of some research. Because of mandatory retirement provisions for officers of most major companies, executives over sixty-five are relatively rare. Hence, age ranges are severely truncated, and such measures may be capturing tenure-based phenomena more than age-based phenomena. Nonetheless, research has extended Vroom and Pahl's (1971) observation that managerial age is negatively associated with risk-taking, finding that executive age is negatively associated with (1) product or market innovation strategies (Thomas, Litschert, and Ramaswamy 1991); (2) strategic change following industry deregulation (Grimm and Smith 1991); (3) change in diversification profiles (Wiersema and Bantel 1992); and (4) aggressive investment policies (Bertrand and Schoar 2003). Thus, available evidence on executive age conforms to the same general pattern obtained when the focus is executive tenure.

2. Some companies are active in multiple industries, and of course some executives move

from industry to industry. Under these conditions, industry effects on executive CSQ will be muted.

3. This study and several others we review in this section are based on average demographic characteristics of top management teams, not just of individual executives. As a group average, such a characteristic can be thought to tap the collective “mind” or cognition of the top managers, whereas measures of dispersion or heterogeneity would be suggestive of group process and rightly discussed in [chapter 5](#), on TMTs.

4. This study also found that the greater the firm performance, the stronger these effects.

5. Not all studies reported uniform results. In a study of twenty-seven top management teams running hospitals in the United Kingdom (West and Anderson 1996), team tenure was negatively (but not significantly) related to self-reports of innovation but was not related to an objective measure of innovation. This result is somewhat tempered, however, by the design of this study—the inclusion of nine independent variables in a sample of twenty-seven severely restricted degrees of freedom. In addition, Kor and Mahoney (2005) reported a positive association between average top management team tenure in the company and R&D spending in a sample of high-technology entrepreneurial firms.

6. Because this was a sample of accountants, firms with very long-tenured executives who retired or died also tended to dissolve; and therefore the relationship between tenure and dissolution was U-shaped. As tenures increase, firm survival is enhanced, up to the point where tenures are so long that retirement-driven dissolutions start to kick in.

7. We might speculate that the inflection point has narrowed in recent years, in line with the shift toward shorter tenures for CEOs.

8. Research on cognition is highly consistent with this view as well. Relative to novices, experts tend to have fewer schemas, but more information units within each category (Walsh 1995). This result has been supported in several studies (e.g., Rentsch, Heffner, and Duffy 1994; Sujan, Sujan, and Bettman 1988), and suggests that as environmental or other contextual conditions shift, it is unlikely that long-tenured executives will be able to develop new schemas to adjust.

9. Despite the preponderance of studies pointing out the disadvantages of long tenure, one recent study reported a different result. In a study of 495 small, private firms, Simsek (2007) found that CEO tenure was positively related to TMT risk taking, which in turn was related to entrepreneurial initiatives, and then, firm performance. However, while this study does attempt to peek into the various intervening influences between CEOs and firm performance, its reliance on survey data for all the key variables raises questions on validity and generalizability.

10. Nohria and Berkley (1994) provide intriguing data on the further proliferation of a “managerial culture” in America, citing massive growth between 1982 and 1992 in numbers of business schools, MBAs granted, management consultants, corporate expenditures on training, business stories in the media, and business books.

11. Tyler and Steensma (1998) note that a high correspondence between educational specialization and functional background of executives will create confounding effects if just one of these characteristics is included in empirical analysis.

12. To reinforce the connection between the RBV view of fit and traditional contingency theory, we note that by “value” Barney (1991) was referring to the extent to which a resource enabled a firm to meet the environmental threats and opportunities it faced.

13. Some resource-based theorists also emphasize the importance of “bundling,” combining resources in a complementary fashion (Teece, Pisano, and Shuen 1997), which in

this context can be interpreted as a fit argument as well (Carpenter, Sanders, and Gregersen 2001).

14. Hambrick and colleagues' (1996) study of strategic moves in the airline industry included executive education level as a control variable and found it was positively and significantly related to firm performance.

15. Haunschild, Henderson, and Davis-Blake (1998) found that firms run by top managers with elite graduate degrees (but not elite MBAs alone) were more likely to engage in diversifying acquisitions than other firms. However, Palmer, and Barber (2001) also indicate in a footnote that most of the MBA degrees held by the CEOs they studied were from elite institutions.

16. It is interesting to consider the possibility that business schools differ systematically in the types of students they attract. For example, fundamentally different types of individuals may enroll at Harvard than at Chicago; and innovative schools that emphasize creativity and entrepreneurship may attract students who differ widely from the average MBA candidate.

17. This is true for much of upper-echelons theory, but especially important for RBV work that relies on a knowledge or skill-set logic to explain why managerial characteristics are related to firm performance.

CHAPTER 5

1. As one example, in an intriguing analysis of the rise of CFOs in corporations, Zorn (2003) documents how regulatory changes enacted by the Federal Accounting Standards Board (FASB) drove firms to create a new formal position—the chief financial officer—as a solution to an ill-defined problem.

2. We refer to the group of executives at the top of an organization as a “team” only for ease of presentation; we agree with Hambrick (1994) that this constellation of executives may not necessarily behave in a “team-like” fashion. Indeed, as we discuss below, the nature of the interactions among top managers composing a team is an issue that should be studied in its own right.

3. In chapters 3 and 4, we described both the personality characteristics and experiences of executives, so these will not be repeated here. Nevertheless, it is important to keep in mind that mean levels of psychological and demographic attributes of top management teams are consequential (Hage and Dewar 1973; Finkelstein and Hambrick 1990; see also Carpenter, Geletkanycz, and Sanders 2004).

4. Other dimensions of process have been considered. For example, Amason (1996) discusses affective and cognitive conflict, Waldman and Yammarino (1999) and Klein and House (1995) discuss charisma, and Shen and Cannella (2002a) and Bigley and Wiersema (2002) discuss politics. Colbert, Kristof-Brown, Bradley, and Barrick (2008) use “goal importance congruence,” and Van der Vegt, Bunderson, and Oosterhof (2006) consider “interpersonal helping.”

5. For some important exceptions, see Peterson et al. (2003), Amason and Sapienza (1997), Papadakis and Barwise (2002), and Athanassiou and Nigh (1999).

6. This is not meant to imply that all decisions proceed in such a linear, or complete, fashion. Moving toward quick decisions without in-depth analysis (Cohen, March, and Olson 1972), avoiding evaluation of failed strategies (Finkelstein and Mooney 2003), and shifting among the various stages of the process (Mintzberg 1978) are far from unknown. Our goal here is simply to point out that the “intervening processes,” no matter how construed, are

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consequential.

7. The distinction between “team” and “group” is perhaps more subtle in the organizational behavior or organization theory literature than in the upper echelons literature. For example, Weick (1993) goes to some length to convince readers that the smoke jumpers he studied comprised a group. For more micro-oriented scholars the key concern is that the members of a “group” perceive themselves to be part of a group. When this is the case, the “group” becomes more like a “team.” When we use the word “team” we mean that the members of the TMT perceive themselves to be part of a cohesive group, and have a psychological attachment to the group.

8. We continue to use the “TMT” label despite our call for greater attention to the “group” nature of top executive interaction simply for ease of reference and continuity and because essentially all of the research we review in this chapter also adopts this nomenclature.

9. It is critical to control for industry, however, because institutional arrangements within industries often affect structural arrangements, such as the hierarchy of positions at the top (DiMaggio and Powell 1983). For example, the number of vice presidents differs across industries, as does the meaning of the title “vice president.” There are many more vice presidents in firms in the investment banking industry than in other industries, but not all are influential in strategic decision making. As a result, definitions of TMTs that are based on titles may be problematic in cross-industry studies.

10. This is true even when deciding which individual member of a TMT to study. For example, arguing that chief financial officers (CFOs) were central players in ethical dilemmas organizations confront, Stevens, Steensma, Harrison, and Cochran (2005) focused their study solely on CFOs. While one can easily imagine the same research issue also being directed toward a population of CEOs, Stevens and colleagues build an argument to support their design choice.

11. Respondents were asked to rate managerial power for three different strategic decisions (major resource allocations, organizational redesign, and domain changes), with each measured on a seven-point scale (from “no influence” to “total influence”). The reported rating of managerial power is the sum of the scores for each of the three strategic decisions.

12. Recall in [chapter 4](#) our discussion of applying Barney’s (1991) four tests of resource value to evaluate the “fit” of executive experiences with the challenges faced by a firm. In the context of TMTs, this suggests that expertise power can be assessed relative to the expertise power of other top managers within the team, and relative to the expertise power of top executives in competitor firms. There are no studies to date, however, that have addressed this research idea.

13. Although some may suggest that role interdependence is related to TMT consensus, we have purposely refrained from arguing for such an association. When TMT roles are interdependent, there is a greater need for cooperation and resource sharing among senior executives. Nevertheless, a need for such activities does not necessarily translate into actual behavior, so it is not clear whether interdependent TMTs really do cooperate. By the same token, the relationship between role interdependence and social integration is imprecise, because it cannot necessarily be assumed that interdependent TMTs are cohesive (Schmidt and Kochan 1972).

14. A different problem sometimes noted, stemming from the paucity of studies directly examining the association between TMT demography and TMT interaction processes, is that demographic and process constructs may have no direct relationship. While this critique is no different from the one we addressed in [chapter 4](#) on the validity of demographic data, the lack

of empirical work linking demography and process is problematic (Lawrence 1997; West and Schwenk 1996).

15. In fact, in line with this latter argument, Rajagopalan and Datta (1996) reported that capital intensity was negatively, and industry growth positively, related to CEO functional heterogeneity.

16. Of course, when performance reaches a minimal threshold, the interests of TMT members turns more to saving their own security and careers, and less to saving the company (Lane, Cannella, and Lubatkin 1998). In support of this notion, Hambrick and D'Aveni found in their study of bankrupts and survivors that in the year before bankruptcy, "the actual size of the bankrupt teams shrank appreciably" (1992, 1462). Additionally, Cannella, Fraser, Lee and Semadeni (2002) showed that as their sample firms spiraled toward bankruptcy, executives were more likely to "jump ship"—leaving the failing firm to join another company, often at significant personal cost.

17. Actually, we would expect CEO effects on TMTs to be more readily discernible empirically because CEOs can change the makeup of their team more easily than they can the organization's strategy and performance.

18. We define CEO dominance as the power of the CEO relative to the rest of the TMT (Hambrick and D'Aveni 1992; Halebian and Finkelstein 1993), as well as the CEO's willingness to use that power to influence the behavior of others.

19. Although we do so in the context of a chapter on TMTs, it is also possible to offer a proposition on the negative association between CEO openness and CEO tenure.

20. Boone, Olffen, Witteloostuijn, and Brabander (2004) did not find support for their hypothesis that top management team power over the board increased the similarity of new executives entering the team.

21. Research has also been conducted on the association between TMTs and executive turnover (Wagner, Pfeffer, and O'Reilly 1984; Jackson et al. 1991; Wiersema and Bantel 1993; Wiersema and Bird 1993; Cannella and Shen 2001; Shen and Cannella 2002a, 2002b), as we discuss in [chapter 6](#).

22. See West and Schwenk (1996) for a dissenting viewpoint.

23. Almost all of this work has focused on demographic heterogeneity as an independent variable.

24. Both studies included team size as a control variable but reported no significant associations with dependent variables.

25. In a study with a different focus, but of some relevance here, Elenkov, Judge, and Wright (2005) found that TMT heterogeneity moderated the relationship between transformational and transactional leadership behaviors and executive influence on innovation. The authors argued that because heterogeneity conveys cognitive diversity (Pitcher and Smith 2001), TMTs employing leadership behaviors will be more influential. The cognitive or processual mechanisms that link these factors were not clear from this study; however, it does suggest that some attention to TMT heterogeneity as a moderating variable may be warranted.

26. The operational definitions and methods of identifying change in the two studies are also very different and could account for some of the inconsistent results.

27. Neither Hambrick and Mason (1984) nor Pfeffer (1983) suggests direct associations between demographic heterogeneity and organization performance.

28. The theory and evidence from Cannella, Park, and Lee (2008) suggest that we are much more likely to observe a performance association for TMT member intrapersonal

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functional diversity (see Bunderson and Sutcliffe 2002) than for the more common measures of TMT-level background diversity or heterogeneity.

CHAPTER 6

1. See Furtado and Karan (1990) and Kesner and Seborá (1994) for alternative frameworks of executive succession.
2. As we will discuss later, we suspect that the practice of providing the dismissed CEO a “fig leaf” to cover the dismissal may no longer characterize the actions of public companies in dismissing their CEOs.
3. Miller and colleagues (2007) take issue with the common definitions of “family” control, and separate the broad category into entrepreneurially controlled and family controlled, with the former involving only a single owner and the latter involving more than one family member’s active involvement in the business. Further, their study shows that the distinction is critically important to the performance differences between the broadly defined “family firms” and regular public corporations.
4. Some typical definitions of “outsider” include the following: anyone with fewer than two years’ employment at the company (Cannella and Lubatkin 1993); anyone who has never worked for the company (Boeker and Goodstein 1993); and anyone who did not report directly to the preceding CEO (Dalton and Kesner 1985). See Pitcher, Chreim, and Kisfalvi (2000) and Guthrie and Datta (1997) for critiques of the measurement of “outsider” in succession research.

CHAPTER 7

1. For a very detailed look at the decision processes behind divestitures, see Shimizu (2007) and Shimizu and Hitt (2005).
2. They also split out between-season and midseason successions. However, their use of overall season performance, no matter when in the current season the succession occurred, makes these comparisons tenuous.
3. Our interpretation is that smaller firms allow more managerial discretion—that is, opportunity for executive impact—and hence, the stock market responds favorably to outside succession in such firms.
4. Unfortunately, the authors do not describe what they meant by “managers.” However, the numbers they report suggest that they included, in addition to CEOs, executives below the CEO level.

CHAPTER 8

1. Monitoring is defined as the direct and indirect observation of managerial behavior over time (Jensen and Meckling 1976). It “can be achieved through budgets, responsibility accounting, rules, and policies” (Tosi and Gomez-Mejia 1989, 171).
2. Beyond structure and composition, boards may be examined by focusing on process (how they interact as a group, e.g., Vance 1983; Finkelstein and Mooney 2003), style (their “personality” or modes of operation, e.g., Mueller 1981), and internal organization

(committee membership and the flow of information among committees, e.g., Brown 1981).

3. As we will discuss later in the chapter, a sizable body of evidence suggests that during the 1980s and 1990s, public company boards became both smaller and more independent from management (Westphal 1998; Westphal and Zajac 1997; Kaplan and Harrison 1993; Kesner and Johnson 1990).

4. The SEC defines affiliation as (1) employment with the company within the past five years; (2) relatives of the company's executives or founders; (3) a significant customer, supplier, or credit relationship with the company; (4) an investment banker; (5) representative of a holding company with stockholdings in the company; or (6) a member of a law firm employed by the company.

5. Inside directors, as members of top management, have been studied somewhat more extensively (e.g., Wagner, Pfeffer, and O'Reilly 1984). As a result, we will focus on the turnover and selection of outside directors. The appointment of an executive of the firm to the board, however, is also interesting and worthy of study (the removal of an executive from the board is likely to coincide with his or her departure from the firm, so this aspect of director turnover is of somewhat less theoretical interest). For example, it may be that managers are selected to boards (1) when they are anointed as successors, or potential successors, of the CEO (Vancil 1987; Cannella and Shen 2001; Hermalin and Weisbach 1988); (2) as a reward for good performance (Vance 1983); or (3) as a consequence of their power (Finkelstein 1992). Thus, selection of inside directors remains an interesting and important research area.

6. Although our discussion here focuses on director selection from the perspective of the firm, social class theory also suggests that individuals seek directorships because it enhances their social standing in the business elite (Useem 1979; Lester and Cannella 2005).

7. Fama and Jensen (1983) argued that the reputation of outside board members in particular would be an important consideration in their appointments. Hence, to the extent that firm performance is a positive indicator of reputation, agency theory predicts that directors of better-performing firms would be more likely to be appointed to new board directorship positions.

8. The Gilson (1990) study noted earlier reported that the number of directorships held by individual directors of distressed firms who had resigned declined by 35 percent in the three years following resignation.

9. The idea that director turnover is associated with poor performance is consistent with theories of managerial turnover as well (Harrison, Torres, and Kukalis 1988). As a result, a negative association between director turnover and firm performance may reflect attributions about director responsibility. Although such an alternative explanation cannot be easily ruled out, it is not clear who would be making such attributions in a firm.

10. This proposition assumes that sitting CEOs will be more threatened by potential reputational losses than other outside directors.

11. The authors also note the far-reaching consequences of the legislation. Pennsylvania companies lost an estimated \$4 billion in market value (a 9 percent drop) upon the bill's enactment.

12. Unfortunately, their methodology cannot separate these two effects. See also Lester and Cannella (2005).

13. This proposition implies that effective board monitoring requires certain board characteristics that promote board independence, even when boards themselves are relatively powerful. This may appear paradoxical until one considers that the primary mechanism through which boards may exert their power is dismissal of the CEO (Lorsch and MacIver

1989; Mizruchi 1983), while an independent board has the potential to be involved throughout the strategy-making process (e.g., Westphal 1999).

14. The authors defined family firms as those in which the founder or the founder's descendents controlled sizable blocks of the firm's shares or votes.

15. Recall that this situation is currently ruled out for NYSE firms, because in recent years the NYSE has required that nominating, audit, and compensation committees of listed firms be comprised entirely of outsiders.

16. The broader issue of CEO pay and performance, including the role of CEO power, is addressed at length in [chapter 10](#).

17. Although we emphasize the role of agency theory and managerial power in explaining why boards are not always vigilant, other reasons have been suggested. Building on work by Lorsch (1989), Main, O'Reilly, and Wade (1994) argued that because many shareholders have short-term interests that may be in conflict with the long-run goals of a firm, it may not make sense for directors to slavishly promote shareholder interests. Another explanation, suggested by Walsh and Seward (1990), is that because boards may have great difficulty accurately attributing organizational outcomes to top managers, ambiguity may creep into incentive systems. Also, as noted earlier, many boards have an implicit norm to support the CEO and his or her leadership of the firm (Patton and Baker 1987). Finally, outside directors may simply not have sufficient time and information to effectively evaluate managerial proposals and actions (Estes 1980; Baysinger and Hoskisson 1990), while inside directors tend to be more beholden to the CEO (Patton and Baker 1987).

18. See also Lane, Cannella, and Lubatkin (1998). These authors argued that while there are clearly sharp conflicts of interests between managers and shareholders in matters of compensation or takeovers, there is much less reason to believe that similar conflicts of interest exist in matters of corporate strategy. Put differently, managers, like shareholders, want their firms to be successful, and the more successful the better. Though Boyd, Gove, and Hitt (2004) challenge the empirical evidence presented by Lane and colleagues, the fundamental conclusion that many corporate strategies need not pose sharp conflicts of interests remains intact.

19. Further, it is important to specify the interest of the parties involved (the CEO and the board). Power only tells us whose interests are likely to be pursued, not what those specific interests are (Lane, Cannella, and Lubatkin 1998).

20. Interestingly, Sundaramurthy (1996) argues convincingly that there are two types of institutional investors: those that are interested in corporate governance, and those that are not. Financial investment companies tend to be disinterested in governance because their investment strategies require liquidity and they are unlikely to be long-term shareholders. In contrast, public pension funds tend to be very interested in governance because their investment strategies tend to emphasize large investments and long-term holdings. See also Hoskisson, Hitt, Johnson, and Grossman (2002).

21. Note again that *independent* directors are defined by the SEC as those who are not relatives of executives or founders, not current or former employees, not employed by banks or law firms, and not from firms with "substantial" business relationships with the focal firm.

22. Board attributions about firm performance and the responsibility of top management for that performance are not always straightforward (Fredrickson, Hambrick, and Baumrin 1988; Walsh and Seward 1990).

23. In some ways, this parallels work on threat rigidity by Staw, Sandelands, and Dutton (1981), who argued that managers under pressure tend to rely on a narrow set of colleagues for information, shutting out precisely the more critical informants most needed in times of

crisis.

CHAPTER 9

1. Although we discuss the board's governance and strategy formation roles separately for analytical purposes, these roles likely overlap somewhat. In the governance role, the board must approve the strategy that is developed. To do so effectively, board members must understand the strategy and believe that it will work in the context in which the firm operates. One of the best ways to understand the strategy is to be involved in developing it.

2. Board involvement was defined along two dimensions, "formation of new strategic directions" and "evaluation of prior strategic decisions," with respondents asked to rate the "board's general level of involvement in strategic decision making" (Judge and Zeithaml 1992, 793).

3. Chatman and Flynn (2001) demonstrated that while diversity can negatively affect group functioning, if the group successfully develops norms of interaction, the negative effects can be entirely mitigated. Therefore, it is important to note that diversity per se may be a very poor indicator of problems in group functioning.

4. We may go even further by suggesting that larger organizations (and older ones as well [viz. [Proposition 9-5](#)]) face an even greater need for board involvement than do smaller or newer organizations to combat the core rigidities that often take hold in such contexts. To the extent that this is true, board involvement may be more strongly related to firm performance in larger and older organizations than in smaller and newer ones.

5. For some contrasting evidence and theory, see Shimizu and Hitt (2005), who showed that the arrival of new outside directors increased the likelihood of divesting poorly performing units. The authors interpret this evidence as supporting the notion that new outside directors help break the force of organizational inertia.

6. As noted earlier, Hermalin and Weisbach (1988) found that poor performance led to changes in board composition, so cross-sectional regression of performance on board composition may be biased because of changes in board composition resulting from past performance (Hermalin and Weisbach 1991).

7. Some of the problems in relating TMT heterogeneity directly to organizational outcomes discussed in [chapter 5](#) are likely relevant here as well.

8. For example, Amihud and Lev (1981) argued and found that unrelated diversification was greater in manager-controlled firms than in owner-controlled firms. See also Lane, Cannella, and Lubatkin (1998) and Boyd, Gove, and Hitt (2004).

9. As noted earlier, many scholars separate outside directors into affiliated and independent categories. Affiliated directors are those with "significant" business dealings with the firm.

10. Directional interlocks are "created by people who are principally affiliated with (i.e., owners or officers of) one of the two firms they connect," while nondirectional interlocks are "created by people who are principally affiliated with a third institution" (Palmer, Jennings, and Zhou 1993, 107).

11. For other classifications systems for institutional investors see Brickley et al. (1988) and Kochhar and David (1996).

12. The authors provide an excellent discussion of the survey and its construct validation, and provide survey items in an appendix.

13. See also Carpenter, Geletkanycz, and Sanders (2004).

14. In Hambrick and Finkelstein's (1987) original statement of managerial discretion, they argued that powerful outside forces were an important constraint on executive choice. For boards of directors, perhaps the most important "powerful outside force" is the top management team. Hence, when we discuss board discretion, it makes sense conceptually to consider what we have defined as "vigilance" as an integral part of the construct.

Nevertheless, vigilance and discretion are not synonymous; while vigilance refers to a specific aspect of discretion, discretion is a broader construct encompassing a wide range of environmental and individual attributes that go beyond what is typically seen as vigilance.

15. In supplemental analyses, the authors showed that finance CEOs did not tend to make better acquisitions or diversification moves than nonfinance CEOs, and for their sample, diversification did not create shareholder value.

16. The same criticism cannot as readily be made of research on top managers because (1) studies have explicitly documented how top managers affect organizational outcomes (e.g., Pettigrew 1973; Mintzberg 1985; Bower 1986), and (2) the relationship between top management and strategy and performance, while certainly not universally held (Hannan and Freeman 1977), has a stronger theoretical tradition (e.g., Child 1972; Hambrick and Finkelstein 1987).

17. Interestingly, the mere presence of outsiders on the compensation committee had no effect on CEO compensation (before regulatory changes such committees could include insiders) (Anderson and Bizjak 2003), lending even more support to the social comparison logic in these studies.

18. Although we have already noted this point, it is worth reiterating that most studies of this type do not differentiate among affiliated and truly independent outsiders, a shortcoming that may also be contributing to this pattern of inconsistent results.

19. Golden parachutes are contracts between employers and top managers that provide for additional compensation should a change in control or ownership occur (Krueger 1985).

20. Poison pills enable shareholders to purchase their shares in a firm at a discount or tender their shares at a premium. These rights impose unwanted financial obligations on a bidder, making takeovers more expensive.

21. A classified board amendment generally divides a board into three classes, with only one class standing for election each year. As such, its provisions make a transfer of control more difficult (Sundaramurthy and Wang 1993).

22. Greenmail involves the purchase of a firm's stock from a corporate raider at a premium to prevent a takeover.

23. However, Brickley, Coles, and Terry (1994) reported that the average stock market reaction to announcements of poison pill adoption was positive when the board had a majority of outside directors and negative when it did not.

24. In a departure from the "agency theory-centric" bias in research on boards and takeover defenses, Davis (1991) also tested the notion that intercorporate interactions drive the adoption of poison pills and found that network centrality—especially director ties with firms that have already adopted poison pills—were significant predictors of adoption by the focal firm. Hence, this study stands out as one of the few to explicitly test alternative theoretical perspectives on how boards affect organizational outcomes.

25. One explanation for the negative reaction when there were more outsiders arises from Hermalin and Weisbach (1997). These authors note that visible board actions send two kinds of signals: one about the company itself, and the other about the dedication of outside

directors to monitor and oversee managers. When there are more outsiders on the board and antitakeover amendments are adopted, the signal suggests that the outsiders on the board were unwilling or unable to stop the action—clearly a negative signal according to agency theory.

26. Classified boards are those in which directors serve three-year terms, instead of standing for reelection every year. Approximately one-third of directors are up for reelection each year, so the board cannot be replaced quickly, taking a minimum of two election cycles to replace a majority of directors.

27. There are some exceptions. For example, Davis (1991) controlled for other antitakeover mechanisms in his study of the adoption of poison pills. In addition, while some measures of board vigilance may be substitutes, others may be complements because of their construction. For example, outside director representation and outside director equity are related by definition, so we might expect them to be correlated as well. An examination of the interrelationships among measures of board vigilance is needed.

28. Alternatively, it may be that once a board adopts one antitakeover amendment, it will be more likely to adopt others. In either case, this remains an important empirical question to sort out.

CHAPTER 10

1. For an alternative framework, see Devers, Cannella, Reilly, and Yoder (2007).

2. Recent work in finance takes the tack that agency theory really doesn't predict a pay-for-performance relationship, but rather predicts that the pay-performance association will decrease as firm risk increases (e.g., Aggarwal and Samwick 1999b). Although the first of these assertions seems somewhat dubious (after all, countless studies in agency theory have proceeded under a different assumption), a good deal of evidence in support of the second is available. We will discuss these studies later in the chapter.

3. More recently, some research in psychology has challenged how agency theory's predictions might fare in social contexts (e.g., Parks and Conlon 1995; Stroh et al. 1996) while other research has expanded agency theory into the realm of behavioral decision theory (e.g., Wiseman and Gomez-Mejia 1998). While research in the first area is a bit sparse and will not be discussed in detail here, we will discuss behavioral agency theory later in the chapter.

4. The greater vigilance of boards in externally controlled firms may help account for why CEOs in Japanese firms earn less than their U.S. counterparts. In many Japanese companies, large institutional shareholders are common, and often hold extensive corporate debt as well, giving them considerable influence over management (Prowse 1990). Hence, it may not be that surprising that CEOs in Japan are paid much less than those in the United States.

5. But see our discussion of Wade, O'Reilly, and Pollock (2006) later in this chapter.

6. The authors also noted a third (residual) category of institutional investor—pressure indeterminate—comprising corporate pension funds, brokerage houses, and investment counselors. They controlled for this group's ownership in their analyses.

7. Interestingly, Miller and colleagues (2006) point out that the definition of "family" in family firm research is quite ambiguous. Miller and colleagues apply two key criteria: (1) the firm involves *more than one* family member in management and/or governance in the firm, and (2) there is an intention to maintain family ownership across generations. They further

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show that the distinction between what they term “entrepreneurial” firms (i.e., those in which only one family member is present as a large owner) and true family firms is very important to performance outcomes.

8. A recent paper by Carpenter and Seo (2007) explored the related idea that board monitoring of CEOs was easier in firms following simpler strategies, lowering CEO pay increases and strengthening the relationship between pay and performance, ideas that received partial support in their analysis. While not invoking discretion directly, the logic these authors employ is quite consistent with both Hambrick and Finkelstein (1987) and Finkelstein and Peteraf (2007).

9. Note, however, that the Hambrick and Finkelstein (1995) results suggest important subtleties in this relationship.

10. These authors used the terms *skills* and *human capital* interchangeably.

11. Anomalies were gauged in several ways, but all derived from residuals generated by regressions predicting pay level. This is the same method used by Combs and Skill (2003), and Wade, O’Reilly, and Pollock (2006). Later, we comment on the appropriateness of this methodology, especially when used for purposes of assessing pay equity.

12. Firm-level implementation effectiveness was reported by Easton and Jarrell (1998), and the authors adopted those measures directly.

13. It is also worth recalling, as noted in [chapter 8](#), that there were other studies on much the same question that did not find the same effect for compensation committees (Johnson, Daily, and Ellstrand 1996; Conyon and Peck 1998).

14. Fiss (2006) argued that TMT compensation was highly correlated to CEO compensation, but could not use the latter because it was not disclosed in German companies during the time period of his study.

15. There are two other studies in finance that speak to the issue of CEO reputation and compensation (Garvey and Milbourn 2003; Malmendier and Tate 2005b).

16. A study by Main, O’Reilly, and Wade (1994) may be the only exception to date. These authors find support for a model of CEO compensation based on social influence that attempts to explain why boards of directors are not the effective monitors agency theorists typically assume (e.g., Fama and Jensen 1983).

17. Executive utility is not limited to preferences for compensation. Top managers may also desire greater responsibility, achievement, and power.

18. It is difficult to imagine a power-based model of executive compensation that does not use these observations as a starting point. However, one exception may occur in regulated industries, where some have argued that regulatory agencies, in seeking to avoid public dissatisfaction with “excessive” compensation earnings, use their political power to both reduce overall levels of CEO pay and the magnitude of incentives offered to CEOs (to reduce the possibility of large nominal payouts) (Joskow, Rose, and Shepard 1993). Nevertheless, it could be argued that regulatory agencies are really acting as supernormal, and vigilant, boards of directors (Stigler 1971).

19. These authors also report a similar result for the adoption and use of stock repurchase programs (Westphal and Zajac, 2001).

20. There may be another, newer, political force emerging in the debate on executive compensation that will be interesting to follow and study. More and more, shareholder resolutions limiting pay, demanding greater disclosure or fewer perquisites, and pressuring boards to keep compensation contracts under control are being drafted. These efforts rely on web sites, blogs, the media, and other pressure points to rein in executive pay. The

implications of these efforts for corporate governance (they often bypass boards) and compensation are not yet well understood, but may offer researchers a new lens to consider on these issues.

21. We would note, however, that in studies invoking equity theory explanations for pay, it is more difficult to justify relying on firm performance and not some more precise indicator of CEO performance.

22. More broadly, a firm's life-cycle stage may be an important indicator not only of GM pay, but of CEO and other top managerial pay as well. As one example, Wasserman (2006) found that founders earned on average \$25,000 less than nonfounders in his sample of 528 private technology firms (earlier in this chapter we noted that Gomez-Mejia et al. [2003] reported the same pattern for family CEOs vs. nonfamily CEOs), and that this "founder discount" decreased with company size. The potentially important role of organizational life cycles in the setting of executive compensation remains an interesting research question to study.

23. This hypothesis is analogous to Michel and Hambrick's (1992) study of the performance effects of the interaction of diversification and top management team characteristics.

CHAPTER 11

1. Firms may also use nonincentive cash compensation to promote desired strategic behaviors (Ramanan, Simon, and Harris 1993). For example, theoretical work by Kanter (1977) and Rosen (1986) and empirical work by Cannella and Shen (2001) indicate that the desire for promotion is a very important motivator for executives below the CEO level.

2. Finkelstein and Hambrick suggest that this short-term influence may be evidence of a "Hawthorne effect" and that "a steady stream of new incentive schemes is required to kindle managerial action" (1988, 552).

3. This result is analogous to that of Deckop, Merriman, and Gupta (2006), who found that long-term CEO pay was positively related to corporate social responsibility (short-term pay exhibited a negative association).

4. The large number of companies backdating stock option grants is the most recent, and highly visible, example of such behavior.

5. Balkin, Markman and Gomez-Mejia (2000) also concluded that incentive pay is unrelated to future performance.

6. It is not much of a stretch to say that this is what has happened at firms that backdate executive stock option grants.

7. The discussion of business unit GM compensation in the previous chapter may also be relevant. In particular, the spirit behind Hambrick and Snow's (1989) fit prescriptions is very much consistent with the fit ideas suggested here.

8. For a mainstream agency theory approach to acquisitions, see Wright et al. 2002; Fiss 2006.

9. In this regard, traditional equity theory provides a motive for what agency theorists refer to as "shirking" by suggesting that inequity breeds resentment.

10. This expectation may not hold as strongly for CEOs since, as we argued earlier, they benefit most from the prestige and status of their positions.

11. A different form of this proposition has been empirically examined—the

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compensation of an executive relative to the CEO—a topic we turn to later when discussing pay distributions within top management teams.

12. However, it is important to recognize that there is some disagreement about what agency theory predicts will be the form of the association. For example, Aggarwal and Samwick (1999b) conclude that agency theory's broad prediction about compensation is limited to the assertion that pay-performance sensitivity will be inversely related to firm risk.

13. It could also be argued that the motivational impact of incentive-based compensation should be evaluated against the actual wealth of the executive, rather than his or her guaranteed compensation. Zajac (1990), in testing this hypothesis, found that firms whose CEOs perceived greater connection between their personal wealth and the wealth of their firm tended to be more profitable.

14. This initiative is itself a political response to executive compensation practices.

15. See also Zhang and Rajagopalan (2004), who develop a tournament theory argument to explain how firms with more candidates for the CEO position are less likely to use a relay and more likely to use a tournament because tournaments provide informational and motivational advantages. Though not focused on compensation directly, their evidence supported this prediction.

16. Henderson and Fredrickson (2001) also tested a variety of models predicting performance, but the only prediction with empirical support was the tournament theory prediction that the interaction of larger CEO pay gap and greater coordination needs would have a positive relationship to subsequent firm performance.

17. We suggest these propositions here in the context of "intranrank" pay gaps, but we do want to point out that in substance there may be little difference between intranrank pay gaps and pay dispersion. The question of whether to consider the CEO (no for intranrank pay gaps and yes for pay dispersion) should be based on the theory and ideas being tested, and not left to an empirical choice.

18. Consider that scholars of organizations have been studying non-CEO influences on firm performance for decades under the presumption that a firm's success depends on much more than just the work of one individual.

19. Studying a somewhat different context, Larkin (2006) documented a remarkable pattern of manipulation of contracting arrangements by salespersons driven by huge incentive pay plans, further suggesting that unequal pay can create business inefficiencies with potentially detrimental performance impact.

20. Readers may note that this is a version of the tournament hypothesis, at the individual level. Bloom (1999) did not offer any competing predictions at the group or organizational levels of analysis.

21. Not yet explored, to our knowledge, is the perfectly reasonable expectation that complexity (or some other organizational characteristic) will be related to firm performance to the extent that pay differentials and pay dispersion are high (or low), depending on which argument on complexity is operative. In some ways, this is a more natural hypothesis, as it models TMT pay patterns as an administrative mechanism that can support, or hinder, the execution of a strategy.

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