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CEO tenure, boards of directors, and acquisition performance

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Abstract

We explore the impact of CEO tenure on returns to shareholders arising from acquisition announcements. Further, we consider the value added for shareholders when the board of directors is composed in such a way as to enhance vigilance. In the absence of a vigilant board, CEO tenure is positively associated with performance at low to moderate levels of tenure, and negatively associated with performance when tenure further rises to substantial levels. In the presence of a vigilant board, however, shareholder interests can be advanced even at high levels of CEO tenure.
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Acquisitions have long-term consequences for employees, organizations, and industries, and they continue to increase in terms of global impact (nearly $1.95 trillion in 2004 [Hahn, 2005]). Key parties in an acquisition decision are the CEO and the board of directors. The CEO assesses acquisition targets, and formulates and implements acquisition strategy once the decision has been made. The board represents shareholders' interests, providing vigilance and expertise. Although CEO experience should benefit the decision process, prior research informs us that CEO effectiveness may in part be contingent on the length of CEO tenure (e.g., Audia et al., 2000; Hambrick and Fukutomi, 1991; Kiesler and Sproull, 1982; Kroll et al., 2000; Miller, 1990, 1993; Miller and Chen, 1994). We extend these concerns to the acquisition process, and argue that when boards are likely to be vigilant (i.e., comprised of independent outsiders, blockholders, and/or outside owners), they may positively influence the relationship between CEO tenure and performance. As CEO tenure advances, are specific board characteristics helpful in mitigating potential deleterious effects of CEOs' pursuit of personal interests at the expense of shareholders? This is an especially important question given that acquisitions continue to be popular while at the same time their performance is often less than desirable.

In the remainder of the paper, we discuss how CEO tenure may affect shareholder returns arising from acquisition announcements at lower and higher levels of tenure, and offer a hypothesis as to the temporal effects of tenure on returns. Next, we introduce board vigilance, and offer hypotheses addressing the joint effects of vigilant boards and CEOs on acquisition performance as tenure advances. We then describe our sample construction and research methodology, report the results of our study, and present our discussion and conclusions.

1. Temporal effects of CEO tenure on returns to shareholders

Whether they come from inside or outside the firm, new CEOs confront a steep learning curve, and acquire considerable vital, job-specific knowledge in the first two or three years in their positions (Harris and Helfat, 1997). Although CEOs ideally benefit from a "honeymoon period," allowing them time to make mistakes and acquire job-specific knowledge and skills, Shen (2003) notes that many CEOs lose their jobs in less than three years, barely enough time to complete the process of taking charge (Gabarro, 1987). Zhang (2005) argues that quick

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CEO dismissal may be a result of the board's mandate to correct an inappropriate selection before CEOs become entrenched. Thus, new CEOs often lack job security and are still acquiring knowledge and skills, decreasing the likelihood that pursuit of acquisitions will prove beneficial. The challenges involved in successful acquisitions are well documented. Issues surrounding acquisitions often divert managerial attention from other important matters related to CEOs' normal tasks (Hayward and Hambrick, 1997), and CEOs may not always possess the experience base needed to carry out the activities required in making well-informed acquisition judgments.

Given the extensive learning and growth occurring in the early years of tenure and the challenges of acquiring sufficient task knowledge (Hambrick and Fukutomi, 1991), a CEO with at least a few years of experience might make better acquisitions than less experienced chief executives. At this stage, a CEO is more likely to have acquired the task knowledge, confidence, and familiarity with salient elements of the competitive situation conducive to effective acquisitions. Such a context is more fertile ground for realizing positive benefits arising from acquisitions, such as gaining access to new knowledge, maintaining the firm's agility, and overcoming inertia (Hayward, 2002). Additionally, the CEO is less likely to have amassed an inordinate amount of power vis-à-vis the board than a long-tenured CEO, and thus not likely in a position to pursue acquisitions benefiting the CEO more than shareholders.

Long-tenured CEOs, however, often slow their knowledge acquisition, growth and development (Audia et al., 2000; Hambrick and Fukutomi, 1991; Kroll et al., 2000), decrease their commitment to learning, and narrow their information search (Finkelstein and Hambrick, 1996), thus hindering performance (Miller, 1990, 1993). Tenure has been found to be inversely related to the strategy–environment and structure–environment match prescribed by contingency theory (Miller, 1991), and may facilitate development of a particular "dominant logic" (Prahalad and Bettis, 1986), hampering effective judgment of present conditions if different from the past. CEOs may erroneously generalize previous situations to new ones (Kiesler and Sproull, 1982; Mazer, 1994), possibly leading to overestimation of "private synergies" and other attributes of a proposed acquisition. Subordinates may filter and mold information to "fit" CEOs' acceptance zones, restricting information entering into decision processes (Finkelstein and Hambrick, 1996) and increasing commitment to the status quo (e.g., Finkelstein and Hambrick, 1996; Hambrick and Fukutomi, 1991). Commitment to a paradigm increases because of investment in a particular course of action, visibility of choices made, and the notion that longevity itself indicates adequacy on the job. Beyond the early stages of a CEO's time in office, "each passing year in the job tends to bring the CEO a heightened sense of correctness in his or her established way of operating and viewing the world" (Hambrick and Fukutomi, 1991: 725). Resistance to change accompanies increased influence and autonomy (Miller, 1991), and CEOs' mental representations of the world are more likely to be of historical environments than of current ones (Kiesler and Sproull, 1982). Even major environmental changes may not be incorporated, and executives with personal stakes in plans may under-interpret negative information and over-interpret positive information. Information executives seek from unfavorable sources may decrease as a result of past success (Audia et al., 2000). Tenure in office may bring with it organizational "simplicity," and over time, managerial lenses become narrower and attention to phenomena becomes more selective and focused. Information systems increasingly channel and constrain goals and perspectives (Miller, 1993; Miller et al., 1996), and "strategies will respond more to stable internal concerns than to fluctuating external ones" (Miller, 1993: 127). Miller and Chen (1994: 4) note in their study of competitive inertia, "Success may be interpreted as a sign that less vigilance and less environmental scanning or search are required," blinding managers to the need for action.

Long-tenured CEOs may also gain considerable influence over board member selection and develop personal relationships with directors (Westphal and Zajac, 1995). Over time, directors may come to trust their CEOs implicitly (Shen, 2003; Zajac and Westphal, 1996). Such a power shift may facilitate CEOs' pursuit of acquisitions for reasons other than shareholder welfare, such as firm growth in order to justify greater pecuniary benefits (Kroll et al., 1997), risk diversification (Wright et al., 2002a,b), and the satiation of their own narcissism (Hayward and Hambrick, 1997). Under conditions of strategic rigidity, restricted information search, organizational simplicity, power over the board, and potential hubris, the analytical acumen and strategic flexibility required for CEOs to anticipate post-integration issues, properly evaluate a target's merits, and achieve unique synergies in a proposed acquisition may be unlikely. These issues are compounded by the possibility of rising agency costs resulting from diversification benefiting CEOs more than shareholders.

Based on the foregoing, we anticipate a non-monotonic relationship between tenure and acquisition outcomes. As tenure rises from negligible to moderate levels, CEOs' increased task knowledge, confidence, and familiarity with salient elements of the competitive situation should enhance their ability to pursue beneficial acquisitions. Although power increases over time, they are less likely to have inordinate power at this stage than long-tenured CEOs, and may be at the peak of their service to the firm, and less likely in a position to pursue acquisitions benefiting them more than shareholders. As tenure rises from moderate to substantial levels, CEOs may lose interest in learning; their task knowledge plateaus; and they gain power vis-à-vis the board, facilitating acquisitions favoring management over shareholders. We thus anticipate a curvilinear or inverted U-shaped relationship between CEO tenure and acquisition outcomes.

H_1. At the time of an acquisition announcement, the relationship between CEO tenure and returns to shareholders will be positive where CEO tenure increases from negligible to moderate levels, but negative where CEO tenure further increases to substantial levels.

2. Board vigilance and CEO tenure

Shen (2003) argues that when CEO tenure is low, shareholders benefit more when the board focuses on leadership

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