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The use and effectiveness of top executive dismissal

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ABSTRACT

We provide a systematic assessment of the empirical evidence on the use and effectiveness of top executive dismissal as a governance and performance improvement mechanism. Our results suggest that poor individual and firm performance significantly increase the likelihood of executive dismissal. A strong power base might help under-performing top executives to extend their tenure in office, but effective ownership and governance structures can provide a counterweight to such entrenchment behaviors. However, our review casts doubt on the effectiveness of top executive dismissal as a means to enhance future firm performance: employing meta-analytical techniques we show that, although the dismissal announcement leads to positive abnormal returns, it has no significant effect on long-term measures of firm performance. On the basis of our findings, we develop a conceptual model of the possible antecedents and consequences of top executive dismissal. We derive implications for boards involved in situations of executive dismissal and for the successors of dismissed executives, and we provide directions for future leadership research on executive dismissal.

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1. Introduction

The rise and fall of top executives has attracted significant attention in leadership research. Much of the literature on the effectiveness of leadership on organizational performance has looked at executive succession events i.e., the replacement of one top manager by another one (Boal & Hooijberg, 2000; Yukl, 2008). Furthermore, the literature on leadership failure has investigated situations in which top executives fail to be as successful as they and/or others had hoped them to be, and the individual- and organizational-level conditions leading to such situations (Finkelstein, 2003; Gabarro, 1987). However, this literature has been relatively silent regarding *how* failed leaders leave their positions, and are replaced by others.

One particularly drastic way in which a change within the leadership position can take place is with the board of directors' dismissal of a top executive. The corporate governance literature considers executive dismissal key to the process of corporate control and as the board's ultimate recourse in their relationship with top management (Fama, 1980; Finkelstein, Hambrick, & Cannella, 2009; Menon & Williams, 2008; Volpin, 2002). Empirical evidence shows that the incidence of top executive dismissal, especially of chief executive officers (CEOs), has increased sharply in the last 20 years (Favaro, Karlsson, & Neilson, 2010; Huson, Parrino, & Starks, 2001).

In exercising its prerogative to dismiss a senior manager, a board is in a particularly precarious situation. If it hesitates to use this option, it might be accused of being sluggish in exercising its statutory monitoring function (Ferris, Jandik, Lawless, & Makhija, 2007; Romano, 1991), and perceived as condoning the supposed mal-performance or wrongdoing of the top manager concerned, thereby implicating itself in it. However, if it resorts to dismissal too eagerly, then it casts doubt on its choice of the executive in the first place. It might also be suspected of sacrificing the dismissed manager in order to placate other parties such as shareholders, or even of easy scapegoating in a situation for which the individual bears little responsibility, in order to divert attention from own failures (Rowe, Cannella, Rankin, & Gorman, 2005).

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Against this background, the purpose of this paper is to (a) provide an assessment of the empirical evidence regarding the possible antecedents and consequences of executive dismissal and to (b) derive implications from this evidence for future research on executive dismissal in the leadership area. We present a systematic evaluation of 91 empirical studies published between 1960 and 2010. Given their complexity, the possible consequences of dismissal (e.g., for firm performance) are particularly difficult to assess. However, this assessment is important in that, if the firing of a top executive did not help raise firm performance, this finding would cast serious doubt on the board's exercise of dismissal in the first place (Wiersema, 2002). We employ meta-analysis for this purpose. On the basis of our results, we propose a theoretical model of top executive dismissal. Furthermore, we outline practical implications for the parties involved in or affected by top executive dismissal, and sketch avenues for future research in this area.

2. Top executive dismissal and leadership failure

Leadership literature regards executive failure as a situation in which an individual in a leadership position fails to meet her/his own expectations, or the legitimate expectations of others (Finkelstein, 2003; Hunter, Tate, Dzieweczynski, & Bedell-Avers, 2011). Most executive failure takes place in situations of new venture creation, business integration processes following mergers and acquisitions, and environmental pressures resulting from technological change and competitive threats (Cooper, 2002). Leadership literature looks not only at the individual-level factors and organizational conditions that contribute to the executive failures, but also at the organizational crises preceding and following them. However, it provides little analysis regarding the process by which executives are replaced (Finkelstein, 2003; Ward, Sonnenfeld, & Kimberly, 1995).

Top executive turnover may occur as a result of routine changes (e.g., retirements, departures for external career reasons), or as a result of forced departure (Finkelstein et al., 2009; Fredrickson, Hambrick, & Baumrin, 1988). The latter category includes outright dismissal as well as the decision of a manager to leave office in order to avert the possibility (or overt threat) of dismissal, a sanction that is known to significantly worsen one's career and future earnings prospects (Ward et al., 1995). The power to both hire and replace a senior manager, specifically the CEO, rests with the governing body of a firm; namely, its board of directors (respectively, with the supervisory board in corporate governance systems with a dual board structure, such as Germany). In considering whether to exercise its prerogative of dismissing a top manager, the board is in a particularly precarious situation for at least three reasons, namely a lack of independence, unclear performance evaluation standards, and pressures inherent to the process of deciding on dismissal.

2.1. Lack of independence

In countries such as the United States and Great Britain, which have a unitary board structure, virtually all boards of publicly listed companies have at least one and often several top managers of the firm as their members. According to a recent report by SpencerStuart (2011), the boards of 43% of all S&P 500 companies count not only the CEO, but at least one other top manager — usually the chief financial officer (CFO), chief operations officer (COO) or president — among their members. Moreover, in 59% of these companies, the CEO also chairs the board (for an even higher estimate, see Kim, Al-Shammari, Kim, & Lee, 2009). Even if this is not the case, the CEO usually has an elevated position on the board (Warther, 1998). Recent legislation (e.g., the Sarbanes–Oxley Act in the U.S. (Sarbanes Oxley Act, 2002)) and paralegal provisions (e.g., the UK Corporate Governance Code (Financial Reporting Council, 2010)) have sought to make boards of directors more independent; e.g., by urging a separation of the board chair and chief executive roles, or by recommending establishment of board committees that are fully or predominantly composed of directors (Gordon, 2008). However, in the eyes of many observers, progress towards independent boards has been slow (e.g., Murphy & Topyan, 2005). Therefore, firing the CEO or another top manager who is also a board member often involves significant political maneuvering, coalition-building, and the like by the other board members — reportedly a difficult undertaking (Daily & Schwenk, 1996). It also bears the risk of significant potential negative secondary effects such as a loss of reputation should this political wrangling become public or go awry (Friedman & Saul, 1991).

2.2. Unclear performance evaluation standards

Most cases of executive dismissal do not result from illegal activity by the executive, but rather from board members' dissatisfaction with the executive's performance. In dismissal announcements, this dissatisfaction is often couched in terms of “disagreements between the board and the executive about the strategic direction of the company” or similar (see Bresser & Valle Thiele, 2008; Bresser, Valle Thiele, Biedermann, & Lüdeke, 2005); nevertheless, such statements barely conceal a board's discontent with the extent to which the executive concerned has met its performance expectations. However, defining and agreeing on an appropriate performance standard for top managers and measuring their performance is notoriously difficult (Newman, Tyler, & Dunbar, 2001; Tyler, 2012). This problem is confounded by the fact that top executives often face a set of diverse and potentially conflicting performance expectations from different stakeholder groups (Bruton, Fried, & Hisrich, 1997). Since individual performance is hard to evaluate, boards of directors usually resort to firm performance indicators (e.g., share price developments) as proxies for top executives' individual performance. Board members develop expectations of the future development of firm performance, and executives are judged based on how these expectations are met (Puffer & Weintrop, 1991). Therefore, both rewards and sanctions for top managers are often tied to firm performance (Lambert, Larcker, & Weigelt, 1993), and boards use firm performance as a proxy of individual performance in making decisions about the dismissal and replacement of individual top executives (Brickley, 2003). However, basing evaluation upon firm-related performance measures means that individual managers might be rewarded or sanctioned (e.g., through dismissal) for factors beyond their control, such as macroeconomic or industry-specific developments.

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