

# **TOP MANAGEMENT SUCCESSIONS: THE CHOICE BETWEEN INTERNAL AND EXTERNAL SOURCES**

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## **Abstract**

There is no conclusive evidence on the firm's preference in appointments of top management. In this study four theoretical hypotheses on the likely source of appointment (internal vs. external) are examined using multivariate logistic regressions on a sample of 260 top management appointments in U.S. firms. Two factors were found to have a significant effect: 1) Firm size - Larger firms tend to appoint more from their internal sources, probably due to their informal commitment to their reservoir of internal talent; 2) Power - The more power the firm is willing to delegate to its next manager, the more likely are external successions. Two other factors, the disposition of the former top manager (left/stayed with the firm) and firm's past performance, were found to be insignificant.

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There is a strong consensus in the business community that top management has a considerable impact on a company's performance and market value. The popular literature (Peters and Waterman, 1982) contends that almost every "excellent" company has a powerful manager leading it to its success.

The academic literature is less unanimous about the top manager's contribution. Bibeault (1982), Hofer (1980), and Romanelli and Tushman (1988) argue that the top management's input is crucial for the firm, while Liberson and O'Connor (1972) present evidence suggesting the opposite. Liberson and O'Connor find that only 6% of the total variation in firm's sales and earnings can be attributed to leadership. The proposition that managers have little impact is further reinforced by colorful scientific evidence on sport teams management success, including the "vicious circle" (Grusky, 1963) and "ritual scapegoating" (Gamson and Scoth, 1964; Brown, 1982) hypotheses and tests.

Beyond the issue of whether replacing top management can improve a firm's performance, a topic frequently debated is the preferable source from which the successor will be recruited (external or internal sources). Internal succession provides continuity. The internal candidate has developed the existing corporate strategy with incumbent management. Thus, the internal candidate is not likely to disrupt current strategies, corporate culture, and control structure. By providing stability, internal succession also promotes loyalty. Fiercely loyal employees are developed by moving employees up through the ranks of the company. Proponents of external successions (Helmich and Brown, 1972) suggest that an external succession can achieve more drastic changes in the company because the external manager is not bound by old policies and implicit contracts in the firm. On the other hand, the external manager needs to overcome an induction period, and may confront some opposition from remaining top management of the firm. Hence, the balance between the advantages and disadvantages of external successions is not clear-cut and the optimal source of replacement remains case-dependent and in general indeterminate. The purpose of this study is to suggest a set of theoretical hypotheses on the source of top management appointments. These hypotheses are tested on a large sample of top management successions using multivariate logistic regression techniques.

## Theories and previous evidence on top management appointments

Several theories have been suggested in relation with the decision on the source from which top management will be appointed (external or internal). The first and most frequently mentioned theory focuses on the relation between the source of appointment and the company's past performance. Hicks and Gullett (1981) argue that the return on investment is the key criterion by which owners judge managers.

Kosnik (1987) emphasizes that an external succession is the most effective cure for internal inefficiency because a new manager brought from outside is more likely to conceive and implement "fresh" ideas and initiatives. In the same spirit, Hambrick and Mason (1984) argue that when an organization performs poorly and needs a "change agent", an external succession becomes more likely.

Empirical evidence is however mixed. Schwartz and Menon (1985) find that firms in financial distress are more likely to replace management from outside, as evidenced by the fact that 65% of these firms preferred external successions. (On average, external successions account for only 25% of succession events - see Vancil, 1987.) In contrast, studies such as Friedman and Singh (1989) do not find any significant relation between past performance and the successor's source. A third variation is presented in Dalton and Kesner (1985) which finds a non-linear relation: firms with poor or excellent past performance tend to appoint from inside, while firms with medium-grade past performance use a relatively high proportion of external successions. Finally, and most recently, Boeker and Goodstein (1993) claim that performance influences successions, but board of directors composition (the percent of insiders on the board), firm ownership (percent ownership by insiders) and ownership concentration (number of insiders) moderate the relation.

Because empirical evidence is mixed and theory is inconclusive, our null hypotheses is that:

*Hypothesis 1: Firms' past performance has no bearing on the source from which their new top manager will be recruited.*

Another theoretical proposition made is that there is a relation between firm size and the source of succession (Dalton and Kesner, 1983). The argument is that larger companies typically have good management prospects growing within the firm which they constantly develop and train. Hence, larger firms are less likely to recruit from the outside. In contrast, smaller firms may not have a suitable internal candidate and may be forced to recruit from the outside. In smaller firms, the opportunities for promotion

within the firm are fewer, and, therefore, competent managers may not wait for the opportunity of top management succession, and may move to other firms.

Empirical evidence on the effect of firm size on top management appointments is mixed. Helmich and Brown (1972) report that larger firms use more external recruiting than smaller firms, while Dalton and Kesner (1983) claim the opposite. Schwartz and Menon (1985) find no relation between successor origin and firm size.

Since empirical evidence is mixed, and since the issue of the size impact has not been extensively debated in the theoretical literature, our null hypothesis is that:

*Hypothesis 2: Firm size is unrelated with the source of the successor.*

A third theory in the area of succession focuses on an analysis of the amount of power offered to the new manager. Pfeffer (1992) argues that the most difficult task of a top manager is not reaching correct decisions but implementing them, and that the efficient implementation of decisions requires hierarchical authority and exercising power. Thus, adequate power is a prerequisite for top management success.

We propose that prospective managers worry about their power and ability to affect the organization. Hence, particularly candidates from outside the organization, are reluctant to join and head companies that do not offer them “sufficient” discretion. This is essentially the supply side of the top management appointment decision. It is not enough that the company demands an external succession. Competent external candidates must be convinced to step in.

Although power is a complex construct (Pfeffer, 1981), managers’ power is generally defined as the capability to exert their will. According to Finkelstein (1992) power in the organization can stem from ownership, special expertise, or prestige, but most commonly it is associated with some hierarchical structure, with CEO ranking at the top.

Hambrick and Finkelstein (1987) and Harrison, Torres and Kukalis (1988) advocate the direct measure of structural power, namely, the number of top positions delegated to the new manager. More top positions indicate more discretion and fewer constraints on implementing the manager’s programs. It appears to us that external managers, as change agents, depend more on discretion. Thus, it is predicted that:

*Hypothesis 3: The more top positions the firm is willing to offer the new manager, the more likely is an external succession.*

Another dimension of power is the disposition of the former top manager. The range of discretion afforded to the new manager is probably lowered if the former manager

retains some power in the firm (Friedman and Singh, 1989: 727). Thus, companies that keep the predecessor in an influential position within the firm may deter external successions. Our hypothesis is that:

*Hypothesis 4: When a predecessor stays with the firm, the likelihood of external successions decreases.*

The remainder of the paper describes and discusses empirical tests of the above-developed hypotheses.

## **Methods**

### *Sample*

The sample is based on Reinganum's (1985) list of top management appointments in the United States (note 1). In order to refine and optimize the sample, the following groups were excluded: 1) lower-rank management changes such as an appointment to a position other than Chief Executive Officer, Chairman, or President; 2) minor management changes such as an appointment of a chairman to an additional top position (note 2); 3) managerial changes during periods of merger or restructuring activity in the firm; 4) appointments announced as interim; and 5) appointments for which complete data are not available. The final sample consists of 260 appointment events. (note 3)

### *Measures*

For each succession event we either collected or calculated data on the following variables: (1) the source from which the successor was appointed (internal or external) (note 4); (2) the former manager's disposition (left or stayed in the firm) (note 5); (3) the number of positions offered to the new manager (single or multiple); (4) the pre-succession performance of the firm; and (5) the size of the company (relative to other firms traded on the exchange). Data on the first three variables were retrieved from the Wall Street Journal articles describing each appointment, while the remaining variables were calculated using the CRSP (Center for Research in Security Prices) tapes, available from the University of Chicago.

One of the two calculated variables utilizes CRSP stock return data. Following Lubatkin, Chung, Rogers and Owers (1989), we estimate pre-succession performance as the "excess return" of the firm's stock in the 200 trading days (approximately one

year) preceding the appointment. This measure relies on the notion that security markets are efficient in the sense that they follow the firm's value closely and quickly. Thus, any pre-appointment deterioration of the firm must be accompanied by lower than normal stock returns (i.e., negative excess returns) during that period. The excess return measure was preferred to accounting earnings because accounting numbers are frequently marred with problems (Davidson III and Worrell, 1988).

Details on the technical calculation of excess returns are provided in the Appendix. The procedure employed has previously been used in numerous studies (e.g. Reinganum, 1985; Beatty and Zajac, 1987; Friedman and Singh, 1989).

The second calculated variable, relative size of the company, is constructed in two steps using the CRSP data. First, the total market value of the company's common stock is computed at the end of the year preceding the appointment. Then, this stock capitalization figure is ranked relative to the stock capitalization of all New York Stock Exchange and American Stock Exchange companies at that time, in order to determine the stock capitalization decile of the firm. The capitalization decile of the firm is the size variable employed in the empirical analysis.

## Results

Table 1 outlines the main characteristics of the sample. Most of the appointments (71.5%) were internal; in most of the cases (67.8%) the former manager stayed in a position related to the firm; and in the majority of successions (67.3%) the new manager received more than one top position (for example, was appointed as both CEO and president). In addition, the companies in the sample seem reasonably well dispersed across all capitalization deciles (see note 6); and the average pre-succession excess return of the companies was minor (2.5% with a standard error of 2.1%).

**Table 1: Means, standard deviations and Pearson correlation coefficients**

Variables	Levels	Means <sup>a</sup>	s.d.	Correlations			
				1	2	3	4
1. Origin of successor	0-external	.715	.452				
	1-internal	(260)					
2. Disposition of predecessor	0-stayed with the firm	.322	.468	.04			
	1-left	(236)					
3. Power of successor (number of positions offered to new managers)	0-one	.673	.470	-.19**	-.21**		
	1-multiple	(260)					
4. Size of the company	ten levels,	5.85	2.98	.17**	-.05	.09	
	1-smallest	(260)					
	10-largest						
5. Pre-succession performance (excess return)	continuous	.0249	.338	-.05	.08	-.04	-.10
		(256)					

Notes: <sup>a</sup> The number of observations is shown in parentheses.

\*\*  $p < .01$ .

The Pearson correlation coefficients in Table 1 are in general small (less than 0.2 in absolute value). However, three relations appear statistically significant. First, when the number of positions offered to the new manager increases, the proportion of external successions also increases. Second, when company size increases, the proportion of internal successions increases. Third, when the former manager stays related to the firm, the number of top positions offered to the successor increases.

The evidence in Table 1 that external successions are more likely in firms which offer the successor more top positions, and the lack of relation between past performance and the origin of the successor, support hypotheses 1 and 3. However, since the correlation tests are bivariate tests only, and do not control for the effect of other variables, the conclusions drawn from Table 1 are preliminary.

More rigorous tests of the research hypotheses employ the multivariate logistic

regression technique. A dichotomous variable indicating the origin of the successor (0=external, 1=internal) is regressed on four independent variables: past stock performance, size of the company, former manager disposition, and amount of power afforded to the successor (number of top positions she or he receive).

Table 2 summarizes the results of the logistic regression. The estimated regression equation is:

$$\text{Logit} \left( \begin{array}{c} \text{Probability} \\ \text{of external} \\ \text{successions} \end{array} \right) = -0.812 + 0.212 \left( \begin{array}{c} \text{Pre-succession} \\ \text{performance} \end{array} \right) - 0.170 \left( \begin{array}{c} \text{Predecessor} \\ \text{disposition} \end{array} \right) \\ + 0.926 \left( \begin{array}{c} \text{Number of} \\ \text{positions} \end{array} \right) - 0.155 \left( \begin{array}{c} \text{Size of the} \\ \text{company} \end{array} \right)$$

where the variables are defined and measured as in Table 1.

**Table 2: Results of a logistic regression model of successor's origin<sup>a</sup>**

$$(\text{logit}(P) = \ln(P/1-P) = \alpha + \beta'X^b)$$

<i>Independent variables</i>	<i>Coefficients</i>	<i>Standard errors</i>	<i>Variable Chi-square (p-value)</i>
Intercept	-0.812	0.435	3.48 (0.06)
Pre-appointment performance	0.212	0.463	0.21 (0.65)
Predecessor disposition	-0.170	0.347	0.24 (0.63)
Number of positions offered to new manager	0.926*	0.378	6.00 (0.014)
Size of the company	-0.155**	0.053	8.49 (0.004)
Wald-test Chi-Square (4 d.f.) of the model		14.24**	

*Notes*

a The number of observations is 236.

b  $P$  is the probability of an external succession conditional on the vector of independent variables;  $X$  is the vector of independent variables used in this regression;  $\beta$  is a vector of coefficients;  $\alpha$  is the intercept; and  $\ln(\cdot)$  is the natural (base  $e$ ) logarithm.

\*  $p < .05$ .

\*\*  $p < .01$ .

The coefficients of past performance and former manager disposition are statistically insignificant, while the coefficients of firm size and successor's number of positions are statistically significant. External successions are indicated to be more frequent in smaller firms and in companies which offer the new manager more top positions. The null hypothesis that the variables employed have no explanatory power with respect to the source of successor is rejected at the 1% significance level, using a Likelihood Ratio Wald-test (note 7). The c-statistic (Goodman and Kruskal, 1979) which measures the proportion of correct predictions of the fitted model in pairwise comparisons of the actual succession-choice observations is 0.666, suggesting a fair predictive power of the model.

A further analysis of a possible non-linear relation between firm's performance and source of successor, as suggested by Dalton and Kesner (1985), was also performed. We sort the sample firms according to pre-succession excess returns, and divide them into performance quintiles. Then, we calculate and compare the proportion of external successions in each performance quintile. The results are shown in Table 3

**Table 3: Contingency analysis of the effect of past performance on successor's origin<sup>a</sup>**

	<i>Number of external successions</i>	<i>Number of internal successions</i>
Lowest performance quintile (past excess returns < -23%)	13	38
Low performance quintile (-23% < past excess returns < -5.8%)	10	41
Mid-performance quintile (-5.8% < past excess returns < -8.2%)	17	34
Good performance quintile (-8.2% < past excess returns < 25%)	19	32
Top performance quintile (25% < past excess returns)	13	39
Chi-square test of homogeneity (4 d.f.) <sup>b</sup>		5.15

*Notes*

*a* The number of observations is 256

*b* The null hypothesis is that the frequency of external successions is identical across all rows.

The evidence is mixed. On the one hand, the point-estimates demonstrate a Dalton and Kesner-like phenomenon: external successions appear most frequently in mid-grade performance firms, where the proportion of external successions is approximately 0.35. On the other hand, this phenomenon is statistically insignificant. A test of homogeneity cannot reject the hypothesis that, in our sample, the proportion of external successions is equal across all performance quintiles (note 8).

## Discussion

The empirical analysis found two significant relations: a) larger firms appoint from their internal sources more frequently than smaller firms; and b) firms which offer the successor more power (top positions) have significantly higher proportions of external successions. These findings support Hypothesis 3 and reject Hypothesis 2 of the paper. Similarly, the fact that firm's pre-succession performance and predecessor's disposition were not found to be significantly correlated with the source from which the successor is drawn, lends support to Hypothesis 1 and rejects Hypothesis 4.

A coherent interpretation of the results can be based on an analysis of the market for top managers. Both sides of the managerial labor market (demand and supply) appear important in explaining our results and in determining the final match between top manager and firm. Consider, for example, the effect of past performance (Hypothesis 1). Demand side argues that firms with poor past performance are striving for a drastic change, thus they are more likely to demand an external manager, while firms with excellent pre-succession performances prefer an internal succession in order to maintain continuity. However, supply side forces operate in the opposite direction. Outside managers probably prefer to join successful firms and may be reluctant to join the quagmire of a failing firm (Trow, 1961).

The evidence in Table 2 that there is no significant relation between past performance and origin of successor suggests that the opposing supply and demand forces are roughly offsetting. In reality, poor performing firms may have no choice but to appoint from inside, while firms with excellent pre-succession performance may not be able to ignore the outside talent knocking on the door. Thus, despite what seems to be the companies' original intentions (the demand side), the actual outcome is no significant relation between past performance and successor's origin.

Comparisons of the appointment tendencies of firms that belong to different performance quintiles (see Table 3) yielded insignificant results as well. Nevertheless,

the point-estimates indicate that mid-grade performance companies, consisting primarily of companies with slight pre-succession losses or modest pre-succession gains, were most open to external successions. This pattern of mid-grade performance firms behavior, albeit insignificant, appeared previously in Dalton and Kesner (1985) and deserves further examination in future research.

The size hypothesis (Hypothesis 2) results can also be explained by demand and supply. Demand side considerations are straightforward. Larger firms have more intensive investments in their human capital and more abundant human capital reservoirs from which they can draw a suitable successor. Thus, larger firms demand internal successions more often than small firms. The supply side analysis, however, is more complicated. On the one hand, managers may prefer heading larger companies. On the other hand, larger firms are often too stagnant and too dogmatic for the new manager to turn around, therefore, managers from outside may prefer to join relatively small firms. These mixed attitudes of external candidates towards the size of the firm suggest that the supply side is probably indeterminant and does not offset the demand side inclinations.

Hypothesis 3 focusing on the number of positions offered to the new manager was confirmed because it is consistent with both demand and supply considerations. Companies that offer more positions to the new manager typically have more vacant positions at the top, and thus are in greater demand for an external infusion. Companies that offer the new manager more top positions also tend to encounter a higher supply of prospective managers. This is because external managers are attracted by the power (more top positions) ingredient which increases the likelihood that their fresh perspectives and programs would be more easily accommodated. In this case, supply and demand complement each other and trigger an unambiguous relation between a larger number of offered top positions and an increased frequency of external successions.

Finally, examinations of the effect of former manager disposition (Hypothesis 4) highlight a case of completely offsetting supply and demand forces. On the one hand, firms that keep the former manager close by (typically as Chairman of the Executive Committee in the Board of Directors) are less reluctant to recruit from outside because any new policies that the new manager may be willing to introduce can be tempered by the predecessor. Hence, the demand for external successions is relatively higher when the predecessor stays in to "guide" the newcomer. On the other

hand, an external candidate may perceive the predecessor involvement as a mean for hampering his or her authority in the organization. Thus, external candidates may prefer companies that oust the predecessor completely. The empirical finding that the proportion of external (and internal) successions did not depend on whether or not the former manager left suggests that demand and supply offset each other. Friedman and Singh (1989), the only other study to examine predecessor disposition explicitly, could not find significant relations between the origin of the successor and predecessor's disposition either.

## **Conclusions**

A review of the choice of successor evidence in this paper reveals that considerations of the successor's views and interests are essential in explaining the source of the new top manager. The findings that external successions were more frequent in small firms and in firms which offered the candidate more discretion, and the evidence that the rate of external successions was not higher in poor performing firms, portray a rational external candidate carefully weighing his or her success probability in the new job. Evidently, there are two sides to the top managers market, the firms' demand and the candidates' supply, and neither side can be ignored.

A stimulating question concerns the relative weight of the supply and demand factors in the final match decision. Studies of this topic require data about the recruiting intentions and recruiting efforts of the firm. This issue is left for future research. Kerr and Bettis (1987) and Zajac (1990) also recommend the use of primary and perceptual data from within the firm when researching top management phenomena.

Beyond the proposition that supply and demand are both important in determining the source from which the new manager comes, a contribution of this study is the introduction of a new factor, power, into the empirical analysis. The power variable, estimated as the number of top positions offered to the new manager, scored a statistically significant coefficient. Thus, it appears that it (manager's power) is essential in succession considerations and in future succession research.

## Notes

1. We thank Mark Reinganum for providing us with his list. Reinganum scanned all Wall Street Journal daily issues in the years 1978-1979, and extracted all published appointment announcements.
2. Some of these changes are just variations in nomenclature. For example, in some cases the new position did not exist before, i.e., the top manager receives an additional title that nobody in the firm previously held. Similarly, in many cases the named top manager was already the most powerful top manager in the firm, and the addition of a title does not represent a significant change in the firm. Given our large sample, and the difficulty of past research in extracting conclusive results, we have decided to be conservative and focus on major management changes only.
3. The main difference between the clean sample and the original sample (obtained from Reinganum) is in the proportion of external successions. Reinganum's sample has 18% external successions while ours has 28% external successions. This is due primarily to the second exclusion clause (exclusion of minor changes) which, by definition, eliminates only internal succession events.
4. Successors who, prior to the appointment, served on the board of directors of the company, are classified as internal successors.
5. Former managers are classified as having "stayed in the firm" whenever they retained a top position in the firm or on the board of directors. It is not uncommon for the predecessor to become the Chairman or retain a seat on the board.
6. Twenty-one companies belong to decile 1 (the smallest-firms' decile on the exchange), 30 belong to decile 2, 23 to decile 3, 22 to decile 4, 23 to decile 5, 20 to decile 6, 21 to decile 7, 31 to decile 8, 37 to decile 9 and 32 to decile 10 (the top capitalization decile).
7. Diagnostic tests do not reveal any statistical problems (such as multicollinearity) in the fitted regression.
8. A possible reason for the difference from results in Dalton and Kesner (1985) is the difference in prior performance measures. Dalton and Kesner use the accounting return on equity and the trend in stock price as their estimate of prior performance, while we use the excess return measure which is essentially the trend in stock price corrected for the general trend of the market.

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