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INVESTOR PERCEPTIONS OF CEO SUCCESSOR SELECTION IN THE WAKE OF INTEGRITY AND COMPETENCE FAILURES: A POLICY CAPTURING STUDY

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Research summary: *Drawing on theory about signaling, sensemaking, and the romance of leadership, we extend inquiry on investors' perceptions of CEO succession following misconduct. Whereas past studies have treated misconduct monolithically, we examine failures of integrity and competence separately. Using a policy capturing methodology that isolates investors' decision making from potential confounds, we find that, following an integrity failure, investors perceive outside and interim successors positively but inside successors negatively. Following a competence failure, investors perceive outside successors positively but are ambivalent toward inside and interim successors. Our findings indicate that whether an act of misconduct was an integrity failure or a competence failure, and what type of successor the firm chooses, are important considerations when using CEO succession as a means to restore investor confidence.*

Managerial summary: *Business headlines regularly feature episodes of organizational misconduct, such as product safety problems, environmental violations, employee mistreatment, and securities lawsuits, and their aftermath. In such scenarios, shareholders demand answers from the people at the top, even if those people were not directly responsible for the problem. As a result, companies often fire the CEO as a means to restore investor confidence. Does this work? It depends on the type of misconduct and who is the CEO's successor. Following a competence failure, investors welcome the appointment of an outsider, but they are indifferent to inside and interim successors. Following an integrity failure, shareholders greet outside and interim CEO successors favorably while frowning on the promotion of insiders.*

INTRODUCTION

When a firm has been caught in an act of misconduct, the consequences are often devastating. We define organizational misconduct as a grievously illegal, unethical, or incompetent act (Greve, Palmer, and Pozner, 2010), for example, deceptive accounting, options backdating, employee mistreatment, releasing dangerous products, or environmental offenses (e.g., Govindaraj, Jaggi, and Lin, 2004; Marcel and Cowen, 2014).[1] A

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[1]Misconduct is often closely associated with ethical lapses, but the term also encapsulates poor management episodes that do not involve an ethical component. The Merriam-Webster Dictionary, for example, defines misconduct both in terms of "intentional wrongdoing" and "mismanagement." Thus, we use misconduct as a cover term that refers to both integrity and competence failures.

single incidence of misconduct leads to an average 18 percent drop in stock price (Francis, Philbrick, and Schipper, 1994) and can also result in increased cost of capital, reputational penalties, and reduced payouts to shareholders (Chava *et al.*, 2010; Feldmann, Read, and Abdolmohammadi, 2009; McTier and Wald, 2011). In the wake of misconduct, firms often focus on taking steps to restore investor confidence (Arthaud-Day *et al.*, 2006). One of the most common actions is eliminating the person at the top — the chief executive officer (CEO) — in an effort to convince investors that the firm has addressed the problem and thus is worthy of renewed trust (Marcel and Cowen, 2014).

Signaling theory provides an explanation for this process. Observers (such as investors) examine visible clues about an organization (such as its behavior) to draw inferences about their unobservable attributes (Bergh *et al.*, 2014; Spence, 1973). If a firm fires its CEO following misconduct, for example, investors may believe this action is indicative of a bona fide desire to reform (Arthaud-Day *et al.*, 2006). Accordingly, past studies have found that investors respond favorably when a CEO is dismissed following misconduct (e.g., Bonnier and Bruner, 1989; Friedman and Singh, 1989).

While such studies have yielded important insights about the likelihood (Arthaud-Day *et al.*, 2006) and effectiveness (Davidson, Worrell, and Dutia, 1993) of firing a CEO following organizational failure, scholars have devoted less attention to *whom is selected as the successor* (Shen and Cannella, 2003). This is a significant omission because different types of successors (outsiders, insiders, and interims) convey different messages to investors. Tapping an outsider, for example, suggests the firm believes a break from the past is needed. Moreover, not all failures are the same, and investors may react to a firms' choice of successor differently depending on the nature of the infraction. Research on trust repair draws a distinction between failures of integrity versus failures of competence and describes how restoring trust following each type of failure requires a different approach (Ferrin *et al.*, 2007). We extend past work on CEO succession by drawing on the distinction between integrity and competence-based failures and tying this distinction to what kind of successor the firm selects. This is a worthwhile endeavor because separating constructs into meaningful categories can uncover key differences in the relationships between them that would otherwise be obscured if researchers lumped them together (Miller, 1987). As a result, we could find that investor perceptions of CEO succession operate differently depending on whether the misconduct was a failure of competence or one of integrity.

Whereas past studies have treated misconduct monolithically, we build on theory about signaling, sensemaking, and the romance of leadership to describe how investors react differently to a firm's choice of successor – outsider, insider, or interim – following failures of competence and integrity. Our focus is on punctuated events that can trigger a prompt dismissal of the CEO as opposed to a long-term, gradual decline. Within this context, a competence failure refers to specific situations where a firm falls short of technically proficient performance (Lee, 2004). Examples include making an ill-advised acquisition, not anticipating a foreseeable environmental shock that harms the firm, or lax internal procedures that create the need for a product recall (e.g., Wowak, Mannor, and Wowak, 2014). An integrity failure is a specific situation wherein the firm's motives, honesty, and/or character fall short (Kramer, Brewer, and Hanna, 1996). Examples include incidents such as financial fraud, withholding important negative information about new products, or tax evasion (e.g., Marcel and Cowen, 2014). We expect this difference in failure type could have key implications for CEO succession following misconduct. For instance, firms often wish to appoint an insider to provide continuity and establish a reputation for promoting from within, but following an integrity failure appointing an insider can signal investors that the firm is not serious about reform.

We test our theorizing by using a policy-capturing methodology on a set of mutual fund managers with average assets under management of $1.8 billion and on a set of credentialed financial professionals. This methodology allows us to isolate the stimuli under examination without the problem of nuisance variables (i.e., maximizing internal validity [Choi and Shepherd, 2004]). We use hierarchical linear modeling to examine within- and between-respondent variance in how they perceive different types of successors in scenarios that are presented as clearly either a competence or an integrity failure. This approach complements extant financial event studies that rely on archival data. Results support our hypotheses, suggesting that when considering the effects of CEO succession as a means to restore investor confidence, scholars

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and managers need to account for (1) whether an act of misconduct was a failure of integrity or competence and (2) what type of successor the firm chooses.

THEORETICAL BACKGROUND

Corporate misconduct and the romance of leadership

Corporate misconduct refers to "organizational pursuit of any action considered illegitimate from an ethical, regulatory, or legal standpoint," (Harris and Bromiley, 2007: 351). Strategy scholars have examined misconduct in a variety of forms, such as product safety problems, earnings mismanagement, environmental violations, options backdating, employee mistreatment, and securities fraud (Govindaraj *et al.*, 2004; Marcel and Cowen, 2014; Shi, Connelly, and Sanders, in press; Wowak *et al.*, 2014). Shareholders and other stakeholders often attribute such activity to the CEO, even when the actual source of the failure is uncertain (Larcker and Tayan, 2011).

Research on the romance of leadership (Bligh, Kohles, and Pillai, 2011; Meindl, Ehrlich, and Dukerich, 1985) helps explain why this is so. For investors, an important part of understanding corporate misconduct involves their efforts to generate causal attribution for the specific failure (Salancik and Meindl, 1984). In the face of many possible ways to interpret the complexities of organizational failures, blaming an organization's top leader constitutes a psychologically attractive, though biased, account of why failures occur (Meindl, 1990). This appears to be true whether there is actual evidence of the causal determinants of the failure or not, and even more so when the failure is extreme (Haunschild and Miner, 1997; Staw, 1975).

The romance of leadership literature offers several reasons why attributing misconduct to the CEO is psychologically attractive. First, doing so provides a sense of human agency and control, which reduces feelings of uncertainty and provides a sense of comfort (Bligh *et al.*, 2011). In other words, it allows investors to come to grips with forces that, in actuality, might be unknowable or indeterminate by reducing them to a simple solution. A related reason is that providing a human explanation for an organizational failure is something that is readily understood and easily communicated to others. As such, it translates well from the board of directors to various organizational stakeholders and is a message that investors can in turn communicate to their constituents. Some also have suggested that observers are prone to overestimate the amount of control top leaders have over organizational outcomes, and this is especially so when the outcome in question is significant (Meindl *et al.*, 1985). Meindl and Ehrlich (1987) describe this in terms of a cognitive bias wherein individuals ascribe a halo effect to leaders, giving them inordinate credit for organizational successes and inordinate blame for failures.

The ideas underlying the romance of leadership have garnered considerable empirical support. For example, Kang (2008) used this literature to theorize that investors are likely to attribute responsibility for alleged financial reporting fraud to the accused firms' top leaders. Gibson and Schroeder (2003) found that observers tend to blame upper-level management to a greater degree than lower-level employees for organizational failures. Gomulya and Boeker (2014) find that investors attribute material financial restatements to the CEO, and even more when the restatement is severe. Others report similar findings regarding investor attributions to the CEO in response to poor firm performance and bankruptcy (Quigley and Hambrick, 2014; Sanders, 2001). This is consistent with research on symbolic management, which stresses the impression management and public relations value of taking highly visible actions—such as replacing the CEO—in the hope of pacifying shareholders (Westphal and Zajac, 1998; Zajac and Westphal, 1995). To understand the communication mechanisms behind the tactics firms use to restore investors' confidence, scholars often rely on signaling theory (e.g., Gomulya and Boeker, 2014).

Signaling theory

A core premise of strategic management applications of Spence's (1973) signaling theory is that signaling is a tool for a firm to reduce information asymmetry between itself and investors regarding the firm's unobservable characteristics (Connelly *et al.*, 2011). Past research has examined how firms signal investors about features such as managerial talent, value of knowledge stocks, and quality of a strategy, among others (Bergh *et al.,* 2014). The usefulness of any given signal depends largely on the extent to which the signal actually corresponds with unobservable quality that the receivers (e.g.,

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investors) desire (Busenitz, Fiet, and Moesel, 2005). Some management scholars call this signal *credibility* (Connelly *et al.*, 2011; Davila, Foster, and Gupta, 2003), which essentially describes whether the signal can be trusted. Signals with low credibility could be subject to false signaling, wherein firms send an apparent signal even though they do not have the desired underlying characteristic (Bergh *et al.,* 2014).

Given that investors are prone to attribute organizational failures to the CEO, boards of directors often replace the CEO after an act of misconduct, in part as a signal intended to restore investor confidence in the firm (Arthaud-Day *et al.*, 2006). Marcus and Goodman (1991) describe how, following misconduct, firms seek to distance themselves from past problems and may do so through executive changes designed to prevent recurrence of the dubious behavior. Firms that announce CEO successions reinforce investors' tendency to attribute failure to the CEO: investors believe the CEO is at fault and the CEO's termination suggests that the board of directors (who have more information than do investors) holds the same belief. Supporting these ideas, Shapiro (1991) found that blame assignment reduces the negative reaction of shareholders. Assigning blame to a specific person holds the potential of limiting the organization's punishment and reducing organizational stigma (Mishina, Block, and Mannor, 2012; Pfarrer *et al.*, 2008).

It is important to note, however, that CEO succession actually involves two actions that each send a signal to investors: (1) removing the CEO and (2) choosing his or her successor. These two signals are, of course, intertwined because the firm cannot have one without the other, but Friedman and Singh (1989: 726) contend that CEO "successor origin, a highly visible attribute, seems to convey the clearest signal among the messages implicit in successions." A rich set of studies show that CEO exit is higher following misconduct (e.g., Arthaud-Day *et al.*, 2006; Hennes, Leone, and Miller, 2008; Leone and Liu, 2010), and a subset of these studies considers the second signal: what type of successor the firm selects as a replacement (Gangloff, Connelly, and Shook, in press; Gomulya and Boeker, 2014; Wiersema and Zhang, 2013). We argue that who takes the CEO's place is an important determinant of the signal's credibility. Moreover, we theorize that how investors interpret different types of successors in the wake of misconduct depends on the nature of the infraction.

Sensemaking and signals

While signaling theory draws attention to how signalers provide information to observers (Spence, 1973), the sensemaking literature provides an explanation for how observers process and act upon that information (Weick, 1995). Gioia and Thomas (1996) describe sensemaking in terms of perceiving the meaning of events based on information surrounding a strategic change. From a sensemaking perspective, individuals rely on schemas—patterns of thought that organize a person's assumptions and knowledge—to make sense of and then react to phenomena as they are encountered (Thomas, Clark, and Gioia, 1993).

There is some evidence that observers' sensemaking about infractions differs depending on the nature of the infraction. According to research on trust repair, competence (i.e., "the degree to which one possesses the technical and interpersonal skills required for a job") and integrity (i.e., "the degree to which one adheres to a set of principles that is considered acceptable") represent substantively different drivers of trust (Kim *et al.*, 2006: 51). These two different aspects of a relationship are associated with a different set of expectations about partner behavior (Janowicz-Panjaitan and Krishnan, 2009; Tomlinson and Mryer, 2009). In the language of sensemaking research, observers use different schema to evaluate information about competence issues than they use to evaluate information about integrity issues (Rouleau and Balogun, 2011). As a result, some approaches to restoring trust may be more successful following a competence failure than they are following an integrity failure and vice versa (Ferrin *et al.*, 2007).

With respect to timing, investors generally are aware that a failure has occurred before they encounter and have to interpret a firm's signals aimed at restoring investor confidence (Greve *et al.*, 2010). Investors are likely to draw conclusions, in conjunction with information intermediaries such as analysts and the media, about whether the failure was one of competence or integrity (Gangloff *et al.*, in press; Paruchuri and Misangyi, 2014). Sometime afterward, the firm constructs verbal accounts to explain the failure and puts forward a plan to rectify the problem, which may include firing the CEO (Zavyalova *et al.*, 2012). Investors work to make sense of the information as part of the process of arriving at perceptions of what the firm's actions, such as CEO turnover, means for the firm's future.

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HYPOTHESES

Investor perceptions of succession following integrity failures

The schemas that develop around integrity are *hierarchically restrictive* (Reeder and Brewer, 1979), meaning that observers (in our case, investors) believe that the behavior of an actor (e.g., a CEO) who has an attribute at one end of a continuum will be restricted, but behavior is not restricted at the other end (Ferrin *et al.*, 2007). With regard to observers' schemas about integrity, the belief is that an honest person always will be honest when making important choices, while a dishonest person sometimes will be honest and sometimes dishonest (Kim *et al.*, 2004). Importantly, in the minds of observers, no amount of honest behavior can compensate for an integrity failure when making attributions about an actor who failed. As Reeder and Brewer (1979: 68) note, "a single dishonest behavior is sufficient to produce a confident attribution that the actor is dishonest."

Stated differently, observers believe that behavior is locked in at the desirable end of the honest–dishonest continuum, but not at the undesirable end. As a result, "embezzling from a company once makes us an embezzler even if we do not engage in additional thefts" (Kim *et al.*, 2004: 106). The hierarchically restrictive schemas associated with a CEO's integrity are likely to inform how observers (i.e., investors) make sense of the firm's attempts to restore trust (i.e., their signals) in the wake of an integrity failure.

When a firm announces a CEO succession following an integrity failure, it effectively sends two signals. With the first signal (removing the incumbent CEO) the firm essentially admits that there has indeed been an ethical violation worthy of firing the CEO. Owing to the hierarchically restricted schema by which observers interpret signals, an episode of unethical behavior leads to attributions that the prior CEO lacks integrity because honest CEOs never act dishonestly (Kim, Diekmann, and Tenbrunsel, 2003). Investors will be pleased that the firm has removed such a CEO, but, consistent with the aphorism that "one bad apple spoils the barrel," they are likely to worry that the rest of the executive team might also have low integrity (Trevino and Youngblood, 1990: 378).

The second signal is the choice of a replacement CEO. Tapping an outsider following an integrity failure is likely to be well-received by investors, in part due to an expectation that s/he will "clean house." An outsider is not tied to the firm's administrative heritage, so an outsider's arrival signals an inclination to revisit organizational procedures and controls (Friedman and Saul, 1991). Appointing an outsider serves as a credible signal to investors, meaning that it shows that the signaler actually has the unobservable quality being signaled (i.e., willingness to change). Bringing in an outsider is credible because it comes at a cost to the current management team. Specifically, it installs a watchdog that is not committed to them (Cannella and Lubatkin, 1993). Thus, investors are likely to perceive the replacement of an incumbent with someone who is not tied to the previous regime as a positive signal (Friedman and Saul, 1991)—one that carries the hope of instilling a new culture with a presumably more ethical approach. This leads us to hypothesize:

> *Hypothesis 1: Following an integrity failure, investors perceive outside CEO succession positively.*

The baseline of comparison for this prediction and those below is a null condition wherein the firm provides no information about the CEO's fate. In other words, we are anticipating that investor perceptions of outside succession to be both positive and significantly different from perceptions of the no-information condition.

If a firm taps an insider as the new CEO, this sends a signal to the investment community that conflicts with the signal sent by dismissing the incumbent CEO. Insiders have often worked closely with the incumbent, affording them transparent access to the tasks and office of the CEO, a scenario that is likely to influence their behavior when they assume that role themselves (Shen and Cannella, 2002; Zhang and Rajagopalan, 2004). This works against the inside successor because, owing to their hierarchically restrictive schema, investors are likely to perceive the outgoing CEO to have been a dishonest person based on this single integrity failure (Kim *et al.*, 2004). As a result, the candidates for inside succession – controllers, chief operating officers, and senior vice presidents – could potentially be embedded and invested in a culture that permitted bad behavior (Rezaee, 2005). Investors simply cannot be sure: perhaps the insider had knowledge of the ethical problems and perhaps s/he did not. The problem, as Barker and Patterson (1996: 305) note, is that if they did then the CEO should not be "replaced by executives with similar views who will perpetuate existing organizational belief systems and practices." As a result, some investors likely will interpret the promotion of an insider as a signal that lacks credibility because it undermines confidence that the firm is serious about changing its mores (Zhang and Wiersema, 2009).

These conflicting signals lead to unflattering perceptions by investors of the firms' unobservable intentions, which will lead investors collectively to drive down the value of the stock (Shen and Cannella, 2003). Some investors may be in a hold or buy mode, but more investors will want to dispose of their shares. If investors perceive inside CEO succession following an integrity failure negatively, it is tantamount to saying that investors are more worried than they would be if they had no information yet about the incumbent CEO's fate. To explain why, it is helpful to consider investor sensemaking that surrounds the signals sent by CEO succession.

Sensemaking research suggests that navigating ambiguity is a particularly daunting challenge for decision makers (Weick, 1979, 1995). Ambiguity exists when multiple viable interpretations surround some given information. Decision makers facing ambiguity must analyze more than one possible explanation for the signals they are observing and attempt to figure out which explanation is the correct one (Gioia and Chittipeddi, 1991). If a CEO remains in place following an apparent failure of integrity, it is unclear (i.e., ambiguous) to investors whether the board of directors believes a change at the top is needed or whether the board will eventually act (Graffin, Carpenter, and Boivie, 2011). Investors are left grappling with several viable explanations for nonaction. Perhaps the firm is investigating the situation further. Perhaps the firm has examined the situation and has determined that the CEO's level of culpability does not warrant dismissal. Perhaps the firm has decided to fire the CEO and it is working out the details of his/her exit. We expect that investors will postpone fully reacting to such scenarios until the ambiguity they face is resolved (Pitcher, Chreim, and Kisfalvi, 2000). If a firm retains the incumbent CEO following disclosure of an integrity failure, there is still hope that the firm will ultimately "do the right thing." But by promoting an insider, the firm plays its hand, and it is a bad one. The result is that, in the wake of an integrity failure, investors perceive inside succession as a combination of conflicting signals, and thus discount the credibility of the firms' signaling. Therefore, we expect:

Hypothesis 2: Following an integrity failure, investors perceive inside CEO succession negatively.

Investor perceptions of succession following competence failures

For competence failures, hierarchically restrictive schemas are again important, but the schemas are structured differently. As before, observers (e.g., investors) assume that the behavior of an actor (e.g., a CEO) is restricted at one end of a continuum but not at the other (Reeder and Brewer, 1979). However, with regard to competence, observers intuitively believe that incompetent actors can only perform poorly but that competent actors are capable of performing well or poorly (Kim *et al.*, 2003). Here behavior is locked in at the undesirable end of the continuum, but not at the desirable end (i.e., the reverse of the structure of the schemas that develop about integrity).

This is likely to be consequential to how investors respond to a firm's choice of CEO successor because, while they may blame the incumbent CEO for the failure (Bligh *et al.*, 2011; Kang, 2008), they cannot tell from this single incident whether the CEO is competent or incompetent. If they cannot make this determination about the previous CEO, then there would be little reason, based on a single failure of competence, for investors to believe that incompetence runs throughout the executive team. In sum, investors are pleased to have a hook on which to hang their attributions for failure (Gibson and Schroeder, 2003), but they stop short of making broad attributions of incompetence (Kim *et al.*, 2003).

As a result, inside successors do not suffer from the same liability as in the case of an integrity failure. Following a competence failure, appointing an insider may or may not be a credible signal because investors simply do not know how to make sense of it (Kesner and Sebora, 1994). The competence failure could be symptomatic of larger problems, but anyone can make a competence mistake once (Kim *et al.*, 2006), so investors are uncertain about the reliability of the signal, and thus it does not steer their perceptions to be more negative or more positive. Therefore, we do not formulate a

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hypothesis related to inside CEO succession following a competence failure.

In contrast, investors may be intrigued by the possibility of change offered by the appointment of an outsider following a competence failure (Davidson *et al.*, 1993). Outsiders carry with them a range of fresh perspectives and are more likely to make adjustments in accordance with stakeholders' demands (Shen and Cannella, 2002). Indeed, firms frequently bring in outside CEOs as "change agents" who are expected to infuse top management with new strategic thinking (Parrino, 1997). Relative to insiders, outside CEO successors can more objectively evaluate a firm's operations and perhaps uncover previously hidden sources of the competence failure and initiate appropriate changes (Cannella and Lubatkin, 1993).

Bringing in an outsider serves as a credible signal because it carries with it the likelihood of change (Lafley, 2011; Wiersema, 1992). Choosing an outside CEO successor signals investors that the succession is not simply symbolic in an attempt to pacify them (Pfeffer, 1981; Westphal and Zajac, 1994, 1998), but rather it foreshadows the implementation of meaningful differences to organizational procedures or personnel. It reduces the likelihood that the firm is simply attempting to satisfy external demands for accountability while avoiding the costs of substantive change (Zajac and Westphal, 1995). Therefore, we expect that investors will view positively the selection of an outside successor in the wake of a competence failure. Stated formally,

> *Hypothesis 3: Following a competence failure, investors perceive outside CEO succession positively.*

Firms also have a third choice: appointing an interim CEO who will temporarily run the company until they find a permanent successor. This is a less definitive move because tapping an interim CEO does not send a clear positive or negative signal. Appointing an interim CEO demonstrates that the firm is serious about taking its time and finding the right person, but firms can suffer when appointing an interim because some are "place keepers" that lack clear strategic plans (Dalton and Dalton, 2007) and avoid making key decisions (Farquhar, 1994). Thus, appointing an interim CEO puts investors in a "wait-and-see" mode, and their guesses about who might end up as the permanent CEO could drive their responses more than who is the interim CEO. Interim CEOs are an important component of the succession landscape (Mooney, Semadeni, and Kesner, 2013), but theory does not provide an obvious rationale about investor perceptions of interim successions following either type of failure. Rather than developing hypotheses, we investigate this phenomenon via post-hoc analysis.

METHODOLOGY

Although most studies of investor reactions to CEO succession are event studies that rely on archival data (e.g., Shen and Cannella, 2003), we used policy capturing to test our hypotheses. Policy capturing melds aspects of experimental and survey methods by asking respondents how they would respond to hypothetical but realistic scenarios (Priem, Walters, and Li, 2011). We presented respondents with a series of scenarios that differed only in terms of our variables of interest: the nature of wrongdoing (competence-based vs. integrity-based) and whether a new CEO is an outsider, insider, or interim. This approach allows researchers to isolate the effects of different pieces of information on decision-makers' choices (Priem *et al.*, 2011).

Policy capturing is quite useful for examining respondent perceptions of an organizational event such as CEO succession because the method avoids potential confounds that can surround such events when using archival data (Hitt *et al.*, 2004). In the case of CEO succession, for example, archival data cannot reveal the extent to which a particular investor's decision to sell a stock might be influenced by the behavior of other investors (Nofsinger and Sias, 1999). Policy capturing can avoid this issue by not providing respondents with cues about what other investors are doing. Further, policy capturing allows us to delineate clearly between competence and integrity failures, whereas in archival data the line of demarcation between the two is not always obvious. Meanwhile, a key limitation of policy capturing is that, unlike in archival studies, we do not assess actual behavior. In sum, the strengths and weaknesses of our policy-capturing approach complement those of the archival designs that have dominated investigation of investors' reactions to CEO succession (Cannella and Shen, 2001; Graffin, Boivie, and Carpenter, 2013).

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We relied on two sources for respondents. The first group consists of major institutional investors. We used the FACTSET database to identify such investors and contacted them via phone to request their participation. We contacted 179 institutional investors; 17 completed our online instrument (i.e., 9.5%). Data collection was not anonymous, and some investors who initially agreed to participate expressed concerns about confidentiality, which we believe contributed to the low response rate. Participants are principal managers of major investment funds, with median assets of $1.8 billion. Because our first group of respondents was too small to provide adequate statistical power, we also pursued a second group of individuals whose jobs require them to make important financial decisions, such as which equities to own. In particular, we targeted 331 experienced (minimum three years) financial professionals gleaned from a database of master's degree alumni of a highly rated graduate program in the United States. This yielded 73 usable surveys for a response rate of 22.1 percent.

Design

Participants were asked to imagine that their investment fund owned a "sizable amount of holdings" of LuxCo, a hypothetical company that is the target of a securities class action lawsuit as a result of being accused of organizational misconduct. To ensure realism, we provided generic details about the company (e.g., age, industries, employees, subsidiaries, performance) that were modeled after an actual S&P 500 firm (Ralph Lauren Corporation), but participants were not given enough information to identify this firm as the model. The description we provided of LuxCo's current CEO was modeled after the average CEO for all S&P 500 firms (e.g., age, education, experience with the company, salary). We specified that there is no heir apparent to the current CEO and that no changes are being made to the board of directors.

Participants evaluated a series of hypothetical scenarios and decided whether to buy, sell, or hold LuxCo stock (Choi and Shepherd, 2004). Each scenario described either a competence or an integrity failure, which were of sufficient scale that they threatened to shake investor confidence. The competence failure involved "a household item that was not properly tested and could lead to a home fire" wherein LuxCo "executives did not know, but should have known, that the product needed specific tests that were not completed before it went to market." The integrity failure was that "company executives designed a complex web of imaginary holding firms that solely did business with LuxCo with the purpose of hiding losses in LuxCo's quarterly balance sheets."

For the competence failure, we showed respondents four different scenarios: the CEO is replaced by an insider, an outsider, an interim, or no information is given about the current CEO's fate. For the integrity failure, we showed respondents the same four scenarios: the CEO is replaced by an insider, an outsider, an interim, or no information is given about the current CEO's fate. This resulted in the creation of eight different scenarios. We randomized the order in which the eight scenarios were presented to each participant. We also provided opportunity for respondents to explain the rationale underlying their responses if they wished to do so. As a check of judgment consistency, we then added two additional scenarios that were simply duplicates selected from the eight different scenarios described above. The duplicate scenarios were always presented last. We did not include responses to the duplicate scenarios in the analysis; we just compared responses to the duplicate scenarios to original responses for the same scenario to check how close they were. Average judgment consistency within plus or minus one point on the Likert scale was high, at 0.96 (cf. Kristof-Brown, Jansen, and Colbert, 2002).

In a pilot study, we emailed our survey to the first 50 financial professionals listed in our Master's alumni database (not part of the 331 invited to participate in the study). Eight individuals (not included in our analysis) responded, providing us insights that led us to fine-tune the instrument with minor adjustments to the scenarios to eliminate confusion and ensure realism.

Measures

The independent variable was the choice of CEO successor: *outsider* indicated appointment of an executive from another firm; *insider* was succession by another LuxCo executive; and *interim* referred to appointment of a temporary CEO "while the firm searches for a permanent replacement." We also state that the interim CEO "used to be CEO of LuxCo but is now retired," so the interim is neither an insider nor an outsider. Using eight different scenarios allowed us to create three dummy variables

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as predictors: insider, outsider, and interim CEO succession. Insider takes a value of 1 for the scenarios where the firm chooses an inside CEO successor and 0 otherwise. Similarly, outsider is 1 for outside CEO succession and 0 otherwise; and interim is 1 for an interim CEO and 0 otherwise. All three dummy variables take a value of 0 for the scenario that provides no information about the fate of the incumbent CEO, making that the excluded referent category.

The dependent variable represented investor perceptions about each type of CEO succession, measured as their likelihood of buying, selling, or holding the firm's stock. Participants selected their responses on seven-point Likert scales that asked them what they would do "based solely on the limited information provided here," ranging from "definitely sell LuxCo stock" to "definitely buy LuxCo stock."

We controlled for attributes of the decision makers that could potentially influence their responses. Specifically, we controlled for *gender* and *age* because some suggest that female and older participants could be more risk-averse in financial decision making than others (Eckel and Grossman, 2002). We also measured participants' comfort level with risk by using a seven-point *risk propensity* scale (Meertens and Lion, 2008). Because companies are asking investors to trust them with their succession announcements, we controlled for *trusting stance* using a five-point scale developed by Heretick (1981) to measure expectancies concerning the trustworthiness of others. Investors in different parts of the United States could have more systematically mild or severe reactions, so we controlled for geographic *region* with dummy variables coded for the Midwest, Northeast, Pacific Northwest, South, Southeast, and West. Lastly, we included a dummy control variable for the *participant type*: institutional investor or financial professional.

Using multivariate analysis of variance (MANOVA), we found no statistically significant differences between the responses of the two types of respondents (institutional investors and financial professionals). We also tested for sample representativeness for both sources. For the institutional investors, we compared our respondents to the sample (i.e., all those in our institutional investor database) on several dimensions: gender, level of education, assets under management, asset turnover, and geographic location. There were no significant differences between respondents and the sample on any of these dimensions. We compared our financial professional respondents to the sample (i.e., all financial professionals in our alumni database) on gender, age, and geographic location (level of education is a constant because they are all master's graduates). Again here, there were no statistically significant differences between respondents and sample.

Analysis and results

We analyzed the data using hierarchical linear modeling (HLM) to account for the nested nature of our data (i.e., each respondent saw eight different scenarios that are nested within a single survey). Such a structure violates the assumption of independence of observations associated with regression models, but there is no such assumption in HLM because it separately evaluates the influences of within-person and between-person variance on the dependent variable. To evaluate the effects of successor choice following specific types of episodes, we conducted separate analyses for scenarios that followed a competence failure and those that followed an integrity failure.

In terms of descriptive statistics, respondents were, on average, 39 years old with a standard deviation of 10 years. Forty-four percent were female and 93 percent hold a master's degree. The average Likert score responses to trusting stance were 2.74 (standard deviation of 0.59), and the average Likert score responses to risk propensity were 3.45 (standard deviation of 0.85). As is common with policy-capturing studies, we do not include a correlation matrix because many of the cells are null (e.g., Choi and Shepherd, 2004; Moon *et al.*, 2003).

Table 1 displays the results. Control variables, which were not significant, are shown in Model 1 (integrity failure) and Model 3 (competence failure). Models 2 and 4 show the influences of our predictor variables following an integrity failure and a competence failure, respectively.

In the aftermath of an integrity failure, investors perceive outside CEO succession positively as compared to the null case wherein no information is provided about the incumbent CEO's fate ($p < 0.001$), yielding support for Hypothesis 1. Respondents' open-ended comments added richness to this finding. One respondent noted that tapping "a CEO from another company may lead to discontinuity, but if it means a clean break from past improprieties,

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Table 1. Hierarchical linear modeling of investor reactions

Variables	Model 1 Following integrity failure	Model 2 Following integrity failure	Model 3 Following competence failure	Model 4 Following competence failure
Gender	−0.21	−0.21	−0.28	−0.28
Age	0.01	0.01	−0.01	−0.01
Risk propensity	−0.10	−0.10	0.01	0.01
Trusting stance	−0.14	−0.14	0.10	0.10
Participant type	0.04	0.04	0.05	0.05
Outside successor		0.91***		0.57***
Inside successor		−0.23*		0.01
Interim successor		0.41***		0.13
Geographic region (dummy variables)	*Included*	*Included*	*Included*	*Included*
Chi-sq.	2.93	119.30	5.02	55.17
d.f.	10	13	10	13

*$p < 0.05$; **$p < 0.01$; ***$p < 0.001$
N = 360 for all models. Two-tail tests for all variables in all models.

it is best." Similarly, a second respondent indicated that "a new CEO from another company would be less knowledgeable about the detailed operations of the company, but he/she would bring a fresh perspective and the company would avoid [rewarding] unethical behavior by not promoting someone internally." Another suggested bringing in an outsider "may be the best action to show that you want to avoid a reoccurrence." Others suggested that outside succession is "probably healthy" following an integrity failure because "someone with an independent perspective could be helpful in remediating the issues."

Following an integrity failure, investors perceive inside CEO succession negatively ($p < 0.05$). One respondent noted, "If there were a major ethical violation at the company, the investing public would probably assume that the knowledge or willingness to participate in the violation by the other top executives was pervasive, even if this was not the case. As such, it would probably seem like a weak response to a major ethical violation." Some other illustrative comments about why promoting an insider would be alarming include "bad apples work together; an internal candidate might be dishonest as well," "he might have been involved with the ethical violation," "it can give the appearance to investors that nothing has really changed," and it "might not completely solve a more deep-rooted problem within the management ranks of the company."

As expected, investors perceived inside CEO succession as neither significantly positive nor significantly negative in the wake of a competence failure. Hypothesis 3, however, suggested that investors would look positively on outside CEO succession following a competence failure. This hypothesis was supported ($p < 0.001$). For bringing in an outsider under this scenario, one respondent noted that "the resulting increase in stakeholder confidence in management's ability to 'right the ship' could be positive for the company immediately" and that shareholders would have "expectations about a new management's ability to turn things around." Another suggested that bringing in an outsider would "provide shareholders with a feeling that failure is not acceptable and the company has demonstrated its commitment to providing shareholder value."

Post-hoc analyses

Appointing an interim CEO is an increasingly popular phenomenon (Mooney, Semadeni, and Kesner, 2014) that we investigated without developing formal hypotheses. Following an integrity failure, investors have positive perceptions of appointing an interim CEO as compared to the null case wherein no information is provided about the incumbent CEO's fate ($p < 0.001$). One respondent suggested that appointing an interim has "few drawbacks" because "taking action is good and showing that you want to be thoughtful is even better." Another respondent noted that "if the interim CEO can provide a positive and effective face for the company as it moves forward through a crisis, it would be of great benefit. The right person for the permanent job cannot be selected in only a matter of days; therefore an interim CEO allows the company proper time to search for the best option." Similarly, one respondent contended that appointing an interim "signals that the board is serious about making changes, but is not going to rush into finding a replacement." Others posited that tapping an interim "seems like the right thing to do while sifting through the investigations surrounding the violation" and that it "could be a good approach to have a 'cooling off' period before finding a permanent solution."

These results and comments appear to suggest that appointing an interim CEO signals investors that the firm realizes the problem is severe enough that the source must be removed immediately (Ballinger and Marcel, 2010). This is a credible signal because it conveys the firm's apparent intent to conduct an extensive search to identify an outstanding candidate (Reiter, 2009). Thus, appointing an interim CEO demonstrates to investors that the firm is committed to ridding itself of unethical influences, even though it does not yet have a long-term solution in place.

However, not all respondents were so favorably disposed. One, for example would be pleased that "the company is taking it's time to resolve the issue" but s/he would worry that an "interim CEO is only a temporary resolution which means the company cannot move on and recover from this scandal." Others were concerned that "an interim CEO might be viewed as having no real authority or motivation to get the company back on track and reestablish a tone of integrity" and "the focus of the interim CEO will be short-term." These latter comments draw attention to the mixed reception that interim CEOs could engender in the wake of an integrity failure. For example, interim CEOs frequently have diminished authority compared to other CEOs and may neglect long-term issues in favor of the firm's short-term well-being. In fact, a z-score comparison of the respective beta coefficients (Paternoster *et al.*, 1998) reveals that, following integrity failure, investor perceptions of outside CEO succession (0.91) are significantly more positive ($p < 0.01$) than investor perceptions of appointing an interim CEO (0.41).

Following a competence failure, investor perceptions of interim CEO succession are positive but not significant ($p = 0.15$ in a two-tailed test). Following a competence failure, investors are not completely convinced about the presence of a systemic problem because talented CEOs could, occasionally, make incompetent choices (Kim *et al.*, 2006). Therefore, following a competence failure, investors do not draw strong conclusions about a CEO's removal and may even be cognizant of the potential drawbacks of having an interim CEO. More generally, our post hoc analysis highlights the benefits of appointing an interim CEO to eliminate an unethical CEO immediately, but they do not show significant benefits in the context of competence failures.

DISCUSSION

We set out to accomplish two main goals. First, we sought to examine how investors perceive different choices of CEO successors following failures of competence and integrity. Second, we intended to complement extant financial event studies on CEO succession with an experimental method that isolates investors' decision making from potential confounds and focuses them on scenarios that are definitively failures of competence or integrity. Prior studies have found that CEO succession is often used to restore investor confidence following misconduct, and the appointment of outside, inside, and interim CEOs are all relatively common (Karpoff, Lee, and Martin, 2008). Our results reveal contingencies under which some successor selections are more effective tools than others. These results appear likely to inform both research and practice.

Implications for research

Our findings enhance the strategic management field's knowledge base in at least three areas: (1) signaling, (2) CEO succession, and (3) organizational misconduct. First, our study adds to the body of literature on signaling by incorporating research on sensemaking to help explain how observers perceive (i.e., make sense of) various signals. Signaling theory is useful for explaining how investors make decisions in response to firm actions, such as alliance announcements, branding decisions, and CEO successions (Bergh *et al.*, 2014). We add that the signaling process may not be as economically efficient as researchers sometimes assume because observers have cognitive tendencies and patterns that affect how they make sense of and respond to signals. In our case, we posit that observers process information about competence and integrity using hierarchically restrictive schema that differ substantially in their nature and that these differences have implications for sensemaking and action.

We hope this initial attempt to augment signaling theory with individual-level concepts and theorizing spurs others to do more of the same, where appropriate. Researchers might consider the extent to which observers are subject to particular cognitive biases, thus changing the nature of their reactions. The availability bias, for example, refers to the tendency to place undue weight on recent events and easily recalled information when making attributions (Tversky and Kahneman, 1973). Following an episode of failure, we might expect transient institutional investors (i.e., those who quickly move in and out of various stocks) to be more prone to the availability bias than dedicated institutional investors (i.e., those who hold stock for extended periods) because the latter are likely to be more thoroughly informed about the firm, the infraction, and the successor. As such, dedicated investors may incorporate a broader range of issues into their perceptions of the choice of a CEO successor than transient investors.

While we focused on the sensemaking conducted by signal observers, others might also consider how theory on *sensegiving* can help explain the signaling process. Sensegiving refers to attempts to influence the perceptions of others during strategic change (Gioia and Chittipeddi, 1991). Perhaps some firms are better than others at matching their choice of signal to the circumstances surrounding a bad outcome or bolstering their signals with socially legitimate language (e.g., using apologies, denial, or external attribution) (Westphal and Zajac, 1998). Investors would likely perceive firms that package their signals convincingly more positively than those that struggle with this process.

Second, our study advances understanding of executive succession by highlighting the distinction between integrity failures and competence failures. Following an integrity failure, investors view outside successors positively and inside successors negatively, but this is not the case following a competence failure. One implication is that researchers need to account for the integrity–competence distinction when examining the effects of misconduct. Miller (1987) suggests that if meaningful categories are empirically lumped together into one whole rather than considered separately, the data analysis that follows is likely to lead to erroneous conclusions. For instance, we ran one more post hoc analysis, combining our data for both types of misconduct. After doing so, inside succession was negatively related to investor reaction ($p < 0.05$), masking the more nuanced understanding provided by our hypothesis testing. Similarly, investors do *not* react significantly to the appointment of interims overall, again hiding our more nuanced pair of findings. One implication for future studies is that findings involving investor perceptions of firm responses to misconduct may be distorted if the integrity vs. competence distinction is ignored.

Third, our study has implications for research on organizational misconduct. Much of the work on misconduct explores predictors of wrongdoing or considers its consequences (e.g., Alexander, 2008; Persons, 2006). Our study adds to this line of research by testing the efficacy of one of the most common approaches to restoring investor confidence following misconduct: turnover at the top (Collins, Reitenga, and Sanchez, 2008; Gomulya and Boeker, 2014). Spence (2002) notes that signalers are often unaware of what signals they are sending and how those signals could cause damage. This may be the case with firms' choice of successors following misconduct. Although firms may intend CEO succession to be a signal to investors that they are righting the ship (Agrawal, Jaffe, and Karpoff, 1999), we uncover evidence that investors interpret those signals differently–depending on both the choice of successor and the nature of the infraction (Janowicz-Panjaitan and Krishnan, 2009). Thus, the signals sent by CEO succession are multifaceted rather than simple and straightforward. Future research could delve more deeply into this multifaceted nature by considering what other actions (e.g., restructuring, board turnover, acts of contrition) firms might package with a succession event in order to restore investor confidence following misconduct (Wiersema and Zhang, 2013). Moreover, scholars might build on our study by examining investor perceptions of various firm actions when organizational misconduct involves elements of both competence and integrity failure.

In terms of methods, our study departs from past practice by taking on a behavioral perspective of investors. Our policy-capturing approach has an array of strengths and limitations that complement those of the financial event studies used in previous work (e.g., Davidson, Worrell, and Cheng, 1990; Lee and James, 2007). Strengths of the latter approach include large sample sizes, a diversity of firms and industries, and the

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examination of actual events in the marketplace (Pitcher *et al.*, 2000). These are, admittedly, limitations of policy-capturing studies, which rely on a small number of respondents, a small subset of scenarios, and hypothetical events. However, event studies of archival data also suffer from being subject to a wide range of nuisance variables, alternative explanations (e.g., investors reacting to other investors), and problems of construct validity (i.e., relying on distal proxies). Policy capturing surmounts these specific problems because investors respond only to the information at hand (free of nuisance variables), predictors can be manipulated via design choices, and researchers know precisely what they are measuring (Aiman-Smith, Scullen, and Barr, 2002). Therefore, as the community of scholars continues to build a body of findings on CEO succession, this study provides a unique new piece of the puzzle.

Overall, to the extent that both policy capturing and event studies draw the same conclusions, we can enhance confidence in those conclusions (Jick, 1979). Our results, for example, provide confirmatory evidence that CEO succession following misconduct matters to investors, and they help rule out the possibility that event studies have identified such linkages simply due to methodological weaknesses. More generally, this sort of triangulation could be useful for dealing with endogeneity. The complexity and controversy surrounding endogeneity has become profound enough that the *Strategic Management Journal*'s editors recently published a policy statement[2] urging researchers to address endogeneity, while acknowledging that no remedy is perfect. Because policy capturing can be implemented in ways that exclude endogeneous influences, we suggest this method can be a potent arrow in researchers' methodological quiver, especially when contributing to research streams wherein most studies face endogeneity concerns.

Implications for practice

Our examination of CEO succession specifically in the context of integrity-related and competence-related failures is important for firms because as many as half of the firms that engage in misconduct may use CEO turnover as a strategy for restoring investor trust (Arthaud-Day *et al.*, 2006; Wang, Davidson, and Wang, 2010). Our results caution, however, that perhaps some firms should not be so eager to do so. Following a competence failure, investors appear to be unmoved by two types of CEO succession—insider and interim appointments. Outside succession does improve investors' views of the firm's prospects, but it creates costs (e.g., the old CEO's severance package) and introduces the uncertainty of bringing in a new leader who is not part of the firm's history and has no commitment to the current strategy and management team (Dalton and Dalton, 2007). In short, if the problem is competence-related, then removing the CEO may not be the best strategy for repairing investor relations. Here forgiveness (rather than replacement) of the CEO might really be divine.

If the misconduct is integrity-related, our findings indicate that a firm should avoid promoting an insider. However, if the company can identify an appropriate outside successor, investors will view such a selection favorably. In addition, it may be important that firms act quickly when there has been an integrity failure (Hazarika, Karpoff, and Nahata, 2012). If they are unsure about their long-term choice, appointing an interim CEO following an ethical breach may be well received by investors. Such an appointment communicates to investors that the firm knows it has a problem and it is committed to solving it (Ballinger and Marcel, 2010).

To provide firms with additional guidance, future research might examine the actions firms take after they appoint an interim CEO (Mooney *et al.*, 2014). Real options theory (Trigeorgis, 1996) may be useful here. A real option called "deferral" exists when a decision maker is able to postpone making a strategic decision until the passage of time resolves uncertainty by providing additional relevant information (Hult, Craighead, and Ketchen, 2010). Appointing an interim CEO effectively provides the firm with a deferral option wherein it can glean information in the months following the misconduct episode that could inform when to choose a permanent successor and who that successor should be. This possibility raises intriguing research questions. It would be interesting, for example, to discover whether the negative effects of eventually promoting an insider following an integrity failure are tempered if the firm initially appoints an interim CEO. Another avenue for building knowledge would be to examine whether investors' initial positive response to an interim CEO in the aftermath

[2] http://strategicmanagement.net/pdfs/SMJ_Guidelines_Regarding_Endogeneity.pdf

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of an integrity failure dissolves if the interim CEO stays in office too long. Similarly, scholars might investigate the interplay between governance mechanisms (e.g., activist shareholders, boards of directors, the market for corporate control) and investor perceptions of actions these different mechanisms impose on firms following competence and integrity failures.

CONCLUSION

Bad news attracts attention and generates publicity, so revelations of organizational misconduct seem likely to continue to grab headlines in the years ahead. As misconduct episodes unfold, firms at the center of the storm will need to make high-stakes decisions, such as whether to fire the CEO and, if so, whom to tap as a replacement. Our findings extend past research by revealing that, although past studies have treated misconduct monolithically, investors perceive some succession choices differently in the wake of failures of integrity than they do in the wake of failures of competence. For firms, our findings suggest the need to account for whether misconduct is a failure of integrity or one of competence when considering the use of CEO succession as a means of restoring investor confidence.

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