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# EFFECTS OF EXECUTIVE DEPARTURES ON THE PERFORMANCE OF ACQUIRED FIRMS

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*Using a sample of 96 acquisitions that occurred between 1980 and 1984, this study concludes that the departure of executives from acquired firms is harmful to post acquisition performance. The negative effects of departures of the highest ranking executives (such as CEOs, Presidents, and Chairmen) appear to be most severe. Acquisition relatedness, contrary to hypothesis, did not moderate the departure–performance relationship. Finally we find that providing one or more executives with top management team status in the newly combined firm leads to better postacquisition performance. Our study implies that executives from acquired firms are an intrinsic component of the acquired firm's resource base, and that their retention is an important determinant of postacquisition performance. Our evidence supports the view that executives are important to postacquisition performance, and we believe that this evidence extends to other restructuring contexts as well.*

Acquisitions and other forms of corporate restructuring are a frequent topic of interest, both for strategy scholars and agency theorists. Further, both groups of scholars see acquisitions and restructurings in general as having great potential for providing benefits (Hoskisson and Turk, 1990). On the other hand, many forms of restructuring may involve the wholesale violation of implicit contracts, leading to higher long term costs (Schleifer and Summers, 1988). Further, as Hirsch (1987) has noted, to the people displaced in a restructuring, it makes no difference if the restructuring was initiated by a hostile raider or the firm's original management.

Acquisitions are often a precursor to substantial changes in the management cadre of the acquired firm. Some authors perceive these personnel changes to be a key acquisition success factor. For example, Manne (1965), Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983) argue that acquisitions are caused (ultimately) by incompetent or dishonest management in acquired firms, and that the replacement of these executives is critical to postacquisition performance. Others (Pitts, 1976; Jemison and Sitkin, 1986; Younger, 1983) believe that executives are an important resource, and their retention is critical to acquisition success.

Given that so many authors have implied that postacquisition executive departure would have strong effects on subsequent performance, it is surprising that this issue has not been subjected to empirical examination. While several studies have examined the determinants of postacquisition departure (Walsh, 1988; 1989; Walsh and Ellwood, 1991), none that we are aware of has examined the consequences of departure. The present study begins to fill this gap by reviewing theory and examining evidence regarding the effects of executive departure on the subsequent performance of the acquired firm. The theory draws from agency, strategic management, and

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executive succession perspectives. From these theories, we develop hypotheses which we test with empirical evidence from a sample of 96 large acquisitions that took place between 1980 and 1984. Table 1 provides some widely cited works from each of the three literature streams along with the corresponding arguments provided and implications for the departure–performance relationship.

The focus of analysis for our study is the performance of the acquired entity, not the overall combined firm. Further, the theory we review is most relevant to performance *changes* brought about by the acquisition. For these reasons, we examined postacquisition performance in relation to preacquisition performance.

## THEORY AND HYPOTHESES

### Agency theory

The first section of Table 1 outlines the agency perspective on acquisitions and the departure–performance relationship. To the agency theorist, acquisitions represent contests in which management teams vie for the right to manage organizational resources. These contests are typically initiated in the context of low share prices. The low prices are caused by dissatisfied shareholders, who sell their shares because they conclude that the firm's management is not maximizing the value of the firm, and that the board of directors is unable or unwilling to impose discipline. When managers outside the firm perceive more profitable uses for the firm's resources, they buy the firm from its owners (the shareholders) and reconfigure the acquired firm's resources, leading to improved efficiency and greater shareholder wealth (Manne, 1965; Jensen and Meckling, 1976; Fama 1980; Fama and Jensen,1983; Jensen, 1988).

This theory implies quite clearly that the postacquisition retention of executives from acquired firms is, in general, undesirable. Because the control change was initiated by the poor performance of the executive cadre, the health of the acquired firm is expected to be improved by their replacement. Further, these executives are expected to suffer damage to their reputations because of the takeover, and are unlikely to find comparable employment outside the postacquisition firm (Fama, 1980; Fama and Jensen, 1983). Consistent with the predictions from this theory, evidence indicates that executives from acquired firms are more likely to depart than are executives not involved in acquisition activity (Walsh, 1988; 1989).

The empirical evidence presented in support of the agency approach relies primarily upon the use of cumulative abnormal returns (CARs) or cumulative prediction errors (CPEs) that are generated by the takover. This methodology directly examines the immediate shareholder wealth effects of takeovers. Further, researchers have uniformly concluded that acquired firm shareholders reap large gains in most takeover transactions. Acquiring firm shareholders, on the other hand, do not fare as well. This latter evidence is mixed, with some acquiring firm shareholders exhibiting slight gains, while others bear slight losses. For example, Datta, Narayanan, and Pinches (1992) in a meta-analysis of acquisition shareholder wealth studies, report that the mean prediction error for bidding firms (acquirers) ranged from −0.5 percent to +0.6 percent, depending upon the cumulation interval. For acquired firms, the range was from 2.8 percent to 14.6 percent. When examining a single interval (−10 days to +10 days), the wealth change was 0.4 percent for acquirers and 21.8 percent for targets. Because the benefits to acquired firm shareholders seem to exceed any losses to acquiring firm shareholders, agency researchers have concluded that acquisitions create value (Jensen and Ruback, 1983; Jarrell, Brickley and Netter, 1988; Jensen, 1988).

### Strategic management

The second section of Table 1 outlines briefly the literature in strategic management with respect to acquisitions and the departure–performance relationship. Strategy scholars explicitly consider *how* competitive advantage may be derived from acquisition strategies. This approach differs substantially from the agency approach. Acquisitions are perceived by strategy scholars as attempts by acquiring firms to build unique and difficult-to-imitate combinations of resources and to gain economies of scale and scope (Rumelt, 1974; Pitts, 1976; Salter and Weinhold, 1979).

The strategic management approach contrasts sharply with the agency approach in two respects.

Table 1. Literature summary

| Research stream/theoretical perspective | Arguments provided | Implications for departure-performance |
|---|---|---|
| Manne, 1965<br>Jensen and Meckling, 1976<br>Fama, 1980<br>Fama and Jensen, 1983<br>Jensen, 1988<br>Walsh, 1988; 1989 | Acquisitions represent a market for corporate control in which more competent executives displace less competent ones | Executive departure should have a positive effect on subsequent performance |
| Rumelt, 1974<br>Pitts, 1976<br>Salter and Weinhold, 1979; 1988 | Acquisitions represent attempts to form unique and difficult to imitate combinations of resources. Relatedness implies synergy | More relatedness implies that executives from acquired firms are more easily replaced by acquiring firms. In unrelated acquisitions, departure will be harmful to performance |
| Kitching, 1967<br>Jemison and Stikin, 1986<br>Ravenscraft and Scherer, 1988<br>Yunker, 1983<br>Porter, 1987 | Acquisition processes are important to performance outcomes. Postacquisition management is particularly important | High departure rates may imply mismanagement of the postacquisition processes, leading to disappointing performance outcomes |
| Barney, 1988<br>Walsh and Ellwood, 1991<br>Castanias and Helfat, 1991 | Traditional views of relatedness are misplaced. Executives may have unique and firm-specific talents and skills | Executives from acquired firms are not easily replaceable, regardless of relatedness or synergy. Departures are likely to be harmful to subsequent performance. |
| Romanelli and Tushman, 1987 | CEO turnover, considered in isolation, has no effect on subsequent performance | Departures, considered in isolation, will have no performance implications. Characteristics of the executives and the context must be considered. |
| Grusky, 1969<br>Helmich and Brown, 1972 | Outsider successors are more disruptive than are insiders | Departures are likely to be disruptive, and may harm ongoing performance |
| Smith, *et al.*, 1984<br>Pfeffer and Davis-Blake, 1986 | The abilities and skills of replacement executives have important performance implications | If able and experienced replacements are available, the negative effects of departure on subsequent performance may be lessened |
| Romanelli and Tushman, 1987<br>Virany *et al.*, 1992 | The need for discontinuous change moderates the relationship between turnover and subsequent performance | The need for discontinuous change (in the context of poor preacquisition performance) may moderate the departure–performance relationship. Retention of more senior officers may be beneficial |

First, strategy scholars direct attention to the implications of the acquisition for the postacquisition firm. Agency theorists, in the tradition of financial economics, examine the immediate shareholder wealth effects of an acquisition event. Strategy theorists are less persuaded that immediate stock market reactions provide a good measure of ultimate *ex post* performance[1] and instead tend to focus on the eventual demonstrated performance of acquisitions. Second, strategy scholars tend to see executives from acquired firms as part of the resources obtained in the acquisition, and often perceive these executives as valuable (Pitts, 1976; Jemison and Sitkin, 1986; Walsh and Ellwood, 1991). To strategy scholars, the success of acquisitions may hinge on the retention and integration of a competent management team in the acquired firm. While most strategy scholars would not argue with the assertion that some executives from acquired firms are more competent than others, most would not agree with the assertion that executives from acquired firms tend predominantly to be incompetent (Kitching, 1967; Pitts, 1976).

Finally, scholars from strategic management and other fields have expressed reservations about the event-study methodology. Magenheim and Mueller (1988) illustrated how the conclusions drawn in shareholder wealth studies can be significantly changed merely by changing the period (often arbitrarily selected) in which CAPM parameter estimates are derived. Alberts and Varaiya (1989) examined the premiums paid by a sample of acquirers and estimated the likelihood that those premiums would be recaptured, based on the performance of other firms in the overall economy. These authors concluded that acquirers were quite unlikely to recover the premiums paid for acquired firms. Many scholars seem skeptical that postacquisition performance can be assessed by gauging short-term movements in stock prices. Porter (1987: 45) went so far as to say '. . .the short-term market reaction is a highly imperfect measure of the long-term success of diversification, and no self-respecting executive would judge a corporate strategy this way.' Porter (1987), Ravenscraft and Scherer (1988) observe that many acquisitions fail, and while target shareholders may have benefitted, those benefits came at the expense of acquiring firm shareholders.

[1] Several studies support these doubts about the conclusions from shareholder wealth studies. See, for example, Ravenscraft and Scherer, 1988, Meeks, 1977, and Porter, 1987.

### Executive succession

The final section of Table 1 outlines the literature on executive succession and its implications for subsequent performance. While the implications of acquired executive departure on postacquisition performance have received little empirical examination, the consequences of executive succession have a rich history in managerial research. The bulk of available evidence, however, implies that succession, considered in isolation, has no effect on subsequent performance (see Romanelli and Tushman, 1987, and Virany, Tushman, and Romanelli, 1992 for excellent reviews of this literature).

Before we can confidently predict the outcome of a succession event, we must know something of the context surrounding the event. For example, Grusky (1969) and Helmich and Brown (1972) report that successions involving outsiders are more disruptive than those involving insiders. Smith, Carson, and Alexander (1984) and Pfeffer and Davis-Blake (1986) report that new leaders with good performance records in prior leadership positions are more likely to bring about performance improvements than are leaders without such records.

Virany *et al.* (1992) examined both CEO succession and top management team succession in a turbulent environment (the minicomputer industry). They argued that stability among the executive cadre leads to strategic inertia in this dynamic environment, and that renewal among the executive cadre is important to organizational success. The evidence, however, suggested that CEO stability coupled with changes in other positions on the top management team led to the very highest performance. Thus, these authors concluded that *both* stability and change were needed to cope with a dynamic environment. In sum, the literature on the consequences of executive succession implies that contextual factors will have important implications for the succession–performance relationship.

The three research streams introduced above offer diverging predictions regarding the effects of executive departure on postacquisition performance. Much of the variation in these predictions derives from differing assumptions about the role of executives in the management process, the context in which the departures take place, and the exent to which acquisitions represent contests for corporate control.

### Executive departure and acquisition performance: A main effect?

Considerable evidence implies that acquisitions generate great disruption in acquired firms (Meeks, 1977; Costello, Kubis and Shaffer, 1963; Buono, Bowditch, and Lewis, 1985). The preexisting power and control structures in the acquired firm are often completely supplanted in postacquisition periods, as senior executives from acquired firms often find themselves serving under additional layers of management (Gaddis, 1987). Employees at all levels, accustomed to long-standing patterns of interaction, confront great uncertainties. Further, this disruptiveness extends to customers, suppliers, and local communities (Schleifer and Summers, 1988).

In some contexts (e.g., Virany *et al.*, 1992) executive change may be used to *generate* disruption, breaking the force of inertia and initiating discontinuous changes in strategy. If existing executives are inadequate or inflexible, their removal may have some salutary effects. However, the aftermath of an acquisition is already exceedingly disruptive (Hirsch, 1987) and we expect the loss of established leaders to have harmful consequences—the costs outweighing the benefits.

For example, Mintzberg (1987) argues that successful strategic management requires a deep understanding of the organization and its values, traditions, and processes, as these often comprise critical resources. Should the executives depart, this intimate, nontransferable knowledge will not be easily gained by replacements from outside the firm. Kotter (1982) argued that the loss of an executive includes the loss of that executive's knowledge of and plans for the organization. Thus, new executives typically incur heavy startup costs, as they must gain familiarity in their new positions and establish new networks of contacts to accomplish activities.

Both Mintzberg (1987) and Kotter (1982) were discussing executives in the context of ongoing organizational processes. In the aftermath of an acquisition, an executive change may be viewed with suspicion or alarm by acquired employees and external stakeholders, even if the new executive has been promoted from within (Costello *et al.*, 1963; Buono *et al.*, 1985; Siehl, Smith and Omura, 1990; Schleifer and Summers, 1988). Because disruption is already endemic to acquisitions, succession may not spark appropriate organizational change, but rather may push the organization to a state of anxious paralysis or an internally induced 'threat–rigidity response' (Staw, Sandelands, and Dutton, 1981). Indeed, continuity is expected to be an important component of successful postacquisition adjustment. Thus, we expect that the greater the rate of acquired executive departure, the greater the deterioration of the acquired firm's performance.

> *Hypothesis 1: The extent of executive departures will be negatively related to postacquisition performance changes.*

### Preacquisition performance

When the acquired firm has exhibited poor preacquisition performance, theory suggests that executive departure will lead to performance improvement. For example, the concept of a market for corporate control clearly implies that more capable and competent executive teams will tend to replace less capable and competent teams (Manne, 1965; Jensen and Meckling, 1976; Jensen, 1988).

Not all authors believe that executive competence is easily inferred from observable performance indicators (Lipton, 1985; Lowenstein, 1983; Herman and Lowenstein, 1988). Still, the argument that takeover targets tend to be led by incompetent management teams seems widespread among practitioners and the business press. Instead of sympathy for displaced executives from poorly performing firms, many observers believe that these executives got what they deserved and their replacement will be an improvement (Jensen, 1988; Hirsch, 1987).

In contrast, when the acquired firm has exhibited good performance in preacquisition periods, there are reasons to believe that postacquisition executive departure will be particularly harmful. First, unlike the poor performance context, there is little reason to believe that replacement executives will be, a priori, more competent than those who depart. Indeed, given the extent of firm-specific skills lost in departure, the opposite is more likely to be the case (Kotter, 1982; Castanias and Helfat, 1991). Second, in the disruptive aftermath of an acquisition, executive departure sends the symbolic message that something has gone wrong with the deal or that the departing executives were somehow unsatisfactory (Pfeffer, 1981). Whether this message is correct or not, it can easily disrupt the acquired firm's ongoing strategy, leading to performance declines. On the other hand, executive continuity will tend to preserve strategic continuity because it assures organization members that the new owners support the acquired firm's ongoing strategies.

Finally, as mentioned earlier, replacement executives are particularly disadvantaged when strategic continuity is desired. No executive can orient him or herself to a new situation immediately, but must take time to become acclimated to new surroundings (Kotter, 1982; Virany *et al.*, 1992). In addition, replacement executives must immediately move to mitigate the stress and disruption generated by the acquisition event (Buono *et al.*, 1985; Levinson, 1973). While organization members look to traditional leaders for stability in stressful times (Pfeffer, 1981), replacement executives will not have time to establish the legitimacy essential to their new roles. For high performing acquired firms, then, executive departure should be particularly harmful to postacquisition performance.

*Hypothesis 1a: The harmful performance effects of acquired executive departure will be greater for firms with high preacquisition performance than for firms with low preacquisition performance.*

**Relatedness**

Relatedness is often defined as the extent to which acquired and acquiring firms serve similar customers or utilize similar production processes (Rumelt, 1974; Salter and Weinhold, 1979; Porter, 1987). In the present study, we consider three categories of relatedness, based on product/market similarities between the acquirer and the acquired firm. When the two firms neither serve the same or similar customers, nor utilize the same or similar production processes, the acquisition is unrelated. When the two firms are in essentially the same dominant business, the acquisiton is horizontal. Remaining acquisitions are simply related. In most unrelated acquisitions, the acquiring firm acts as a passive investor and desires strategic continuity in the acquired firm (Pitts, 1976; Salter and Weinhold, 1979; Ravenscraft and Scherer, 1988). In horizontal acquisitions, on the other hand, the acquiring firm's managerial care may have knowledge and skills relevant to the management of the acquired firm, even possessing enough understanding to make major decisions for the acquired firm (Jemison and Sitkin, 1986; Porter, 1987; Salter and Weinhold, 1979; Datta, 1991). In other-related acquisitions (not horizontal) acquiring executives probably have some valuable skills that can be brought to bear, but not so much that they are able to completely replace departing executives in the acquired firm. Thus, the more related the acquisition, the more acquiring executives are able to replace departing executives in the acquired firm without negative performance effects.

Because unrelated diversifiers have little experience relevant to the operation of acquired businesses, the retention of the preacquisition executive cadre seems essential. For example, Pitts (1976) argued that unrelated acquirers must adopt a 'hands-off' policy with respect to the acquired firm. He reasoned that this was because any involvement in the affairs of the acquired firm would increase the likelihood of departures. Should these executives depart, the acquirer would have difficulty in replacing them, as acquiring executives have few experiences relevant to the unrelated field of endeavor. Acquirers could replace departing executives with outsider successors recruited from other firms in the industry, especially if the industry consisted of relatively homogeneous firms. This seems difficult and costly, however. Thus, it would seem that the less related the acquired firm is to the acquiring firm, the more harmful executive departure will be.

*Hypothesis 2: The harmful effects of acquired executive departure will be greater for unrelated acquisitions than for related acquisitions, and* *greater for related acquisitions than for horizontal acquisitions.*

### Departing executive seniority

There is reason to believe that the loss of executive resources may be more damaging if the executives who are departing are among the highest ranking in the dominant coalition. For example, officers who hold the titles of CEO, Chairman, President, or Vice-Chairman are the firm's most senior and symbolically important, and are likely the cadre most responsible for the firm's ongoing strategy (Vancil, 1987; Pfeffer, 1981; Castanias and Helfat, 1991). Should lower-ranking executives depart while the top cadre remained, the senior-most officers could make informed judgements about who to promote in their places. Should the senior-most executives depart, on the other hand, the decisions about whom to promote would likely come from the acquiring firm. These executives are likely to be less informed than those in the acquired firm, and their involvement in promotion decisions is likely to be viewed with skepticism by acquired personnel (Costello *et al.*, 1963; Buono *et al.*, 1985).

Because the senior-most executives are associated closely with the history and traditions of the acquired firm, their retention symbolically implies continuity and stability to organization members (Schweiger, Ivancevich, and Power, 1987). Should these individuals depart, for whatever reason, organization members may conclude that these executives were terminated or that something is amiss in the relationship with the acquiring firm. The retention of very senior executives, then, should be more conducive to postacquisition success than the retention of less-senior executives.

*Hypothesis 3: The departure of more-senior executives from acquired firms will be more harmful to postacquisition performance than will the departure of less-senior executives.*

### Status bestowal

Prior to acquisition, executives from acquired firms represent decision making at the highest levels of the organization (March and Simon, 1958). Because of their positions, these executives are ascribed high status, both inside and outide the firm. After an acquisition, these executives may find that their status considerably diminished, because they have lost their membership in the dominant coalition (Gephardt, 1978). This sharp decline in status is likely to engender feelings of unfairness as well as reduced discretion in decision making (Levinson, 1973; Buono *et al.*, 1985). The resulting decline in morale among senior executives comes at a time when other organization members need symbolic reassurance of stability and optimism among the leading cadre.

Acquirers may mitigate this negative effect by bestowing status (officerships and/or directorships) on some executives from acquired firms. These status-bestowed executives may feel little or no status decline, maintaining a high degree of morale and effectiveness. If the acquisition was made for synergy, the cooperation of the acquired firm's executives is essential. The inclusion of executives from acquired firms on the postacquisition firm's dominant coalition should facilitate this process (Yunker, 1983).

The executive who receives this status may find that his or her career has received a large boost. This is particularly true when the acquiring firm is substantially larger than the acquired firm, as is often the case. The executive bestowed with status will be able to make informed decisions about how to proceed with postacquisition adjustments, and smooth potential sources of conflict. Further, top management team status is a visible symbol of both the acquiring firm's commitment to making the marriage work and the conclusion that the acquired firm is strong. Thus, we expect a positive effect on postacquisition performance.

*Hypothesis 4: Awarding one or more members of the acquired firm's executive cadre with top management team status in the postacquisition firm will be positively related to postacquisition performance changes.*

## METHOD

### Sample

Issues of *Mergers & Acquisitions* published between January 1, 1980, and December 31, 1984 were examined to identify the largest 200 acquisition transactions made during that 5-year interval. After removing observations in which either the acquired or the acquiring firm were private, the sample was reduced to 138. Of these, data on executive departure (discussed below) were available for 109. From the sample of 109, postacquisition performance (also discussed below) was available for 96. Thus, the present sample includes 96 very large acquisitions made in the 1980–1984 interval. The average value of the acquisition transactions studied here was $775 million, and ranged from $200 million to nearly $7 billion.

**Data sources and measures**

*Executive departure*

The executives of interest in the present study were officers of the acquired firm who either held a title above the rank of Vice-President or were inside directors, or both. These executives were identified through public filings made prior to the acquisition. Departures among these executives were assessed by contacting postacquisition firms and requesting employment information. For many of the executives in the sample, the final date of employment (if employment had been ended) was provided over the phone. In other instances, a written request was sent. Using these approaches, full departure information was gathered on 67 percent of the initially sampled 138 top management teams.[2] This yielded data on 451 executives in 96 acquired firms (4.5 executives per firm). Departure was defined as the proportion of executives present at the time of the acquisition who had departed by the end of the second postacquisition year.

*More-Senior and Less-Senior departure*

Executives who held any of the following five titles were classified as 'More-Senior': Chairman, Vice-Chairman, President, CEO, and COO. The remainder were classified as 'Less Senior.' The senior-designated titles correspond to Vancil's (1987) discussion of executives who are at the very top of corporate decision making. The percent of each group that had departed within 2 years was then calculated. Our sample of executives was comprised of 36 percent More-Senior and 64 percent Less-Senior executives.

*Performance*

As mentioned earlier, examinations of acquisition success have relied overwhelmingly on studies of share price movements surrounding the event. For example, Jensen's (1988) review of takeover activities cites shareholder returns studies exclusively. Two widely cited exceptions to this rule (Porter, 1987; Ravenscraft and Scherer, 1988) used divestitures, a very coarse measure, as a gauge of postacquisition success. The reason for the widespread use of these less-than-ideal measures is clear: there is little public information available on the performance of acquired firms after the acquisition has been consummated. We felt that shareholder returns measures fell short of reflecting the actual subsequent performance of the acquired firm—the focus of our interest. The divestiture measure was too coarse-grained for our study. Therefore, in order to gather interval-level data on postacquisition performance we elected to use expert informants.

For each acquisition, we selected six executives from the acquiring firm and six security analysts who specialized in the securities of the acquiring firm to be expert informants. These individuals were asked 'How would you rate the profitability of [the acquired firm] at the time the deal was made (in 19—); and 'Four years later (in 19—)' on 7-point scales.[3] Anchors were 'very poor' and 'very good.' The overall response rate was 34 percent (32 percent among executives and 36 percent among security analysts). The average number of respondents was 4.02 per acquisition.

Both pre- and postacquisition performance measures exhibited high reliability, calculated as an intraclass correlation coefficient (Shrout and Fleiss, 1979). The preacquisition performance

[2] This response rate compares favorably with that of Walsh (1988: 1989) who averaged about a 60 percent response rate for his two studies using a similar methodology.

[3] In a pilot test of the instrument, we included questions about the strategic health of the acquired firm. Responses were relatively unreliable, however, so those questions were dropped. Additionally, in the pilot test of the instrument, we attempted to gather performance assessments from competitors. Unfortunately, the response rate was very low (about 7%). Therefore, we did not use expert informants from competing firms in the full study.

($t = 0$) reliability coefficient was 0.852 ($p < 0.001$), and that for postacquisition performance ($t = 4$) was 0.846 ($p < 0.001$). In addition, the validity of the measures appears strong, as the correlation between performance at $t = 0$ and preacquisition return on equity was 0.573 ($p < 0.001$). Our primary dependent variable, Performance Change, was calculated as the average *within rater* difference between performance at $t = 4$ and performance at $t = 0$. Thus, negative values imply performance declines, while positive values imply improvement. The reliability coefficient for this measure was 0.848 ($p < 0.001$).

Our method of acquisition performance measurement is distinctive in three respects. First, we used multiple informants for each acquisition to reduce the likelihood of bias. Using multiple informants, we obtained performance information for 96 of our original sample of 109 acquisitions. Second, because each expert provided assessments of *both* pre- and postacquisition performance and we modeled the difference as our dependent variable, scaling idiosyncrasies across informants were reduced. Third, we used two different groups of raters (executives and security analysts), yet still achieved quite high reliability for our measures.[4]

Clearly, our method of performance assessment has limitations. Essentially, there is no clear-cut way to finely measure the performance of an acquisition that has been tightly integrated. The best hope—and we believe it is quite valid—is to rely on the overall judgement of informed observers who are in the best position to know how the acquired firm—its assets and employees—performed. This is admittedly impressionistic data; however, two groups of raters did provide ratings with strong reliability and validity. To further evaluate the validity of our instrument, we phoned 10 respondents to discuss with them how they interpreted the survey. Every one of the respondents stated that they understood the subject of our performance evaluation, and that they were comfortable attaching performance ratings to acquisitions.

The use of 2-year departure as a determinant of 4-year performance change represents an attempt to reconcile a difficult issue for our study. That is, we wish to make causal inferences about departure and performance, but each of these may influence the other. By modeling performance change over a 4-year interval, and using 2-year departure as a causal measure, we enhance our ability to interpret departures as causing the performance outcomes, and not the other way around. While we cannot completely rule out the possibility that poor postacquisition performance is causing high levels of executive departure, we believe that our analytic method minimizes this possibility.

### *Status bestowal*

This measure was coded 1 if any member of the acquired firm's top management team received corporate-level officership and/or directorship in the postacquisition firm, and 0 otherwise. This condition was evaluated by examining the first annual report or proxy statement filed by the acquiring firm following the acquisition event. Thus, status bestowal did not reflect rewards for eventual good postacquisition performance outcomes.

### *Relatedness*

Because our sample falls outside the time period for which the Federal Trade Commission provides relatedness information, two judges independently categorized each acquisition. The judges were a tenure-track faculty member and a fourth-year doctoral student, both in strategic management, who were not otherwise associated with the research project. The judges were given business descriptions of the two merging firms from *Moody's Industrial Manuals*, and asked to consider the extent of product-marked similarities between the two firms. If the judges felt that the firms served the same or similar customers or produced the same or similar products, they were to categorize the acquisition as 'Related,' and otherwise as 'Unrelated.' Of the sample of 96 acquisitions, the judges disagreed on the classification of only 6 observations. These conflicts were discussed and resolved.

We then examined the SIC codes provided by CRSP for the firms categorized as 'Related'.

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[4] A reviewer pointed out to us that security analysts typically must rely upon executives for information, and thus, consistency between our two groups of raters is not surprising. Still, security analysts also speak to customers and competitors, and may treat executive reports with some skepticism.

When both firms were in the same dominant 4-digit SIC industry, the acquisition was classified as 'Horizontal.' Thus, we examine three categories of relatedness, measured via two dummy variables. If the judges classified the acquisition as 'Unrelated,' the variable 'Unrelated' was coded 1, and otherwise 0. If the judges classified the acquisition as 'Related' *and* CRSP provided the same 4-digit SIC code for the two firms, the variable 'Horizontal' was coded 1, and otherwise 0. The third category, Other-Related, was the omitted category. The sample included 18 Horizontal acquisitions, 48 Other-Related acquisitions, and 30 Unrelated acquisitions.

### *Change in acquired firm's industry performance*

The change in the acquired firm's industry performance was included as a control variable. The average ROE across firms listed on COMPUSTAT in the acquired firm's 2-digit SIC industry was estimated for the year prior to the acquisition, and the fourth year following the acquisition. We excluded from this calculation firms which were involved in acquisition activity during the 4-year interval. Change in Industry Performance was calculated as the difference between industry average ROE at $t = 0$ and industry average ROE at $t = 4$.

## RESULTS

### Descriptive and bivariate statistics

Table 2 provides descriptive statistics and a correlation matrix for all the measures. Note that performance at $t = 0$ is slightly below the 4.00 midpoint of our scale (3.82), while performance after 4 years (at $t = 4$) is above the midpoint (4.42). Thus, for our sample, performance improved following the acquisition. On average, about 49 percent of executives had departed by the end of the second year, a rate in close agreement with Walsh (1988; 1989). Further, the rate of departure among More-Senior executives is somewhat higher than that among Less-Senior executives.

Correlations in Table 2 provide preliminary indications of the data patterns. First, executive departure is significantly and negatively related to both Preacquisitions Performance ($t = 0$) and Postacquisition Performance ($t = 4$). Further, departure among More-Senior executives is more strongly correlated with Postacquisition Performance than with Preacquisition Performance, while the opposite is true for Less-Senior executives. Status Bestowal is positively related to postacquisition performance. Interestingly, the dichotomous variables Unrelated and Horizontal are not significantly correlated with any other measures. The lack of correlation between departure and relatedness is in agreement with evidence presented by Walsh (1988; 1989) who reported that departure levels did not differ across relatedness categories.

Two other correlational points are worth noting. First, while Preacquisition Performance ($t = 0$) is strongly correlated with preacquisition ROE ($r = 0.57$; $p < 0.001$), Postacquisition Performance ($t = 4$) is completely uncorrelated with either Preacquisition Performance ($r = 0.04$; ns) or preacquisition ROE ($r = -0.03$; ns). This implies, as we suggested earlier that acquisitions are very disruptive to the ongoing strategies of acquired firms, leading to a large performance discontinuity. Further, the correlation between Performance Change and Change in Industry ROE over the same period is positive and significant ($r = 0.21$; $p < 0.05$).

### Multivariate results

Table 3 provides five regression models designed to examine the hypotheses developed above. The first model (Model 1) tests only main effects, and includes Performance ($t = 0$) and Change in Industry ROE as controls. Departure has a negative and significant coefficient ($B = -1.395$; $p < 0.05$), providing support for Hypothesis 1—that executive departure, in general, has negative implications for postacquisition performance. Additionally, the Status Bestowal measure exhibits a positive and significant coefficient ($B = 0.779$; $p < 0.05$). The coefficients for both Unrelated and Horizontal are negative, but insignificant. The coefficient for Change in Industry ROE is very small and insignificant. This latter result further substantiates our earlier arguments that acquisitions create major discontinuities for acquired firms, and the strategies and performance profiles of these firms may be changed significantly by the acquisition. Thus, it matters if acquirers retain the executives from acquired firms, and the treatment of these

Table 2. Pearson correlation coefficients/Prob > IRI Under HO:RHO = O/$N$ = 96

| | Mean (S.D.) | 1. | 2. | 3. | 4. | 5. | 6. | 7. | 8. | 9. | 10. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Performance ($t$ = 0) | 3.82 (1.41) | | | | | | | | | | |
| 2. Performance ($t$ = 4) | 4.42 (1.57) | 0.04 | | | | | | | | | |
| 3. Performance change | 0.61 (2.03) | −0.64*** | 0.73*** | | | | | | | | |
| 4. Executive departure | 0.49 (0.30) | −0.25* | −0.25* | −0.03 | | | | | | | |
| 5. More-Senior departure | 0.51 (0.42) | −0.14 | −0.25* | −0.12 | 0.71*** | | | | | | |
| 6. Less-Senior departure | 0.44 (0.37) | −0.29** | −0.08 | 0.13 | 0.70*** | 0.19 | | | | | |
| 7. Status bestowal | 0.47 (0.51) | 0.16 | 0.26* | 0.09 | −0.05 | 0.05 | 0.02 | | | | |
| 8. Unrelated (0/1) | 0.31 (0.47) | −0.02 | 0.03 | 0.04 | 0.10 | 0.03 | 0.11 | 0.04 | | | |
| 9. Horizontal (0/1) | 0.19 (0.39) | −0.08 | 0.15 | 0.15 | −0.01 | −0.02 | −0.01 | −0.05 | −0.32** | | |
| 10. Preacq. ROE | 12.06 (5.89) | 0.57*** | −0.03 | −0.38*** | −0.20 | −0.07 | −0.16 | 0.14 | 0.19 | −0.19 | |
| 11. Industry change in ROE | 0.72 (8.91) | −0.35*** | −0.02 | 0.21* | 0.14 | 0.13 | 0.21* | −0.04 | −0.03 | 0.04 | −0.27** |

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3. Regression analysis of performance change from $t$ = 0 to $t$ = 4

| | Model I | Model II | Model III | Model IV | Model V |
|---|---|---|---|---|---|
| Intercept | 4.608*** (0.614) | 4.647** (0.641) | 4.491*** (0.634) | 4.356*** (0.548) | 3.956*** (0.605) |
| Preacquisition performance ($t$=0) | −1.030*** (0.121) | −1.028*** (0.124) | −1.013*** (0.121) | −0.998*** (0.117) | −0.988*** (0.126) |
| Executive departure | −1.395* (0.524) | −1.499* (0.728) | | | |
| Unrelated (0/1) | 0.366 (0.350) | 0.205 (0.698) | 0.329 (0.349) | 0.310 (0.345) | 0.310 (0.362) |
| Horizontal (0/1) | 0.715 (0.481) | 0.694 (0.791) | 0.709 (0.462) | 0.711 (0.471) | 0.710 (0.449) |
| Unrelated X departure | | 0.315 (1.189) | | | |
| Horizontal X departure | | 0.050 (1.380) | | | |
| Status bestowal | 0.779* (0.303) | 0.788* (0.309) | 0.866** (0.303) | 0.858** (0.301) | 0.810* (0.314) |
| More-Senior departure | | | −1.083** (0.372) | −1.110** (0.367) | |
| Less-Senior departure | | | −0.230 (0.444) | | −0.410 (0.458) |
| Change in industry ROE | 0.001 (0.019) | 0.001 (0.019) | 0.003 (0.018) | 0.002 (0.018) | 0.001 (0.019) |
| $R$-Square | 0.503*** | 0.504*** | 0.516*** | 0.514*** | 0.469*** |

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

executives can have important performance implications.

Model II from Table 3 provides the test of Hypothesis 2, in which we predicted that the effects of departure would be stronger in less-related acquisitions than in more-related acquisitions. Because relatedness is assessed through dichotomous variables (coded 0 or 1), the significance test for the interaction coefficient provides a direct test of the hypothesis (Neter, Wasserman, and Kutner, 1985). As indicated by the evidence in Model II, however, the interaction between Unrelated and departure is not significant (B = 0.315; ns), nor is the interaction between Horizontal and departure (B = 0.050; ns). Thus, Hypothesis 2 is not supported by the evidence from our sample. The effects of departure appear to be negative regardless of acquisition relatedness.

Model III from Table 3 provides the first examination of Hypothesis 3. Here, we have predicted that the departure of More-Senior executives will be more harmful to subsequent performance than the departure of Less-Senior executives. As indicated in Model III, this hypothesis receives some support. Model III examines the effects of More-Senior and Less-Senior departure separately (but in the same model), and only the coefficient for More-Senior departure is significant (B = −1.083; $p < 0.01$). The coefficient estimate for Less-Senior departure, on the other hand, does have the expected negative sign, but is not significant (B = −0.230; ns).

Models IV and V examine the departure of More-Senior and Less-Senior departure independently. This analysis builds on the evidence suggested by Model III. That is, the departure of More-Senior executives appears to be driving the overall negative effect of departure evident in Models I and II. Specifically, the coefficient for More-Senior departure is significant in Model III, even though Less-Senior departure is included. On the other hand, Model V indicates that Less-Senior departure has an insignificant effect even when More-Senior departure is not included. This evidence implies that departure among the senior-most executives is particularly harmful to subsequent acquisition performance, thus providing support for Hypothesis 3.

All 5 models of Table 3 provide evidence in support of Hypothesis 4. That is, the bestowal of status to at least one acquired executive has a beneficial effect on subsequent performance. In all 5 models, the coefficient for Status Bestowal is positive and significant ($p < 0.05$). Thus, Hypothesis 4 is supported.

In our Hypothesis 1a, we argued that preacquisition performance would have a moderating effect on the departure–performance relationship. We tested this hypothesis with a regression model specified as in Model I, but with a departure X preacquisition performance interaction added. The interaction term, however, was not significant (B = 5.28; $p = 0.17$). Thus, we report no evidence to support Hypothesis 1a.

Figure 1 provides a visual examination of the effects of executive departure for high and low preacquisition performance subsamples. In it, we plotted separately the performance changes for acquired firms with low and high preacquisition performance, separating high and low preacquisition performers at the median for the sample (4.00). We further subdivided each category into high-departure and low-departure subgroups, splitting at the sample median departure rate, which was 50 percent.

As can be seen the data exhibit a general 'regression-to-the-mean' effect—low performers tend to improve and high performers tend to

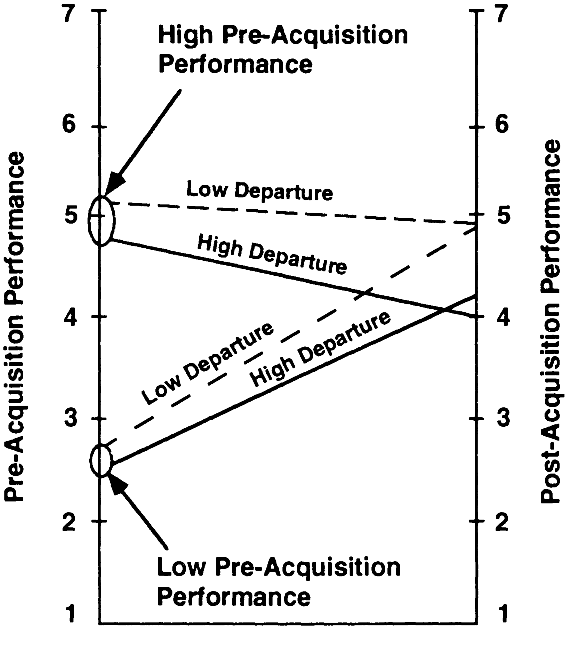


Figure 1. Performance profiles for low and high preacquisition performance subgroups

deteriorate in performance. However, what is striking is that the performance changes of the low-departure subgroups are superior to those of their corresponding high-departure subgroups. Namely, high prior performance acquisitions that had high departure rates deteriorated in performance more than those with low departure rates, and low prior performance acquisitions that had high departure rates did not improve as much as those with low departure rates. Thus, Figure 1 provides striking visual support to our first hypothesis—that the postacquisition departure of executives is harmful to postacquisition performance. Further, Figure 1 illustrates that the negative performance consequences of departure do not differ by preacquisition performance categories.

## DISCUSSION

Our chief conclusion, that acquired executive departure has negative implications for subsequent performance, is fully in accord with arguments from Pitts (1976), Ravenscraft and Scherer, (1988), Lipton (1985), Lowenstein (1983) and others. This result provides support to the idea that the loss of substantive experience may not be easily recovered. Further, the symbolic effects of the loss of established leaders is very unsettling to organization members as well as external stakeholders (Pfeffer, 1981; Virany *et al.*, 1992; Schleifer and Summers, 1988). The strong and consistent positive effect of status bestowal further supports the assertion that executive continuity may be a key determinant of the eventual performance outcome.

Our study provides indirect evidence of the extraordinary disruptiveness described by clinical studies of postacquisition processes (Meeks, 1977; Costello *et al.*, 1963; Buono *et al.*, 1985). For our sample of acquired firms, performance change during the first 4 post-acquisition years bore no association to performance change among firms in the same industry, though performance at the outset was highly correlated with industry performance. Further, performance after 4 years was not significantly correlated with preacquisition performance. Acquired firms appear to be thrown into a stochastic arena, where substantial breaks with prior organizational processes occur. For some, performance declines; for others, performance improves. Our study provides evidence that leadership continuity is an important component of stability, leading to more beneficial changes, rather than less beneficial ones.

Importantly, and understandably, the seniority of the departing executives exerted a moderating influence on the departure–performance relationship, as it was the departure of senior-most executives that had the greatest effect on subsequent performance. These departures generate a major symbolic impact, both inside and outside the firm. We believe that acquirers often replace departing executives with their own executives, thus exacerbating the disruption (Buono *et al.*, 1985).

Interestingly, relatedness had neither a main nor an interactive effect on acquisition performance, thus implying that the negative effects of departure were consistent across relatedness categories. Thus, surface knowledge of the industry is perhaps not the critical executive resource. Rather, it is an in-depth understanding of the particular firm—its values, strengths, key employees, and implicit contracts (Kotter, 1982; Castanias and Helfat; 1991; Schleifer and Summers, 1988) and the symbolic value of executive stability (Pfeffer, 1981; Virany *et al.*, 1992).

Prior performance does not appear to have any effect (direct or moderating) on the departure–performance relationship. In general, low-performance businesses improved following the ownership change. Further, poor preacquisition performers who retained their executives clearly improved the most! T. Boone Pickens and Michael Jensen would never expect this result, and it provides a graphic testimony to the importance of executive continuity in acquisitions. Further, it suggests the difficulty of inferring executive competence from short-term preacquisition performance. While some authors have expressed this concern (Lipton, 1985; Lowenstein, 1983; Herman and Lowenstein, 1988) our study is the first to provide empirical support. We believe that acquirers (among others) are too anxious to see executives from poor performing firms as villains (Meindl, Ehrlich, and Dukerich, 1985; Chen and Meindl, 1991).

While we perceive most acquired executives to be a critical resource, some acquired executives are likely to be more capable than others. Interestingly, our study has implied that preacquisition performance does not provide a strong indication of executive abilities. Perhaps our measures of preacquisition performance were too coarse-grained to be of use in inferring executive competence. If poor performance is caused by the lack of access to critical resources, such as financing, distribution, or manufacturing, then this performance may not be strongly attributed to executives. On the other hand, if poor performance is caused by lack of managerial attention or an unwillingness to initiate strategic change, then the loss of acquired executives may have beneficial consequences. The moderating effects of executive competence and preacquisition performance are important areas for future research.

Our findings regarding status bestowal are potentially quite important. If retention is better than departure, retention with status bestowal is better still. Status bestowal helps to smooth the postacquisition transition, as status bestowed executives receive a career boost rather than a status decline and are probably strongly committed and motivated to making the acquisition a success. Further, the evidence appears quite robust: Across all models tested, status bestowal was strong and significant in its beneficial effects on performance.

Methodologically, our study differs from much of the research on acquisition performance. Most prior research has relied on examinations of share price movements surrounding the event. There is no doubt that these studies are valuable, and they derive from objective and easily available data. On the other hand, our study and several recent others (Datta, 1991; Dess and Robinson, 1984; Porter, 1987) suggest that researchers need not rely solely on share prices to evaluate postacquisition performance. Our method used two classes of expert informants to provide what we believe to be reliable and valid performance assessments. Further, this method need not be limited to the assessment of postacquisition performance; other dimensions could be examined as well. Executives and security analysts are very close to organizations, capable of providing unique information and willing to respond if the survey is not burdensome.

Our research has important implications for managers. Our study has implied that organizations are more than mere collections of concrete resources, to be reallocated at will. Instead, organizations are fragile, and closely aligned with the executives who manage them. These executives may have firm-specific skills that are very difficult to replace in the short term. Further, the loss of executives from acquired firms may have effects that go beyond the loss of talents and skills. As noted by Schleifer and Summers (1988), the loss of executives may imply to other organizational stakeholders that the firm's owners are no longer trustworthy, thus making the nexus of contracts we call the firm much more expensive to maintain. Thus, acquiring firm executives must move carefully in postacquisition periods, and take full advantage of the skills and experiences of the acquired executive cadre.

Clearly, our study has limitations. We have focused our attention on a sample of very large acquired firms—the 200 largest over a 5 year interval. The effects of acquisitions on smaller firms could be different. Further, we consider only publicly traded firms. Those which are private prior to the transaction, as well as subunits of other firms are not represented in our sample. Our performance measure is one dimensional, focusing on a general picture of overall profitability, rather than multiple dimensions of performance. We focused attention primarily on the dominant coalition in the acquired firm. We are unable to say with any conviction what effects departures among other organization members may have on postacquisition performance. Further, our study examines a limited postacquisition time frame—4 years. Clearly, given time, acquiring firms may make up for the loss of executive talent. Still, our study suggests that executive departure represents a serious cost for acquiring firms.

Our study leaves many questions unanswered. Perhaps most interesting would be the effects of acquisitions on the careers of executives who are acquired. Clearly, some of our sample executives (the status bestowed ones) received career boosts from the acquisition. The departure of nearly 50 per cent of sample executives within 2 years, however, indicates that many other executives confronted serious career disruption. What happened to those executives? Who replaced them? What problems did these replacement executives face? Of particular interest may be the role of outsider replacements for departures in unrelated acquisitions. Also, the prospect of promotion for acquired employees (both officers and lower level executives) is an important area for future research. If these executives face inordinate challenges in the promotion process, their motivation and commitment is in question.

In sum, much more needs to be known about the antecedents and consequences of turnover in restructuring contexts. Hirsch (1987) described the personal discomfort felt by managers involved in organizational restructurings, including acquisitions. Yet much of the available research seems unconcerned with the human and social processes that are generated. There are strong economic motives for initiating acquisitions and other forms of restructuring, but there are also strong social processes at work that may seriously affect the outcomes. A better understanding of the factors influencing the performance outcomes of restructurings can only serve to improve the odds of success, to the benefit of all involved.

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