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THE PERFORMANCE OF SPUN-OFF SUBSIDIARIES: EFFECTS OF PROACTIVENESS, LEGITIMACY, AND HUBRIS

ABSTRACT

After being separated from its parent (divesting firm), the child firm (spun-off subsidiary) becomes a stand-alone, independent publicly traded entity. This corporate restructuring activity can be considered such a unique transaction due to the fact that the child firm needs to perform independently without relying on resources provided by the parent firm. Having a proactive posture is expected to help the child firm better establish its legitimacy in the sector and in turn better perform overall. In addition, having a hubristic CEO can negatively affect this process at the beginning (before establishing the legitimacy); however this effect may become positive at later stages (after establishing the legitimacy). Therefore, this paper examines factors influencing the performance of the child firm grounded in resource dependence and institutional theories.

Keywords: Corporate spin-offs, Proactiveness, Organizational legitimacy, CEO hubris.

INTRODUCTION

The corporate spin-off is a form of restructuring technique that aims to create value for the shareholders (Makhija, 2004). In this transaction, there are three major players: the parent firm, which is the divesting firm, the child firm, which is the spun-off subsidiary, and shareholders of the parent firm (Maxwell and Rao, 2003). After this transaction is completed, the child firm becomes an independent, stand-alone public entity (Miles and Rosenfeld, 1983) with an ultimate goal of creating a better shareholder value (Wruck and Wruck, 2002).

As stated by Veld and Veld-Merkoulova (2008), the decision of a corporate spin-off has two distinct aspects: “the restructuring of the parent firm and the improvement of overall operations of both the parent and its subsidiary” (p. 103). From their statement, it can be seen that the spin-off event is expected to benefit both the parent and its child. Desai and Jain (1999) explain this process of spinning off a subsidiary as follows: “a pro-rata distribution of the shares of the subsidiary to the parent's shareholders in order to create a new entity that trades independently of its former parent” (p. 78). Additionally, from the perspective of investors, this corporate restructuring technique is also very critical due to the fact that it enables “investors to better understand and assess the restructuring firm’s value-creating potential” (Bergh, Johnson, and Dewitt, 2008: 137).

It is expected that creating value for the child firm after becoming an independent entity may be quite challenging due to several internal and external reasons. In order to handle these challenges both effectively and efficiently, it is important to study both the behavior of the child

firm as well as the behavior of top decision makers such as CEOs by also considering industry requirements. In this paper, I look at the impact of proactiveness on the performance of child firm mediated by organizational legitimacy and moderated by CEO hubris. Particularly, I argue that the proactiveness as a firm behavior will help the child better establish its legitimacy and therefore this child can achieve positive performance outcomes such as creating further shareholder value. In addition, I argue that until the legitimacy is established, a hubristic CEO will negatively affect this process; however after this establishment, a hubristic CEO will actually become beneficial for the child firm. Therefore, this paper conceptually explores critical success parameters for the child firm as stand-alone, independent entities in the industry grounded in resource dependence and institutional theories. The conceptual framework of this paper is shown in Figure 1.

Insert figure 1 about here

THEORY DEVELOPMENT

Proactiveness as a firm-level behavior

According to Chen and Hambrick (1995), the proactiveness refers to conditions in which the firm is able to take initiative towards opportunities that may create successful outcomes. In the field of strategy, since the main question is to understand why some firms perform better than others, the proactiveness needs to be considered a critical factor while examining conditions required for creating healthy firms that can survive for a long time (Chen and Hambrick, 1995).

In Clerck, Sapienza, and Crijns (2005), they define the proactiveness as follows: “the firm’s propensity to undertake a continuous search for opportunities, especially opportunities that do not pertain to the firm’s current activities” (p. 412). Since environmental changes are an expected part of global world’s conditions, it will be very critical for firms to monitor these changes and take necessary actions accordingly so that they can survive longer (Lumpkin and Dess, 1996). For instance, in hostile environments, in order to stay competitive in the industry, having a proactive posture may be more desirable for the firm (Covin and Slevin, 1989) via “challenging the status quo rather than passively adapting to present conditions” (Crant, 2000: 436). Therefore, firms need to realize the importance of being proactive in today’s world.

Being proactive basically means searching for new opportunities and information constantly instead of staying passive and embracing the status quo in the organizational life (Crant, 2000). From the perspective of entrepreneurial orientation, being proactive explains the firm’s willingness for taking initiative towards future success and the ability of taking advantage of opportunities being captured during the environmental scanning (Lumpkin and Dess, 1996). In other words, the proactiveness is “a response to opportunities” (Lumpkin and Dess, 2001: 430) and considered “a forward-looking perspective” (Lumpkin and Dess, 2001: 431) for the firm. Thus this concept provides the firm with accessing unique opportunities towards a better future.

For the child firm, after the corporate separation from its parent, it will be very critical to become an “officially” stand-alone entity via seeking new opportunities and improving its product or service line accordingly so that it can compete with its rivals effectively (Venkatraman, 1989). Before the spin-off event, the subsidiary is basically dependent on its

parent; however, after this corporate separation, it is crucial for the child to survive on its own and this can be achieved via proactive efforts and strategies. As Lumpkin and Dess (1996) argue, proactive firms will have a better chance to become industry leaders due to their desire and willingness for searching and taking advantage of new opportunities. According to the resource dependence theory, organizations can survive longer dependent on resources obtained from the external environment (Hillman, Shropshire, and Cannella, 2007) and they can also better deal with environmental uncertainties by efficiently using those resources (Hillman et al., 2007). Therefore, proactive child firms can be in a better position in terms of their survival via connections with the external environment that provides abundance of resources for growth.

As Feldman, Gilson, and Villalonga (2014) define, spin-offs are “extraordinarily complex transactions, necessitating the separation of formal and informal linkages between the divesting parent companies and their spun-off subsidiaries, including common resources” (p.1449). When the spin-off event is completed, this will be considered a “cut-off” point of resources for the child firm since there are no more (or very little) “parental” resources available. As a result, this corporate separation will require significant efforts for the child in order to take strong steps in its business operations so that it will become “legitimate” in the industry. In other words, proactive efforts will help the child better establish its legitimacy after becoming an independent, stand-alone entity following the spin-off event.

Organizational legitimacy as a mediator

Deephouse and Carter (2005) define the legitimacy as “the social acceptance resulting from adherence to regulative, normative, or cognitive norms and expectations” (p.332). Parallel to their definition, Arnold, Handelman, and Tigert (1996) define the institutional environment as an environment that “contains the norms, rules, and requirements to which individual organizations must conform” (p.231). Both of these definitions show that firms are obligated to adapt to conditions of the institutional environment that they are a part of and thus they will be accepted as an “official” member of that environment, which refers to becoming legitimate.

As Certo and Hodge (2007) argue, the organizational legitimacy depends on whether the individual firm is able to understand, accept, and follow general guidelines that are considered appropriate in the institutional environment. This particular condition will especially become very critical in the context of corporate spin-offs since the child firm becomes a stand-alone entity and has no (or very little) connection with its parent after their separation. In other words, after becoming independent, the child will have the responsibility for thoroughly scanning the environment on its own and understanding norms and expectations of that environment so that it can obtain resources necessary for growth without getting any help from its parent. As Suddaby and Greenwood (2005) also argue, the legitimacy is “a crucial element in the creation and survival of new organizational forms” (p.37). Their argument provides further evidence for the legitimacy being an important survival factor for the child firm since these firms are newly independent organizational forms.

As Cusatis, Miles, and Woolridge (1993) state, one of the most important reasons for the spin-off event is the lack of fit between the divesting firm and its subsidiary in terms of business operations. When that is the case, some parent firms prefer spinning of their child in order to create more efficient conditions for themselves and their child (Krishnaswami and Subramaniam, 1999) as well as renew their organizational identity via applying changes in their corporate focus (Corley and Gioia, 2004). For the child firm, following the separation, it will be very important to carefully analyze the environment so that it better understands what it needs to do in order to become a “legitimate player” in its environment. According to the institutional theory, organizations can better gain legitimacy via adapting to norms and expectations of the external environment (Gupta, Dirsmith, and Fogarty, 1994). As a newly independent entity, the child firm will have to take these environmental demands and norms into serious consideration and create its strategies accordingly so that it can survive in the long run.

By being proactive, the child will get to know its industry better and faster including culture, norms, rules, regulations, and expectations within that particular industry. In addition to that, by proactively searching, discovering, and acquiring scarce resources that may not be readily available (Obloj, Obloj, and Pratt, 2010), the child firm will also expedite the process of running its business operations on its own and more efficiently. After going through all these proactive steps, the child firm will be able to establish its legitimacy and increase its performance. Therefore, I argue that the proactive behavior of the child firm will have a positive effect on its performance and the organizational legitimacy will mediate the relationship.

Proposition 1: The proactiveness is positively related to the performance of the child firm and this relationship is mediated by the legitimacy.

CEO hubris as a moderator

Hayward and Hambrick (1997) define the hubris as an “exaggerated pride or self-confidence, often resulting in retribution” (p.106). By another definition, the hubris is “an exaggerated belief about one’s own judgment that may deviate from objective standards” (Li and Tang, 2010: 46). In the literature, the executive hubris is considered a cognitive bias in decision-making (Li and Tang, 2010) and expected to yield three main consequences: “overestimation of individual’s own problem-solving capabilities, underestimation of resource requirements of risky initiatives as well as uncertainties facing their firms” (Li and Tang, 2010: 45-46). All these definitions show that the hubris may make executives take faulty steps in their decisions.

According to Malmendier and Tate (2008), the extreme overconfidence that hubristic executives possess usually results in the overestimation of their abilities in creating value for their organizations. They further argue that these kinds of misperceptions may cause a significant decrease in the investment of shareholders in these companies as well as the level of synergies between business partners (Malmendier and Tate, 2008). Additionally, extreme overconfident behaviors of executives may lead to using too much simplistic procedures to undertake difficult projects and organizational tasks as well as not being able to see shifting realities within the environment (Kroll, Toombs, and Wright, 2000). Also, from the perspective of decision making, hubristic executives tend to primarily rely on mental short-cuts and miss out on critical information required for detailed analysis (Trevelyan, 2008).

On the “bright side” of hubris, Galasso and Simcoe (2011) argue that hubristic executives tend to lean toward an increased propensity in innovation efforts of their firms. Executives’ extreme overconfidence can also have an important impact on both changing the firm’s strategic directions and spending more resources for R&D activities, which may lead to an increase in the productivity of their firm (Galasso and Simcoe, 2011). Parallel to this argument, Simon and Houghton (2013) state that those executives who possess extreme overconfidence are better able to pursue product introductions that are considered pioneering and risky. Since they have the tendency of believing in themselves so much for executing difficult tasks rather than simple ones as well as better dealing with uncertainties, hubristic executives are more dedicated to firm innovation and newness (Tang, Li, and Yang, 2012). This kind of a mindset for executives should be considered unique since it makes the firm competitive among its rivals.

In the context of spin-offs, after the corporate separation from its parent, the child firm will first need to establish its legitimacy within its industry as the initial step for becoming strong stand-alone entities. In order to accomplish that, top executives of the child firm, particularly CEOs, will need to critically analyze all dimensions of the environment by avoiding any “short-cuts” on their decisions. In other words, for the child firm, until the legitimacy is established, all corporate efforts will need to be done on a “step-by-step” basis by not simplifying situations that may affect organizational tasks and procedures. This will require a careful attention on all tasks regardless of the level of their difficulty. Therefore, having a hubristic CEO may not work quite well until the child firm establishes its legitimacy due to their misperceptions or miscalculations caused by their extreme overconfidence.

After the establishment of legitimacy, however, top executives' (such as CEOs) inclinations towards more risky actions may become an advantage for the child firm in order to become more competitive in the industry. These hubristic CEOs may prefer spending more resources on R&D towards innovation and taking the risk of creating new product and services to become an industry leader. For the child firm, it may be quite important to take further steps for becoming "completely" independent from its parent by making significant changes in its operations instead of being stuck with same practices before the spin-off event. Therefore, hubristic CEOs may be quite helpful to carry the child firm to a higher stage in the industry via trying something new and risk-involved innovative activities.

As stated in the literature on hubris, this is a construct that has both positive and negative sides in terms of its effects on firm performance (Hayward, Shepherd, and Griffin, 2006; Hayward and Hambrick, 1997; Kroll et al., 2000; Li and Tang, 2010; Seth, Song, and Pettit, 2000). In the context of spin-offs, I argue that until the child firm establishes its legitimacy, having a hubristic CEO may not be quite desirable; however, after this legitimacy is established, having a hubristic CEO may be actually beneficial.

Proposition 2a: Having a hubristic CEO will negatively moderate the relationship between child firm proactiveness and organizational legitimacy.

Proposition 2b: Having a hubristic CEO will positively moderate the relationship between organizational legitimacy and child firm performance.

DISCUSSION

Corporate spin-offs are unique restructuring activities that particularly help businesses focus on their core activities (Daley, Mehrotra, and Sivakumar, 1997), provide investors with a transparency on business operations (Bergh et al., 2008) as well as mitigate the information asymmetry on its operations (Krishnaswami and Subramaniam, 1999), and create a better shareholder value (Miles and Rosenfeld, 1983). After this corporate separation, the spun-off subsidiary (the child firm) becomes an independent, stand-alone publicly traded entity, which means that most resources available via its parent will no longer exist.

By embracing a proactive posture, the child firm will be able to look for new opportunities via a careful scanning of the environment and acquire resources necessary for its long-term survival. In other words, being proactive will provide the child firm with a strategic advantage in regard to taking innovative steps and rejecting the status quo coming from the parent firm (Crant, 2000). All these unique efforts towards being new will first help this child better and faster establish its legitimacy within the sector, which refers to being able to meet requirements of the institutional environment (Deephouse and Carter, 2005). As a result, becoming “legitimate” will help the child firm achieve positive performance outcomes.

During all these challenging organizational processes, managerial factors will also need to be critically considered. After the spin-off event, top executives in the child firm will have to take into account each single detail and not miss on any critical information that may make a negative influence on their firms’ efforts of establishing legitimacy. This means that a hubristic

CEO may not be the best option at the first place for the child firm. However, after the firm's legitimacy is established, it may be quite beneficial to have a hubristic CEO who is willing to take risks for further improve business operations and put more emphasis on innovative activities that the child firm is not familiar with. Therefore, the CEO hubris plays a bilateral role in the context of spin-offs.

CONCLUSION

This research focuses on success parameters of the child firm after the spin-off event. In particular, I argue that being proactive will help the child establish its legitimacy and in turn increase its performance. I define this process as a fully-mediated model. In addition, I argue that top decision makers' behavioral characteristics will make a significant impact on this process. More specifically, I argue that having a hubristic CEO will be harmful for the child firm before the legitimacy is established; however, in later stages a hubristic CEO will actually become beneficial for the child firm. Therefore this conceptual research shows effects of proactiveness, legitimacy, and hubris on the performance of the child firm.

This research has some limitations. First, it only looks at proactiveness as a firm-level behavior. Second, it does consider any environmental dimensions that may have a contingency effect on this model. Third, it only looks at the CEO as the top decision maker without considering the board structure. However, these limitations can certainly be addressed in future research. First of all, it may be helpful to identify some other firm-level behaviors while explaining the performance of the child firm. Secondly, environmental dimensions such as

dynamism and munificence may be included as contingency factors in the model. And finally, it may be fruitful to look at how the interaction between the board and CEO can help to better explain the phenomenon.

In conclusion, the child firm's performance after becoming an independent, stand-alone entity may depend on several factors. It is very important to further examine the behavior of the firm and executives as well as industry conditions in order to come up with a better understanding for why some child firms perform better than others after their corporate separation. Expanding the conceptual framework proposed in this study and empirically analyzing it in later stages will be very helpful for examining the performance of spun-off subsidiaries.

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FIGURES

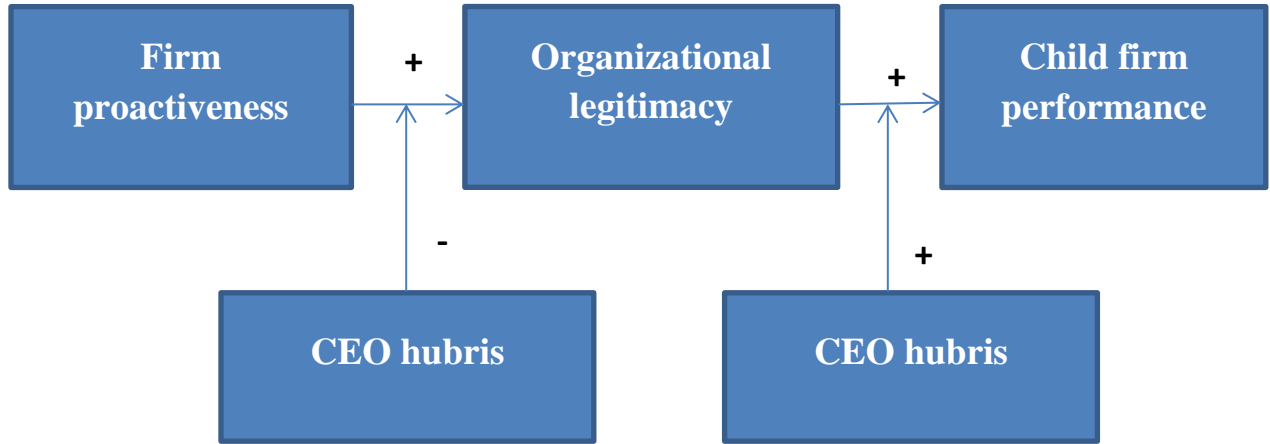


Figure 1 The post-spin-off performance of the child firm