

What Lies Behind CEO Failure?

Introduction

Judging by the results of some recent studies (Capapé and Stein, 2009), management literature has no clear answer to the question of what causes CEO dismissal. However, articles published over the last 30 years in journals such as *The Journal of Finance*, *Journal of Financial Economics*, *Academy of Management* and *Journal of Management* come to the opposite conclusion.

Some maintain that CEOs who are paid in stock are more inclined to identify with the company (Jensen and Murphy, 1990). Although this view is widely accepted, stock-based compensation can also tempt CEOs to manipulate their company's results (Bartol et al., 2008) to their own benefit. Recent history provides several examples, from Enron and WorldCom in 2001, when the dotcom bubble burst, to Satyam in 2009, during the global crisis that began in 2007.

The question of what compensation structure elicits optimal CEO performance – one of the most interesting areas of corporate governance – has not yet found a satisfactory answer. Not only is there no generally accepted view among scholars; some (Tosi et al., 2000) have even argued –based on a sample of 1,000 companies over four years – that CEO remuneration is better predicted by company size than by company performance. Not even on an issue as intensely debated as this, including in the media, is there a clear consensus.

This divergence of views, which is repeated across most of the factors studied by Capapé and Stein, is one of the weaknesses of management research. Professor Steven Kaplan and doctoral student Mark Klebanov (Chicago Booth School of Business), together with Morten Sorensen (Columbia), put their finger on this same weakness in a recent article on the

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characteristics of the CEOs hired in private equity transactions. There is evidence of a systematic incapacity to take account of the most decisive factor in CEO failure: the CEO himself. The characteristics, competencies or motivations behind a CEO's decisions are the factors that have received least attention in empirical studies. The reason is obvious: reliable information on these factors is hard to come by.

We generally consider information reliable if it matches reality. According to Cardona and García Lombardía (2005), what we need to study is competencies, insofar as they are observable in people (in this case, CEOs). And by reliable we mean that the information comes from activities related to the performance of tasks specific to CEOs. On this latter point, Rosanas and Andreu, in an article published in *La Vanguardia* (May 7, 2009), note that a group of MIT researchers propose to assess leadership potential based on observable behaviors such as time spent listening to colleagues and subordinates, tone of voice and other behaviors, which basically have little to do with CEO success and merely serve as fodder for copious academic studies centered on empirical evidence. They raise an important point: the "hammer syndrome," which prompts victims to beat anything that comes their way with a hammer (technology). The hammer is a great tool, but not for every job. It may be this insistence on statistical evidence that prevents management scholars from understanding CEO failure.

The same explanatory variables have been worked through time and again: CEO origin (insider-outsider); director selection; CEO age and length of service; company type; industry type; mergers and acquisitions. Other popular themes include board size, proportion of independent directors, and separation of the roles of CEO and chairman. None of these factors receives unanimous support from the literature. In each case, empirical studies vary in their assessment of the scale and nature of the effect.

In this technical note we aim to provide an overview of the explanations given by management scholars. The recent report published by Booz & Co. will help us assess these explanations.

Company Performance

According to the annual CEO succession study published by Booz & Co., covering the world's 2,500 largest publicly traded companies, in 2008 the number of CEOs who left their company increased to 14.4%, compared to 13.8% in 2007. CEO turnover in the world's largest companies thus increased. This is understandable, given an economy in free fall, where companies have lost much of the ground gained over the last six years or more.

This slight increase is not the most interesting part of the study, however. The report's authors focus on the statistical breakdown and the differences between regions. The full breakdown is essential in order to understand the results. The study describes three ways a CEO can leave his company: according to plan (retirement, contract termination), exit on acquisition or dismissal. These options are listed in decreasing order of interest: planned successions are unrelated to performance and so tell us next to nothing about CEO failure; acquisitions have been studied as a "good monitor" of the CEO talent market and provide more interesting information; however, the most studied option is, by far, dismissals (often

presented as departures “for personal reasons”), as the real reasons behind them can be of great theoretical and practical interest.

Profitability is significantly negatively correlated with CEO succession (Salancik and Pfeffer, 1980; Warner et al., 1988), but it still does not satisfactorily explain CEO failure. Firm performance is measured using a variety of disparate measures (accounting performance, market share, industry-weighted, and so forth), so that the results depend on the sample and the criteria used. As stated, the relationship between firm performance and CEO failure is widely acknowledged (and seems common sense), but it is not a sufficient explanation. This appears to be confirmed by the latest findings in 2008.

Convergence in Good Practices

The regional breakdown shows growing convergence among good practices in corporate governance. As anticipated by Russell Reynolds Associates in 2006, the separation of the roles of CEO and Chairman of the Board of Directors was almost universal among CEOs hired in 2008. Russell Reynolds Associates showed how this separation came about in the early years of the 21st century. This trend reflects the recommendations of MacAvoy and Millstein (2003), who consider the separation of functions essential to enable management to operate effectively and leave the board free to represent the interests of shareholders. In 2001, the two roles were separated in only 21% of S&P 500 companies and 41% of Nasdaq 100 companies. The equivalent figures for the FTSE 100 and Eurotop 100 were 92% and 74%. Five years later, the percentages had risen to 29% in the S&P 500, 45% in the Nasdaq 100, 93% in the FTSE 100 and 79% in the Eurotop 100. This convergence indicates a new approach to corporate governance designed to counter the indignant cries of “Where was the board?” in the wake of the scandals at Enron, WorldCom or Reliant in 2001 and the regulatory response embodied in the Sarbanes-Oxley Act of 2002.

Divergence in Dismissals

In 2008, alongside this convergence of practices, there was a divergence between US and European firms, on the one hand, and the rest of the world, on the other. According to Booz & Co., Asian CEOs experienced higher turnover in 2008 than their Western counterparts. In Japan, the rate of turnover (including all three types of succession) increased from 10.6% in 2007 to 16.4% the following year. In Asia as a whole, the increase was from 9.2% in 2007 to 13% in 2008. In Europe (14.4%) and the US (15.1%), however, the percentages decreased (Figure 1). One possible explanation for this – on the face of it, surprising – result is that there were more planned successions in Japan. Yet the increase was not only in planned successions; dismissals and forced departures quadrupled in Japan last year. This is the interesting point: despite the sharp contraction in economic activity worldwide, the CEOs of “Western” companies stayed in their posts, thanks to a strategy of “better the devil you know than the devil you don’t.” As the title of Booz & Co.’s original report put it, there has been some “stability in the storm.” Boards of directors have preferred to not add to market uncertainty by making changes in top management, and have tried to weather the storm by using the means at their disposal when the crisis broke. The report’s authors speculate that