FROM BOARDROOM TO C-SUITE

WHY WOULD A COMPANY PICK A CURRENT DIRECTOR AS CEO?

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MARCH 28, 2017

INTRODUCTION

To many observers the most important responsibility of the board of directors is to hire and fire the CEO. This includes not only evaluating potential CEO talent and assessing performance once hired, but also planning for the inevitable turnover that occurs when a change in leadership takes place. At some point, every company needs to enter the labor market for executive talent to source a new CEO, either by promoting from within or recruiting an executive from another company.

To this end, an interesting situation arises when a CEO resigns and the board chooses neither an internal nor external candidate, but a current board member as successor.[1] Although rare, such a decision has been made at several prominent companies over the last decade, including DuPont, General Motors, Hewlett-Packard, and Visa.

Why would a company make such a decision? The benefit of appointing a current director to the CEO position is that the director can act as a hybrid "inside-outside" CEO. He or she is likely well versed in all aspects of the company, including strategy, business model, and risk-management practices. Also, a current director likely has personal relationships with the executive team and fellow board members, making it easier to determine cultural fit prior to hiring. At the same time, this individual is not a member of the current senior management team, and therefore has greater freedom to make organizational changes if needed. To this end, Citrin and Odgen (2010) find that board members-turned-CEO outperform all other types of candidates (including insiders, outsiders, former executives, and COO promotions). They measure performance using a combination of relative stock price returns, revenue growth, and profit growth, and conclude that "directors-turned-CEOs represent a strong blend of insider and outsider [attributes]."[2]

On the other hand, appointing a current director as CEO has potential drawbacks. The most obvious of these is that it signals a lack of preparedness on the company's part to groom internal talent. It may also signal a lack of preparedness among the board to carry out a rigorous search process. As such, appointing a director to the CEO role could actually be an "emergency" succession in disguise. Research has shown the downside of emergency—or interim—appointments. Ballinger and Marcel (2010) find that emergency appointments are negatively associated with firm performance and increase a company's long-term risk of failure, particularly when someone other than the chairman is appointed to the interim position. They conclude that "the use of an interim CEO during successions is an inferior *post hoc* fix to succession planning processes that boards of directors should avoid."[3]

DIRECTORS-TURNED-CEO

To understand the circumstances in which a company appoints a current board member as CEO, we conducted a search of CEO successions among Fortune 1000 companies between 2005 and 2016 and identified 58 instances where a nonexecutive (outside) director became CEO.[4] Some companies—such as H&R Block, Starwood Hotels, and Visa—made this decision more than once during the measurement period, and so our final sample includes 58 directors-turned-CEO at 50 companies (see Exhibit 1).

Most director-turned-CEO appointments occur following a sudden resignation of the outgoing CEO. Over two-thirds (69 percent) follow a sudden resignation, whereas only one-third (31 percent) appear to be part of planned succession.

Furthermore, director-turned-CEO appointments have an above average likelihood of following termination of a CEO for performance. Half (52 percent) of the outgoing CEOs in our sample resigned due to poor performance, and an additional 12 percent resigned as part of a corporate-governance crisis, such as accounting restatement or ethical violation.[5] That is, 64 percent of director-turned-CEO appointments followed a performance-driven turnover event compared to an estimated general market average of less than 40 percent.[6]

Shareholders do not appear to be active drivers of these successions. In over three-quarters (78 percent) of the incidents in our sample, we failed to detect any significant press coverage of shareholder pressure for the outgoing CEO to resign.[7] In 13 of 58 incidents (23 percent), a hedge fund, activist investor, or other major blockholder played a part in instigating the transition. For example, in June 2008 three major shareholder groups banded together to lobby for the resignation of CEO Martin Sullivan at AIG, who was replaced by then-chairman Robert Willumstad.[8] (The company again changed CEOs just three months later following its collapse in the financial crisis). Similarly, activist investor William Ackman was involved in the resignation of CEO John McGlade at Air Products in 2013, and Carl Icahn in the retirement of long-time CEO Howard Solomon at Forest Labs in 2013.[9] The hedge fund Citadel, which owned a 9.6 percent stake in financial firm E*Trade and had a seat on that company's board, had significant influence over the resignation of CEO Stephen Freiberg in 2012 and the appointment of interim CEO Frank Petrilli.[10]

In most cases, companies name the director-turned-CEO as successor on the same day that the outgoing CEO resigns. In 91 percent of the incidents in our sample, the director was hired on the same day that the outgoing CEO stepped down; in only 9 percent of the incidents was there a gap between these announcements. When a gap did occur, the average number of days between the announcement of the resignation and the announcement of the successor was approximately four months (129 days). These situations included a mix of orderly successions and performance- or crisis-driven turnover.

The stock market reaction to the announcement of a director-turned-CEO is modest. We measure average abnormal returns (returns relative to the S&P 500 Index) of -0.2 percent over the three-day period preceding, including, and following the announcement date. Given the small sample size, these returns are not significantly different from zero. Furthermore, because the outgoing CEO resignation tends to occur on the same day that the successor is named it is not clear how the market weighs the hiring decision of the director-turned-CEO relative to the news of the outgoing CEO resignation. (Clearly, the return is a combination of the information contained in both events.) In the small number of cases where the outgoing CEO resigned on a different date than the successor was appointed, we observe positive abnormal returns both to the resignation (2.4 percent) and to the succession (3.2 percent). This suggests that, in these cases, the market viewed favorably the decision to appoint a director as CEO.

A large minority of director-turned-CEO appointments appear to be "emergency" appointments. In 45 percent of cases, directors were appointed CEO on an interim basis, although in a quarter of these the director was subsequently named permanent CEO. In the remaining 55 percent of cases, the director was named permanent CEO at the initial announcement date.

In terms of background, most directors-turned-CEO have significant experience with the company, with the industry, or as CEO of another company. Fifty-seven percent of directors-turned-CEO in our sample were recruited to the board during their predecessor's tenure and served for an average of 6.9 years *before* being named CEO. Two-thirds (67 percent) had prior CEO experience at another company, and almost three-quarters (72 percent) had direct industry experience. Of note, only 9 percent had neither industry nor CEO experience. For example, Mike Mikan was former CFO of United Healthcare before becoming CEO of Best Buy; Eddie Lampert was (and remained) a hedge fund manager and majority shareholder before stepping in as CEO of Sears; William Cobb was a senior executive at eBay and Alan Bennett CFO of Aetna before separately becoming CEOs of H&R Block; and William Stafford was a lawyer before becoming CEO of First Community Bancshares. Three of these directors (Mikan, Bennett, and Stafford) were initially named interim CEO (although Stafford later had the interim title removed) while the other two were named permanent CEO.

The directors-turned-CEO tend to start their new jobs right away. In 59 percent of the cases we examined, the director-turned-CEO assumed the CEO role on the same day as the announcement; in 41 percent there was a delay between the announcement and the beginning of his or her tenure as CEO. When a delay did occur, the average number of days between being appointed to the position and assuming CEO duties was 1.5 months (46 days).

Of note, directors-turned-CEO do not remain in the position very long, regardless of whether they are named permanently to the position or on an interim basis. We found that the directors-turned-CEO who served on an interim basis remained CEO for 174 days (just shy of 6 months) on average; directors permanently named to the CEO position remained CEO for only 3.3 years on average, compared to an average tenure of 8 years among all public company CEOs.[11] It might be that their shorter tenure was driven by more challenging operating conditions at the time of their appointment, as indicated by the higher likelihood of performance-driven turnover preceding their tenure.[12]

Finally, in contrast to Citrin and Ogden (2010) we do not find evidence that directors-turned-CEO exhibit above-average performance. Across our entire sample, we find slightly negative cumulative abnormal stock price returns (-2.3 percent) for companies who hire a director as CEO, relative to the S&P 500 Index. The results are similar when interim and permanent CEOs are evaluated separately. Permanent directors-turned-CEO generated cumulative abnormal returns of -0.5 percent over their tenure, not materially different from zero on an annualized basis. Interim directors-turned-CEO experienced significant abnormal share-price declines of -5.6 percent over their short tenure, consistent with the evidence above that interim CEOs are associated with below-average performance.[13] This suggests that the nature of the succession, rather than the choice of director as successor, is likely the more significant determinant of performance among these companies.

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WHY THIS MATTERS

1. One of the most important responsibilities of a board of directors is to identify and recruit the best executive to manage a company. What does it say about the quality of a company's succession planning when the board decides to appoint a fellow nonexecutive board member to the CEO position? Is this individual the most qualified candidate, or does it reflect an emergency situation in which a board is not prepared to conduct a thorough and rigorous search?
2. Director-turned-CEO appointments have an above average likelihood of following the termination of a CEO for performance or a governance crisis. In these cases, is the appointment of a director the best pathway to add stability to the company, or does it represent a stop-gap measure to prevent further damage while a permanent successor is sought? What does it say about the board's ability to monitor corporate performance before the predecessor was terminated, given the sudden nature of these transitions?
3. Shareholders are rarely made aware of the circumstances that precede the appointment of a director as CEO. What is the process by which a board makes this decision? Does the director make known that he or she wants to be considered a candidate for successor, or do members of the board initiate the conversation because of this person's experience and leadership skills? How does this influence the objectivity and rigor of the evaluation process? ■

[1] In this case, we are explicitly referring to outside board members and not current executives serving on the board such as president, chief operating officer, or chief financial officer.

[2] Note that the authors do not appear to use industry or company controls so it is not clear how significant their results are. See James M. Citrin and Dayton Ogden, "Succeeding at Succession," *Harvard Business Review* (November 2010).

[3] Note that this study is on all interim CEOs, not directors-turned-CEOs. Gary A. Ballinger and Jeremy J. Marcel, "The Use of an Interim CEO during Succession Episodes and Firm Performance," *Strategic Management Journal* (2010).

[4] By comparison, Citrin and Ogden (2010) identify 19 directors-turned-CEO between 2004 and 2008.

[5] Based on commentary in the media.

[6] Jenter and Lewellen (2014) estimate that 40 percent of all CEO turnovers are performance-related. See Dirk Jenter and Katherina Lewellen, "Performance-Induced CEO Turnover," *Social Science Research Network* (March 2014), available at: https://ssrn.com/abstract=1570635.

[7] This does not rule out the possibility that shareholders privately pressed the board of directors for change.

[8] Liam Pleven and Randall Smith, "Big Shareholders Rebel at AIG—Letter to the Board Cites Problems with Senior Management," *The Wall Street Journal* (June 9, 2008).

[9] Ben Lefebvre and David Benoit, "Air Products CEO Bows to Activist," *The Wall Street Journal* (September 27, 2013); and Meg Tirrell, "Forest Labs' 85-Year-Old CEO Solomon to Leave at Year End," *Bloomberg* (May 23, 2013).

[10] Nandini Sukumar, "E*Trade CEO Freiberg Ousted, Broker Seeks New Leader," *Bloomberg* (August 9, 2012).

[11] The Conference Board, "CEO Succession Practices," (2014).

[12] Additionally, two measurement-related factors might distort the observed average of 3.3 years. First, some CEOs in our sample continued to serve as CEO at the end of the measurement period and so their tenure is not complete. (Excluding these CEOs from the sample, however, still yields an average tenure of approximately 3 years.) Second, our sample period includes only directors-turned-CEO after 2005. Long-tenured directors-turned-CEO are therefore excluded from our sample and calculations, therefore depressing the average.

[13] Directors who were initially named interim CEO but later became permanent CEO are treated as permanent in this analysis.

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EXHIBIT 1 — DIRECTORS-TURNED-CEO (2005-2016)

Descriptive Data		
Number of directors-turned-CEO	58	
Number of companies	50	
Sudden resignation	40	69%
Planned transition	18	31%
Reason for change in CEO		
Performance	30	52%
Corporate governance crisis	7	12%
Retirement or other orderly transition	17	29%
Outgoing CEO took another job	3	5%
Unknown	1	2%
Shareholder involvement in transition		
Activist involvement	8	14%
Other blockholder involvement	5	9%
No visible shareholder involvement	45	78%

EXHIBIT 1 — CONTINUED

Descriptive Data		
CEO resignation same day as director hire	53	91%
CEO resignation before director hire	5	9%
Average number of days between, if different	129	
Director-turned-CEO starts on announcement date	34	59%
Director-turned-CEO starts after announcement date	24	41%
Average number of days between, if different	46	
Director-turned-CEO status		
Interim	20	34%
Interim became permanent	6	10%
Permanent	32	55%
Director-turned-CEO experience		
Joined board during predecessor's tenure	33	57%
Average number of years on board before becoming CEO	6.9	
Prior CEO experience	39	67%
Prior industry experience	42	72%
No CEO or industry experience	5	9%

EXHIBIT 1 — CONTINUED

Descriptive Data	
Tenure as CEO	
Average number of days as CEO, if interim	174
Average number of years as CEO, if permanent	3.2
Stock price reaction relative to S&P 500	
Announcement of director-turned-CEO, all	-0.2%
Announcement of CEO resignation, if different date	2.4%
Announcement of director-turned-CEO, if different date	3.2%
Stock price performance relative to S&P 500	
Performance over tenure, all	-2.3%
Performance over tenure, interim only	-5.6%
Performance over tenure, permanent only	-0.5%

Source: Stock price information from Center for Research in Securities Prices (University of Chicago). Research and calculations by the authors.