CEO TURNOVER

RESEARCH SPOTLIGHT

David F. Larcker and Brian Tayan
Corporate Governance Research Initiative
Stanford Graduate School of Business

STANFORD GRADUATE SCHOOL OF BUSINESS | Corporate Governance Research Initiative

KEY CONCEPTS

CEO Performance and Turnover

- One important indicator of governance quality is whether the board is willing to terminate an underperforming CEO.

- From a research perspective, two questions are salient:
  - How likely is it that a board terminates an underperforming CEO? (i.e., what is the sensitivity of CEO turnover to performance)
  - What governance attributes are associated with stricter oversight? (i.e., what increases the sensitivity of CEO turnover to performance)

Research provides modest evidence that independent and engaged boards hold CEOs accountable for performance.

CEO TURNOVER AND PERFORMANCE

- Brickley (2003) reviews the early research on the relation between CEO turnover and performance.
- Sample: ~10 studies, 1980s and 1990s.
- Finds that:
  - Sensitivity of CEO turnover to performance is low.
  - Firms in the bottom decile in performance are only 4% more likely to terminate CEO than firms in top decile.
  - Age is more significant determinant of turnover than performance.

Conclusion: CEOs are not likely to be terminated for poor performance.

CEO TURNOVER AND PERFORMANCE

- Huson, Parrino, and Starks (2001) also study the relation between CEO turnover and performance.
- Sample: 1,802 CEOs, 1971-1994.
- Group companies into quartiles based on performance over 6-year periods (ROA, change in ROA, and stock-price performance).
- Find that termination rates for CEOs in bottom quartile are only ~3% higher than those in top quartile even though performance is considerably worse.
- Relation between CEO turnover and performance has not changed over time.

Conclusion: CEOs are not likely to be terminated for poor performance.

CEO TURNOVER AND PERFORMANCE

- Jenter and Lewellen (2014) measure CEO performance over time to determine whether turnover is "performance-induced."

- Sample: 5,356 CEOs, 1993-2011.
  - Track CEO performance (stock price).
  - Calculate probability of turnover when performance is at 95^{th} percentile. (assume that this is not performance-related)
  - Calculate relation between turnover and performance below 95^{th} percentile.

- Find that CEO turnover is more closely linked to performance than estimated by prior studies.

- Estimate that ~40% of all CEO turnovers are performance-related.

Conclusion: CEOs are likely to be terminated for poor performance.

CEO TURNOVER AND PERFORMANCE

- Fee, Hadlock, Huang, and Pierce (2015) examine the influence of modeling assumptions on the association between turnover and performance.
- Sample: 6,787 turnover events, 1991-2007.
  - Reexamine whether terminations are categorized as "voluntary" or "involuntary."
  - Consider previously excluded variables, such as severance payments and post-termination employment outcomes to determine whether CEO was fired.
- Find that inclusion of previously excluded variables suggests a closer relation between performance and likelihood of termination.
- Demonstrate that sensitivity of turnover to performance is highly dependent on modeling choices.

Conclusion: CEOs are likely to be terminated for poor performance.

CEO TURNOVER AND INDUSTRY PERFORMANCE

- Jenter and Kanaan (2015) examine whether CEOs are terminated for industry and market factors outside of their control.
- Sample: 3,365 turnover events, 1993-2009.
  - Correlated turnover and industry stock price performance.
- Find that:
  - CEOs are more likely to be terminated after poor industry performance.
  - CEOs in industries at the 10th percentile are twice as likely to be terminated as CEOs in industries at the 90th percentile.

Conclusion: Boards consider industry performance in evaluating CEOs.

"Our results are consistent with the idea that boards mistakenly credit and blame CEOs for performance beyond their control."

GOVERNANCE QUALITY AND CEO TURNOVER

- Mobbs (2013) studies whether companies with a viable internal replacement on the board are more likely to terminate an underperforming CEO.
- Sample: 2,231 companies, 1997-2006.
- Identifies companies with “talented” inside directors.
(Non-CEO, inside directors who also hold external board seats)
- Finds that companies with talented inside directors are more likely to terminate underperforming CEOs (based on ROA).

Conclusion: Boards with viable alternatives provide stricter oversight of CEO performance.

> “Certain insiders strengthen board monitoring by serving as a readily available CEO replacement.”

GOVERNANCE QUALITY AND CEO TURNOVER

- Huson, Malatesta, and Parrino (2004) examine whether outside directors and institutional shareholders provide stricter oversight of CEO performance.
- Sample: 1,344 succession events, 1971-1994.
- Measure corporate performance (ROA) before and after involuntary terminations.
- Find that performance improvements are:
  - Positively associated with the level of institutional ownership.
  - Positively associated with the number of outside directors.

Conclusion: Outsiders provide stricter oversight of CEO performance.

GOVERNANCE QUALITY AND CEO TURNOVER

- Guo and Masulis (2015) study the relation between board independence and CEO turnover.
- Sample: 1,231 companies, 1996-2009.
- Identify companies that were forced to increase board independence to comply with Sarbanes-Oxley.
- Find that sensitivity of CEO turnover to performance is:
  - Positively associated with board independence.
  - Positively associated with nominating committee independence.

Conclusion: Independent directors provide stricter oversight of CEO performance.

GOVERNANCE QUALITY AND CEO TURNOVER

- Fich and Shivdasani (2006) study the relation between "busy" boards and CEO turnover.
- Sample: 508 companies, 1989-1995.
  - "Busy" directors: Directors holding 3 or more board seats.
  - "Busy" boards: Boards with a majority of busy directors.
- Find that busy boards are less likely to terminate an underperforming CEO (ROA).

Conclusion: Busy directors provide worse oversight of CEO performance.

"As directors accumulate more directorships, they may become increasingly constrained in being effective monitors."

GOVERNANCE QUALITY AND CEO TURNOVER

- Ellis, Guo, and Mobbs (2016) study whether directors become better monitors after experiencing a forced CEO termination.
- Sample: S&P 1500 companies, 1997-2010.
  - Identify directors with prior experience terminating an underperforming CEO.
  - Measure sensitivity of turnover to performance at their current companies.
- Find a positive relation between experience and the likelihood that a CEO is terminated for performance reasons.

Conclusion: Experienced directors provide stricter monitoring.

> "The skills and information gained from managing a forced CEO turnover event make experienced directors distinctly different from the inexperienced ones and can serve to transform their decision making."

CONCLUSIONS

- The relation between performance and forced termination is difficult to measure. It is not always clear whether a CEO resigned or was terminated.
- In general, research suggests that companies are likely to terminate an underperforming CEO.
- Still, termination rates are not especially high, and modeling assumptions have a significant impact on observed outcomes.
- Certain governance attributes are associated with stricter monitoring:
  - Independent/outside directors
  - Experienced/engaged directors
  - Significant institutional ownership
  - Companies with access to replacement candidates

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