Corporate Governance, Board Oversight, and CEO Turnover

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Contents

Abstract

One of the primary roles of corporate boards is to control the processes by which top executives are assessed and if necessary replaced. CEO turnover cannot be viewed in isolation because it affects the behavior of the involved players and hence interacts with other organizational goals. This monograph seeks to synthesize recent research that analyzes these interactions. I focus on a number of recurring themes, including the implications of CEO assessment and replacement on optimal contracting, board monitoring, project selection, financial reporting, and CEO selection.

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1

Introduction

The role of boards of directors in corporations has received much attention in the accounting, economics, and finance literature.[1] In a recent analysis of private data on detailed minutes of board meetings, Schwartz-Ziv and Weisbach [2013] conclude that "... boards spend most of their time monitoring management" (p. 349). An important goal of monitoring is to assess executives' talent and fit and to use this information to decide whether to retain or replace them. Indeed, using U.S. sample data from 2000 to 2007, Kaplan and Minton [2012] find an annual CEO turnover rate of 16.8%, showing that the average CEO stays less than 6 years in control.[2] Lucier et al. [2005] put it this way: CEOs are "the world's most prominent temp workers".

The assessment of executives' abilities is a nontrivial exercise because it critically affects the behavior of the players involved.[3] The board's desire to evaluate and, if necessary, replace executives can therefore interact with other organizational goals such as truthful disclosure of earnings and investment in long-term projects. This

[1]See Adams et al. [2010] for an extensive survey of the literature on boards.

[2]See also Huson et al. [2001].

[3]See also Hermalin and Weisbach [2014], who argue that managerial career concerns are a key aspect for the study of corporate governance.

monograph seeks to synthesize recent research that examines these interactions and their implications on (i) firms' investment strategies, (ii) executive compensation packages, (iii) board monitoring and transparency, (iv) the likelihood and characteristics of CEO turnover, (v) financial reporting, (vi) CEO selection, and (vii) board composition. Analyzing governance from the perspective of assessment can help explain observed practices that, viewed in isolation, seem counterproductive or inefficient. The analysis is framed around five themes related to CEO assessment and replacement. Each theme is the focus of one section.

Transparency is often regarded as the key for good governance. Transparency allows boards to monitor management and to make better decisions such as replacing incompetent CEOs. Cremer [1995] was one of the first to show that increased transparency comes at a cost. Section 2 studies these costs in a setting in which the board seeks to assess the CEO and, if warranted, replace him. One way to learn about CEO ability is to draw inferences from observed firm performance. Anticipating this assessment process, the CEO is eager to succeed not only to increase expected compensation in the current period but also to impress the board and to increase the probability of staying in charge. This effect is related to Holmstrom [1982, 1999] who shows that the CEO's desire to boost the market's perception of his skills provides valuable effort incentives. However, firm performance is not the only information available to assess managerial ability. The board can also engage in costly monitoring activities to uncover further evidence. Monitoring is desirable ex post because it generates information that the board uses to make better replacement decisions. But it weakens ex ante effort incentives because it decouples the board's firing decision from firm performance. Intuitively, the CEO is less eager to generate high profits when the board has other means besides firm performance to assess his ability. When this adverse incentive effect is strong enough, it is optimal for the board to commit to abstain from monitoring by, for example, installing an ineffective accounting system. The analysis generates the following two main insights. First, a lack of transparency in firms is not necessarily a sign of governance failure as typically argued but can arise as an optimal solution to commitment and incentive problems. Second, the particular processes by which boards evaluate executives matter. Whereas drawing inferences about ability from firm performance can have positive side effects on managerial effort, actively acquiring other signals pertaining to CEO ability counteracts and destroys these incentives. Thus, the model challenges the standard view that boards do not spend enough time monitoring management: at times, boards actually may end up monitoring too much.

The threat of CEO replacement can alleviate existing agency problems (as discussed above) or create new ones. The problem is that executives can engage in a multitude of activities to increase the probability of staying in control, many of which are undesirable from the shareholders' perspective. Section 3 draws from Laux [2008] and Inderst and Mueller [2010] and studies a setting in which the CEO privately observes an earnings signal and issues a public report about earnings, which, however, does not need to be truthful. The earnings signal is informative about the incumbent's ability and hence useful for deciding whether to keep him in charge. Given this kind of information asymmetry, the threat of CEO replacement can no longer be used as a valuable effort incentive tool. After all, the CEO can entrench himself simply by misreporting the earnings signal. To induce truthful reporting, the board has to offer generous severance pay. Severance pay protects the CEO from the cost of being fired and renders him willing to disclose unfavorable information. But this protection comes at the cost of weaker effort incentives. Intuitively, the CEO realizes that he can reap a reward simply by getting fired, and hence has weaker incentives to do a good job in the first place. The board therefore has to trade off the cost of inducing managerial effort with the benefits of better replacement decisions. In contrast to the model in Section 2, this trade-off leads to an optimal *ex ante* replacement policy that is less aggressive (that is, less sensitive to performance) than the *ex post* optimal one. Committing to a weak turnover-performance sensitivity is optimal because it reduces the level of severance pay required to induce truthful communication and, in turn, the bonus required to induce effort. The model generates two main insights: First, CEO entrenchment is not necessarily an artifact of powerless or captured boards, as is often argued, but can arise from optimal contracting when the CEO possesses private information. Second, although severance pay has acquired a negative reputation lately [Bebchuk and Fried, 2004], severance pay can actually play a valuable role in governance because it facilitates truthful reporting and allows for more effective CEO replacement decisions.

Assessment and replacement interact not only with the CEO's reporting incentives but also with other organizational activities such as the firm's investment strategies. This interaction is the focus of Section 4, which is based on Laux [2012]. The board's desire to draw inferences about CEO ability from firm performance alters the firm's optimal investment strategy even in a first-best world in which managerial actions are contractible (but CEO ability is still unknown *ex ante* to all players). Relative to long-term projects, short-term projects have the advantage of generating quick results, enabling the board to assess the new CEO's skills early in his tenure. In a sense, distorting the investment choices toward short-term projects is a way of producing more timely information about managerial ability. In a second-best world, in which managerial actions are not observable, the CEO is tempted to focus excessively on short-term performance in order to demonstrate his ability and to reduce the probability of being removed. This temptation is not a problem if investment in the short-term project is indeed first-best optimal. The board can then achieve the desired investment strategy and elicit effort simply by rewarding short-term performance. However, if investment in the long-term project is first-best optimal, the board's problem becomes more complicated. Assuming long-term compensation contracts are feasible, the board can always counteract the CEO's preference for short-term performance and induce long-term investment. However, doing so is not necessarily in the best interests of shareholders because it requires offering the CEO a pay plan that leaves him with high rents. The model therefore demonstrates that forgoing long-term investments in favor of seemingly less profitable short-term investments is not necessarily a sign of faulty governance or impatient shareholders but rather can be the solution to the optimal contracting problem.

The analysis in Section 4 also examines how the possibility of forced CEO turnover can alter the conventional view that long vesting periods in executive stock option plans mitigate short-termist behavior. Vesting periods play an important role in contracting design because they determine when the CEO owns the options. The CEO anticipates that he will forfeit the options that have not yet vested if he is dismissed due to poor performance. The risk of losing the unvested equity encourages the CEO to focus excessively on short-term results to increase the probability of staying in charge. As a result, long vesting terms do not combat but encourage short-termist behavior. The optimal contract that induces long-term investment therefore consists of a stock option plan that allows a fraction of the options to vest early but prohibits immediate exercise after vesting to further link pay to long-term firm value. In contrast to the setting in Section 3, severance pay in the form of cash cannot be part of an optimal contract.

Empirical research suggests that a change in firm strategy is often associated with CEO turnover [Weisbach, 1995]. One common argument to explain this observation is that executives have a specific set of skills that qualifies them to implement a particular strategy [Shleifer and Vishny, 1989, Bertrand and Schoar, 2003]. Consequently, if the board wants to change the strategic direction of the firm, a new CEO with a different skill set is desirable. Section 5 is based on Casamatta and Guembel [2010] and shows that linking CEO turnover to a change in firm strategy can be optimal even when the incumbent is as qualified to implement the new strategy as the replacement CEO. The positive association arises solely due to effort moral hazard considerations. A key assumption in this model is that the CEO wishes to build a reputation in the labor market as a talented decision maker. After the CEO makes his initial project choice based on a private signal, the board decides whether to continue the project or whether to switch to an alternative. When the board continues the initial project, the CEO is eager to succeed not only to obtain a high compensation but to signal to the labor market that he made the right initial project choice. Retaining the incumbent is then optimal because his career concern reduces the cost of inducing effort. Since the board can exploit this positive reputation effect only if it continues the status quo and retains the incumbent, the firm exhibits inertia in the sense that it will more often pursue the status quo than what would be optimal in a first-best world. In contrast, if the board switches to the alternative strategy, the incumbent is eager to see the firm fail to signal that his initial strategy was indeed the right one. Replacing the incumbent is then optimal because the new CEO was not involved in the initial decision and hence is not driven by reputation concerns to thwart the success of the chosen strategy.

Boards are responsible not only for assessing and replacing executives, but also for selecting a successor. A key decision in succession planning is whether to appoint a CEO from within or from outside the firm. There are many differences between insiders and outsiders but the focus here is on one particular difference. Less is known about outside candidates than about inside candidates, which renders them more risky [Zhang, 2008]. Section 6 draws from Hermalin [2005] and shows that the increased risk is not necessarily a disadvantage but can be an advantage because the board has the option of replacing the new hire at a future date. Intuitively, the board benefits from the outsider's upside potential and can largely avoid his downside risk through assessment and replacement. The *ex ante* value of the replacement option depends not only on the uncertainty of the CEO's skills and fit but also on the board's monitoring abilities. When the board can acquire additional signals about CEO ability through monitoring (as in Section 2), CEO replacement becomes more efficient and the value of the replacement option increases. An immediate implication of this result is that the efficiency of CEO replacement influences the board's decision whom to hire in the first place. The model predicts that boards that are more diligent in gathering information about CEO ability are more willing to hire outside candidates than boards that are less diligent.

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