



# **Are CEO's Fired for Bad Luck?**

**Prof. Francesca Cornelli,  
London Business School**

# What is happening to CEO turnover?

- CEO turnover has increased dramatically in the last 20 years.
- Already in 2002, a study by Booz & Company showed that CEO succession in the world's 2,500 largest public companies turnover increased by 53% from 1995 to 2001, performance induced turnover increased by 130% and the average tenure of CEOs declined from 9.5 to 7.3 years. Europe had the highest turnover.
- Kaplan and Minton (2012) look at Fortune 500 firms and find that turnover is 12.6% in the period 1992-99, implying average tenure of 7.9 years, but since 2000 turnover increases to 16.8%, implying average tenure of 6 years.

# What is happening to CEO turnover?

- Kaplan and Minton (2012) also show that turnover is very sensitive to performance and so do several other papers.
- Jenter and Lewellen (2014) drop the distinction between voluntary and forced turnover and just look at turnover induced by poor performance and find that almost 40% of all turnover is performance induced.
- In general, the corporate governance literature interprets a high CEO turnover and especially a high sensitivity of CEO turnover to performance as the sign of an active and effective board.

- In support of this, the literature on corporate governance has shown that boards fire CEOs following poor performance and that performance improves afterwards. Is this enough to conclude turnover (or its sensitivity) is a sign of good corporate governance?
- Jenter and Kanaan (2015) argue that forced CEO turnover increase following low industry stock returns and low market returns.
- Kaplan and Minton (2012) also show that boards do not index CEO turnover to the industry or the market. Are thus CEOs punished for bad luck?

- In addition, the corporate governance literature has shown that the sensitivity of CEO turnover to performance increases when more outside directors sit on the board.
- Thus, outside directors are seen as non-entrenched and more likely to act in the interest of the shareholders.
- An alternative view is that outside directors do not have enough inside information about the role of the board to base their decision on anything else but publicly observed performance.
- Therefore, are outsiders better monitor (**the monitoring hypothesis**) or do they rely on the only (imperfect) information they have (**the inside information hypothesis**)?

## Looking beyond public companies

- All the literature covered so far focuses on public companies.
- Can we learn something from different types of ownership?
- Gao, Harford and Li (2015) compare private and public companies.
- Cornelli and Karakas (2016) and Cornelli, Kominek and Ljungqvist (2013) look at private companies with a private equity investment.

# Looking beyond public companies

- Why public to private?
  - Some firm characteristics remain the same while the corporate governance changes.
- Why private equity?
  - Private equity supporters claim it has superior corporate governance.
  - Outsider directors are replaced by private equity partners who (1) like outside directors are not `friends' of the CEO, but (2) are heavily involved in the firm operation and therefore will have inside information of the firm.

# CEOs turnover in private companies

- Gao, Harford and Li (2015) find that public firms have higher turnover rates and higher turnover-performance sensitivity.
- Does it mean public firms have better corporate governance?
- But performance improvement following turnover is larger for private firms.
- Cornelli and Karakas (2016) find that when a company is taken private in an LBO the CEO turnover decreases and it is less sensitive to performance.
- These results put into question the usual conclusion that a higher turnover or a higher sensitivity to performance is a good sign of corporate governance.





“It’s important to note we really did try hard.”

# Cornelli- Karakas: CEO Turnover in LBOs: The Role of Boards

- Hand-collected dataset of all public to private transactions in UK from January 1998 until October 2003, observed until 2009.
- We reconstruct the boards (before and after the LBO) year by year and we look at the identity of all directors who are categorized as (1) insiders; (2) outsiders; and (3) LBO sponsors.
- For each LBO, we find a matching company (by industry and size) that remains public.

# CEO Turnover

- Define:

$$\text{CEO turnover} = \frac{\text{Number of times the CEO changed}}{\text{Number of years observed}}$$

- We do not distinguish between voluntary and forced turnover.
- We abstract from turnover during the transition, since we want to look at what happens to board turnover when the new corporate governance is in place.

# CEO Turnover Rate

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	<b>Before</b>	<b>After</b>
<b>LBOs</b>	14.5%	9.2%* †
<b>Matching Companies</b>	16.5%	14.4%
<b>Obs.</b>	86	83

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# Does Private Equity Monitor?

- May be the turnover is lower because private equity sponsors only want to extract value using leverage.
- We need to identify the LBOs where the focus is on value creation.
- To identify these deals we focus on the board: how many PE partners are sitting on the board?
- LBOs where LBO sponsors are not very involved are either financial engineering deals, or deals where there is no much need for monitoring/advice.

# Factors affecting PE involvement

- We find that private equity partners are more involved
  1. When the CEO was changed during transition
    - More work needed to restructure company
    - The new CEO does not know the company as well
    - Not financial engineering deals
  2. When the firm business is more complex
    - Fraction of outside directors when company was public (Boone, Casares Field, Karpoff and Raheja, 2007)
    - Difference from matched public company
  3. When leverage is low
    - Financial engineering

# Board Composition

	%LBO Sponsors				
<b>Intercept</b>	-0.00 (-0.00)	-0.18 (-0.85)	0.10 (0.53)	-0.10 (-0.82)	-0.28* (-1.72)
<b>Firm Size</b>	0.02 (1.22)	0.01 (0.73)	0.03 (1.59)	0.01 (0.86)	0.00 (0.32)
<b>Change in CEO at LBO</b>	0.11** (2.38)	0.11** (2.41)	0.13** (2.43)	0.12*** (2.62)	0.12*** (2.65)
<b>Number of LBO sponsors</b>	0.14*** (2.51)	0.14*** (2.62)	0.11* (1.90)	0.13** (2.42)	0.13*** (2.57)
<b>Experienced sponsor</b>	0.04 (0.32)	0.03 (0.29)	0.10 (0.76)		
<b>Bank affiliated sponsor</b>	-0.04 (-0.68)	-0.05 (-0.79)	-0.00 (-0.02)		
<b>Fraction of outsiders before the LBO</b>	0.29* (1.92)	0.60*** (2.67)	0.36** (2.26)	0.29* (1.95)	0.59*** (2.75)
<b>Active Sponsor</b>				0.08* (1.87)	0.08* (1.89)
<b>Real Estate</b>	0.06 (0.70)	0.08 (0.90)	-0.05 (-0.68)	0.08 (0.95)	0.09 (1.17)
<b>Exited Deal</b>	-0.08* (-1.74)	-0.07 (-1.43)	-0.13** (-2.53)	-0.09* (-1.87)	-0.07 (-1.56)
<b>Difference in percentage outsiders (LBO vs. Public)</b>		-0.32* (-1.84)			-0.32* (-1.92)
<b>Leverage</b>			-0.17* (-1.70)		
<b>R-squared</b>	25.2%	28.2%	25.0%	27.9%	30.8%
<b>Obs.</b>	87	87	74	87	87

## Impact of LBO sponsors involvement on CEO turnover

- More difficult deals have higher CEO turnover
- The CEO turnover is lower the higher is the PE involvement.
- Thus an increase in monitoring by PE decreases, rather than increasing, CEO turnover.
- Jenter and Kanaan (2012) look at public firms and find CEOs are fired for the wrong reasons (for example, industry shocks)
- Cornelli, Kominek and Ljungqvist (2012) look at private firms backed by private equity and find they do not seem to make that mistake.
- Cornelli and Karakas reconciliates these two findings showing that it is the involvement of PE that reduces the chances of making mistakes.



# Change in Average CEO Turnover

	$\Delta$ Average CEO turnover			
	(3)	(4)	(5)	(6)
Intercept	-0.09 (-0.27)	-0.15 (-0.73)	0.11 (0.27)	0.02 (0.06)
Firm Size	0.01 (0.33)	0.00 (0.16)	0.04 (0.91)	0.03 (0.83)
Percentage of LBO sponsors (IV)	-1.63* (-1.63)	-1.63* (-1.64)	-1.56* (-1.73)	-1.56* (-1.73)
Change in CEO at LBO	0.33** (2.42)	0.33** (2.37)	0.31** (2.10)	0.31** (2.19)
Number of LBO sponsors	0.30* (1.91)	0.29* (1.92)	0.25** (2.02)	0.23** (2.02)
Experienced sponsor	0.10 (0.54)		0.08 (0.38)	
Bank affiliated sponsor	0.01 (0.05)		-0.01 (-0.06)	
Fraction of outsiders before the LBO				
Active Sponsor		0.10 (0.97)		0.10 (0.98)
Real Estate	0.07 (0.47)	0.09 (0.60)	-0.03 (-0.25)	-0.01 (-0.06)
Exited Deal	-0.14 (-1.61)	-0.16* (-1.71)	-0.20* (-1.80)	-0.21* (-1.83)
Obs.	82	82	71	71

# Cornelli, Kominek and Ljungqvist: Monitoring Managers: Does it Matter?

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Data from private equity investments in transition countries, with very detailed information about what the board knows or thinks.

When deciding whether to fire the CEO, the board will have hard information from the financial performance and soft information from the monitoring about the CEO quality:

Good proxies for board's **soft information set**:

- 1) CEO type: is he competent/a good match?
- 2) In case of poor performance, are CEOs' actions or decisions to blame?
- 3) Or was it due to bad luck?

# Examples

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## In/competence:

- “The top **management team is strong.**”
- “It is now evident that **the CEO lacks sufficient skills** in some areas and we are searching for a suitable candidate to complement the current CEO in the senior management team.”
- “Given the more competitive environment on the Polish post-Accession market, the Fund Manager sees the need for a more efficient sales and marketing strategy. The CEO is being **replaced with someone more competent** in these areas effective January 1, 2006.”

# Examples

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## Management actions and decisions:

- “Management made a serious mistake and signed FX options to hedge against the strengthening PLN shortly before the currency substantially weakened.”

## Bad luck:

- “On 10 September the finished goods warehouse ... caught fire. The fire completely destroyed the company's warehouses as well as the main [production] facility.”

# Determinants of board intervention

	=1 if CEO viewed as incompetent (1)	Dependent variable =1 if fire ...							=1 if streng- then mgt (9)
		CEO (2)	CEO (3)	CEO (4)	CEO (5)	CEO (6)	CEO (7)	junior manager (8)	
<b>Board's information set and beliefs</b>									
performance in year $t-1$ relative to budget	-0.157*** 0.050								
=1 if poor perf. blamed on manager's decisions in $t-1$	0.126 0.205								
=1 if poor performance blamed on bad luck in $t-1$	-0.259** 0.125								
=1 if manager viewed as incompetent in $t-1$	1.148*** 0.123								
<b>Deal characteristics</b>									
log investment cost through $t-1$									
=1 if privatization	0.342** 0.134								
=1 if deal is staged	-0.047 0.086								
<b>Reform progress and macro conditions</b>									
lagged EBRD transition indicator	-0.175 0.174								
lagged real GDP growth	-0.002 0.012								
<b>Law changes</b>									
=1 if corporate governance law enacted	-0.051 0.134								
<b>Diagnostics</b>									
Staiger-Stock (1997) test ( $\chi^2$ )	0.1								
Pseudo $R^2$	13.6%								

4x more  
likely

# Determinants of board intervention

	=1 if CEO viewed as	Dependent variable =1 if fire ...						=1 if streng- then mgt	
	incompetent (1)	CEO (2)	CEO (3)	CEO (4)	CEO (5)	CEO (6)	CEO (7)	junior manager (8)	(9)
<b>Board's information set and beliefs</b>									
performance in year $t-1$ relative to budget		-0.316*** 0.050	-0.320*** 0.057						
... x (=1 if corporate governance law enacted)									
=1 if poor perf. blamed on manager's decisions in $t-1$		0.032 0.179	0.029 0.215						
=1 if poor performance blamed on bad luck in $t-1$		-0.070 0.129	-0.069 0.131						
=1 if manager viewed as incompetent in $t-1$		1.336*** 0.130	1.366*** 0.131						
<b>Deal characteristics</b>									
log investment cost through $t-1$		-0.006 0.033	-0.007 0.029						
=1 if privatization		0.392** 0.167	0.402** 0.175						
=1 if deal is staged		0.172* 0.093	0.177* 0.100						
<b>Reform progress and macro conditions</b>									
lagged EBRD transition indicator		0.119 0.191	0.113 0.266						
lagged real GDP growth		-0.007 0.014	-0.007 0.016						
<b>Law changes</b>									
=1 if corporate governance law enacted		0.644*** 0.148	0.657*** 0.153						
<b>Diagnostics</b>									

+122%

# Table 3: Determinants of board intervention

	=1 if CEO viewed as incompetent (1)	Dependent variable =1 if fire ...						junior manager (8)	=1 if streng- then mgt (9)
		CEO (2)	CEO (3)	CEO (4)	CEO (5)	CEO (6)	CEO (7)		
<b>Board's information set and beliefs</b>									
performance in year $t-1$ relative to budget		-0.316 <sup>***</sup> <i>0.050</i>	-0.320 <sup>***</sup> <i>0.057</i>						
... x (=1 if corporate governance law enacted)									
=1 if poor perf. blamed on manager's decisions in $t-1$		0.032 <i>0.179</i>	0.029 <i>0.215</i>						
=1 if poor performance blamed on bad luck in $t-1$		-0.070 <i>0.129</i>	-0.069 <i>0.131</i>						
=1 if manager viewed as incompetent in $t-1$		1.336 <sup>***</sup> <i>0.130</i>	1.366 <sup>***</sup> <i>0.131</i>						
<b>Deal characteristics</b>									
log investment cost through $t-1$		-0.006 <i>0.033</i>	-0.006 <i>0.029</i>						
=1 if privatization		0.392 <sup>**</sup> <i>0.167</i>	0.402 <sup>**</sup> <i>0.175</i>						
=1 if deal is staged		0.172 <sup>*</sup> <i>0.093</i>	0.177 <sup>*</sup> <i>0.100</i>						
<b>Reform progress and macro conditions</b>									
lagged EBRD transition indicator		0.119 <i>0.191</i>	0.113 <i>0.266</i>						
lagged real GDP growth		-0.007 <i>0.014</i>	-0.007 <i>0.016</i>						
<b>Law changes</b>									
=1 if corporate governance law enacted		0.644 <sup>***</sup> <i>0.148</i>	0.657 <sup>***</sup> <i>0.153</i>						
<b>Diagnostics</b>									

+446%

# Summary of results

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## When do boards intervene?

1. Boards actively monitor managers; they collect both 'hard' and 'soft' information about the CEO's ability
2. CEOs are fired when **a)** evidence of incompetence/bad match has accumulated and/or **b)** the company underperforms relative to plan/the board's expectations
3. CEOs are **not** fired when the board attributes poor performance to adverse developments beyond management's control, nor for making decisions that turn out to be wrong ex post;

## Our interpretation: Active monitoring largely solves a learning problem

- When a CEO is hired, his true ability and the match between his skills and the company's needs are not perfectly known
- Over time, the board collects information and, once it has learnt his true ability, takes corrective action if necessary
- Monitoring helps to observe a less noisy measure of the CEO ability

## Importance of the board?

- If monitoring means (at least in part) collecting soft information, then this provides support for the incomplete-contracts approach to boards.



## **Back to Cornelli and Karakas (2016): Sensitivity of CEO Turnover to performance**

- Going back to Cornelli and Karakas (2016), the literature has argued that what matters is not turnover but its sensitivity to performance. This would allow to argue the decision to fire the CEO is taken for good reasons.
- We therefore also look at the CEO turnover sensitivity to performance.
- Most of the literature looks at the stock performance of public companies.
- We follow Weisbach (1988) and look at operating performance.

- The sensitivity for private equity deals is lower than in the corresponding matching companies.
- The sensitivity for private equity deals is lower the higher is the involvement of the sponsors.
- This is consistent with the evidence in Cornelli, Ljungqvist and Kominek (2013), where operating performance is only part of the evidence that influences what the board thinks of the CEO.
- Sensitivity to performance may be an indication that the board does not have more refined information and this may lead to confusing performance with luck.

## Are CEOs fired for bad luck?

- Performance should only be one of the components of the learning process about the quality/suitability of the CEO.
- The role of the board should be to rely more on soft information, which cannot be conveyed outside easily.
- This requires more involvement of boards in the CEO decisions.
- This supports the view that sometimes the boards of public companies rely too much on short-term performance when choosing to fire the CEO.
- Moreover it supports the inside information view of the board: LBO sponsors are like outsiders with inside information and their presence reduces the CEO turnover sensitivity.