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Worth the wait? Delay in CEO succession after unplanned CEO departures☆

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ABSTRACT

This paper analyzes changes in shareholder value and firm performance in relation to the delay (or lack thereof) in CEO succession. I find that, on average, delay in succession is associated with stronger performance after an unplanned CEO departure. However, the value effect of delay varies and not all firms benefit from long delay. Firms with higher stock price volatility and those whose CEO is hired away experience lower performance. These results suggest that delay affects frictions in the CEO labor market. The impact of delay is particularly important when firms have no succession plan in place.

1. Introduction

CEO succession––the process by which the board of directors prepares for the transition of leadership from one CEO to the next––is cited as one of the board's most important, yet challenging, roles (Biggs, 2004). The importance of shortening CEO replacement times is underscored by a U.S. Securities and Exchange Commission (SEC) recommendation that firms include a CEO succession planning proposal in their proxy statements (SEC Staff Legal Bulletin 14E, 2009). However, firms can be hesitant to disclose detailed succession planning information for competitive reasons.[1] Consequently, empirical evidence on the CEO succession process is lacking.

In this study, I overcome the lack of publicly-available details on succession planning by observing the time it takes the board to name a permanent replacement CEO (i.e., delay in CEO succession). Studying the delay in CEO succession provides evidence on the frictions in the CEO labor market. The CEO-firm match theory posits that the CEO labor market is competitive and efficient, and that the matching between CEOs and firms is optimal (Jenter et al., 2016). Further, Jenter et al. argue in a competitive and frictionless CEO-firm assignment model, a sudden CEO departure such as CEO death cannot change firm value. Yet, they find

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[1] For example, Ford Motor Co announced that Mark Field would succeed Allan Mulally as new Chief Executive Officer in 2014. Ford's spokeswoman mentioned that the "company takes succession planning very seriously and has succession plans in place for each of the key leadership positions. However, for competitive reasons, Ford does not discuss succession plans externally." Keith Naughton, April 21, 2014, Ford said to decide on Fields as CEO as Mulally plans departure (Bloomberg).

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significant value changes (i.e., both positive and negative shareholder reactions) at the announcement of sudden CEO death. The authors define the costs associated with appointing the non-optimal CEO replacement as the "friction" of the CEO labor market. Both anecdotal and empirical evidence shows that frictions exists in the CEO-firm matching process and that CEO departures can be disruptive and negatively impact shareholder value (Johnson et al., 1985; Worrell et al., 1986; Salas, 2010).[2] Furthermore, a 2015 study by PwC's Strategy&. on corporate governance and CEO succession reveals that there is an exceptionally large amount of friction cost when firms make suboptimal choices in selecting the next CEO. Specifically, large companies that are forced into CEO turnovers have lower shareholder value of an approximately $112 Billion.[3] Thus, it is important to understand what affects this friction.

In this paper, I examine whether a delay in succession helps reduce the friction in the CEO labor market or, in contrast, tend to exacerbate it. If delay does indeed reduce the friction (i.e., less costly to firms), I further examine whether firms of all kinds benefit from having delay. Determining the impact of delay in leadership transition is particularly important when a CEO unexpectedly departs, in which case the board is left responsible for selecting a replacement CEO within a narrow time frame and without input from the departing CEO.

To create a reasonable and consistent measure of CEO replacement time, I use a sample of 687 unplanned CEO departures (i.e., unexpected death, illness, resignation, or forced dismissals) occurring between 1995 and 2015. To accurately classify CEO departures as unplanned––as opposed to planned CEO retirement––I examine all CEO turnovers covered in the Compustat Execucomp database during the sample period and manually collect information from corporate news releases and SEC filings surrounding CEO departures. I categorize a CEO departure as *planned* when the announcement of incumbent CEO departure contains key terms indicating that the departure is part of an orderly transition of power (i.e., retirement).[4] I count a CEO departure is as *forced* when the news release indicates that the ousting is preceded by poor firm and stock performance, disagreement between the CEO and the board, or is caused by activist pressure. Finally, I classify a CEO departure as *unexpected* when the incumbent CEO departure is due to his or her unexpected death, illness, resignation, to unforeseen lawsuits and/or criminal investigations, or to being hired away by other public or private companies without prior notice (i.e., greener pasture).[5] For the purpose of this paper, both forced and unexpected CEO departures are classified as *unplanned*.

I focus on unplanned CEO departures because firms incur high disruption and friction costs when selecting the new permanent CEO after either an unexpected or forced CEO departure. Specifically, compared to firms with planned CEO retirements, boards in firms with unplanned CEO departures may be more likely to make suboptimal choices in the new permanent CEO selection. Moreover, unlike planned CEO transitions in which the incumbent CEO voluntarily steps down from her position, unplanned CEO departures compel firms to involuntarily enter the CEO labor market. It is under these circumstances that CEO replacement becomes a primary board responsibility, and the departing CEO is not available or suitable for consultation. Therefore, any effect on firm value and other transitional cost is related to how quickly, and how well, boards make the replacement decisions and to the friction in the new CEO-firm matching process.

Delay can either allow boards time to plan for succession if there is none in place, or to carefully evaluate the suitability of the predetermined CEO replacement (i.e., the heir apparent) given the unusual circumstances of unplanned CEO departures. As such, delay may help reduce the friction cost in both the selection of the new CEO and the operation of the firm following the leadership transition. Alternatively, delay can signal that firms are struggling to attract a new CEO or that boards are not prepared for leadership transition. In these circumstances, delay can exacerbate the friction in the CEO labor market, and as a result, firm performance suffers.

I find that delay in appointing the next permanent CEO is an important determinant of shareholder value and firm operating performance for many firms, and that the CEO-firm matching process is not frictionless. In the context of unplanned CEO departures, longer delay in naming a new permanent CEO is associated with positive shareholder reaction at the new permanent CEOs' appointment, greater firm performance (i.e., change in industry-adjusted ROA) two years around the new CEO appointment, and a higher likelihood of outside successions. Specifically, firms with non-zero delay outperform those with no delay by 250 basis points in terms of industry-adjusted ROAs and 270 to 380 basis points in terms of cumulative abnormal returns (CARs) three days around the new CEOs' appointments. Delay is particularly important when firms do not have a succession plan in place.[6]

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[2] The sudden loss of a CEO has the potential to induce performance problems. For example, Hewlett-Packard's (HP) former CEO Mark Hurd unexpectedly resigned due to an investigation surrounding a claim of sexual harassment by a former contractor with the company. Following Hurd's resignation, HP's market value fell by $10 billion. In addition, HP's return on assets (ROA) fell from 7.50% to −11.87% within three years after Hurd's departure, nearly a 20% decline. See, "HP CEO Mark Hurd resigns; CFO Cathie Lesjak Appointed Interim CEO; HP Announces Preliminary Results and Raises Full-year Outlook", HP press release, August 2010.

[3] Using a sample of 2500 largest companies in the world, a 2015 PwC *Strategy&* CEO succession study states that the difference in median shareholder returns for companies undergoing planned versus forced CEO successions is approximately $120bln. "The cost of failed CEO succession planning", PwC's Strategy&. Available at: https://www.strategyand.pwc.com/reports/cost-failed-ceo-succession-planning.

[4] Key words indicating an orderly transition of power include, but are not limited to: "succession", "succession planning", "succession plan", "natural transition", "retirement age", "retirement", and "orderly transition of power".

[5] Consider, for instance, the sudden resignation on Sep. 13, 1996 of Jerry M. Socol, then CEO of Casual Male Corporation, to become the new CEO of Fun Design. "It was a surprise, we had no idea!" said the CFO (News source: Factiva).

[6] Following McConnell and Qi (2016), I hand collect succession information from firms' proxy statements. A firm is considered having a succession plan if they disclose that there is a plan in place for executive transitions in the proxy filings the year before the CEO turnover. On the contrary, a firm is considered not having a succession plan if there is no disclosure of any succession related information. Unfortunately, due to competitive reasons, firms do not disclose detailed succession planning process in the SEC filings nor in the news release. Hence, detailed succession information is not accessible.