RISK MANAGEMENT

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Immovable Objects

by Lori Widmer

In retrospect, Tony Hayward's time at the top was short. The former BP CEO, whose now-infamous comments regarding the BP oil spill in the Gulf of Mexico led to his ouster, held the title for just three years and five months. Conversely, Hayward was hired to replace John Browne, a CEO whose tenure atop the company began in 1984, two mergers before the company became the BP that exists today. While the length of Browne's 23-year term is uncommon, new evidence suggests that boards are hanging on to CEOs well beyond their shelf life.

A study conducted by the Wharton School of Business shows that a mere 2% of Fortune 500 CEOs are fired. Part of the reason could lie in the perceived costs of such a move. According to the Wharton study, boards tend to think that firing their top executive will have a negative financial impact on the company, many citing that the move comes with a $1.3 billion price tag. They may be overestimating. Research in the report shows that the figure is actually closer to $300 million.

So what gives? Why are boards reluctant to dismiss ineffective leaders? Why are bad CEOs kept on as companies falter and problems compound?

Chief Executive Turnover

Whether you are measuring CEO movement at companies across the street or across the globe, there is a study to support whatever theory exists. You can find data suggesting that CEOs are both frequently moving on and staying put. A recent Booz and Co. study titled "CEO Succession 2000-2009: A Decade of Convergence and Compression" measured the movement of CEOs in the world's top 2,500 public companies. The study reports the average tenure of the CEO in today's global corporation is seven years and that, in a seeming contrast to the Wharton study, succession rates have climbed to more than 14% overall.

In addition, a 2010 report conducted by the University of Chicago's Stephen Kaplan and Ohio State University's Bernadette Minton titled "How Has CEO Turnover Changed?" looked at a sample of companies, including all of the Fortune 500, and found that the CEO turnover rate between 1992 and 2007 is actually 15.8%. Since 2000, that rate has reached as high as 16.8%.

The difference is in what's being measured. The Wharton study focuses on the forced turnover of CEOsthose times in which CEOs are asked by their boards to leave. So, regardless of the exact numbers, the research suggests that, when it comes to removing a bad or ineffective CEO, boards are waffling.

Why Bad CEOs Remain
John Schuster has seen his share of CEOs who are married to their jobs. The founder and executive coach of Schuster Kane Alliance in Columbus, Ohio, says that some CEOs do operate with an eye on longevity. He has worked with a number of top executives whose goal is to stay in the job. One CEO had a plan to remain on board for 18 years. His plan seemed plausible given that he succeeded a CEO who remained at the helm for 20 years.

Perhaps boards are having a tough time shifting from the hiring process to the removal process. As boards ramp up their efforts to secure top CEO talent, they build contracts designed to keep CEOs happy and on task.

As a result, contracts with terms that include costly payouts upon severance exist, which make it expensive or embarrassing for boards that want to ditch their CEO. "For executives who have been around a long time, and especially if there's been turnover with the board, it's not uncommon for the executive to secure protection in their agreements that make it difficult to terminate the individual for cause," said Andrew Gould, partner at Wick Phillips Gould & Martin LLP, a Dallas law firm. "You elevate the cause language so that it's not even performance-based. The most protective language for an executive is language where the only basis for termination is intentional misconduct."

Another reason ineffective executives are kept is that some boards are adopting the attitude that the devil you know is better than the devil you don't. "It could be that it's just easier," said Gould. "The known bad leader may be believed to be better than the unknown leader."

Dan Konigsburg, ERS director at Deloitte LLP's Center for Corporate Governance in New York, believes ineffective CEOs are retained for good and bad reasons. One of those reasons echoes Gould's thoughts: other options might be worse. "An ineffective CEO could be better than no CEO if the company has no replacement lined up," said Konigsburg.

CEOs who underperform in many areas also often remain at the helm because they are excellent at one thing. The superb strategist could have lousy people skills, for example. Konigsburg indicates there are several instances in which "boards make the decision that it's worth the compromise." Why? Because the disruption could be disastrous to the top management and shareholders. Perhaps the company's performance and growth are on track and the board is reluctant to shake things up. In such a case, the company may not need the CEO for his or her ability to expand or even run operations.

Konigsburg also suggested one other justification for why boards retain "bad" CEOs: they really are not that bad. The perceptions of the media, analysts and investors often come from a bird's-eye view and do not account for what the CEO's performance looks like at the board level. "It boils down to what's most important for the company," said Gould. "Is the CEO intended to be just the face of the company and someone who's perceived as a very strong leader or is it someone who will be driving the business and its performance?"

Then again, a weak board could be the problem. As Konigsburg notes, the company might have a "captured board," one that has been hand-selected by the current CEO. Firing the one who hired you is atypical.

Avoiding Entrenchment
The good news is that boards have become smarter. As ethical scandals rocked the corporate world during the Enron era, the passivity that some experts believe gripped boards was no longer acceptable. Thanks to legislation like the Dodd-Frank act, shareholders now have more of a say in what is happening within their executive team.

According to Schuster, who wrote The Power of Your Past, a book offering advice on personal and professional development, the legislation has helped boards align CEOs with shareholder interests. "There will still be mistakes," he said. "But I'm encouraged by how seriously boards are taking this role."

Some companies are already setting up contingencies that allow them to avoid the negative impact of an entrenched executive or the ousting of one. Spreading the leadership across more than just the chief executive position reduces the dependence on the CEO as the company's primary growth leader. That means separating the chair function from that of the CEO, something Gould sees as a common sense move. "If you have someone who is a controlling shareholder, don't appoint them as your CEO," he said.

Boards should also be setting up contracts to include what Gould calls "cause language." They should define termination-worthy offenses, performance measurements and expectations for CEO involvement.

Sometimes, however, boards do not scrutinize CEO behavior because no one is asking them to. "CEOs stick around because things are good enough," said Schuster. "Entrenchment is another way of saying complacency sets in. 'Good enough' is the enemy of change."

There is of course another obvious reason CEOs stick around: the pay. In 2010, the top executives of more than 200 large U.S. companies took home an average of $10.8 million in compensation, marking a 23% increase in executive pay over the previous year, according to a New York Times study on executive pay. Cash bonuses to executives also rose 38% over 2009evidence that companies are still paying top dollar for their chief executives.

Why? The reason could be because the median pay rate for CEOs keeps changing. Schuster explained a scenario in which analysts review the median pay for a top CEO. But because boards often equate "median" with "average," the median pay is below what most boards dole out to their CEO in salary. "They want to pay a premium because they want to be able to say they hired someone who is special," said Schuster. In his estimation, the public relations benefits are worth more to many boards than the sum given to one individual.

But this practice is about to hit a wall. "The trend on pay is unsustainable," said Schuster. Thanks to the recession and ethics issues, boards are looking more closely at CEO packages, including pay. One item that is appearing more often in CEO contracts is the use of restricted stock, the returns of which are not fully transferable until certain conditions have been met. That means if the CEO creates value, it must be sustainable value and not a short-term blip that CEOs can cash out on, says Schuster. "The whole move is a good move," he said, "because it aligns the CEO more with the shareholders."

Keeping the Top Gun

Sometimes entrenchment can work in a company's favor. Schuster remembers how one company's CEO stayed put for 17 years while others in the telecom industry were changing executives regularly. "What was good about that was while there was a lot of churn within the competitors that looked like instability, this place was stable," said Schuster. "At least they sold it as such [by having] the longest-standing CEO."

Perhaps that perception is one that keeps a CEO in the job for longer than intended, with companies and boards using CEOs as proof of success. "Too much change tells the analysts you're unstable," said Schuster.

Still, sometimes your CEO is showing real value. Some companies have no reason to make a change, which Schuster says serves as a "great reminder of what outstanding CEOs can do and the imagination and empowerment they can bring to an organization."

But retaining the good CEO requires attention. By building a strong relationship between the board and the CEO, boards can go a long way in keeping a good leader in place. That is especially important as boards change and duties are amended. Schuster says that when the board's genetic make-up began changing as companies split the CEO function from the chair function, it became important for a board to communicate and consult with the CEO much more often than they were used to. The Booz and Co. study on executive movement bears that out, showing that CEOs are working more closely with the chair than in the past.

The Case for Succession Planning

Apple's CEO Steve Jobs began a battle with cancer in 2004. He was forced to take three medical leaves of absence over the years, each time leaving markets and staff uneasy about the future of the company. As Jobs' health issues became increasingly likely to push the turtle-necked leader from his position, Apple's board of directors began developing a CEO succession plan.

In August, when Jobs eventually relinquished command of the company he built, the business world went nuts. Many feared the stock would plummet overnight. One month later, however, the tech giant's share price was higher than it had been during Jobs' final weeks at the helm and was threatening to eclipse $400 per share for the second time this year. Investors have responded favorably to the company's new CEO, 13-year company veteran Tim Cook, who Apple's board was confident could successfully lead the company. After all, he had already done so on three other occasions when Jobs was forced into medical leaves of absence.

Unfortunately, stories of seamless transition are uncommon. Few boards build a succession plan. In fact, while 84% of directors find succession plans to be essential, only half of boards of Fortune 1,000 companies have them, according to Korn/Ferry International's "34th Annual Board of Directors Study." It seems that boards are long on talk but short on action.

Gould believes that adopting a succession plan and building an executive contract package that serves the company's interests will help boards lessen the exposures of CEO entrenchment. Companies need to keep their offers competitive, but boards should remain cautious about giving up too much in compensation agreements, according to Gould. Building restrictive covenants and awarding performance benchmarks can help protect a company from the financial impact of losing a top executive. And this in turn will give boards more leeway to make a move if they determine that it will help the company. This is key since the opportunities an organization misses due to executive complacency can be just as detrimental to a company as unmet revenue expectations.

Of course, eventually, the goal is to find a top executive that the board will never want to fire. But that endeavor will be much easier if the board always has the authority it needs to send an underperforming CEO packing. "The companies that do it right create an environment where the CEO wants to stay," said Gould. "It's not the money that's motivating them. It's not the benefits. It's the idea that the business is doing something worthwhile and they're treating the CEO well."

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