

WHY DO CEOs FAIL?

# How the Mighty Are Fallen

By GUIDO STEIN and JAVIER CAPAPÉ



Illustration by MARTIN TOGNOLA

**D**uring his tenure as CEO of the Swiss bank UBS, Peter Wuffli was the envy of his peers. In 2005, at the height of the economic boom, *BusinessWeek* hailed him as “The Master of Zurich” credited with bringing “the glory days back to Swiss banking.” Then, in 2007, the subprime bubble burst, and UBS went into the red. It was forced to admit that its assets had shed more than \$40 billion in value. Then the bank came under investigation for allegedly

helping thousands of wealthy U.S. customers evade taxes. Today, Peter Wuffli and many of his ilk at other large companies – from Lehman Brothers to AIG to The Royal Bank of Scotland – have been knocked from their pedestals. Rather than being envied, many of these high-fliers have been reduced to cautionary tales.

And with some justification. Those responsible for the worst financial crisis since the Great Depression surely deserved to be fired. When the economy goes belly up, CEO

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turnover doubles, as Jenter and Kanaan have shown. Behind these latest scandals, however, there is something else going on. CEO tenure has, on average, halved since 1990. And it can't all be blamed on declining profitability.

Why the increased turnover at the top? Nine times out of 10 the answer is simple: Companies hire a new CEO because the old one retired, fell ill or died. The one case where something bad transpired may seem negligible, but given the fact that CEOs of large corporations control more capital than the governments of many nation-states, the effects of the one bad apple are catastrophic for millions.

To find out why CEOs fall from grace, we sifted through recent academic literature looking for patterns as well as for clues as to how failure can be prevented. What we found is that, in this field, there are no absolute truths. Almost all the factors held up by some authors have been questioned or qualified by others. Besides, there is no consensus as to what constitutes failure. In spite of these limitations, our study manages to shed some light on the obscure circumstances surrounding CEO performance.

## ■ EXECUTIVE SUMMARY

**Companies statistically dismiss twice as many CEOs** in bad economic times as in good. Certainly, many senior executives have lost their jobs lately. Yet this new wave of dismissals masks a deeper trend: In the past two decades, the average tenure of a CEO has halved, and yet, in fewer than half the cases, the reason for their departure was solely because of poor performance.

Experts disagree on the reasons for CEO failure, but the variables can be grouped into two broad categories: *endogenous variables* are those a CEO can influence, such as competencies, compensation policy and stock ownership; *exogenous variables* are those that CEOs cannot control, including the characteristics of the board that will judge their performance, the sector in which the company operates and the presence of a strong successor. Though nobody knows for sure exactly what causes CEO failure, knowing which factors potentially contribute the most to failure will make CEOs better equipped to succeed.

## What Is Failure?

When can a person be said to have failed? There is no easy answer. Failure generally has negative connotations, but negative in what way? Who decides? A person may consider himself to have failed if he achieves less than he personally hoped for, but his company won't let him go if he has sent profits into the stratosphere. Conversely, even if his company has sustained losses, a manager may not have failed necessarily. There's more to it than that.

For our purposes, CEO failure is the inability of a CEO to meet the expectations of the board of directors, the shareholders and the market, leading to dismissal. On this assumption, we have reviewed the literature and found approaches as divergent as the findings. Management theorists do not agree what causes or leads to CEO dismissal.

Despite these uncertainties and differences of opinion, there are two classes of variables that can precipitate the fall of a CEO: *endogenous* and *exogenous* variables. The former are those a CEO may influence to some extent, while the latter are given. Of course, this is a purely theoretical distinction, as there is no clear dividing line. Endogenous and exogenous factors may blend into or influence one another, as we shall discuss later.

## Endogenous Variables

**EXECUTIVE PAY** is an important endogenous variable, and also a hot topic today. In fact, the one lesson many people will have learned from the current financial crisis is that if managers exposed their companies to the extreme risks of junk mortgages, it was because of the way they were paid. They did it because their salary depended on it. For most employees, salaries are fixed, with a small variable component linked to performance. For top executives, the variable component is not so small; for them, bonuses make all the difference.

This way of rewarding managers is based on traditional "agency theory," which says that there have to be mechanisms to bring the interests of managers into line with those of

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the company's owners. Basically, if a senior manager's pay depends on his company's performance, he will do his best to make his company as profitable as possible.

It has been a winning formula. The Dow Jones Industrial Average, for instance, has climbed spectacularly since this system came into favor in the early '90s. The downside is that the failures have been equally spectacular, starting with the decisions that brought the financial system to the precipice. Far from deciding based on what they thought would create value in the long term, CEOs focused on short-term results. Their only goal was to safeguard the fat bonuses they were taking – until the bubble burst.

In extreme cases, this pay system leads to fraud. WorldCom CEO Bernie Ebbers, for

example, booked expenses as investments and used other tricks to cook the company's books. In 2001, WorldCom posted profits of over \$1.4 billion, when in fact it had made a loss. In 2005, Ebbers was convicted of an accounting fraud estimated at \$11 billion and sentenced to 25 years in prison.

Admittedly, CEOs are not responsible for their companies' executive pay policies. But they do have a duty to respect the spirit in which those policies were conceived.

**STOCK OWNERSHIP** is another relevant endogenous variable whose effects are complicated. Like bonuses, stock options have traditionally been used to align the interests of managers with those of the company's owners. Core and Larcker (2002), for example, found that companies performed better if their managers were also shareholders. And if we take CEO dismissal as evidence of failure, Salancik and Pfeffer, writing in the '80s, found that share ownership was significantly correlated with tenure. According to these authors, holding shares in the company effectively shielded CEOs against dismissal.

So, can stock ownership prevent CEO failure? Not always. According to authors such as Morck, Shleifer and Vishny, CEO stock ownership beyond a certain level is counterproductive. Specifically, they show that when a CEO owns more than 35 percent of his company's shares, the ratio of market value to book value starts to fall, making the company's stock less attractive as an investment. This is because the market frowns on excessive mingling of management and ownership, as it defeats the purpose of control and governance mechanisms, such as the board of directors. Other experts warn that stock ownership may tempt managers to artificially push up the share price in the short term for speculative gain. The perverse incentives are there and, as always, it is up to the manager to decide how he intends to further his career.

Another endogenous variable affecting tenure is the **CEO'S POWER OVER THE BOARD OF DIRECTORS**. Here, too, we find a divergence of

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views. Some authors consider that having the right to vote directors onto the board protects the CEO, as it gives him more influence over the only body that can dismiss him. Others believe that investor opinion counts for more. Giving too much power to the CEO, they say, prevents proper control. How can a director be objective when assessing the executive who appointed him? Will the board be strict enough?

Encouraging healthy loyalty among the company's governing bodies is one thing; but for shareholders to lose their first line of defense against mismanagement is quite another. Shivdasani and Yermack (1999) found that groups with a majority of independent, non-executive directors tended to create more value for shareholders. And Boeker (1992) found that, when the going gets tough, CEOs who were also directors were more likely to pass the buck and blame the board for the poor showing.

The CEO's **PROFESSIONAL BACKGROUND** is also a determining variable. A CEO's dismissal often has a lot to do with the post he occupied before he was appointed, in particular his "insider" or "outsider" status. An outsider is defined as someone who did not work, even indirectly, for the company before becoming CEO, and who has no relatives who did so. Sometimes the definition is broadened to include anyone who has been with the group for less than a year. According to authors such as Collins (2001), only 30 percent of companies with outsider CEOs achieved outstanding results. If you are such a CEO, we sympathize, but unfortunately, this is one of the few points on which most experts agree. Numerous authors believe that outsiders are less likely to institutionalize their power and tend to have weaker social networks. In fact, the mere presence of an outsider can send negative signals to subordinates, who may feel discouraged, thinking they will never reach the top through internal promotion. There are counterarguments, of course, but in this case, they are few. And regardless of what the literature says, it stands to reason that taking charge of a company one does not know is

creating another hurdle.

A manager's **COMPETENCIES**, or lack of them, are the most important endogenous cause of CEO failure. Curiously, competencies have been relatively neglected in the business literature until quite recently – not that anyone denied their importance, though. Fredrickson, for example, intuitively understood their power, but his working method limited him to using empirical data, so he was unable to obtain conclusive results. In fact, it is very difficult, if not impossible, to measure the competency factor in technical or quantitative terms. It is not something that can be easily expressed in numbers or statistics.

Strange to say, many executives are named to the top job without being properly qualified. Why is that? Because companies are shortening career plans while at the same time boosting turnover in the top positions. Naturally, the more people you let go, the more you need to appoint to replace them. But as Walker (2002) and Watkins (2004) have both pointed out, a meteoric riser may not have the time to acquire one of the basic competencies of any CEO – namely, people management.

Others fall into the trap of overestimating their abilities. The experts have found evidence that the higher a manager is in the hierarchy, the wider the gap between how he perceives himself and how he is perceived by others. Self-esteem is a good thing, but in moderation. Otherwise, a manager may be fooled into thinking he is capable of anything. But nobody is.

A classic example is the rise and fall of Jill Barad, appointed CEO of Mattel in 1997. Barad's excellent performance as head of the toymaker's marketing division had been her ticket to the top, making her one of only three women heading Fortune 500 companies. The company was in the best of health – or so its new CEO thought.

The business relied heavily on one star product, the Barbie doll. Barbie sales, which accounted for 40 percent of total revenues, were in decline. Barad tried to revitalize the company through a series of acquisitions. The

## ■ Leaving With Your Head Held High

Parting gestures will be remembered. Here are two ways to enhance your stature and leave the job with the comfort of a clear conscience.

Succession often poses the last great challenge of a CEO, mainly because, for some, it signals a fate worse than death: retirement. Stepping down from a lofty post, CEOs may suddenly find themselves feeling useless, disoriented and set adrift.

Apart from these fears, retiring CEOs need to consider the image they will leave behind. A shining reputation built up over years of sterling service can be tarnished overnight by a refusal to go gracefully or through petty acts of sabotage against a successor.

What is the best way to bow out? In the same spirit in which the post was accepted: looking to do what is best for the company. There are two ways a CEO can create value at this stage, and even after leaving the post.

**1. SHARE INFORMATION WITH THE SUCCESSOR.** They say you never fully understand the job of CEO until you have experienced it for yourself. Imagine the value to the incoming CEO of getting wise counsel from someone who knows the job and the company inside out. Some companies, such as Intel, have institutionalized this transfer of knowledge and experience. Changes in the upper echelons are always announced in advance and the future leader is brought onto the board. As a rule, the incumbent mentors his successor, and the two meet together regularly.

Unfortunately, this does not happen everywhere.

Many firms pay the outgoing CEO to be available for consultation if necessary, but they rarely get their money's worth, either because the new CEO sees it as his job to shake things up, or he wants to prove to the world that he can manage on his own.

The outgoing CEO does his company, and his legacy, a huge favor if he extends a helping hand to his successor, passing on his vital knowledge and experience. But it must be offered in good faith, with no hidden agenda.

**2. BOOST THE SUCCESSOR'S AUTHORITY.** Ideally, once the substitution has been announced, the incumbent will let the new executive take charge. After that, it will be best if he disappears for a while. Then, employees will have no choice but to refer to the new boss.

The two executives should agree on how to present the succession to employees and other audiences. It is not in the company's interest to issue conflicting statements or display disagreement over corporate goals. Invariably, some aspects of the new CEO's mandate will highlight areas in need of improvement, and the outgoing executive will have to humbly accept, officially at least, that some change is needed and support the new management unreservedly. Best to keep less generous thoughts to yourself. Whatever your personal feelings, do not try to do the new leader down in order to make your own tenure seem better.

first was Tyco Toys, for which Mattel paid a reported \$755 million, more than Tyco's total sales for 1996. Next came Pleasant Company, which had annual sales of around \$300 million, but for which Mattel paid more than double. Barad then scooped up Bluebird Toys, maker of Polly Pocket. But the straw that broke the camel's back was the acquisition of The Learning Company. Barad's idea was to expand the business toward technology. Mattel paid \$3.5 billion for The Learning Company, four and a half times its annual sales. Worst of all, analysts agreed that The Learning Company's main assets, the Reader Rabbit and Carmen Sandiego educational software series, were outdated.

Barad assured her shareholders that the rest of the group would benefit from the investment. In fact, she predicted \$50 million in profits from The Learning Company alone in the third quarter of 1999. She could hardly have

been more wrong: the quarter ended with a loss of \$105 million. This was final proof that optimism and a flair for marketing do not, on their own, make a good CEO. Unversed in financial management, Barad eventually was forced to resign. Her lack of key competencies cost her her career.

### Exogenous Variables

Unlike endogenous variables, exogenous ones are those a CEO cannot control. Remember what we said earlier: The line between what can and cannot be controlled is not always clear. Although the board of directors may be a factor the CEO can influence by exercising his voting rights as a shareholder, it can also be the main exogenous variable. CEOs whose performances are similar may be judged very differently by their boards. What one board finds acceptable, another may treat as

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grounds for dismissal. CEOs usually have no control over these things, even though their careers are at stake.

So what makes one board more demanding than another? The first thing, of course, is **BOARD COMPOSITION**. The more outside directors there are, the more demanding a board is likely to be. Independents are not involved in the day-to-day running of the group and maintain a more arm's length relationship with management. According to studies by Rostow, Jensen, Meckling and Fama, this makes independent directors more objective and impartial. And these are basic ingredients for effective board supervision. Research shows that CEO turnover is higher in companies that have independents on their boards, while directors who are company insiders are notoriously less inclined to dismiss their CEOs. Similarly, studies by Friedman, Singh, Boeker, Borokhovich, Agrawal, Knoeber and Jensen show that, where the board is dominated by independents, changes of CEO tend not to be initiated by the incumbent.

There are, however, contrasting views. Tobin argues that outside directors are less effective because they do not know the company's secrets and so cannot challenge executives with searching questions: being independent makes them easier to fool.

In any case, if you lead, or aspire to lead, a company that has a majority of outside directors, you need to be prepared for a relatively strict appraisal. There won't be much you can do about it, but knowing it beforehand can save you a lot of aggravation.

The same applies to other board characteristics. **BOARD SIZE**, for example. Large boards with many members are more likely to divide into interest groups. This should be a red flag for the chief executive, as such divisions can lead to infighting and end in tears.

**DIRECTORS' COMMITMENT** to their board duties is another important variable. Whether they are insiders or outsiders, the effort they put into being directors is likely to be greater if this is their principal or only task. And as

you will have guessed, a dedicated board is a demanding board. Studies including those by Beasley, Perry, Peyer, Fich and Shivdasani show that CEO failure increases with board commitment.

Another aspect of board composition is the presence or absence of **INSTITUTIONAL INVESTORS**, generally associated with substantial share ownership. Researchers who have studied this variable come to opposite conclusions. Kieschnick and Moussawi argue that because institutional investors usually demand that the board include a certain proportion of independent directors, their presence is associated with better control of the CEO and stronger corporate governance. Others, such as Doidge, contend that the more concentrated share ownership becomes, the more likely it is that alliances will form to pursue particular interests – in other words, the more likely it is that CEOs and directors will conspire to get rich at the expense of the company and other shareholders.

CEO success and failure is also influenced by **COMPANY AND INDUSTRY CHARACTERISTICS**. Some authors claim that dismissals are more common, statistically speaking, in small companies with insider CEOs. Miller, Kets de Vries and Toulouse, on the other hand, argue that CEO turnover is higher in large companies, where the separation of powers is more institutionalized.

Turning to industry characteristics, Henderson finds more sustained successful CEO performance and, thus, reduced likelihood of CEO failure in mature industries. CEOs are more likely to fail, he concludes, in faster-growing markets, which are generally more unstable and, therefore, riskier. Yet studies by Fredrickson and Parrino show the opposite: the uncertainty typical of new industries makes a CEO's mistakes more forgivable, and so reduces the likelihood of dismissal.

David Maxwell, former CEO of the U.S. mortgage lender Fannie Mae, illustrates both points. In 2000, when Fannie Mae ventured into the subprime market, the party was in full

## ■ Why Do Studies on CEO Failure Fail?

Despite years of research, the experts still cannot state exactly what leads to CEO dismissal. The reasons for this are complicated.

The main problem is the quantitative approach that has been used. The theory is simple: Compare time series to identify objective, comparable variables that correlate with CEO dismissal. Statistical regressions of this kind are the bread and butter of economic research, yet they have their limitations.

The results can be drastically influenced by the choice of sample. Conclusions drawn from a sample of technology companies, for instance, cannot be extrapolated to other sectors. This is one of the challenges facing researchers: First, choose a field of study; then, find objective, reliable information.

A further complicating factor is survival bias. Say you wanted to analyze the performance of tech stocks over the past 10 years. You would only have information about the companies that survived. All those that, for one reason or another, folded before year 10 would not appear in the sample. All the information they could have provided would be lost. The sample would, therefore, be biased, as it would not give a true picture of the set you propose to study.

The big problem, though, is the data source. For data to be valid, they must be consistent and comparable. The number of directors on a company's board is easy to check

and leaves no room for doubt. But what if you want to measure the effect of management competencies? How can you even determine to what extent a person possesses certain competencies?

Conclusions can also vary dramatically depending on which variables you choose to include or omit. Say you want to study the influence that a CEO has on his company's performance. You may decide that performance depends on two things – the effort of employees and the proven qualifications of the CEO – so that, effort being equal, better CEO qualifications would yield better performance. Right? Well, maybe – until the influence of the economic environment is factored in. Then, you would probably find that company profits depend more on the general state of the economy than on the quality of its management. This is because, in the real world, there are dozens of such variables that influence company performance, and each experiment is only as revelatory as the variables allow. You only ever see the trees, not the wood.

And before you ask, designing a model that includes all the variables imaginable would not solve the problem either. The true explanation would be lost in a mass of uninformative correlation coefficients. And then you would not see the trees for the wood.

swing. Then-President Clinton wanted even the poorest U.S. families to own their own homes. This political goal created an unmissable business opportunity. After all, the people who could not normally borrow would have to get the money from somewhere. Maxwell flourished during this period. Then, at the end of 2007, the bubble burst. Fannie Mae posted losses in the billions and eventually had to be bailed out by the U.S. government. Very few CEOs could have survived such a fiasco, but Maxwell's rise and fall illustrate the basic argument: his excesses were excused while Fannie Mae was operating in a burgeoning new industry, but became unforgivable once the market matured.

**AGE**, an exogenous factor if ever there was one, may also play a role in CEO failure. Several authors maintain that turnover is higher in companies with young CEOs. In contrast, some studies blame high turnover on "demographic distance." In a study of 31 Fortune 500 companies with CEOs of a similar age and ten-

ure, O'Reilly found that, when a conflict arose, the older the CEO was in relation to the directors, the more likely he was to be dismissed. These are interesting findings and deserve mention. But they are not conclusive.

A better documented factor in CEO success or failure is the **INFLUENCE OF THE PREDECESSOR OR SUCCESSOR**. If his predecessor was a great success, the incoming CEO may languish in the shadow of a glorious past. Comparisons may be unfair but, as Helmich reminds us, they can be a cause of failure. Also, if the predecessor was CEO for many years, the company's directors and managers may be more loyal to their old boss than to the new one. On this point, Pfeffer, Cannella, Shen, Conger and Nadler agree.

But there's more. A study by Reinganum (1985) showed that if the outgoing CEO retained close ties to the company, the new leader's authority might be undermined. If succession has taken place, but the two CEOs continue to work together, employees may become confused. With the former CEO still

Many questions can only be answered if we take the human factor into account and stop trying to avoid the complexity involved in human decision making. For once, we need to take competencies seriously.

roaming the corridors, must employees do what he says?

Another relevant factor in CEO dismissal is the emergence of a strong successor. The company may have a reason for wanting to promote the pretender at the earliest opportunity. Or the mere threat of succession may tempt the incumbent to make bad decisions merely to set his successor up for failure. Fredrickson goes so far as to suggest that CEOs have a natural incentive to nominate unsuitable candidates to get the board off their back. Whichever the preferred theory, the appointment of an heir and the process of succession are clearly unresolved issues. (See **Leaving With Your Head Held High.**)

### No Magic List, But Salient Warnings

At this point, especially if you hold a position of responsibility in your company, you may be wondering whether all this research cannot be distilled into a list of golden rules for CEOs: *10 Things to Do for Guaranteed Success!* If such a list existed, every CEO would hang it on his wall. Sadly, it doesn't.

It is a harsh fact that nobody knows for sure exactly what leads to CEO failure. Nearly all the arguments put forward in the literature have counterarguments. The reason we have no precise answer is that CEO failure has been studied mainly from a quantitative perspective. Researchers have focused on objective data – profitability, tenure, board composition – which can be compared across companies, and have drawn conclusions accordingly. But their conclusions depend on the model used, the timing of their study and the sample selected. (See **Why Do Studies on CEO Failure Fail?**)

In our opinion, a far more qualitative approach is needed. Many questions can only be answered if we take the human factor into account and stop trying to avoid the complexity involved in human decision making. For once, we need to take the competency factor seriously. And we need to clarify which competencies are most important for a chief executive.

Based on our research, we are inclined to believe that competencies, or the lack of them, explain most failures. CEOs are basically their own worst enemy.

Does this mean that all the research carried out to date is useless? Absolutely not. If, as we noted at the beginning of this article, fewer than half of all CEO dismissals are attributable to poor business performance, then as CEO, you are just as likely to be fired if your company is doing well. That means that, however well you perform, your job will never be safe. So, rather than focusing on which factors are most important for success, CEOs ought to turn their attention to all the potential causes of failure. In this way, you will be much better equipped to succeed. □

**Maurici Figueras** served as editor for this article. Translated by **Stephen Waller**.

### ■ TO KNOW MORE

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