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The Costs of CEO Failure

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During the last half of the 1990s, turnover rates of CEOs of major North American corporations were consistently in the 10 percent to 11 percent range or lower. In the first seven years of this millennium, however, average turnover jumped to 14 percent—an increase of nearly 50 percent.

According to Challenger, Gray & Christmas, the number of CEO departures in the U.S. between 2005 and 2007 averaged almost twice that of the preceding three years. By mid-year 2008, this rate was again on the increase. And among global companies, CEO departures escalated a whopping 41 percent in the first three quarters of 2007 over the same period of 2006.

This trend poses a serious challenge to U.S. businesses and nonprofits for several reasons, not the least of which is what it's costing them. The impact of any change in leadership on both the company and the individual are huge. We are all aware of the exceptional severance packages provided to some notable CEOs like Bob Nardelli from Home Depot ($210 million), Hank McKinnell from Pfizer ($123 million), Gary Forsee from Sprint ($40 million), Carly Fiorina from Hewlett-Packard (a mere $23 million) and Richard Grasso from the New York Stock Exchange ($188 million)[1].

Our experience with hundreds of senior-level executives' severance provisions is less sensational than the extremes mentioned above and more reflective of norms that fail to make the headlines[2]. In 2007 our compensation experts informed us that the average total cash compensation (including bonuses) for large-cap company CEOs (revenues greater than $4.5 billion) was $1,650,000.

Paul Hodgson, senior research associate at The Corporate Library, puts the customary severance that most companies pay a departing CEO equal to approximately three years' total compensation. Using that multiplier, their severance would be around $5 million.[3] (This being the case, however, Martin Sullivan's current $11 million compensation would still convert to a severance of at least $33 million and John Thain's $16 million would translate into a minimum of $48 million.)

It has also been our experience that most CEOs of mid-cap or smaller corporations receive lesser severance packages—two years is more common at the mid-size companies and one seems to be the rule at smaller firms. Using average total compensation figures for these groups, the average severance payments would be closer to $1.7 million and $650,000 respectively.

Some Hidden Costs

While not as impressive as the headline "funny money" payments to a handful of executives, severance costs are not the only direct, cash costs incurred when CEO failure occurs. Other costs may include a retained search to find a replacement or to "benchmark" an internal candidate at 27 percent to 33 percent of total annual first-year compensation, plus the travel costs to and from interviews for all concerned.

Add to that the possibility of buying out the bonuses, options and other incentives the new hire would be leaving on the table at his or her current position. As noted above, severance guarantees made by the candidate's company for purposes of retention must be addressed. Continue by factoring in a six-digit sign on bonus to help with incidental, up-front expenses, and then add in the cost of both parties' advisory support teams, including contract lawyers, compensation and tax specialists, an assessment team, and possibly an on-boarding advisor. Since it usually takes a newly hired or promoted executive six months to reach breakeven—the point at which new leaders have contributed as much value to their new company as they have taken from it—that initial "sunk cost" needs to be factored in, too.[4]

Now throw in all the "exceptional items" for both the departing CEO and the new replacement: the buyback of the house, outplacement services, partial or full-year bonuses (often paid to the outgoing executive and guaranteed to the incoming one), Special Executive Retirement Plan (SERP) costs, relocation expenses (including gross-ups for tax purposes), special medical and life insurance premiums, reimbursement of club memberships, the loss on the sale of the company car, and on, and on, and on. Having tallied up all these direct costs, which are out of pocket and affect the bottom line, take 50 percent, and multiply that amount times three. You'll have the approximate cost of replacing each of the three executives who will comprise "involuntary departures—or the 25 percent of executives who will, on average, leave the company after a new CEO is brought in from the outside.[5]

But hold on. We're not through yet. There are other, non-cash costs that occur when the CEO fails to deliver the expected results. For public companies, one extremely important indirect, but very real cost comes from the stock market's reaction to the change. Researchers at Booz Allen Hamilton recently found that:

In North America, announcing the replacement of a CEO produces a positive effect (3.8 percentage points better than the average return) when a company has been performing poorly for two years and a negative effect (10.2 percentage points worse than average) when the company has been doing well. More notable than the predictable movement described above is that the "selection of an outsider produces a big downtick in stock price; selection of an insider triggers an uptick.[6]

Estimated Costs of CEO Failures at 18 Months in Job ($000s)				
No.	**Item**	**Large-Cap Companies ($4.5B and up)**	**Mid-Cap Companies ($1B to $4.5B)**	**Small-Cap Companies ($300M to 1B)**
1.	Average Annual Cash Comp (2007)	1,650	860	640
2.	Cost of Hiring	825	430	32
3.	Total Cash Comp	2,475	1,290	960
4.	Cost of Maintaining	455	230	170
5.	Severence	4,950	1,720	640
6.	Mistakes, Failures, Wasted and Missed Business Opportunities	32,645	13,770	7,840
7.	Cost of Disruption	16,320	6,890	3,920
8.	Total Cost of Failure	57,670	24,330	13,850
9.	Value of Contribution	5,170	2,230	1,250
10.	Net Cost of Failure	52,500	22,100	12,600

Depending on the condition of the company when the CEO leaves then, the "cure could be worse than the disease" insofar as the stock price is concerned—an outside replacement for a company that isn't doing fairly well could pose a "double-whammy" on the stock's price and market capitalization.

While the stock price will adjust itself over time based on the performance of the company under its new leader, the impact on its volatility can remain a factor for quite some time following a change at the top. In 2003 Rutgers University and the University of Texas in conjunction with the Federal Reserve Bank published research reporting that a firm's stock volatility increased with any form of leadership turnover. But a forced departure could trigger an increase in volatility of up to

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25 percent, which could last for as long as two years following the event.[7]

In short, a company's market capitalization and the stability of its stock are affected when a change is made at the top of a public corporation, and it can take years to fully recover from their effects.

Yet, another—and in some ways perhaps the greatest and certainly the most insidious—cost attributable to a failed leadership change comes from its impact on the organization. This is the price of all the opportunities missed because an organization or an operating unit is leaderless even if only for a short while. The loss of momentum and rise of uncertainty that go hand-in-hand with a change in leadership can, and do, in the estimation of many, cost companies more money, more market share, more loss of reputation and more customer goodwill than any other single event.

Internally, "morale suffers, especially among senior managers, who may wonder if theirs will be the next head on the chopping block. A spirit of innovation and willingness to take risks can disappear for a while, too, as employees wait to see what's expected of them in the new regime."[8] These people-related impacts are not the "soft, people stuff" that they are sometimes labeled. On the contrary, this "people stuff" is as hard and as real as the currency used to measure organizational success and failure.

Just as the volatility of a company's stock does not settle out immediately upon the appointment of a new leader, neither do the problems afflicting the organization. In fact, there is one really insidious effect that turnover at the top can instill: a loss of trust. Organizational trust, once lost, can take years to restore.

Bottom-line Impact

The fallout from leadership failures, then, plays out in many directions: There are direct costs related to the individual's compensation (salary and bonuses) and to the cost of maintaining the person in the job (health insurance, travel, office expense, and the like). There are also indirect costs, which result from errors in judgment, bad strategies, poor execution, opportunities foregone and the disruption to the organization caused by inconsistencies, lack of direction and, worst of all, loss of trust.

Trying to isolate and measure the financial impacts to the organization of all these direct and indirect factors on a meaningful basis is a challenging exercise because there are so many moving parts. However, Dr. Bradford Smart, author of *Topgrading,* has given us a framework for estimating the overall financial effects of failure among CEOs based on research findings from work done by Chris Mursau.[9]

Through a series of interviews with executives (half of whom were division presidents or higher) about their experiences with 26 "mis-hires," the amounts these poorly performing "B" and "C" managers (whose salaries averaged slightly more than $168,000 per year) cost their companies during their first 18 months in the job were identified. We conservatively assumed that the impact of the CEO who failed after 18 months in the job (which is 40 percent of the cases) would be, proportionately, no less than that of the lower level executives as reported by Smart.

Clearly, the case can be made as to why these numbers should be *greater* given the impact the CEO has versus a middle-level manager. Where we made changes to the ratios in Smart's findings we have provided notes.[10]

According to the estimates in Table 1.1, the cost of having the wrong CEO at the helm, even for just 18 months, can range between $12 million and $50 million depending on the size of the corporation.

This analysis also reveals two other relevant points:

1. Smaller companies are hurt significantly more by selecting the wrong CEO.

If we assume that the profit margins are the same regardless of the size of the company, then the impact of having selected the wrong CEO to lead the business is greater on the small-cap companies than the bigger ones, even though the absolute dollar impact is roughly five times greater for the large-cap firms. Assuming that the profit margin for mid-sized and small-cap companies is 6.0 percent (as it is for the 487 publicly traded U.S. corporations with revenues in excess of $4.5 billion that constitute the large-cap group) then, the direct (cash) costs of CEO failures as a percent of average profits goes from 0.3 percent for large-cap companies, to 9.6 percent for mid-caps, to a whopping 23.2 percent for small-caps.[11] Needless to say, the effect of the wrong leader on a smaller entity can be devastating, as has been seen time and again over the years.

2. The impact on the U.S. economy is nearly $14 billion per year.

Recognizing that the turnover rate of CEOs has plateaued over the past three years at an average of 1,385 per year, the total cost of CEO failures in terms of cash, inefficiencies and opportunities foregone is calculated to be $13.8 billion, assuming the failures are distributed on a quid pro quo basis relative to the number of companies in each of the three segments. And this number does not include the lost shareholder value caused by the mistakes, failed strategies, organizational upheaval and increased stock volatility that comes from having selected the wrong leader—all of which adds up to a very target-rich environment for anyone looking to find disciplined ways to put an end to such waste.

Long-Term Implications

To place today's "churn at the top" into even sharper focus, additional statistics indicate that 64 percent—nearly two-thirds—of U.S. CEOs fail to achieve the objectives for which they were brought in and are replaced or "retired" within four years of their appointment.[12] Forty percent are gone within 18 months.[13] Moreover, CEOs are being held more accountable for their results as performance-related terminations have increased by 318 percent in the past 10 years.[14]

The success these executives are after can be very fickle, indeed, as the odds of success do not dramatically improve as conventional wisdom would lead us to expect. For instance, it doesn't appear that a newly selected leader who comes from within an organization performs any better than one who came from the outside. (Actually, outsiders outperform inside appointees during their first five years in the position for those who manage to stay that long.)[15]

Nor does prior CEO experience help increase the chances of success. In 2005, the percentage of sitting CEOs who had prior CEO experience when they took their current positions was approximately 37 percent.[16] Yet that same year, 35 percent of the CEOs who left office due to performance issues were from that very same group.[17] If prior experience had any appreciative value, then the failure rate of this group should have been significantly lower than those who had not had any previous CEO experience. But that was not the case.

It can certainly be argued that some amount of change in the executive suite is appropriate and essential to promote innovation. Further, as baby-boomer leaders begin to retire, the number of executive replacements should increase naturally. Regardless, no one has suggested that today's level of churn is healthy, or natural, or in the interest of anyone who has a stake in the process or an interest in the future of the company itself.

As a result of all this turnover at the top of the house, at the end of 2006 nearly half of the CEOs of NYSE member companies (46 percent) had less than four years of on-the-job experience, and a quarter of them (26 percent) had been in the role for less than two years.[18] Since 1995, the tenure of sitting CEOs of public companies fell from 10 years to seven years by 2001[19] and to five years by 2007.[20] As the tenure of CEOs drops below the lead times required to conduct a meaningful succession and grooming plan— boards will have to speed up the process and start looking for the successor's successor almost at the same time they're looking for the successor.

Some boards will even feel as though they are engaged in two cycles of succession planning simultaneously. At this rate, the U.S. will soon have the most inexperienced cadre of corporate leaders of any developed country—and that will certainly cost us dearly.

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1. J. P. Donlon, "Time Out Between Nardelli Meltdowns" (*www.chiefexecutive.net*, January 9, 2007).
2. The larger severance amounts most often reported contain the value of the gain on stock options due to the accelerated vesting that usually occurs upon termination. While large, the "cost" of these gains is borne by the market and not the company nor the shareholders necessarily. The other factor inflating large severance payments is that they are not "severance" payments at all but "hiring payments" deferred until (if) something goes wrong. These guarantees were given to the executives by their previous employer usually to keep them in place during a transition, as was the case with Bob Nardelli. In order to lure him away from GE, Home Depot had to match the benefit in its hiring offer, although they did not need to recognize the potential liability it created until he was fired.

3. Data courtesy of Capital IQ, a division of Standard & Poors (*www.capitaliq.com*)
4. Michael Watkins, *The First 90 Days* (Boston: Harvard Business School Press, 2003), 2–3.
5. Kevin Coyne and Edward Coyne, "Surviving Your New CEO," *Harvard Business Review* (May 2007): 64.
6. Chuck Lucier, et al, "The Era of the Inclusive Leader," 47.
7. Pamela Mendels, "The Real Cost of Firing a CEO," *Chief Executive* (April 2002).
8. Jennifer Norton, "CEO Departures at an All-Time High," *Burson-Marsteller* press release, *www.ceogo.com* (November 2005).
9. Bradford Smart, *Topgrading* (New York: Portfolio, 2005), 44–51, 540–543.
10. On page 50 of the earlier edition of *Topgrading* (1999), Smart provided cost data for executives earning $100,000-$250,000 ($168,000 average), which we used on the basis that it was more representative of the impact that a CEO would have than that of lower paid managers reported in the 2005 edition. To develop Table 1.1, we began by taking each line item Smart had quantified through Mursau's interviews and calculated what percentage each one represented of the sum of the costs for mis-hires. We replaced Smart's severance figures with those based upon Hodgson's findings (3X for CEOs and 2X for other top executives) as reported in this chapter, and, also as discussed in the text, we reduced the severance multiplier for CEOs of mid-cap and smaller firms to 2X and 1X respectively, salary to be conservative and to be more in alignment with our experience at Crenshaw assisting executives as they are leaving jobs and negotiating packages at new ones. We also calculated the "Cost to Hire" based on a 33 percent contingency search fee and added an amount equal to 50 percent of the recruitment fees to cover the sign-on bonuses, relocation expenses, cars, club fees and other upfront expenses usually incurred for CEOs that are not a proportional part of a lower-level manager's cost-to-hire picture. The only place we otherwise deviated from the Smart/Mursau research values provided by Smart was in the area of "Disruption Costs." We did this for two reasons: 1) Smart indicates in the 2005 edition that "The biggest understated cost is the cost of disruption. More than half the respondents registered the cost at $0. When asked why, they said that assigning a dollar value to the costs was too difficult, too subjective. Almost all respondents, however, indicated that they believed costs associated with disrupting the workplace to be huge" (pp. 46–47). We agree. 2) We know from other research presented in this chapter (Coyne and Coyne, "Surviving Your New CEO") that, on average, 25 percent of executives will be involuntarily terminated upon the arrival of a new CEO. Consequently, we raised the estimate of disruption costs from 6 percent of Mistakes and Failures to 25 percent. Bear in mind that Table 1.1 does not reflect the value of stock options or the negative impacts to shareholder value, market capitalization or stock volatility, all of which can be quite significant. Nor does it consider any of the future costs associated with the bad decisions made by the CEO during his or her 18 months on the job.
11. Steve Koepp, ed., "*Fortune* 500: America's Largest Corporations," *Fortune* (May 5, 2008). These calculations were made by using the mean size for the large-cap group due to the wide spread in the range (from $4.5 billion to $351.1 billion) and the median for the other two segments where revenue and profit information was not available. Annual average profits were assumed to occur equally throughout the year for all segments in converting the annual profit contributions to 18 months for comparison to the cost data for CEO failures. Since the direct costs are deductible business expenses, we assumed all segments

had the same (35 percent) corporate tax rate which was applied before calculating the percentages in the text.

12. Dan Ciampa and Michael Watkins, *Right from the Start: Taking Charge in a New Leadership Role* (Boston: Harvard Business School Press 1999), 4.
13. George Bradt, Jayme Check and Jorge Pedraza, *The New Leader's 100-Day Action Plan* (Hoboken, NJ: Wiley 2006), 1
14. Lucier, et al, "The Era of the Inclusive Leader": 47.
15. Booz Allen Hamilton, "Global CEO Turnover Set New Record in 2005," *Booz Allen Hamilton* press release (May 18, 2006). If performance (or lack thereof) is the key driver of CEO departures, however, this phenomenon can be understood in light of the short time frames afforded these top leaders to deliver results or be replaced. This study by Booz Allen Hamilton indicates that outside CEOs perform better than insiders during the first years of their tenures, while insiders deliver higher returns to shareholders during their later years on the job. Given the greatly shortened tenure of a CEO these days, it appears that internal ascendants who get off to a slow start are axed before their longer-term contributions ever reach fruition. Outside hires, on the other hand, who appear to bring more objectivity and willingness to slaughter sacred cows, tend to buy more time initially.
16. Ram Charan, "Ending the CEO Succession Crisis," *Harvard Business Review* (February 2005): 74.
17. Lucier, et al, "The Crest of the Wave," 8.
18. Opinion Research Corporation, "Putting Customers First," *Opinion Research Corporation*, NYSE CEO Report 2008 (April 2007): 61.
19. Chuck Lucier, Eric Spiegal, and Rob Schuyt, "Why CEOs Fall," *Strategy + Business* 28 (2002).
20. Opinion Research Corporation, "Putting Customers First": 61.