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New evidence on managerial labor markets: An analysis of CEO retreads☆

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ABSTRACT

We examine career outcomes of CEOs subsequent to turnover. CEOs often resurface after turnover, but they secure positions that are inferior to their prior posts. Success in the retread market is unrelated to prior employer performance and board composition. CEOs who were particularly attached to their prior employer tend to have the poorest subsequent job prospects. These results suggest a generally efficient CEO turnover process in which firms dismiss CEOs of low ability. As CEOs acquire specific human capital over time, their outside options and bargaining power appear to diminish, offering a potential explanation for the specialist CEO compensation discount.

1. Introduction

A large academic literature considers the determinants of CEO turnover. This literature is relevant for understanding two distinct issues. One is the role of the turnover mechanism in affecting a CEO's incentives and choices. The other is the efficiency of turnover policies in assigning the optimal individual to lead a firm at any given point in time. Given the importance of the CEO's role in the firm, it is not surprising that there has been much academic discussion of these issues. While the existing literature offers many interesting findings, some important questions remain largely unanswered.

In this paper we examine what happens to CEOs *after* a turnover event. In particular, we examine the likelihood that a CEO will fair relatively better in the post-turnover labor market, referred to hereafter as the retread market, as a function of firm and individual characteristics at the time of the turnover event. We conduct this analysis on two samples. Our main sample includes almost all CEOs who experience a job separation at a publicly traded U.S. firm at any point between 1991 and 2007, a set of over 6700 CEOs. The second sample we examine, referred to as the auxiliary sample, includes all Execucomp CEOs from 1994 to 2014, a set of over 2700 CEOs. Our investigation of these samples allows us to more fully understand CEO incentives gen-

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erated by the threat of turnover and helps identify some of the relevant threat points in compensation negotiations between a firm and its CEO. In addition, it provides us with an external labor market lens on the efficiency of a firm's internal turnover decisions by allowing us to detect which dismissed executives are perceived as being particularly talented (or untalented) by other firms.

We find that a substantial number of CEOs do obtain new executive employment after departing from their employer. However, these new positions tend to be substantially inferior to prior positions measured along a variety of dimensions. Thus, losing the CEO post does appear to be a sharply negative career event. Consequently, the incentive effect from the threat of losing the CEO position should be quite large. Both the likelihood of obtaining a new position and the quality of any position that is obtained do not appear to be related to various measures of firm and industry performance at the old employer. This evidence is consistent with the notion that firms follow efficient filtering rules when dismissing CEOs and that they rely on both public and private signals in their evaluation. Governance characteristics of the prior employer also appear to be unrelated to post-turnover labor market outcomes, suggesting that different governance structures do not lead to systematic differences in the talent pool of dismissed managers. This evidence casts doubt on the notion that certain types of firms are likely to inefficiently dismiss or retain executive talent.

Our evidence indicates that a CEO's career history and attachment to his/her employer are important factors in the labor market for the individual's services. In particular, using job tenure and insider/outsider status to gauge attachment to an employer, we find that more closely attached executives fare significantly worse in the retread labor market, while more weakly attached executives tend to fare better. This suggests that the degree of attachment to an employer is a particularly important dimension of the CEO employment relationship. We conjecture that the relatively low demand for the services of a dismissed CEO who was closely attached to their prior employer (i.e., long tenure, hired as an insider) could reflect two economic phenomena. First, a close firm attachment may capture the development or presence of firm-specific human capital that is of limited value outside of the firm. Second, separation from a closely attached employer may serve as a relatively more negative signal of managerial ability, as the prior employer may have a particularly deep understanding of the talents of these executives.

While we cannot disentangle the relative importance of these two possibilities, both scenarios provide an explanation for the compensation premium for general managerial skills that has been noted by Custódio et al. (2013). In particular, our findings suggest that as a CEO becomes more attached to his/her firm, the individual's appeal to the external labor market declines, thus weakening the manager's bargaining position. This could have important implications for understanding CEO compensation over the course of a manager's career with a given firm. The specific human capital scenario also suggests that a firm's preference for a given manager may grow over time, in which case the firm's bargaining power may simultaneously weaken and the net effect could be indeterminate (i.e., the firm-manager match may approach a bilateral monopoly). The information precision scenario does not suggest the same counteracting influence to the employer's bargaining position.

The rest of the paper is organized as follows. In Section 2 we position our analysis in the context of the related literature and motivate our empirical tests. In Section 3 we discuss our samples, present initial summary statistics, and briefly consider the determinants of CEO turnover. In Section 4 we present our main results regarding the determinants of obtaining a position in the retread market and the quality of the positons that are obtained. We offer concluding remarks and observations in Section 5.

2. Background and motivation

2.1. CEO turnover

A long empirical literature dating back to Coughlan and Schmidt (1985) and Warner et al. (1988) considers the determinants of CEO turnover. Many authors assume that boards remove managers when their assessment of the manager's ability falls below some threshold. Since firm performance should provide information on ability, this leads naturally to a consideration of the sensitivity of turnover to firm performance. Under the (often implicit) assumption that higher turnover performance sensitivities are generally desirable, the strength of the turnover-performance relation can be used to measure governance effectiveness (e.g., Weisbach, 1988; Defond and Hung, 2004).

A related set of studies examine whether variations in the observed turnover-performance relation are consistent with firms making optimal CEO replacement decisions. Many results supporting this hypothesis have been reported. These include findings based on changes in turnover behavior associated with variations in product market competition intensity (DeFond and Park, 1999), CEO tenure (Allgood and Farrell, 2003), and information precision (Engel et al., 2003; Bushman et al., 2010).

While many of the patterns reported in the literature are consistent with firms optimally replacing CEOs, the nature of most tests are indirect. Thus, the possibility remains that there exists a substantial number of suboptimal CEOs who are retained and/or optimal CEOs who are removed in broad cross-sections of publicly traded corporations. Early evidence from Khanna and Poulson (1995) suggests that talented CEOs sometimes serve as scapegoats and are inefficiently dismissed as a result. More recently, somewhat startling evidence on the lack of relative performance evaluation (RPE) in CEO turnover (e.g., Jenter and Kanaan, 2015) suggests possible widespread inefficiencies in turnover decisions, possibly because boards inappropriately credit CEOs for good luck and/or blame them for bad luck.[1]

[1] There is a long literature examining the RPE hypothesis in CEO turnover, with many early papers finding evidence in support of this hypothesis, see Gibbons and Murphy (1990), Barro and Barro (1990) and Garvey and Milbourn (2006). Several recent papers are less supportive of the RPE hypothesis in CEO turnover, for example Gopalan et al. (2010), Kaplan and Minton (2012), and Eisfeldt and Kuhnen (2013). For a synthesis and critique of some of this evidence, see Fee et al. (2017).