Appointing an Interim CEO? Not surprising if you failed the corporate governance test

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- **Interim CEOs are appointed by boards with shorter tenure**
Board members who appoint interim CEOs have served their companies for fewer years as compared to those appointing permanent ones. This might imply lack of experience, therefore poor management. Alternatively, tenured directors might be leaving because the company is going through turmoil. In either case, we see it as a governance failure.

- **A Board's connectedness matters**
Directors who appoint interim CEOs hold fewer outside board seats. This might imply lower board quality as directors are not in demand. It might also suggest that these directors are connected to fewer CEO candidates. Permanent CEO searches take less time as connectedness increases, which is further evidence on the latter argument.

- **CEO duality implies lower likelihood of interim appointment upon departure**
A CEO who also holds the Chairman title is more likely to be succeeded by a permanent one. This is consistent with an established phenomenon that successful CEOs are awarded board leadership as part of the promotion and succession process. CEO duality is one of the most controversial issues in corporate governance: activists pressure for separation of titles, whereas research shows duality has no universal impact on performance.

Introduction

8% of CEO successions in the U.S. face assignment of an interim. Intel Corp. CEO, Brian Krzanich, resigned on June 20th for violating the company's non-fraternization policy. The board appointed Robert Swan, the company's CFO, as the Interim CEO. The company was faced with a corporate governance crisis and there likely was no succession plan in place, so an interim CEO had to be assigned.

A quick look at the Intel board of directors reveals the median tenure is only 1.3 years, with the majority of the board members having been appointed after 2016. Interestingly, three directors with long tenures (an average of 21 years) left the board in May of this year. Intel has embraced separation of CEO and board chair roles.[1]

Academic literature has associated interim CEOs with poor management and poor performance. Interim CEO successions lead to worse financial performance than permanent CEO successions (Ballinger and Marcel, 2010). This is explained by the limited managerial discretion of the Interim CEOs, and the fact that such a disruptive episode could lead to the politicization of management processes. Ballinger and Marcel (2010) note that "The interviews and our analysis of press documents confirm a picture of interim CEOs as the succession choice of 'last resort', …boards seem most likely to hire an interim CEO during periods of crisis, or seemingly when they have difficulty finding a person … (pg. 267)".

Hymowitz (2006) suggests "the choice of a temporary CEO … highlights succession-planning failure in many boardrooms".[2] Intintoli et al. (2014) confirm that firms using an interim CEO have lower performance than their counterparts, nevertheless suggesting that the underperformance is driven by voluntary turnover interim

[1] Source: Bloomberg.
[2] A Growing Number of Interim CEOs Add to Companies' Turmoil, by Carol Hymowitz, Wall Street Journal, December 18, 2006.

appointments. They also note "the lack of succession planning seems to be driving the poor performance immediately following the voluntary turnover (pg. 561)." In fact, according to a 2014 survey, "Companies recognize the importance of a thorough and rigorous succession process for both the CEO and senior executive positions; however, most fail to create one (pg. 1)".[3]

Furthermore, Chen et al. (2015) demonstrate that interim CEOs are more likely to engage in earnings management to improve firm performance, so as to successfully increase their chances of becoming permanent CEOs. However, the authors find that effective corporate governance weakens the undesired relationship between earnings management and interim CEO promotion.

We analyze board characteristics of firms appointing interim CEOs and demonstrate that there were already signs of poor corporate governance. Such boards have shorter tenure, lower connectedness and chairs who do not hold the CEO title. We associate this evidence with low board quality, fewer permanent CEO candidates and possibly turmoil. We believe these observable characteristics are related to the lack of succession planning, which results in the appointment of an interim CEO.

Analysis

First, we summarize the board characteristics of the firms which eventually appointed interim CEOs. As a comparison, we look at the firms which appointed permanent CEOs. Out of 10,537 CEO successions during the period 2000-2017, 798 involve the appointment of an interim CEO.

Table 1: Characteristics of US companies appointing interim vs. permanent CEOs

Characteristics	**Interim**	**Permanent**	**Diff (int-perm)**	**t-value**
Board size	8.03	8.92	-0.89	-8.21***
Average directorship	1.39	1.45	-0.05	-3.57***
Median tenure	4.11	4.60	-0.49	-3.95***
% Outside directors	74.31	75.40	-1.09	-1.66*
Departing CEO duality	31.66	43.72	-12.06	-6.79***
Departing CEO tenure	5.54	6.66	-1.12	-5.27***
Total assets (M $)	5.78	414.12	408.33	-4.21***
Market capitalization (MM $)	1436	4489	-3053	-10.33***
Return on assets	-5.56	2.59	-8.15	-0.78
Number of observations	798	9739		

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed tests).

Boards which appoint interim CEOs have fewer directorships, shorter tenure and lower percentage of outside directors. These traits are typically associated with poor corporate governance, which we explore in the next paragraphs. These firms are also smaller in terms of assets and market capitalization, which may explain the smaller board size, another aspect we see in the data.

[3] 2014 Report on Senior Executive Succession Planning and Talent Development, by David F. Larcker and Scott Saslow, Institute of Executive Development and Stanford University, February 2014.

Larcker et al. (2013) show that firms with more connected boards perform better. The authors relate this to the information and resources exchanged through boardroom networks. Also, there is a market for directorship (Yermack, 2006). High quality directors are more likely to collect board memberships, resulting in more connections. More connections also imply more candidates for the CEO position available through directors' networks. We proxy for board connectedness by average directorship, which is the sum of all board seats held by directors divided by board size. We find lower board connectedness in firms with interim CEOs, which can be explained by low board quality or lack of CEO candidates.

The longer the directors serve on a board, the more management experience and firm-specific information they will have. Board tenure, for this reason, proxies for management quality. Moreover, directors are likely to resign to protect their reputation or avoid the workload when they anticipate the company will disclose adverse performance or news (Fahlenbrach et al, 2017). Therefore, short board tenure might also be a proxy for turmoil. We analyze median tenure and find it to be lower for boards that appoint interim CEOs. Lack of experience and future bad events are potential explanations. It is also possible these companies, in general, have a high turnover, pointing to a problematic firm environment.

We see the percentage of outside (non-executive) directors is lower on boards which appoint interim CEOs. To some extent, this is seen as bad corporate governance, as such boards have less independence from the management. However, there is no reliable empirical evidence suggesting uniform effect of board independence on firm performance. Instead, research highlights that effectiveness of outside directors depends on the cost of acquiring information about the firm, which is different for each one (Duchin et al., 2010). Therefore, we do not derive further conclusions from this variable.

Another difference we see is that in only 32% of firms which appoint interim CEOs, the departing CEO was also the Chairman of the board (so-called CEO duality).[4] This compares to 44% of firms which appoint a permanent CEO. Many governance experts and shareholder activists view CEO duality as poor corporate governance. They argue that separating the roles will improve the ability of the board to monitor the management. However, research suggests CEO duality does not affect firm performance, and for some firms, the cost of separation (such as forgoing CEO firm-specific knowledge at the board leadership level) might be higher than the benefit (Baliga et al., 1996; Krause et al., 2014). Brickley et al. (1997) find that effective CEOs are promoted to duality, typically as part of succession planning. Dey et al. (2011) show that firms with more able CEOs and stronger governance are more likely to have CEO duality. Therefore, lower ratio of departing CEO duality in firms appointing interim CEOs is possibly due to lack of succession planning, and lower management quality.

We also see that departing CEOs have a shorter tenure in interim appointment cases, which is consistent with the literature (Brickley et al., 1997; Chen et al., 2015). We believe this might be related to differences in the samples such as firm size and median board tenure, pointing to a more volatile firm environment.

Our next analysis focuses on Russell 3000 companies. This enables us to make a better comparison due to similarity of firms (in terms of size and investor attention), and assures that results will not be driven by small firms. Out of 4,684 CEO appointments to Russell 3000 companies, 330 of them (7%) are interim.

[4] Duality is a categorical variable. For this variable, we also perform a proportion test and compare X-squared. The significance of the result is similar to that of the t-test in each of the analysis.

Table 2: Characteristics of Russell 3000 companies appointing interim vs. permanent CEOs

Characteristics	Interim	Permanent	Diff (int-perm)	t-value
Board size	9.01	9.96	-0.95	-6.69***
Average directorship	1.55	1.63	-0.08	-3.09***
Median tenure	4.63	5.37	-0.74	-4.32***
% Outside directors	80.01	80.26	-0.25	-0.43
Departing CEO duality	0.36	0.54	-0.18	-6.11***
Departing CEO tenure	6.36	7.82	-1.46	-4.09***
Total assets (M $)	8.10	12.38	-4.29	-1.14
Market capitalization (MM $)	1984	6369	-4385	-10.03***
Return on assets	-0.04	15.60	-15.63	-1
Number of observations	330	4354		

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed tests).

We get a similar picture to the full sample regarding characteristics. Boards which appoint interim CEOs have smaller market capitalization, fewer directorships and shorter tenure. Further, the departing CEOs have lower duality ratio and shorter tenure. The percentage of outside directors is not significantly different; perhaps due to many years of corporate governance propaganda, these percentages have been high for all large companies.[5] In terms of asset size, the two samples are not different.

We aim to create a more comparable sample for further analysis, mainly to account for smaller sized firms which appoint interim CEOs. For each interim CEO episode, we identify the firms which appointed a permanent CEO within 45 days, in the same sector (two-digit GICS classification) and Russell membership (R1000 or R2000).[6] We then use propensity score matching to select the most similar firm in terms of size (market capitalization) and performance (ROA) among these. The resulting control sample has the same number of observations and similar firm characteristics with the firms which appoint interim CEOs. Table 3 reports the statistics and paired test results.

[5] In R3000 sample, percentage of outside directors has a mean of 84 and a median of 86.

[6] We chose 45 days to balance the trade-off between the ability to pick a close event date and find corresponding firms so as to not lose too many observations. Alternative choices return similar results.

Table 3: Characteristics of comparable Russell 3000 companies

Characteristics	Interim	Permanent control	Diff (int-cont)	t-value
Board size	8.97	9.23	-0.26	-1.60
Average directorship	1.55	1.61	-0.06	-1.74*
Median tenure	4.61	5.38	-0.77	-2.81***
% Outside directors	79.84	79.53	0.31	0.39
Departing CEO duality	35.47	48.10	-12.63	-3.07***
Departing CEO tenure	6.34	6.81	-0.47	-0.60
Number of observations	306	306		

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed tests).

Median tenure and CEO duality continue to be significantly different for firms with interim vs. permanent CEO appointments. Firms with interim CEOs also have fewer board seats, however the significance has decreased. This implies some of the variation in board connectedness is explained by firm size, as expected. The differences in board size, percentage of outside directors and departing CEO tenure are no longer significant.

Next, we predict the likelihood of interim CEO appointment. We pool our Russell 3000 firms and estimate a logit regression by using relevant firm characteristics. Around ten percent of the observations are missing departing CEO duality. We therefore present the results of estimation with and without this variable.

Table 4: Likelihood of interim CEO appointment in Russell 3000 companies

Variables	Est.	Std. Error	z value	Pr(>|z|)	Est.	Std. Error	z value	Pr(>|z|)
Intercept	1.84	0.90	2.04	0.04**	1.69	0.91	1.85	0.06*
Avg. directorship	-0.25	0.15	-1.65	0.10*	-0.21	0.16	-1.32	0.19
Median tenure	-0.04	0.02	-2.25	0.02**	-0.04	0.02	-1.94	0.05*
% Outside dir.	0.85	0.60	1.43	0.15	0.79	0.63	1.25	0.21
Dep. CEO duality					-0.53	0.13	-4.22	0.00***
Log(MarketCap)	-0.21	0.04	-4.78	0.00***	-0.19	0.04	-4.24	0.00***
ROA	-0.37	0.27	-1.38	0.17	0.00	0.37	0.00	1.00
Fixed sector eff.	Yes				Yes			
R-squared	0.04				0.09			
Number of obs.	4646				4254			

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively.

Consistent with our prior analysis, we find that board connectedness and tenure decreases the likelihood of the interim episode. However, when we include CEO duality, connectedness is no longer significant. This might be due to missing observations or, more likely, it is due to the fact that CEO duality is a good predictor of boards which appoint a permanent CEO and its effect subsumes that of board connectedness. Departing CEO duality is arguably the best proxy for whether the firm has a CEO succession plan or not.[7]

Finally, we estimate how many days it would take the board to replace the interim CEO with a permanent one. We find that search takes less time at more connected boards. We believe there are two effects working together. More connected boards must have higher quality as their directors are in more demand. Better directors are expected to resolve the interim CEO episode quicker. Also, such boards would know more CEO candidates through their connections, and this would shorten the search process. Other board characteristics do not play a role in determining the length of the CEO search.

Table 5: Estimating CEO search days in Russell 3000 companies with interim CEOs

Variables	Est.	Std. Error	t val.	Pr (>|t|)	Est.	Std. Error	t val.	Pr (<|t|)
Intercept	12.88	366.08	0.04	0.97	-52.64	384.01	-0.14	0.89
Avg. directorship	-143.10	68.16	-2.10	0.04**	-144.48	70.68	-2.04	0.04**
Median tenure	-8.01	8.09	-0.99	0.32	-9.29	8.35	-1.11	0.27
% Outside dir.	-216.00	249.54	-0.87	0.39	-159.43	261.94	-0.61	0.54
Dep. CEO dual.					72.35	51.48	1.41	0.16
Log(MarketCap)	30.58	18.42	1.66	0.10*	30.25	19.34	1.56	0.12
ROA	-0.37	0.27	-1.38	0.17	69.43	183.87	0.38	0.71
Fixed sector eff.	Yes				Yes			
R-squared	0.05				0.06			
Number of obs.	302				291			

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively.

We confirm that our main results hold in the larger sample of US firms. Table 6 reports the results when previous analysis is performed using all US companies. Departing CEO duality is the single most important predictor of permanent CEO appointment. Median tenure effect is weak and average directorship does not have a significant effect for small firms. However, connections matter for CEO search time: more connected boards find a permanent replacement sooner.

[7] We find qualitatively similar results when we use a probit regression, or we pool together only comparable companies for the regression (as discussed in Table 3).

Table 6: Likelihood of interim CEO appointment and corresponding CEO search days in US

Variables	Est.	Std. Error	z val.	Pr (>|z|)	Est.	Std. Error	t val.	Pr (<|t|)
	Likelihood of interim appointment				Estimating CEO search days			
Intercept	0.16	0.32	0.50	0.62	474.55	149.10	3.18	0.00***
Avg. directorship	-0.06	0.11	-0.53	0.60	-115.80	43.47	-2.66	0.01***
Median tenure	-0.02	0.01	-1.52	0.13	-6.05	5.02	-1.21	0.23
% Outside dir.	0.25	0.24	1.05	0.29	-95.14	110.90	-0.86	0.39
Dep. CEO duality	-0.45	0.08	-5.25	0.00***	34.49	33.41	1.03	0.30
Log(MarketCap)	-0.11	0.02	-6.16	0.00***	0.65	8.48	0.08	0.94
ROA	0.00	0.00	0.16	0.88	11.66	11.73	0.99	0.32
Fixed sector eff.	Yes				Yes			
R-squared	0.14				0.03			
Number of obs.	8693				597			

Source: PanAgora Asset Management. Thomson Reuters. ***, **, * denote statistical significance at the 1%, 5% and 10% levels, respectively.

Conclusion

The appointment of an interim CEO has been associated with poor performance. We analyze the characteristics of boards which appoint interim CEOs in large US companies (Russell 3000) during the period 2000-2017. We find that directors in these boards are less connected and have shorter tenure. These are, most likely, manifestations of poor management quality.

Interim CEO appointments are believed to be caused by lack of a proper CEO succession plan; a common problem in the corporate world. CEO duality is typically associated with the promotion of effective CEOs as part of a succession plan. Therefore, it is not surprising that CEO duality is the strongest predictor for appointment of permanent CEOs.

Overall, results indicate that better corporate governance could help companies avoid the interim CEO episode. But, once the interim CEO is appointed, what determines how long the search for the permanent one will take? We find that board connectedness significantly shortens the search. We explain this by board quality and more CEO candidates via connections.

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