

# Time To Fire Your CEO?

by Ray Gallo

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**Boards have proven more willing to sack underperforming CEOs lately, but before taking this ultimate step, directors must ask themselves a few questions. What does our CEO's contract actually say about dismissal? Can we truly find better leadership than we have now? How can we craft a new CEO agreement to avoid the same problems (and assure better results)?**

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Suddenly, it seems like open season on high-profile CEOs. Hank Greenberg at AIG... Michael Eisner at Disney... Carly Fiorina at Hewlett-Packard... Harry Stonecipher at Boeing. Others, too, have been fired by their boards for reasons ranging from regulatory investigations to poor performance to sex with a co-worker.

Long-time watchers of corporate governance are asking: Is this a passing trend, the result of corporate scandals, regulatory scrutiny and changed corporate governance rules? Or is it something more fundamental and durable? Is the underlying cause a renewed awareness of the flawed humanity of professional managers, and the responsibility of boards to govern?

**Have boards changed their attitudes about firing CEOs? Yes, and the change is likely to be permanent.**

The answers are both "yes" and "yes." Boards have indeed reasserted their legal powers. Threats of civil litigation and even criminal prosecution have forced them to. They are once again fulfilling their duties to govern—duties neglected when boards hand-picked by CEO's rubber-stamped those CEO's agendas. Because the reasons for these changes of boardroom heart will endure, so will the changes.

What do boards really do? They set policy. They elect officers. They govern absolutely but only

through the corporate officers they select, officers led by the CEO. Boards therefore act most decisively when they vote to change CEOs.

Have boards changed their attitudes and approaches to firing their CEO? They have, and it is likely to be a permanent, positive change. In today's climate, boards must think about:

- Whether it is time to fire the CEO;
- How to value and pay a replacement; and
- How building success into any new CEOs contract should benefit all concerned.

The board's fundamental role *vis à vis* the CEO has always been the same—to make sure the CEO delivers value by maximizing gains (profits and opportunities for future profit) and minimizing risks (losses, civil and criminal liabilities), in an appropriate balance, over both the short and long term. What we have seen lately are highly visible, often disastrous situations where executives harmed shareholder value in one of those ways. Securities fraud, for example, is too risky and too short term a strategy and one where no real value is delivered. Enron and WorldCom illustrated the point.

Even the cases that may not immediately appear to fit into that value box (for example, Harry Stonecipher's termination by Boeing for involvement with a fellow executive) actually do. Stonecipher's sexy email, the discovery of which triggered the brouhaha, was perceived by the board as a branding problem. Stonecipher had to leave to prove that Boeing was serious about enforcing its own internal rules at all levels. This was vital in its strategy to rebuild confidence in the integrity of its public contracting and therefore its future.

Stonecipher's termination shows that CEOs are no longer all-powerful, even at Fortune 50 companies. The board took responsibility and acted even against a tremendously powerful CEO (and large individual shareholder).

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## Executive Exodus

### Some Major CEO Departures And Why They Left

Company	CEO	Date	Reason
<i>Basic Performance Failure</i>			
Kodak	Daniel Carp	May 2005	Falling sales
Merck	Raymond Gilmartin	May 2005	Financial trouble, Vioxx problems
May Department Stores	Gene Kahn	January 2005	Poor corporate performance
ARAMARK	William Leonard	September 2004	Poor corporate performance
Charles Schwab	David S. Pottruck	July 2004	Poor performance
Siebel Systems	J. Michael Lawrie	April 2004	Sales slump
<i>Fundamental Leadership Issues</i>			
Hewlett-Packard	Carly Fiorina	February 2005	Dispute with board
PeopleSoft	Craig Conway	October 2004	Lost confidence of board
<i>Change in Company's Strategic Direction</i>			
Fannie Mae	Franklin Raines	December 2004	Forced out by board
Winn-Dixie	Frank Lazaran	December 2004	Forced out; poor performance
Office Depot	Bruce Nelson	October 2004	Poor performance, resigned
Burger King	Brad Blum	July 2004	Strategic differences with board
US Airways	David Siegel	April 2004	Forced out by unions
<i>Wrongful Act</i>			
AIG	Maurice Greenberg	March 2005	Regulatory investigation
Boeing	Harry Stonecipher	March 2005	Improper office affair
OfficeMax	Christopher Milliken	February 2005	Accounting scandal
Krispy Kreme	Scott Livengood	January 2005	Accounting and regulatory issues
Marsh	Jeffrey Greenberg	October 2005	Spitzer probe
Odyssey Healthcare	David Gasmire	October 2004	Justice Department probe
Computer Associates	Sanjay Kumar	April 2004	SEC investigation
Nortel Networks	Frank Dunn	April 2004	Internal accounting investigation
Gruner + Jahr	Dan Brewster	January 2004	Circulation scandal
Boeing	Phil Condit	December 2003	Resigned in wake of controversies
Putnam Investments	Lawrence Lasser	November 2003	Trading scandal

We can summarize the primary reasons to terminate your CEO in four categories:

- Basic performance failures.
- Fundamental leadership issues.
- A change in the company's strategic direction requiring a different set of talents at the helm.
- Wrongful acts.

View each of these categories, and every application of them, in terms of its effect on shareholder value, even though it may not be a direct connection. Again, citing the Boeing example, would it adversely affect Boeing's share price if Harry Stonecipher has an extramarital affair with another executive at the company? Arguably not, unless the company puts it in the media by terminating him and making a big deal out of it.

However, in light of Boeing's ethics issues (government contracting scandals and the like), the board felt compelled to require the highest standards of ethics throughout. Arguably the contracting future of the company depends on that perception. The Boeing board was simply unwilling to take any chances.

**Before you terminate a CEO, look at his employment contract. What are severance provisions? What constitutes "good cause," and how much will you pay without one?**

*What should the board do before you terminate?* First, look at the CEO's employment contract. What are the severance provisions? What constitutes good cause for termination (under what circumstances can you fire the CEO before his contract expires without paying severance)? What is the severance pay if "good cause" for termination (as defined in his employment contract) does not exist under these circumstances? In short, how much is it going to cost you in cash outlay to say goodbye to the CEO?

Second, there are liability considerations in terminating any employee (discrimination claims, etc.), but those are fairly rare when you get to the level of CEO. As long as you have a legitimate non-discriminatory reason driving the decision to terminate, you probably have no concerns here with a CEO.

However, make sure nobody calls him names in the heat of the moment.

Third, your board must analyze the stock market impact of the termination. There is no way to make a CEO termination look good (it is an admission that something was wrong). Yet it is also an opportunity to demonstrate that the board really is in charge, to return the focus on the company's long-term value proposition, and to put the company on a track the market likes.

Finally, ensure that the company will be better off without the current CEO. This means that there is a better value proposition offered by a different prospective leader.

*CEO value proposition.* No termination is a good decision unless a replacement CEO offers a superior value proposition. Think about your approach to valuing the CEO. As a director, responsible for maximizing shareholder value, you must thoughtfully assess the financial value-based risks, rewards, and costs of terminating one CEO and then hiring and paying a new one.

The competition for great talent in corporate America is arguably more intense than that in entertainment or professional sports. Executives in big jobs have as much or more leverage than entertainers. If they have the talent, they can create billions of dollars in profits and/or increased market capitalization. That reality can justify seemingly outlandish CEO pay—when it is tied to results.

In representing executives, we work to value "management talent" in terms of the value a particular executive can create given the platform offered by a particular job at a particular company. What an executive has to offer must be answered in every case in an industry-specific way, in a company-specific way, and in an individual-specific way.

Directors should assess three things. First, what can a new CEO deliver (what are his talents)? Second, what is the likelihood that executive will deliver (is he motivated, focused, reliable, etc.)? Third, how much could the company earn if run well and how much of that should be shared as incentive pay?

This analysis must go beyond simply comparing what other companies pay or similar executives

earn. Also, it requires the compensation committee and outside advisors to change their approach. This model can justify very large pay packages, but only where the executive delivers sufficient value to justify one.

Of course, this approach is not a simple algorithm, readily applied. Its parameters must include the size of the company's financial opportunity and the extent to which realizing that opportunity depends on the efficacy of the CEO charged with exploiting it. Both of these components must be thoroughly analyzed. Using those metrics, a recruiting or compensation committee can quantify the apparent potential value that the right person can bring. You can then recruit quality candidates, giving a reasonable portion of that value to that executive as his or her potential reward—tied, of course, to performance.

In other words, the “market” pay for a particular executive's time may not actually be the right way to value or motivate that executive. It simply is not adequately tailored to the particular application you face. The appropriate pay could be more or less given the particular opportunity and the executive's suitability to it.

□ *Pay for performance.* When corporate governance critics single out compensation packages as outrageous, what are they saying? That performance does not justify the executive's pay. However, those executives were able to negotiate those packages (and companies chose to pay those packages) not because most boards are venal or naïve. Boards know that the right leadership can create shareholder value that far exceeds the most generous of pay packages. So they agree to big pay for someone with a big track record and the associated promise of big results.

Many large corporations are positioned to generate tremendous income and stock price appreciation if properly led. What is the value of GM's opportunity to make a few billion dollars next year and how much is it worth to put the right leader in place so that can happen? How much of that revenue, or the resulting large increase in market capitalization, would you be willing to pay, as a board member, to dramatically increase your odds that it will happen?

Tie pay closely to results. Minimize fixed com-

ensation. Be generous with sharing the upside in exchange for less pay absent results. Just make sure the big pay results from the executive's efforts, not a structural reality that the company was going to do well anyway. If that was the case, you had no need for the level of talent you paid for and the critics will be right when they criticize your board.

**The CEO's employment contract is your opportunity to reach a shared understanding of objectives. It should be more fully a statement of agreement than it traditionally is.**

□ *Contracting for success.* The core document for all of this, both in beginning the CEO's relationship and in ending it, is the employment contract. Here the board really can and should have an impact by negotiating effectively with the CEO and then communicating effectively with corporate counsel. The employment contract is an opportunity to reach a shared understanding of objectives and how the CEO and board work together to resolve problems before they happen, to create an atmosphere of excitement, and to plan for success.

The CEO's employment contract should reflect discussions between the executive and the company as represented by its board, in terms of expectations, strategies, goals, values, etc. In that way the contract can be much more fully a statement of the agreement than it traditionally is. Develop an extensive “recital” statement at the beginning of the contract (the ones that used to begin “whereas...”) outlining the circumstances under which the agreement is being entered into, who is involved, what you are doing and why.

If done properly, such statements help commit everyone to a common understanding of a shared goal, a shared approach, etc. From the board's perspective, the company can use the negotiation process and the contracting process to effectively communicate what it wants from the executive and by what standard he or she will be judged.

Then, everyone should agree on what support the executive will reasonably need from the board

to achieve the company's goals and assure that the executive will get it (authority, resources, time). If you do this, success becomes dramatically more likely. This contrasts starkly with the "set up to fail" situations many executives have experienced at least once in their careers.

Similarly, from the executive's perspective, the negotiation and discussion surrounding the contracting process can be used to make sure that he or she knows what is going on, and has made and obtained all needed disclosures. The new CEO also gains any needed protections—that is, the company does not expect him to do the unrealistic and will provide him with the support needed to achieve the mutually agreed goals.

That support may involve capitalization issues, it may be about assuring adequate resources to achieve corporate goals, or it may be *carte blanche* to fire the old team and hire a totally new one. However, it is critical for both sides to know in advance what it entails and that the CEO and the board are of one mind.

Employment contracts surprisingly often fail to contain that level of detail and fail to develop such a useful, problem-solving approach. That omission shortchanges the value of the contract as a device to facilitate the success of the relationship. Contracts can and should be roadmaps to success.

The terms of the CEO's employment contract are the board's responsibility. For the reasons outlined above, that contract should be a clear, detailed statement of the parties shared goals and expectations, and should reward results.

The contract should seek to "lock-up" your management talent for some reasonable time to help ensure the shareholders the company will have a leader during that term. A "reasonable" duration (or contract term) will depend, in part, on the timeframe during which you expect this CEO to be right for the company. For example, a turnaround artist will have a shorter timeframe than a long-term steward.

Obviously, the term of the contract, like the total pay package, will vary with the needs of the parties and their leverage. How much leverage the candidate has depends on the person, his particular

circumstances at that moment in his career, and the particular circumstances of your company.

If you seek somebody with a perfect record to rescue a highly troubled company, that executive will have tremendous leverage in negotiating favorable employment terms. He should negotiate for, among other things, dramatic severance provisions and/or dramatic pay to compensate for the career risk you are asking him to take.

In turn, someone who is at a troubled point in his or her career coming into a company with everything going for it may effectively be an at-will employee.

What are causes for early termination? Your lawyer should provide a laundry list of specific circumstances and general language that will allow early termination if the board has a genuinely good reason. A Yale professor of mine used to say that options are the key to good judgment—good choices cannot happen when good options are unavailable. These are the options the board should negotiate for and get—subject to the executive's negotiating leverage and use of it to protect himself against boardroom caprice and the resulting risk to his career.

Generally speaking, mediocre performance, has not been cause for early termination, but there is no reason it need not be. If you are promising the executive the support and time reasonably needed to deliver results, your board can set corresponding metrics by which CEO performance can be judged. Then make continuing tenure dependent on meeting those metrics.

The boardroom's changing approach to handling the CEO reflects the end of the imperial CEO era, where professional managers dominated the boardroom, and a return to the republican concepts on which corporate governance legally is based. Boards are re-discovering their powers and duties to diligently track what happens in the corporation, and to govern it by choosing and directing its CEO. Boards are no longer merely advising or acquiescing. We are turning a dictator back into a president, and an advisory committee back into a governing body. ■