Why More Companies Look Elsewhere for CEO Talent

A new academic theory suggests that the market pays up only for skills that travel. Tough luck, all you company veterans. (Or maybe the outsiders are just overpaid.)

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CEO ECONOMICS New Chrysler chief Bob Nardelli supplanted insider Tony LaSorda's "firm-specific capital."
The devil you know? Better than the devil you don't, as they say. Cheaper, too, if you're a corporate board seeking a new chief executive. Nonetheless, more and more boards are looking outside their company's ranks to fill CEO vacancies—and now there's a new academic theory to help explain this trend that has many an ambitious corporate insider seeing red.

In a recently published paper, professors Kevin Murphy of the University of Southern California and Ján Zábojnik of Canada's Queen's University suggested that over the past few decades, the so-called CEO market has come to value "general managerial ability," or skills that translate across companies and industries (read: outsider), over "firm-specific managerial capital," or all knowledge and experience that's recognized as valuable only within a company (read: insider).

Furthermore, general management ability—including previous CEO experience, as well as a mastery of economics, accounting, management science and other disciplines—is transferable and "priced" into the labor market, the authors argue.

Conversely, firm-specific capital, such as understanding the company's operations, markets, suppliers and clients, is "unpriced" in the CEO market.

The old-school CEO needed to acquire a certain amount of firm-specific information. The modern CEO lets an assistant sweat those details.

"Bottom line is that you don't have to pay very much to promote someone internally to the CEO chair," said Mr. Murphy, in an interview. "You could probably ask that executive to take a cut and they'd agree to it just to get the general managerial experience. But you have to pay a lot to compete with other firms for the top managers, and that pay will depend on how much of a CEO's skills are transferable across firms and industries."

It's a counterargument to a theory proposed by Harvard professor Lucian Bebchuk, which argues that the escalation in executive pay has been determined by board cronies rubber-stamping fat packages.

CEOs from outside the company certainly fetch bigger pay packages than insiders. The

authors found that external CEO hires in the 1990s made 22% more than promoted execs. In 2005, outsider CEO hires at S&P 500 companies earned a median pay of $13 million, compared with $5 million for insiders, according to the Corporate Library. Of the 52 CEO appointments at S&P 500 companies that year, just 32 were internal promotions.

And not only are these outsider CEOs costlier than promoted execs, they're riskier, said Dan Dalton, the director of the Institute for Corporate Governance at the Kelley School of Business at Indiana University. "These outsider CEOs are usually dropped into really tough situations and have a hard time making it. So you pay more, take more risk, and then pay again if the exec fails [via golden parachutes]."

Consider: The Center for Creative Leadership, a management consulting firm, found that 55% of external CEO hires leave their posts within 18 months, compared with only 35% of those internally promoted.

The preference for outside hires has been growing for three decades. Mr. Murphy noted that during the '70s and '80s, outside hires accounted for 15% and 17% of all replacements, respectively. In the '90s, they accounted for 25%—by 2005, 40%.

Just look at the headlines. Last fall, Ford Motor snagged top Boeing exec Alan Mulally for $18.5 million to be its new chief executive.

Earlier this month, Cerberus Capital Management named former Home Depot chief Robert Nardelli to run Chrysler. (Cerberus won't reveal the details of Mr. Nardelli's pay.) And last week, Qwest appointed former Williams-Sonoma chief Edward Mueller to replace its retiring chairman and CEO. Mr. Mueller will receive an annual base salary of $1.2 million, plus a bonus of up to twice that amount.

Some argue that boards aren't placing a high enough priority on succession planning, which leaves them scrambling for talent when crisis hits. Half the boards of public, private and non-profit companies recently surveyed by the National Association of Corporate Directors said they were "less than effective" at CEO succession planning.

Pearl Meyer, a partner at Stephen Hall & Partners, a compensation consulting firm, said boards are responding to shareholder criticism of their succession planning. "Hiring from within is less expensive and less disruptive to the company," she said. "Plus, a lot of these external recruits aren't sticking. Promoting someone means you get the devil you know."