Tournament of Managers: Lessons from the Academic Leadership Market

Usha R. Rodrigues[*]

Why do firms usually make, not buy, their chief executive officers (CEOs)? Public corporations hire their CEOs from within the firm 78% of the time. They do so although earlier studies have found no clear evidence that internal hires perform better than external ones. So why do firms prefer them? Few scholars have focused on this simple question.

The reason why firms favor internal candidates matters not only in its own right, but also for an overlooked reason: it informs the controversial question of executive compensation. Currently board-compensation committees look to peer benchmarks to set executive pay. But, taking cues from comparable companies presumes a robust managerial market, one where firms must pay their CEOs "market price" or risk poaching. If firms predominantly hire from within, it is far from clear why benchmarking, with its concomitant upward pressure on executive pay across the board, is appropriate.

Why firms hire internal candidates thus provides a theoretical basis for determining appropriate pay. For example, if candidates' superior knowledge of the institution (firm-specific capital) drives the internal preference, then firms can pay less than a "market" rate because no true market for managers exists: a CEO's value is tied up with a particular firm, and he cannot credibly threaten to leave. Similarly, if firms promote from within to inspire competition in lower ranks (tournament theory), then compensation should reflect the price needed to incentivize lower ranks to compete to become CEO. In contrast, if the board's better information on internal candidates (informational asymmetry) explains the preference, then a true market may exist for externals able to demonstrate their superiority. Which of these theories is motivating boards to favor internal candidates?

To answer this question, this Article considers leadership in an area where the firm-specific capital and information asymmetry explanations apply, but a tournament is absent: academia. Analysis of a sample of top university presidents reveals a bias in favor of external, rather than internal, candidates. This finding suggests that the tournament theory motivates public firms and has important implications for executive compensation policy.

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[*]M.E. Kilpatrick Professor of Corporate and Securities Law, Associate Dean for Faculty Development, University of Georgia School of Law. I thank Dan T. Coenen, Gregg Polsky, and participants at the Villanova Business Law Colloquium. The Statistical Consulting Center of the University of Georgia provided valuable support, as did the Alexander Campbell King Law Library, Jared Batte, and Audria Crain. Mistakes are my own.

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I. INTRODUCTION

In *Brehm v. Eisner*, a defining corporate law case,[1] critics viewed the Disney board's decision to hire Michael Ovitz, and then fire him fourteen months later with a $140 million severance package, as the epitome of the problem of excess executive compensation: compliant, complacent boards who were overly generous with shareholder money.[2]

Despite the many law review articles focused on the Disney case, and the countless others that cite it, one important lesson remains overlooked by the legal literature. Corporate law scholars, like the Delaware courts, focused on the board's faulty process in negotiations to hire and fire Ovitz.[3] And, catalyzed by Lucian Bebchuk and Jesse Fried's *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, they have

1. Brehm v. Eisner, 764 A.2d 244 (Del. 2000).

2. *See, e.g.*, Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 1012 (2007) (comparing the Disney case to that of *Smith v. Van Gorkom* and questioning whether the Delaware Supreme Court was no longer up to calling "a complacent board to account").

3. *See, e.g.*, Sarah Helene Duggin & Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith*, 56 AM. U. L. REV. 211 (2006) (looking at the duty of good faith in the context of Disney); Marc I. Steinberg & Matthew D. Bivona, *Disney Goes Goofy: Agency, Delegation, and Corporate Governance*, 60 HASTINGS L.J. 201 (2008) (discussing the potentially diminished role of independent directors in corporate governance after Disney).

discussed the topic of executive compensation at great length.[4]

However, legal scholars start with the firing, all but ignoring the first step in the process: the hiring of Michael Ovitz as the next chief executive of Disney.[5] The responsibility of a public company board is to manage in situations where internal management faces a conflict of interest, and chief among these is the selection, monitoring, and firing of the CEO.[6] Yet, the board's choice of Ovitz—an industry outsider—received relatively little attention.

Hiring Ovitz, an external candidate, was an anomaly. For-profit corporations generally favor internal candidates, hiring externally only about 22% of the time.[7] The literature is divided as to why boards would favor internal candidates over external ones,[8] but the answer to this question is of paramount importance for evaluating arguments about compensation. Optimal contracting scholars point to the market for managerial talent as a major justification for large pay packages.[9] "If we don't pay our CEO the market rate, we will lose her," or so the argument goes. The compensation committees of public firms typically engage compensation consultants who "benchmark" pay by reporting the pay packages of the chief executives of comparable companies.[10] Critics of benchmarking cite its inexorable tendency to ratchet up pay: if all boards regularly aim for their CEO to exceed the median pay level, pay inevitably rises.[11] But the numbers make clear a more fundamental issue: most CEOs come from inside an organization.[12] This simple fact casts doubt on the existence of a market for managerial talent. And, if there is no market for CEOs, then perhaps firms can safely pay them significantly less.

A potential objection is that benchmarking is what prevents more of a market for CEOs: by this logic, firms who break with industry practice and pay their CEOs less than market rate risk poaching by other firms.[13] Thus, the question this Article seeks to answer: *why* do publicly traded firms favor internal CEOs, and what effect does that reason have on determining the appropriate level of executive compensation?

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4. *See, e.g.*, Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481 (2007) (discussing Bebchuk and Fried's writing on executive compensation along with the Disney case).

5. *See, e.g.*, Lawrence Lederman, *Disney Examined: A Case Study in Corporate Governance and CEO Succession*, 52 N.Y. L. SCH. L. REV. 557 (2007–2008) (questioning the process by which the former CEO brought Ovitz on board and the succession plan, but only through the lens of the board of directors' fiduciary duties).

6. *Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*, 65 BUS. LAW. 107, 123 (2009) (listing those functions as central to the board's focus).

7. DeAnne Aguirre et al., *From the Outside In*, STRATEGY & BUS. (May 2, 2016), http://www.strategy-business.com/feature/From-the-Outside-In?gko=24 9fb ("In the latest four-year period (2012–15), boards chose outsiders in 22 percent of planned turnovers . . . .").

8. *See infra* Part III (describing potential reasons for preferring inside candidates).

9. *See infra* Part II (describing executive pay levels).

10. *See* Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 494–95 (2013) (discussing the process boards typically use when benchmarking).

11. *Id.* at 498; *see also Executive Pay: Fat Cats Feeding*, ECONOMIST (Oct. 9, 2003), http://www.economist.com/node/2119378 ("Warren Buffett said recently, '[i]t would be a travesty if the bloated pay of recent years became a baseline for future compensation. Compensation committees should go back to the drawing board.'").

12. Aguirre et al., *supra* note 7.

13. *See* Elson & Ferrere, *supra* note 10, at 504 ("Failure to respond to the external market environment would result in raids of talent by other firms . . . .").

One potential explanation for favoring internal CEOs is that they perform better. Unlike legal scholars, other literatures focus a great deal of attention on the question of CEO selection.[14] In particular, the focus is on the eternal "make or buy" question: should companies promote internal candidates, or instead hire a replacement from outside the firm? The literature on the topic is vast and not limited in scope to the CEOs of public companies—or, indeed, traditional business settings. There are also studies of internal versus external NCAA basketball coaches and professional baseball managers, among other leadership contexts.[15] Yet, despite the myriad studies, results remain inconclusive—they do not reliably show that internal candidates perform better.[16]

A second explanation is that internal candidates spend years developing firm-specific capital.[17] As employees rise through the ranks of a company, they learn not only the industry, but also what makes their particular organization run.[18] They build up relational capital, enabling them to navigate the intricacies of the company.[19] They understand the strengths and weaknesses of the organization, and can hit the ground running with relatively little time required to acclimate to their new role.

Information asymmetry, a third explanation, focuses not on what the internal candidate knows about the firm, but instead on what the board knows about the internal candidate.[20] Internal candidates participate, in a real sense, in a years-long interview process. Boards generally have a sense of a current employee's reputation within the organization, and likely have worked with them and interacted with them socially on a variety of occasions.[21] Boards are at a comparative disadvantage when it comes to external candidates. They generally have relatively little time to interview outsiders and conduct due diligence as to their character, work habits, and knowledge. Typically, the external candidate is interviewing in secret, further limiting the board's ability to investigate an individual's character and attributes.[22]

The final explanation for public company boards favoring internal candidates is to foster a tournament system that incentivizes lower ranks, and keeps them competing for the ultimate prize of leadership over the organization.[23] When it is hard for employers to

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14. *See infra* notes 63–79 and accompanying text (describing the literature on CEO selection).

15. *Id.* (describing the literature on selection of internal or external candidates for CEO positions).

16. Mark R. Huson et al., *Managerial Succession and Firm Performance*, 74 J. FIN. ECON. 237, 238 (2004) ("The evidence on the consequences of these managerial replacement decisions is not so clear.").

17. *See* Eugene P.H. Furtado & Michael S. Rozeff, *The Wealth Effects of Company Initiated Management Changes*, 18 J. FIN. ECON. 147, 152 (1987) (discussing the advantage of firm-specific capital internal candidates have over external candidates).

18. *See* Anup Agrawal et al., *Are outsiders handicapped in CEO successions?*, 12 J. CORP. FIN. 619, 620 (2006) (discussing the potential for internal managers to build knowledge and relationships while working within the firm).

19. *Id.*

20. *See, e.g.*, Edward J. Zajac, *CEO Selection, Succession, Compensation and Firm Performance: A Theoretical Integration and Empirical Analysis*, 11 STRATEGIC MGMT. J. 217, 219 (1990) (arguing that the differences between internal and external candidates arise out of the principal-agent relationship of the Board and CEO).

21. *Id.* at 220 ("It seems more likely that the Board has had the opportunity to update its ability estimate of an insider CEO candidate more accurately over multiple [time] periods.").

22. *Id.*

23. *See* Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1559 (2005) ("[In the tournament model,] compensation is not a variable reward that increases directly

monitor output reliably, then it may be preferable to structure a "tournament" that enables the employer to measure, and ultimately rank, employees against one another rather than against an objective output measure.[24] Marc Galanter and Thomas Palay famously applied this principle to promotion at a law firm: associates compete in a tournament against one another, for the prize of making partner.[25]

Economists Edward P. Lazear and Sherwin Rosen give an excellent example of how their theory plays out in explaining executive compensation. Typically, the "salary of . . . the vice-president of a particular corporation is substantially below that of the president of the same corporation."[26] Yet, somehow, "on the day that a given individual is promoted from vice-president to president, his salary may triple. It is difficult to argue that his skills have tripled in that one-day period . . . ."[27] But this compensation structure is not surprising if viewed as a tournament, where high CEO pay reflects not current productivity as president, but rather efforts exerted at lower levels to compete in pursuit of CEO status.[28] The practice of favoring internals reassures current employees that there is a limited pool of competition for the grand prize, and that outsiders will not swoop in to claim the reward an internal aspirant has spent a substantial portion of her career working towards.

No articles have discussed in depth which of these theories—firm-specific capital, information asymmetry, or tournament theory—best explains the favoring of internal candidates. This Article offers support for the tournament theory, by way of an unexplored source: the academic leadership market.

Academia offers an ideal setting to test the power of tournament theory for a simple reason: tenured academics do not engage in a leadership tournament.[29] The other two explanations for favoring internal candidates, firm-specific capital and information asymmetry, still apply: internal candidates know more about their university, and the institution knows more about them, as compared to outsiders.[30] Tournament theory, in contrast, does not apply.[31] The typical academic professes something of a horror of administration, sometimes termed moving to the "dark side."[32] Thus, if the tournament theory is the dominant explanation for favoring internal candidates in the for-profit setting, internal candidates should not be as favored in the academic setting. If, in contrast, firm-specific capital or informational asymmetry explain the dominance of internal candidates, then internal candidates should likewise predominate in the academic leadership setting.

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with absolute performance. Instead, it is designed to motivate employees to compete for promotions by providing positive wage spreads between each level of the organizational hierarchy and the next higher level.").

24. *See* Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841, 848–49 (1981) ("[T]he costs of measurement for each conceivable candidate are prohibitively expensive. Instead, it might be said that those in the running are 'tested' by assessments of performance at lower positions.").

25. MARC GALANTER & THOMAS PALAY, TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM (1991).

26. Lazear & Rosen, *supra* note 24, at 847.

27. *Id.*

28. *Id.*

29. *See infra* Part IV.

30. *Id.*

31. Marlene I. Strathe & Vicki W. Wilson, *Academic Leadership: The Pathway To and From*, 134 NEW DIRECTIONS IN HIGHER EDUC. 5, 7 (2006) ("[F]aculty members are prepared through their degree programs for teaching, research and scholarship, and service responsibilities, not administrative roles.").

32. *See, e.g.*, Susan J. Becker, *Thanks, But I'm Just Looking: Or, Why I Don't Want to Be a Dean*, 49 J. LEGAL EDUC. 595, 595 (1999) (describing her time as an administrator as being on "the dark side").

I conduct a study from 1995–2016 of top fifty university presidents, and find support for the tournament theory of CEO selection. Only 24% of the presidents of leading universities are internal. This notable bias in favor of external candidates in a setting with no tournament, but where firm-specific capital and information asymmetry still exist, suggests that tournament theory explains the internal CEO bias. The implications for explaining why public firms favor internal CEOs are profound.

The Article proceeds as follows: Part II describes the debate surrounding executive pay levels. Notably, the optimal contracting view identifies the market for managerial talent as one justification for high rates of executive pay. However, given the strong tendency to favor internal candidates, such a market may be more fiction than fact. Part III describes the potential reasons for preferring inside candidates: firm-specific capital, information asymmetry, and tournament theory. Part IV moves to the academic setting to test the tournament theory. After establishing the absence of an academic leadership tournament and describing the process of selecting a university president, this Part briefly surveys the scant literature on university presidents. Part V provides the data, a sample of university presidents in schools regularly ranked in the U.S. News top fifty universities from 1995–2016. The main finding is that external candidates predominate. I test for gender, public versus private institution, and state system versus sole-governed institution, and fail to find statistically significant results. Part V offers implications for executive compensation.

II. EXECUTIVE COMPENSATION CONTROVERSY AND REFORM

Legal scholars have focused a great deal of attention on the compensation contract between CEO and firm, and in particular on the question of whether executive pay is "excessive." The "optimal contracting" school argues that executive pay is not excessive, but is instead the product of efficient bargaining between board and CEO.[33] "Managerial power" advocates, in contrast, believe that executives are in fact overpaid, because CEOs effectively set their own pay: managers wield a great deal of de facto power over boards that are independent in name only.[34]

The optimal contracting model presumes that the board bargains with the CEO to serve the corporation as a whole, and shareholders in particular.[35] The classic problem with CEO compensation is an agency problem: the risk that the CEO, though the corporation's agent and bound to serve it in good faith, will not in fact serve as the principal would

33. *See* John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 27, 27 (2003) ("[E]fficient contract[s] . . . maximize[ ] the net expected economic value to shareholders after transaction costs . . . . An equivalent way of saying this is we assume that contracts minimize agency costs."); *see also*, Anabtawi, *supra* note 23, at 1561; Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134, 138 (1973) ("We may conclude, then, that the class of payoff structures that simultaneously solve the principal's problem and lead to Pareto efficiency . . . is quite important and quite likely to arise in practice.").

34. Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 766–73 (2002) (describing various ways corporate management exerts power over "nominally independent" boards, including influence over the appointment of directors, overall board dynamics, and insufficient information).

35. PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 217–18 (1992).

wish.[36] Aside from garden-variety shirking or stealing, CEOs also impose a more insidious agency cost on investors. Generally greater returns require greater risk, but CEOs will be relatively risk averse for fear of losing their jobs.[37] Thus, they will be more cautious with the management of the firm than shareholders would prefer.

Under the optimal contracting view, boards, as faithful agents of the corporation, will enter into efficient compensation contracts that will compensate their managers for running risks on shareholders' behalf.[38] For example, golden parachutes protect CEOs from their own failures. If the CEO decides on a risky course that does not pan out, he can nonetheless reap some payment from the firm even if he is fired for poor performance.[39] This "parachute" offers him the security to run risks in the first place, risks that may be wealth-maximizing to shareholders in the aggregate. Another example is stock-based compensation, which aligns the CEO's compensation with the firm's performance, and thus with shareholders' interests.[40] CEOs can take higher risks with the firm, compensated for risking their human capital with the knowledge that they will share alongside the firm's other owners if those higher risks translate into in higher reward.

In contrast, the managerial contracting model views executive compensation as being excessive, the product of weak boards under the thumb of powerful managers.[41] Lucian Bebchuk and Jesse Fried made the case for this position in their book, *Pay without Performance*.[42] They argue that stock options do not reward CEO's for good performance, because their value may increase because of macroeconomic conditions or industry-specific factors that have nothing to do with their particular firm's performance.[43] Compensation truly geared towards rewarding performance would control for these factors and only reward performance measured by metrics within the CEO's control. These scholars advocate for increased disclosure and for empowering shareholders in order to counter CEO's ability to pressure the board into overly favorably pay packages—that is, into "excessive" levels of compensation.[44]

In the political arena, reformers have been quick to decry the unfairness and inequity of "excessive" executive pay. The 1986 Tax Code revisions added Section 162(m), which effectively limits CEO compensation by providing that no more than $1 million in salary

36. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("In most agency relationships the principal and the agent will incur positive monitoring and bonding costs . . . and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal.").

37. Michael J. Mannor et al., *Heavy Lies the Crown? How Job Anxiety Affects Top Executive Decision Making in Gain and Loss Contexts*, 37 STRATEGIC MGMT. J. 1968, 1984 (2016) ("We specifically demonstrate that more anxious top executives tend to avoid risks in their strategic decisions.").

38. *See* Core et al., *supra* note 33, at 28 ("[O]n average the system is efficient within transaction costs.").

39. Bebchuk et al., *supra* note 34, at 834 ("Some researchers have argued that golden parachutes encourage managers to take desirable risks . . . .").

40. *See* Anabtawi, *supra* note 23, at 1563 (suggesting that increased "pay-performance sensitivity" aligns executive and shareholder interests).

41. Bebchuk et al., *supra* note 34, at 837 (noting a weak or ineffectual board as a factor in increased managerial power).

42. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard Univ. Press 2004).

43. *See id.* at 140 (describing how boosts in stock price from industry- and market-wide factors result in rewards to executives without affecting "managers' incentives for good performance").

44. *See id.* at 206–16 (discussing increased shareholder influence over director selection).

be tax deductible.[45] Ironically, an important exception—for performance-based compensation such as stock options—set the stage for yet larger amounts of compensation, because it encouraged what some termed the "profligate" issuance of stock options as CEO compensation.[46]

Since the 1980s, reformers have used one main tool to curb "excessive" pay, with limited amounts of success: disclosure.[47] This Part will describe disclosure requirements in place before the Dodd-Frank Act of 2010 ("Dodd-Frank"),[48] but defer discussion of specific Dodd-Frank provisions such as pay versus performance disclosures, "say on pay" votes and pay ratio disclosures, until Part VI. The optimal contract school likely views each of these measures as ham-handed over-regulation, and this Article will argue that they are, in fact, misguided, because they do not provide shareholders with information needed to evaluate executive pay.

A. The Problem With Disclosure: The Market for External CEOs is not Robust

Disclosure is the main mechanism by which securities law works.[49] Unsurprisingly, the first tool for limiting executive compensation was mandated disclosure of compensation packages. The original theory was that disclosing executive compensation levels alone would serve as a check on excessive pay.[50] Either corporations would be shamed by overpaying their CEOs or outraged shareholders would balk at paying the CEO "too much."[51] It is widely believed, however, that disclosure has *increased* CEO pay levels. Not only do "inflated executive egos demand inflated executive pay,"[52] but the process by which compensation committees work compounds the problem. They hire compensation consultants who "benchmark," that is, survey the compensation of the CEO's of rival

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45. 26 U.S.C. § 162(m) (1986).

46. Arthur H. Kohn, *The Regulation of Executive Compensation: Unintended Consequences (Mostly), Unexpected Achievements (Say What?), and the SEC's New Rules (No Mas!)*, 2016 WL 676116, at *2 ("What Congress failed to anticipate was how Section 162(m)'s deductibility cap, taken together with other factors—most notably favorable accounting treatment for stock options—would encourage what some argue was the profligate use of stock options that led to the dot-com bubble, the backdated options scandal of the dot-com era, and the corporate fraud carried out by Enron executives.").

47. *See, e.g.*, Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'* 16 (Columbia Law Sch. Law & Econ. Res. Paper No. 273, 2005) (calling for disclosures to report the "bottom line" of executive compensation); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138, 144 (May/June 1990) (discussing government mandated disclosures that keep executive pay visible).

48. *See* 12 U.S.C. Ch. 53 (2010).

49. *See* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 132 (1973) ("Indeed, the Securities Exchange Act is described in its title and usually referred to as a "disclosure statute.").

50. Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 807–08 (1994) ("Following a public outcry over the size of executive compensation, the Commission reacted in 1992 by adopting a rule that required increased disclosure of executive compensation in the annual proxy statement.").

51. Charles Elson, *What's Wrong with Executive Compensation?*, 81 HARV. BUS. REV. 68, 76 (2003) (statement of Brian Hall) ("The idea was that if we shed some light on the problem, CEOs and boards would get embarrassed and maybe the problem would disappear.").

52. Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 447 (2010).

firms.[53]

Nearly every corporate board believes that their CEO is above average, and should be compensated accordingly,[54] in a process that has been dubbed the "Lake Wobegon Effect."[55] Accordingly, "pay inevitably rises."[56] For example, Time Warner, seeking "to attract and retain high-caliber executive[s]," generally targets compensation at the seventy-fifth percentile of companies in its three peer groups.[57] Obviously, if each corporation acts in a similar way, overall averages will quickly rise.

Companies justify these polices by looking to the market for managerial talent. The rationale is that if they do not pay their CEOs well, more generous corporations will raid their ranks and leave a managerial vacuum.[58] The presumption of a robust external market for managerial underpins the concept of benchmarking. If such a market exists, then benchmarking is necessary in order to retain the CEO.[59] If such a market does *not* exist, then disclosure of CEO compensation alone will only increase compensation—and will not provide useful information to shareholders because it is divorced from any useful data with which to compare.

In this vein, Steven A. Bank, Brian R. Cheffins, and Harwell Wells look at CEO compensation over time, and conclude that the rise of the market for managerial talent explains the rise in CEO compensation. They argue that "[i]f companies are competing intensely in the market for managerial talent to retain or recruit senior executives, this should bolster the bargaining power of these executives and drive up managerial compensation."[60] They assert an increase, beginning in the 1970s, in companies' willingness to hire external CEOs, and cite evidence of increased CEO turnover in the 1980s.[61]

In fact, the "market" for external managerial talent may be something of a misnomer. Empirically, there is little evidence that a market for external CEOs exists at all. Traditionally, insiders dominated CEO successions. In the 1970s and 1980s, only 15% of CEOs came from outside the corporation.[62] Another study, of the period from between 1974–95, found less than 20% of CEOs were external.[63]

In the late 2000s, however, outside candidates gained ground, accounting for "almost

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53. Martin J. Conyon et al., *Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom*, 23 ACAD. MGMT. PERS. 43, 45–46 (2009) (discussing how benchmarking leads to ratcheted up pay).

54. *See* Davis, *supra* note 52 ("Nearly all major corporations target their executive compensation levels to exceed the mean compensation among their peer groups.").

55. *See* Elson & Ferrere, *supra* note 10, at 499 (referring to this effect, which is based on Garrison Keillor's Lake Wobegon where "every child is above average").

56. Davis, *supra* note 52.

57. *Id.*

58. *See* Elson & Ferrerre, *supra* note 10, at 504 ("Failure to respond to the external market environment would result in raids of talent by other firms . . . .").

59. *See id.* at 449 (discussing how upward adjustments of executive pay to at least the "going rate" are necessary for retention).

60. Steven A. Bank et al., *Executive Pay: What Worked?*, 42 J. CORP. L. 59, 96 (2016).

61. *Id.* at 97–99 (discussing the changes in the market for managerial talent during these time periods).

62. *See* Elson & Ferrere, *supra* note 10, at 506 (explaining how "[a]bout 15% of CEO successions involved the appointment of an outside executive in the 1970s and 1980s.").

63. Agrawal et al., *supra* note 18 ("Most often, firms choose to promote insiders. For large U.S. firms over the period 1974–1995, better than 80% (848 out of 1035) of all CEO successions involved the promotion of an insider to the CEO position.").

one-third of new CEO hires."[64] The proportionate increase in outsider representation has been cited as evidence of the increased importance of generalized managerial skills that an executive can easily transfer from firm to firm.[65] Furthermore, the advent of computers allowed for the compilation and access of a multitude of firm-specific data, rendering firm-specific knowledge less important than in the past. Thus, external CEOs have become stronger candidates over time.

Yet those who concluded that this increase in external candidates would continue, or even increase, presumed too much. The uptick in outsider hiring did not persist.[66] Although external CEOs are more common than they were in the past, they are still relatively rare. Hiring from within remains the "dominant mode of CEO succession in American corporations."[67] In the four-year period from 2012–15, the proportion of S&P 500 companies hiring outside CEOs, registered at around 22%.[68] Internal candidates are the first resort, and the choice of an external CEO is usually "[a] judgment by directors that no competent successor candidate is available within their firm."[69]

Indeed, the management literature implicitly discounts the external market for CEOs by emphasizing the importance of succession planning. Succession planning—meaning the fostering of a pipeline of internal candidates groomed to take over from a predecessor[70]—is of crucial importance at most leading firms.[71] The SEC has characterized succession planning as "a significant policy [and governance] issue" for boards "so that [a] company

64. Charles M. Yablon, *Is the Market for CEOs Rational?*, 4 N.Y.U. J.L. & BUS. 89, 115 (2007) (citing RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 141 n.14 (2002)).

65. *See* Elson & Ferrere, *supra* note 10, at 506–07 (citing Kevin Murphy & Ján Zábojník, *Managerial Capital and the Market for CEOs* (Queens Econ. Dep't, Working Paper No. 1110, 2007)).

66. *See* Karen Schnatterly & Scott G. Johnson, *Competing to be CEO in High-tech Firms: Insider, Board Member, or Outsider Candidates*, 18 J. HIGH TECH. MGMT. RES. 132, 134 (2008) (explaining that "[t]he most common form of succession is that of an internal appointment. Of all the CEOs of the current Fortune 100 firms, fewer than 10 have been appointed from outside."); William Chan, *External Recruitment versus Internal Promotion*, 14 J. LAB. ECON. 555, 555–56 (1996) (citing similar numbers in the Fortune 100).

67. Yablon, *supra* note 64; Huson et al., *supra* note 16, at 242 ("Most top management appointees are selected from among firm insiders, those who are already senior officers of the firm.").

68. Aguirre et al., *supra* note 7; *see also* Elson & Ferrere, *supra* note 10, at 506 (citing *2012 CEO Transitions*, SPENCERSTUART (Dec. 31, 2012)) (citing SpencerStuart to show that for the years 2007 to 2012, the proportion of S&P 500 CEOs hiring externally ranged from 20–27%).

69. Wei Shen & Albert A. Cannella Jr., *Revisiting the Performance Consequences of CEO Succession: The Impacts of Successor Type, Postsuccession Senior Executive Turnover, and Departing CEO Tenure*, 45 ACAD. MGMT. J. 717, 722 (2002).

70. William J. Rothwell, *Replacement Planning: A Starting Point for Succession Planning and Talent Management*, 15 INT'L J. TRAINING & DEV. 87, 87 (2011) ("succession planning . . . focuses on developing a pool of people to consider for promotion[.]"); Yeonsoo Kim, *Measuring the Value of Succession Planning and Management: A Qualitative Study of Multinational Companies*, 23 PERFORMANCE IMPROVEMENT Q. 5, 5 (2010) ("In the 1980s, it centered on CEO succession practices and attendant issues. In the 1990s, succession planning expanded its focus to include other key executive positions. And now it may include all employees in key leadership positions."); Robert Barnett & Sandra Davis, *Creating Greater Success in Succession Planning*, 10 ADVANCES DEV. HUM. RES. 721, 721 (2008) ("Generally, however, succession planning refers to special efforts to invest in the best, highest performing, or highest potential talent at any organizational level or function, but particularly at or near the top.").

71. Melissa F. Klein & Raintry Jean Salk, *Presidential Succession Planning: A Qualitative Study in Private Higher Education*, 20 J. LEADERSHIP & ORG. STUD. 335, 337 (2013) ("Succession planning has long been a part of the corporate world.").

is not adversely affected due to a vacancy in leadership."[72] The presumption is that succession planning is part of a successful business, to the point that one academic remarked, "make no mistake about it: no matter how successful [an] outsider may ultimately be, his or her recruitment by definition is the result of failure."[73] Seen in this light, benchmarking—that is, looking outside the organization to take cues for executive pay levels—is fundamentally misguided. The likelihood of a CEO being "poached" if paid less than market is low—unless benchmarking and uniformly high CEO compensation are inhibiting an otherwise robust market.

This Article is not the first to identify the lack of an external CEO market. Charles M. Elson and Craig K. Ferrere made this point as part of a larger argument about excessive executive compensation. Without such a market, disclosure alone will only prompt benchmarking, which ratchets up pay for no reason. Part III will argue that understanding the reason for the lack of an external CEO market—why, in other words, firms favor internal candidates—can inform the framing of mandatory disclosure rules that provide more relevant information to shareholders.

Having established the rarity of the external CEO, I turn next to the focal question of this Article: the explanation for the dominance of the internal hire.

III. WHY FAVOR AN INTERNAL CANDIDATE?

While the literatures of several disciplines focus on the relative performance of internal versus externally sourced leaders, few have focused on *why* insider candidates dominate the field. This question is a vitally important one for any organization: the tasks of selecting a CEO, monitoring her performance, and deciding when to replace her constitute one of the board's most important jobs.[74] In most publicly traded firms,[75] the subset on which this Article focuses, the majority of the board must consist of independent directors, i.e., directors who do not work for the corporation full time.[76] Indeed, most public companies are supermajority independent, so that only the CEO and perhaps one other full-time employee sit on the board. Thus, most of the board of a publicly traded corporation consists of outsiders—part-timers for whom their service to the corporation is not their "day job."[77]

I have argued elsewhere that the role of an outsider-dominated board of directors is best understood as focusing primarily on areas where the managers face a conflict of

72. SEC Staff Legal Bulletin No. 14E (CF), 2009 WL 4363205, at *3 (Oct. 27, 2009).

73. NOEL TICHY, SUCCESSION: MASTERING THE MAKE-OR-BREAK PROCESS OF LEADERSHIP TRANSITION 207 (2014).

74. Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. ILL. L. REV. 1051, 1085 (2013) ("[T]here is one function the board can perform, and perform better than any other corporate group: '[S]electing, monitoring, and removing the members of the chief executive's office.'" (quoting MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170 (1976))); *see* DENNIS C. CAREY & DAYTON OGDEN, CEO SUCCESSION 3 (2000) (noting "that succession has become a front-burner issue for directors").

75. Aside from controlled companies like Facebook, which are exempt from independence requirements.

76. *See, e.g.*, N.Y.S.E. MANUAL § 303A.01 (2009) ("Listed companies must have a majority of independent directors."); NASDAQ STOCK MARKET RULE (CCH) ¶ 5605(b)(1) (2009) ("A majority of the board of directors must be comprised of Independent Directors . . . .").

77. Rodrigues, *supra* note 74, at 1060 ("In reality, today most public corporations have supermajority independent boards; indeed, often the CEO is the only employee-director.").

interest, areas like related party transactions or derivative suits.[78] Paramount among these conflicts is the evaluation of the performance of the CEO. By definition any full-time employees ultimately report to the CEO, and thus cannot objectively evaluate her performance. Only an outside body has the independence to perform this crucial task.

Despite the vital importance of the task of selecting the CEO, there remains a gap in the literature: a clear reason why firms prefer internal candidates. Four explanations recur repeatedly: performance, firm-specific capital, information asymmetry, and tournament theory. The specific reason for favoring internals matters a great deal, both to questions of compensation and performance. If firm-specific capital is the main driver, then the idea of an external market for managers is mere fantasy because each candidate's highest and best use is as CEO of the specific firm they know best. If, instead, information asymmetry explains the preference for internals, then more lengthy or detailed diligence into external candidates at the hiring stage may produce better results. And, if tournament theory is what explains handicapping outsiders, then the performance of the CEO himself is in a real sense immaterial. What matters is that the preference for internal CEOs fosters beneficial competition within the firm. Thus, compensation should focus on the relationship of CEO compensation to that of the next highest-ranking officers. CEOs' compensation should be enough to incentivize them to compete for the top spot, but no higher. Again, the external market will pale in significance because of the institutional benefits of putting a thumb on the scale in favor of current employees. This Part will examine each explanation in turn.

A. Internal Candidates Perform Better

A robust and varied debate exists in the literature over the fundamental "make or buy" question: do external or internal leaders perform better?[79] Superior performance by firms who promote CEOs internally relative to similarly situated firms led by external CEOs would offer a clear reason for favoring an internal candidate. Luckily, many scholars have examined the performance question. A detailed treatment of the literature on the relationship of CEO provenance to firm performance would span many disciplines and require at least twice the length of this Article.[80] A brief survey of the field reveals the question has provoked intense attention.

Twenty-five years ago, Edward J. Zajac could already observe "[t]he study of CEO succession (the selection of a replacement CEO) and organizational performance has had

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78. *See, e.g.*, *id.* at 1052 ("In such areas of conflict of interest the board's lack of ties to management becomes a strength, and so it is on these subjects that the board should focus.").

79. *See* Beni Lauterbach et al., *Internal vs. External Successions and Their Effect on Firm Performance*, 52 HUM. REL. 1485, 1485 (1999) ("A frequently debated issue is the preferable source of top management successions (external or internal).").

80. There is a vast amount of literature on corporate succession, spanning numerous fields, because of its "unusually broad attraction as a pursuit of scholarly research . . . ." Robert C. Giambatista et al., *Nothing Succeeds Like Succession: A Critical Review of Leader Succession Literature Since 1994*, 16 LEADERSHIP Q. 963, 965 (2005). The question is of logical interest to management studies. Finance scholars find it of equal interest, who focus largely on agency theory and the effect of leadership selection on the financial performance of the firm. *Id.* at 977. But there are many other disciplines with interest in the topic, which view it through varied lenses: "sociologists [who emphasize] bureaucratization and adaptation[], social theorists [who emphasize] leadership change's relationship to organizational effectiveness[], organizational behavior and human resources scholars [who emphasize] managing the process and its impact on careers and coping[], and strategists [who emphasize] achieving competitive advantage[]." *Id.* at 965.

a long history," citing studies stretching back to 1962.[81] Ayse Karaevli in 2007 cataloged published empirical research on the consequences of CEO succession from 1954–2005, and listed 52 separate entries.[82] Just as notable as the sheer number of studies were the varied settings in which they take place. Scholars have looked at the effect of leadership succession in general, or on the effect of the outsider/insider choice, in the various business contexts, from the CEOs of Fortune 500 firms,[83] to CEOs of large firms,[84] CEOs of small firms,[85] CEOs following the death of the predecessor,[86] CEOs in financially distressed firms,[87] CEOs of Japanese companies,[88] CEOs of cement firms,[89] and CEOs of small Iowan telephone firms.[90] Succession research did not limit itself to the business field, however, and scholars explored effects on school superintendents,[91] plant managers,[92] baseball coaches,[93] NCAA basketball coaches,[94] NBA coaches,[95] NFL coaches,[96] and Methodist ministers,[97] to name but a few contexts.

Yet, despite this large body of research, the cumulative results are inconclusive, at best.[98] The "most consistent finding in the literature" is that poor firm performance is associated with increased rates of succession, i.e., increased CEO turnover.[99] Beyond that, as Karaevli writes, "[s]cholars have failed to reach a consensus on whether succession

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81. Edward J. Zajac, *CEO Selection, Succession, Compensation and Firm Performance: A Theoretical Integration and Empirical Analysis*, 11 STRATEGIC MGMT. J. 217, 219 (1990).

82. Ayse Karaevli, *Performance Consequences of New CEO 'Outsiderness': Moderating Effects of Pre- and Post-Succession Contexts*, 28 STRATEGIC MGMT. J. 681, 683–85 (2007).

83. Wallace N. Davidson III, et al., *Key Executive Succession and Stockholder Wealth: The Influence of Successor's Origin, Position, and Age*, 16 J. MGMT. 647 (1990).

84. Michael H. Lubatkin et al., *Stockholder Reactions to CEO Changes in Large Corporations*, 32 ACAD. MGMT. J. 47 (1989).

85. Donald B. Trow, *Executive Succession in Small Companies*, 6 ADMIN. SCI. Q. 228 (1961).

86. Dan L. Worrell & Wallace N. Davidson III, *The Effect of CEO Succession on Stockholder Wealth in Large Firms Following the Death of the Predecessor*, 13 J. MGMT. 509 (1987).

87. Karl-Adam Bonnier & Robert F. Bruner, *An Analysis of Stock Price Reaction to Management Change in Distressed Firms*, 11 J. ACCT. & ECON. 95 (1989).

88. Tomoaki Sakano & Arie Y. Lewin, *Impact of CEO Succession in Japanese Companies: A Coevolutionary Perspective*, 10 ORG. SCI. 654 (1999).

89. Michael L. Tushman & Lori Rosenkopf, *Executive Succession, Strategic Reorientation and Performance Growth: A Longitudinal Study in the U.S. Cement Industry*, 42 MGMT. SCI. 939 (1996).

90. Heather A. Haveman, *Ghosts of Managers Past: Managerial Succession and Organizational Mortality*, 36 ACAD. MGMT. J. 864 (1993).

91. Richard O. Carlson, *Succession and Performance among School Superintendents*, 6 ADMIN. SCI. Q. 210 (1961).

92. Richard H. Guest, *Managerial Succession in Complex Organizations*, 68 AM. J. SOC. 47 (1962).

93. Michael Patrick Allen et al. *Managerial Succession and Organizational Performance: A Recalcitrant Problem Revisited*, 24 ADMIN. SCI. Q. 167 (1979); Oscar Grusky, *Managerial Succession and Organizational Effectiveness*, 69 AM. J. SOC. 21 (1963).

94. D. Stanley Eitzen & Norman R. Yetman, *Managerial Change, Longevity, and Organizational Effectiveness*, 17 ADMIN. SCI. Q. 110 (1972).

95. Jeffrey Pfeffer & Alison Davis-Blake, *Administrative Succession and Organizational Performance: How Administrator Experience Mediates the Succession Effect*, 29 ACAD. MGMT. J. 72 (1986).

96. M. Craig Brown, *Administrative Succession and Organizational Performance: The Succession Effect*, 27 ADMIN. SCI. Q. 1 (1982).

97. Jonathan E. Smith et al., *Leadership: It Can Make a Difference*, 27 ACAD. MGMT. J. 765 (1984).

98. *See* Huson et al., *supra* note 16, at 238 ("The evidence on the consequences of these managerial replacement decisions is not so clear."); Zajac, *supra* note 20 (noting that the field "has been viewed as suffering from the lack of cumulative knowledge").

99. Giambatista et al., *supra* note 80, at 964.

events in general, and insider vs. outsider successions in particular, affect firm performance positively, negatively, or insignificantly."[100] Conventional wisdom has it that poorly performing firms will favor external candidates, because of the sense that change is required.[101] External candidates are not bound by "the old policies and implicit contracts" and can provide "new perspectives, fresh ideas, and decisive actions."[102] Yet, Beni Lauterbach, Joseph Vu, and Jacob Weisberg observe that, "[d]espite the strong intuitive appeal of the above arguments, their empirical support is weak . . . . There is evidence that poor performance increases the frequency of successions, but there is no conclusive evidence that poor performance triggers external successions."[103]

In sum, despite considerable attention from several distinct disciplines, concrete findings regarding the relationship between CEO provenance and firm performance have proved illusory. The most that can reliably be asserted is that firm performance is inversely correlated with the likelihood of a succession event—that is, if a firm is performing poorly, it is more likely that its CEO will be replaced. Conversely, a firm performing well will be relatively unlikely to replace its CEO. One central fact remains clear, although largely taken for granted: most CEOs come from within an organization. That fact should have an impact, on a topic much discussed in the legal literature: executive compensation.

We have chalked superior performance off the list of reasons to favor internal CEO candidates. Three more explanations remain: firm-specific capital, information asymmetry, and the incentive effect of an internal tournament for CEO.

B. Firm-Specific Capital

Firm-specific capital is "perhaps the most often cited" explanation for internal promotion.[104] Both employer and employee know the value of maintaining the employee in the firm: each day the employee invests more of his human capital in understanding not only how his specific industry works, but how to function best within his specific firm. Conversely, the employer benefits from investing in the success of its employees. "And the longer the tenure of the worker, the more specific human capital accumulated, and the more costly it would be for the firm to find an external candidate who could outperform an existing worker within the setting of the firm."[105]

Put simply, insiders know the firm.[106] They have pre-existing social networks, and are intimately familiar with—indeed, have often shaped—corporate strategy.[107] They

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100. Karaevli, *supra* note 82, at 682; *see also* Randolph P. Beatty & Edward J. Zajac, *CEO Change and Firm Performance in Large Corporations: Succession Effects and Manager Effects*, 8 STRATEGIC MGMT. J. 305, 305 (1987) ("[U]nderstanding the general relationship between managerial succession and organizational performance has proven an elusive goal, despite over two decades of research attention in the organization theory literature.").

101. *See* Lauterbach et al., *supra* note 79, at 1486.

102. *Id.*

103. *Id.*; *see also* Karaevli, *supra* note 82, at 686 ("[T]he performance consequences of new CEO origin have also been characterized by mixed results.").

104. Chan, *supra* note 66, at 556.

105. *Id.*

106. Karaevli, *supra* note 82, at 687 ("[The continuity view of successions highlights] the importance of insiders' greater knowledge of the firm and established networks for achieving continuity.").

107. *See* Lauterbach et al., *supra* note 79 (discussing the benefits generally highlighted by proponents of internal succession).

provide the firm with continuity in the midst of succession.[108] Insiders, with their superior knowledge of the firm and relationships formed by working within it, would under this view naturally outperform external candidates who lack these characteristics.[109] They know about the specific production technologies the firm uses, its standard operating procedures, and the product markets in which the firm competes.[110]

Moreover, their knowledge of the firm's relative position in the market, including the development of corporate strategy, "requires the intimate knowledge, coordination, and direction of complex, interrelated corporate assets and personnel."[111] Effective managers draw "on an accumulated specific knowledge of a company's culture, strengths, weaknesses, and interpersonal dynamics."[112] They have developed and implemented firm policies as managers, and are thus in a better position to implement them on a broader scale.[113] With their intimate knowledge of the firm, they may even have invested their capital in areas where they have a comparative advantage over others.[114]

If firm-specific capital is what drives firms to favor internal candidates, then that fact has profound ramifications for the CEO market. In point of fact, it all but eliminates the idea of an external market for managerial talent. As Elson points out: "If an executive's productivity is mainly derived from firm-specific knowledge and skills, which have little value elsewhere, the executives themselves will have little value to outside firms. In such a case the executive is essentially stuck with their current employer, unable to be similarly productive elsewhere."[115]

But, firm-specific capital is not the only reason scholars posit for the preference for internal hires. The second explanation focuses not on what the internal candidate knows about the firm, but instead what the firm—specifically the board—knows about the internal candidate.

C. Information Asymmetry

The information asymmetry explanation posits that boards confront a great deal of confounding information when evaluating external candidates, and may prefer to go with the "less uncertain" prospect of an internal candidate.[116] Compounding the information asymmetry problem is the fact that, at least among publicly-traded corporations, the overwhelming majority of the board will be independent—that is, the board will be composed of outsiders who do not work full-time in the corporation they oversee.[117] Thus, unlike hiring lower down the corporate ladder, when it comes to the CEO, "decisions frequently rest in the hands of individuals who may be relatively unfamiliar with the

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108. *Id.*

109. Agrawal et al., *supra* note 18; *see also* Karaevli, *supra* note 82, at 687; Zajac, *supra* note 20.

110. James P. Guthrie & Deepak K. Datta, *Corporate Strategy, Executive Selection, and Firm Performance*, 37 HUM. RESOURCE MGMT. 101, 102 (1998); Robert Parrino, *CEO Turnover and Outside Succession—A Cross-Sectional Analysis*, 46 J. FIN. ECON. 165, 168 (1996).

111. Elson & Ferrere, *supra* note 10, at 506.

112. *Id.*

113. Parrino, *supra* note 110, at 167.

114. *Id.* at 168.

115. Elson & Ferrere, *supra* note 10, at 505.

116. Chan, *supra* note 66, at 556.

117. Rodrigues, *supra* note 74, at 1060 ("In reality, today most public corporations have supermajority independent boards; indeed, often the CEO is the only employee-director.").

organization and its internal processes."[118]

Edward Zajac argues most directly for the information asymmetry explanation.[119] His study posits that the board of directors of a firm engaged in evaluating potential CEO candidates suffers from a basic information asymmetry problem.[120] While traditionally the law and economics literature has focused on information asymmetries in the context of the agent's decision-making, at the outset of the relationship a formidable information asymmetry exists—that is, in selecting the agent in the first place, the principal suffers from a lack of information regarding "the characteristics of the agent, e.g. ability, risk-aversion, or propensity to leave an organization."[121] At the hiring stage, the board is at an informational disadvantage because the would-be CEO may have secret, negative information about their characteristics relevant to the hiring decision, but these remain unknown to the board.[122]

All things being equal, the board is more likely to be able to distinguish the qualities of an internal candidate as compared to an external one. Put in simple terms, the internal candidate is a known quantity, and is progressively better known the longer the board has the opportunity to observe them over time.[123] "A board of directors usually interacts with an insider candidate on many occasions, and therefore has a chance to observe his or her behavior and personality traits under different circumstances."[124] In contrast, the board has few such opportunities regarding external candidates.[125] Outside candidates from different industries pose even more difficulties in terms of assessment.[126] Because of this difficulty in accurately assessing whether the candidate's abilities match the requirements of the firm, the board may choose a successor poorly suited to the job of CEO.[127]

A variant is the "cozy insider" theory, that a board may favor an internal candidate even over stronger outside candidates, because of laziness or a too-cozy relationship with the insider:[128]

> Internal candidates also seem to have closer relations with the board of directors members. Thus, it appears that sometimes an internal candidate is selected to office despite the fact that an external succession might be optimal. In contrast, it is likely that an external candidate was appointed only after a comprehensive

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118. Lauterbach et al., *supra* note 79, at 1489 (quoting Idalene F. Kesner & Terrence C. Sebora, *Executive Succession: Past, Present & Future*, 20 J. MGMT. 327, 329 (1994)).

119. Zajac, *supra* note 20, at 220.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. Karaevli, *supra* note 82, at 688; *see also* Shen & Cannella Jr., *supra* note 69, at 719–20 ("[B]ecause of their frequent exposure to their firms' boards of directors and other senior executives, coupled with their history of performance inside the firms, the risk of adverse selection is relatively low.").

125. *See* Karaevli, *supra* note 82, at 688 ("[B]oards usually face greater difficulties in acquiring . . . diverse information about external candidates.").

126. *See id.* ("[A] board of directors does not usually have a large amount of information about the best-managed firms in a different industry, although they usually have that benchmark information about the firms in their own industry.").

127. Shen & Cannella Jr., *supra* note 69, at 719 ("The risk of adverse selection arises because information asymmetry between the board and successor candidates makes it difficult for the board to accurately assess if the abilities of a potential successor match the needs of the firm.").

128. Lauterbach et al., *supra* note 79, at 1489.

> search during which the candidate proved herself or himself superior to other external and internal candidates for the post. The above analysis suggests that on average firms that recruited from outside got a more skillful CEO than firms that appointed from inside.[129]

Under this view, boards favor internals based not on efficiency gains, but instead on personal utility. The cozy insider view suggests that an external market could exist, if the board focused on quality over familiarity.

If information asymmetry or the more troubling "cozy insider" variant, and not firm-specific capital, is the reason for favoring insiders, then the external market for managerial talent remains a possibility, as long as successful managers are able to transplant their skills to new firms. Some scholars do indeed argue that firm-specific capital is not as important as good strong managerial skills, and that skilled managers can lead a variety of firms. Proponents of generalizable management skills cite the recent increase in the rate of hiring external CEOs (although that rate has, as described, dropped to about 22% after rising to almost one third), and the increasing percentage of CEOs with MBAs as evidence.[130]

If CEOs' managerial skills are transferable and firm-specific capital is not a crucial part of their success, then firms can look outside of their internal labor market when replacing a CEO. What is more, the converse of firms' ability to hire external CEOs is the vulnerability of their own CEO to being poached from other firms. This wider external market naturally increases CEO compensation, as firms benchmark in order to ensure that their CEOs are being paid a market rate.[131] As Elson puts it: "If, on the other hand, CEO human capital is largely general, and therefore transferable between different companies, the outside opportunities should more closely match wages, and executives should freely move to their most efficient allocation."[132] Elson himself vociferously disagrees, citing empirical studies as well as, anecdotally, a move toward specialization at GE, the vaunted executive training ground. He observes: "The CEO of a large company must know his specific business well. A focused expertise is absolutely necessary to sustain a competitive advantage in this difficult environment. Reliance upon general managerial skills, principles, and techniques will not suffice."[133]

If Elson is wrong, and if it is information asymmetry that drives the internal candidate preference, then boards could perform more due diligence, arrange for test-runs, or otherwise attempt to obtain further information about external candidates. If the cozy insider explanation is the true one, however, internal candidates would continue to dominate so long as boards share an inappropriately close relationship with internal candidates.

So far, we have covered explanations that deal with the knowledge possessed by the internal candidate (firm-specific capital) and the board (information asymmetry). The last explanation shifts to another audience entirely. The focus is not on what the board or candidate knows, but instead on the effect of the choice of internal candidate has on the rest of the firm's employees.

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129. *Id.*
130. Elson & Ferrere, *supra* note 10, at 506–07.
131. *See id.* at 494–95 (discussing the process boards typically use when benchmarking).
132. *Id.* at 505.
133. *Id.* at 510.

D. Tournament Theory

Classic economic tournament theory asserts that when it is difficult to monitor or assess individual performance, firms adopt a tournament style of compensation. Firms will effectively defer a portion of workers' compensation in exchange for the chance to be promoted. Tournament theorists offer two justifications for this state of affairs: first, if it is relatively difficult to measure individual employee's productivity, the firm cannot compensate each one appropriately.[134] There is simply no way to accurately measure how much any individual is contributing. Typically in such settings, compensation is assessed only by the employee's supervisor, in a manner that is inevitably subjective.[135] Firms are thus faced with the problem of how to reward those who perform well without being able to quantify exactly how much they have done.[136] Rank-order tournaments, where firms commit to promote from within, solve the problem because, with the tournament, "the firm can depend upon the lure of the rewards associated with promotion (and the corresponding fear of not winning the competition) to motivate employees to exert high levels of effort and care with relatively little supervision. At the end of the probationary period, firms simply have to choose those employees who performed 'the best' among their peers."[137]

A significant strand of tournament theory seeks to explain why rewards increase disproportionately at the top ranks. Sherwin Rosen illustrates the phenomenon by way of a tennis tournament analogy where "the top four ranks receive 50% or more of the total purse . . ."[138] The situation is generalizable: although executive pay exhibits less extreme concentration at the top, most firms pay increases disproportionately as a worker ascends the corporate hierarchy. Rosen uses tournament theory to explain this increase: without a significant reward for competing further, the worker might be tempted to slack off and rest on her laurels.[139] To incentivize employees to compete, the firm must pay them proportionately more as they advance. On the flipside, employees can relatively easily verify whether or not the firm keeps its promises by in fact paying higher ranks more as they progress through the ranks.[140] In many ways, this theory explains what is largely common sense: vice presidents who ascend to become CEO, with a concomitant doubling in pay, did not become twice as productive overnight. Rather, the prospect of the CEO prize made them more productive over the full measure of their working lives, and the CEO salary is a final payout that rewards the years it took to get them to the ultimate position.[141]

But, this application of tournament theory explains only why firms pay their higher ranks well—it does not explain favoring internal candidates. William Chan argues that if

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134. David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581, 1584 (1998).

135. *See* James M. Malcomson, *Work Incentives, Hierarchy, and Internal Labor Markets*, 92 J. POL. ECON. 486, 487 (1984) ("[P]erformance is frequently something that can be assessed only subjectively by, for example, the judgment of a supervisor.").

136. Lazear & Rosen, *supra* note 24, at 848–49 ("Yet the costs of measurement for each conceivable candidate are prohibitively expensive.").

137. Wilkins & Gulati, *supra* note 134.

138. Sherwin Rosen, *Prizes and Incentives in Elimination Tournaments*, 76 AM. ECON. REV. 701, 701 (1986).

139. *Id.* at 713.

140. *See* Malcomson, *supra* note 135, at 487 ("Whether or not [a firm] abides by [its agreement to pay some employees higher wages] is something that can be verified by employees.").

141. Lazear & Rosen, *supra* note 24, at 847.

the tournament is open to all, moral hazard can arise. Recall that tournament theory focuses on situations when the employer finds it hard to assess an individual's performance. Rank-ordering internal employees reduces the need to measure output precisely. But opening the field, and allowing not only internal candidates (whose relative strength a worker can evaluate against her own), but also external ones, "drastically reduces" an internal candidate's prospect of winning, and therefore the incentive to compete for the prize at all.[142] The firm could compensate for the smaller chance of winning by promising a larger prize, but then the firm has a greater incentive to cheat the internal candidate and avoid the increased payout, and the internal contestants could be induced to sabotage one another.[143] In short, while balancing these countervailing concerns makes setting optimal pay contracts tricky, tournament theory suggests that the goal is to set pay at a high enough level, and to limit the field to internal candidates in order to provide a credible commitment that will incentivize the firm's workers to compete.

Handicapping the external candidates solves this problem by setting the boundaries of competition and limiting the field to a known pool of competitors. What is more, workers can observe their employer's commitment over time to pay reward the winners of the internal tournament, with promotion being based on relative internal stature,[144] as opposed to absolute, objective measures of performance that would obtain in a free market where they would be judged against external candidates. And from the employees' perspective, each can assess her own merits, as compared to that of her competition within the firm, free from the fear that an unknown outsider will not surprise her by claiming the prize at the end of her labors.

In less formalistic terms, tournaments "provide an incentive for insiders to work hard."[145] Anup Agrawal, Charles R. Knoeber, and Theofanis Tsoulouhas argue that boards handicap outsiders—that is, choose them only if "markedly better than the best insider"—in order to bolster the incentive of internal candidates to compete.[146] The CEO position is a prize—indeed, the ultimate prize in terms of the corporate employment hierarchy.[147] Because a corporation gains by fostering competition and hard work by its executives at all levels, it gains by strengthening the link between hard work and ultimate success.[148] But because adding more contestants to the mix decreases the likelihood of an internal candidate's success, it weakens his incentive to work. Favoring internal candidates (or handicapping external candidates, however one phrases it) creates the optimal incentive structure.[149] Less formal economic models also support the general implication of the tournament theory, which is that firms may favor an internal candidate, independent of the candidate's intrinsic merit or knowledge (firm-specific capital theory) or the board's knowledge of the candidate (information asymmetry theory), but because of secondary

142. Chan, *supra* note 66, at 556.

143. *Id.* at 556–57.

144. *Id.* at 557.

145. Agrawal et al., *supra* note 18 (citing Chan, *supra* note 66; Rosen, *supra* note 138; Lazear & Rosen, *supra* note 24).

146. *Id.* at 619 ("Handicapping implies . . . that a firm will be more likely to choose an insider to succeed to the CEO position where insiders are more comparable to each other, where outsiders are less comparable to insiders, and where there are more inside candidates.").

147. *Id.* at 620.

148. *Id.*

149. *See id.* at 624 ("[F]irms will optimally impose a bigger handicap on outsiders making it more likely that an insider will be selected.").

positive outcomes associated with favoring insiders. For example, Beni Lauterbach, Joseph Vu, and Jacob Weisberg argue that "[i]nternal successions . . . promote loyalty. Employees feel more committed when upward mobility to the top rank is afforded."[150]

Iman Anabtawi points out that the tournament theory offers one explanation of the "pay without performance" that Bebchuk and Fried criticize.[151] If CEO pay is a prize to induce competition in the lower ranks, then we should be unsurprised that CEO pay does not reflect an individual CEO's performance.[152] Under this view, the point of high executive pay is not to compensate a particular CEO, but rather to motivate future CEOs within the firm.[153] Professor Anabtawi is correct—tournament theory could explain high CEO pay—but only if tournament theory actually explains why firms favor internal candidates for promotion.[154] If a candidate's firm-specific capital or the board's information asymmetry explains the bias for internals, then high CEO pay may instead reflect undue managerial power over the board. The implication of tournament theory is that what matters is not the quality of the internal candidate herself, but the effect of the choice to source from within the firm.

If tournament theory is right in its predictions, then there should not be much of an external market for managers because of the effects of external hires on the firm as a whole. Under tournament theory, the decision to hire an external CEO is a signal of a radical lack of confidence in the organizational pipeline, a slap in the face of would-be heirs apparent. The internal costs of such a move are potentially high in terms of morale and motivation. Before exploring the question of the root cause for the insider preference, however, we should turn briefly to one final explanation for choice of leadership—one that denies that it matters at all.

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150. Lauterbach et al., *supra* note 79, at 1485–86.

151. Anabtawi, *supra* note 23, at 1558.

152. *Id.* at 1560.

153. *Id.*

154. Some scholars of CEO succession theory have posited variants of tournament theory. One such variant is the power circulation theory of control, which views the firm as a battlefield on which different corporate factions struggle for control. Following this view, Shen and Cannella subclassified internal successors into *contenders* and *followers*. *Contenders* are internal candidates following a forced CEO departure, and "reflect[ ] a successful internal power contest against the CEO [where] the successor . . . has won the support and approval of the board of directors." Shen & Cannella Jr., *supra* note 69, at 719. Thus, they begin the job with a mandate for change, just as an outside candidate theoretically does. *Id.* Followers, in contrast, are internal successors that follow a CEO's ordinary retirement, rather than unplanned firing. *Id.* They inherit the mantle of their predecessor and are expected to maintain continuity with the prior regime. *Id.* Shen and Cannella distinguish between contenders and followers in order to evaluate more carefully the performance outcomes of different kinds of CEOs. For our purposes, the distinctional question of whether the tournament theory, firm-specific capital, or information asymmetry explains favoring internal candidates does not matter. Whether anointing an internal successor rewards a contest of pure merit or a successful internal faction, a tournament incentivizes the lower ranks to continue to strive within the firm. Similarly, some studies have focused on "heirs apparent"—insiders formally or informally designated as the organization's choice for future CEO. *See* Albert A. Cannella Jr. & Wei Shen, *So Close and Yet So Far: Promotion versus Exit for CEO Heirs Apparent*, 44 ACAD. MGMT. J. 252, 252 (2001). These studies note the common practice of CEOs and boards identifying internal successors "well in advance" of a transition, and using the intervening time to "groom" them to eventually take over as CEO. *Id*. While this practice may be common, it also does not undermine the "tournament" theory—internal candidates still compete to be crowned heir apparent. William Ocasio, *Institutionalized Action and Corporate Governance: The Reliance on Rules of CEO Succession*, 44 ADMIN. SCI. Q. 384, 390 (1999).

E. Irrelevance of Leadership Theories

Before turning to the question of testing the three main theories, there remains one category to discuss: two versions of the idea that the provenance of a firm's management does not matter at all. First, the scapegoat hypothesis holds that managers are of equal quality.[155] If a firm's performance is poor, it is the product of bad luck, not bad management.[156] But in order to motivate managers to work hard at their job, they must be threatened with replacement for poor performance.[157] Thus, "[b]oards of directors understand that all managers are alike, but must fire managers of poorly performing firms to induce other managers to provide the desired level of effort."[158] Thus, one should not categorize managers on the basis of internal or external origin—these characteristics simply do not matter.

Coming from a different perspective, match theory starts with the idea that "there are no good workers or good employers; there are only good matches."[159] Depending on relative fit, a worker might be more or less productive in a given job.[160] For example, a CEO known as a "turn-around specialist" might be well suited for a failing firm, but not for one that is on financially firm footing.[161]

These theories are fascinating insights into the many puzzles succession affords, and the disparate ways to observe them. Ultimately, however, they matter little for the focus of this Article, which remains why for-profit firms favor internal candidates. If, as job-match theory and scapegoating theory in divergent ways suggest, one manager is not inherently better than the other, the question remains: why favor internal candidates?

The data on performance of external leaders relative to internal ones are inconclusive. All that seems clear is that internal candidates dominate the field, at least in for-profit corporations. Having eliminated the performance explanation, three competing theories explain why firms would favor current employees over external ones: (1) the internal candidates possess firm-specific capital; (2) the board faces fewer informational asymmetries when evaluating internal candidates; and (3) that handicapping external candidates fosters a firm-wide tournament that ensures hard work and competition in the lower ranks. Each theory could adequately explain the internal premium/external discount.[162] An unexplored area exists for testing one of these theories: the case of leadership in higher education.

IV. THE LACK OF A TOURNAMENT IN ACADEMIA

Academia offers a novel setting in which to test the question of leadership source because it enables us to eliminate the tournament variable. Specifically, take the case of the university president. The firm-specific capital and information asymmetry explanations still hold true, but universities lack the tournament model of for-profit corporations. After

155. Huson et al., *supra* note 16, at 241.

156. *Id.* at 242.

157. *See id.* ("Managers dislike effort so they must be threatened with dismissal if performance is low.").

158. *Id.*

159. Sam Allgood & Kathleen A. Farrell, *The Match between CEO and Firm*, 76 J. BUS. 317, 318 (2003).

160. *Id.* at 320.

161. *Id.*

162. *See* Furtado & Rozeff, *supra* note 17, at 152 (describing these three theories as distinct disadvantages external candidates face).

discussing the first two points briefly, the balance of this Part will establish the crucial contention: the absence of a tournament for leadership in higher education.

First, firm-specific capital is an explanation equally applicable at any firm, be it nonprofit or for-profit. Every employee develops specific knowledge about the people, procedures, and networks of the organization in which she works. While both external and internal candidates must learn the particular requirements of a new position, firm-specific capital enables an insider to "hit the ground running" as compared to external competitors. This explanation applies to university presidents just as much as to for-profit CEOs.

Second, information asymmetry works in much the same way in a university as in a publicly traded for-profit corporation. In each case a part-time board selects the new leader, and in each case the board has more data points about an internal candidate than an external one. Boards have had the chance to interact with internal contenders on multiple occasions, likely over a period of years. They have access to others who have worked with the candidates, as well, and can easily obtain first-hand reports as to others' view of them. In contrast, the board's knowledge of an external candidate is much more circumscribed, the product of relatively few interviews or conversations. While board members can investigate the reputation, decision-making, and quality of outsiders, they are necessarily limited in their "due diligence" efforts. If, as is often the case, external candidates demand confidential consideration so as not to jeopardize their current employment position, then the board's powers of investigation are even more limited. Thus, information asymmetry exists at the university leadership level.

Tournaments are a different story. The remainder of this Part will argue what every single academic with whom the author has raised the question has agreed to on the spot: there is no leadership tournament in academia. No tournament exists because one does not become an academic in order to become a university president, but instead to become a scholar.

Faculty members arrive at universities focused on achieving tenure status. The promotion process emphasizes teaching, scholarship, and service responsibilities,[163] rather than on leadership interest or potential. There is hard work and competition, to be sure—indeed, one could characterize striving for tenure as a tournament in its own right. Certainly the quest for tenure shares some features of the classic Lazear and Rosen model—namely a competition in which relative ability is hard to discern directly.[164]

After triumphing in the tenure tournament, however, academics enjoy a rarefied existence: once tenured, they have jobs that provide prestige, security, and autonomy. Tenure can generally only be revoked in egregious circumstances, and revocation is a long and procedurally complex process. Academics work independently, outside of a fixed schedule.[165] Many became professors because they sought a life of "autonomy and independence."[166] The life of an academic administrator is quite different. Academic leadership, like for-profit leadership, entails subjecting oneself to "public scrutiny, critique,

163. Strathe & Wilson, *supra* note 31, at 7.

164. *See* Lazear & Rosen, *supra* note 24; Richard B. McKenzie, *In Defense of Academic Tenure*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 325, 337 (1996) ("[P]rofessors' relative abilities are difficult to observe directly . . . .").

165. Strathe & Wilson, *supra* note 31.

166. Walter H. Gmelch, *The Department Chair's Balancing Acts*, *in* THE LIFE CYCLE OF A DEPARTMENT CHAIR: NEW DIRECTIONS FOR HIGHER EDUCATION 69, 70 (Walter H. Gmelch & John H. Schuh eds., 2004).

comment, and review."[167] Indeed, the academic who moves into an administrative role is sometimes referred to as having "gone over to the dark side."[168] It is no wonder, then, that "few newly minted Ph.D.s set academic administration as a career aspiration."[169]

Often even faculty members who serve as department head do so out of a sense of obligation, rather than affirmative choice,[170] and often "[return] (relieved and often disillusioned) to their tenured professorial role."[171] Academic administration replaces many of the benefits of the academic life with more mundane bureaucratic burdens:

> While academic administrators may have some independent tasks, those responsibilities reflect a shared mission or vision for the unit. There is limited individual work time, with much of the work being collaborative, consensual, and cooperative rather than independent. The academic administrator has personnel and fiscal responsibilities that differ from those of a faculty member, and time is much more scheduled, often by others. The time commitment to being present in the work environment is much greater . . . Uninterrupted time is rare, and the amount of time an administrator can commit to any single issue is often very limited.[172]

If a person's "fundamental calling" is that of researcher, scholar, and teacher, then the "all-consuming" demands of administrative life will simply not be attractive.[173] While compensating benefits include higher pay, more travel, and increased support,[174] "increasing numbers are unwilling to take their turn, and too few are eager to volunteer for administrative roles."[175] Apparently "the power, prestige and increased income that often accompany managerial roles are not worth the trade-offs."[176] Deans, in particular, face pressure from central university officials to serve university-wide goals, while simultaneously representing the interests of their own faculty, "resulting in administrators 'swiveling between their faculty colleagues and university administration [sic]' as they try to balance these roles."[177] In short, "college professors on average are not likely to seek a

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167. *Id.*

168. Robert F. Bruner, *The 3 Qualities that Make a Good Dean*, CHRON. HIGHER EDUC. (Jan. 15, 2017), http://www.chronicle.com/article/The-3-Qualities-That-Make-a/238883; *see also* Becker, *supra* note 32 (describing her time as an administrator as being on the "dark side"); Deborah DeZure et al., *Cultivating the Next Generation of Academic Leaders*, 46 CHANGE 6, 10 (2014) ("All but one [participant in the study] indicated that the phrase is widely used by their faculty colleagues . . . .").

169. Strathe & Wilson, *supra* note 31, at 5.

170. *See id.* ("[F]aculty members frequently did not choose to enter academic administration; rather, it was their turn . . .").

171. Sherry L. Hoppe, *Identifying and Nurturing Potential Academic Leaders*, *in* IDENTIFYING AND PREPARING ACADEMIC LEADERS: NEW DIRECTIONS FOR HIGHER EDUCATION 3, 3 (Sherry L. Hoppe & Bruce W. Speck eds., 2003).

172. Strathe & Wilson, *supra* note 31, at 10.

173. James B. Carroll & Mimi Wolverton, *Who Becomes a Chair?*, *in* THE LIFE CYCLE OF A DEPARTMENT CHAIR: NEW DIRECTIONS FOR HIGHER EDUCATION 3, 8 (Walter H. Gmelch & John H. Schuh eds., 2004).

174. Strathe & Wilson, *supra* note 31, at 10.

175. Hoppe, *supra* note 171.

176. *Id.* (quoting Thomas H. Davenport, *Knowledge Work and the Future of Management*, *in* THE FUTURE OF LEADERSHIP: TODAY'S TOP LEADERSHIP THINKERS SPEAK TO TOMORROW'S LEADERS 41, 57 (Warren Bennis et al. eds., 2001)).

177. Margaret H. DeFleur et al., *The Masters: Creating a New Generation of Leaders for Mass Communication Education and Beyond*, 59 COMM. EDUC. 19, 21 (2010) (quoting Walter H. Gmelch, *Leadership Succession: How New Deans Take Charge and Learn the Job*, 7 J. LEADERSHIP & ORG. STUD. 69 (2000)).

job outside of the academia or to be willing and able to switch to performing administrative functions."[178] Researchers emphasizing the importance of succession planning within universities acknowledge "a significant challenge within academia is . . . faculty members' lack of interest in moving into administrative positions."[179]

One study of a "large public land-grant research university" involved interviewing university administrators and faculty interested in leadership.[180] It found that faculty resist a move into administration because "it takes faculty from the things they most love about academic life: research, teaching, and students."[181] Concerns about "demands on time, loss of control of time, and the 'grinding amount of work'" were also expressed.[182] With new administrative duties came the "awkward and difficult" task of supervising and evaluating their erstwhile peers.[183] Coupled with these was the perception that their work as administrators would not be appreciated.[184] This lack of interest in administration on the part of the university rank and file means that the bulk of tenured faculty are not interested in the lower level administrative jobs that would enter them in the ranks of academic leadership. Lack of interest in these positions means that relatively few qualified candidates progress from department head to associate dean, dean, vice president, and provost, thus positioning them to compete for the ultimate goal of the top institutional position, university president.

Another related aspect of academic leadership distinguishes it from the CEO tournament: it does not presume or encourage ascending the leadership chain. Most universities do not have robust systems for hiring, training, and promoting leaders, or for succession planning.[185] Academic success often requires specialization, but academic leaders, like all leaders, must be generalists.[186] Academia can be downright "suspicious" of faculty who evince an interest in administration.[187] Their fellow faculty members will presume academic leaders have "given up on their intellectual aspirations."[188]

Far from being a tournament, the data show that, even after ascending the hierarchy to be the university's chief academic officer (CAO)—often termed the provost—frequently does not naturally feed into the presidency at that particular school, much less any other. While a CAO role is the most common launching pad for a presidency, only 34% of presidents were CAOs immediately prior to taking their positions.[189] Just one-fifth of chief

178. Olga V. Sorokina, *Executive Compensation: The Case of Liberal Arts College Presidents*, 12 ISSUES IN POL. ECON. (2003), http://org.elon.edu/ipe/Sorokina%20FINAL.pdf.

179. Klein & Salk, *supra* note 71, at 337.

180. DeZure et al., *supra* note 168, at 7.

181. *Id.*

182. *Id.* at 8.

183. *Id.*

184. *Id.* at 10.

185. *See* Gmelch, *supra* note 166, at 71 (noting that "most institutions of higher education have inadequate hiring, training, promotional, and succession planning systems"); Klein & Salk, *supra* note 71, at 336 (calling presidential succession planning "nonexistent").

186. *See* Gmelch, *supra* note 166, at 70 ("We promulgate the same in higher education, socializing and rewarding new Ph.D.s to become internationally renowned experts in narrow fields and then complain that no one is willing or prepared to be a generalist and serve in a leadership capacity.").

187. Dennis M. Barden & Janel Curry, *Faculty Members Can Lead, but Will They?*, CHRON. HIGHER EDUC. (Apr. 8, 2013), http://www.chronicle.com/article/Faculty-Members-Can-Lead-but/138343/.

188. *Id.*

189. *Leading Demographic Portrait of College Presidents Reveals Ongoing Challenges in Diversity, Aging*,

academic officers ascend to a presidency.[190] A survey found that "two-thirds of CAOs consider the work of the president unappealing, and many consider it too time consuming and too visible."[191]

Having identified the dearth of external CEOs, three possible explanations, and the lack of a tournament in the academic section, the next section moves to the data. I begin with a description of the process of selecting a university president.

A. Selection Process: President

The job of university president is a challenging one. Cohen and Marsh describe it as "part arbitrator, part bureaucrat, part manager, part administrator, part fund-raiser, part coach, part faculty scourge, part politician."[192] As we have seen above, for-profit boards generally have a succession plan in place. Selection of the next CEO is thus a matter of promoting the heir apparent to the leadership role. The selection of a university president is a different process entirely.

Traditionally the process for hiring a university president begins with the current president announcing plans for departure. If the departure is abrupt, the board will generally select an interim president. Traditionally, the next step is an open national search.[193] Boards will often appoint a search committee.[194] The search committee will attempt to recruit the best possible candidates to its search pool. To aid in this effort, the search committee will "almost universally" hire a search firm.[195]

After an open nomination process, the search firm will cull from the nominees to come up with a "short list" of candidates, usually about twelve to fifteen.[196] After reference checks and other "due diligence,"[197] a subset of these candidates will conduct "airport interviews," so named because, for confidentiality and convenience reasons, they are generally conducted at a hotel close to an airport.[198] Following these relatively brief interviews, the search committee will narrow the field to three to four finalists who will

AM. COUNCIL ON EDUC. (Mar. 12, 2012), http://www.acenet.edu/news-room/Pages/ACPS-Release-2012.aspx; *see also* Wei Song & Harold V. Hartley III, *A Study of Presidents of Independent Colleges and Universities*, COUNCIL OF INDEP. CS., (2012), http://files.eric.ed.gov/fulltext/ED533603.pdf (noting that fewer than 24% of surveyed CAOs planned to seek a presidency, and 29% entered their presidencies from the CAO position.).

190. Rita Bornstein, *Succession Planning: The Time Has Come*, TRUSTEESHIP MAG., Sept.–Oct. 2010, at 28, 30.

191. *Id.* Another study specifically found that women CAOs do not seek to be presidents, for "three major reasons": "the belief that the presidency would distance them from 'the academic heart' of the institution, they do not want to engage in the fund raising and socializing required of a president, and they want more balance in their lives than the all-consuming presidential schedule allows." *Id.* (citing a study by Diane Dean).

192. TICHY, *supra* note 73, at 275.

193. Klein & Salk, *supra* note 71, at 338.

194. Sometimes collective bargaining agreements determine the selection of the search chair or committee members; other times "tradition and community expectations" shape these choices. Jamie Ferrare & Theodore Marchese, *Increasing the Odds for Successful Presidential Searches*, TRUSTEESHIP MAG. (Sept./Oct. 2010), https://www.agbsearch.com/resources/increasing-odds-successful-presidential-searches.

195. *Id.*

196. *Id.*

197. *Id.*

198. David Williamson, *Whiffing the Airport Interview*, CHRON. HIGHER EDUC. (May 27, 2008), http://www.chronicle.com/article/Whiffing-the-Airport-Interview/45824. Because candidates are often sitting provosts or presidents who may not want to reveal to their current employers that they interviewing for another post, confidentiality is a key concern.

visit campus for a full day or more of interviews, meetings, campus tours, and often some type of open campus forum.[199] The search committee then invites and receives feedback from the university community on each of the finalists. It prepares a final report with recommendations, and then meets with the board to discuss their findings. The board then decides on a candidate and a subset of the board will negotiate a contract and prepare the public announcement.[200]

Note, too, that public university presidents, in particular, may be different from private university presidents. A number of studies either explicitly or implicitly presume as much. Specifically, most of the university president compensation studies focus on private, rather than public institutions.[201] As Brian Galle and David Walker observe, in private universities the "chain of command" ends with the board of trustees, which is "self-replicating and/or include members elected by alumni."[202] In contrast, public university trustees are chosen by political actors, such as state governors.[203] What is more, many public state universities are organized into a state system, with the system head serving as the senior-most executive.[204] Galle and Walker conclude that the president of a public university is a fundamentally different animal from that of a private university: "At bottom, a public university president is a government official, not an autonomous head of an independent institution."[205] The data analysis section, mindful of this distinction, will explore any differences in leadership choices at public versus private institutions.

B. Literature

Prior literature on academic leadership, much like legal scholarship, has centered on compensation. One study found that the presidents of a group of 387 selective private colleges and universities saw compensation increase by 50% in real terms between 1997 and 2007.[206]

Ronald G. Ehrenberg et al. conducted the first major study of presidential pay in 2001, looking at the Form 990s that over 400 private colleges and universities filed with the IRS, and found that "[t]he typical president in [their] sample began his or her presidency at age 48 and had been in the position for over eight years. . . . About 18% of the presidents were women, but the percentage of women presidents at research and doctoral institutions was only 8%."[207] They found only weak evidence to support the hypothesis that university

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199. Ferrare & Marchese, *supra* note 194. While open visits are more common, some institutions have a more confidential final interview, where they meet with a limited group of stakeholders off campus and under a more confidential setting. *Id.*

200. *Id.*

201. *See, e.g.*, Ronald G. Ehrenberg et al., *Paying Our Presidents: What Do Trustees Value?*, 25 REV. HIGHER EDUC. 15 (2001); Ying Sophie Huang & Carl R. Chen, *Are College Chief Executives Paid Like Corporate CEOs or Bureaucrats?*, 45 APPLIED ECON. 3035 (2013); Sorokina, *supra* note 178. Galle and Walker justify this focus because, in part, compensation of a public university president may be capped under as a matter of state law, or in practice "may be limited by the realities of state budgeting processes." Brian Galle & David I. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities*, 94 B.U. L. REV. 1881, 1903 (2014).

202. Galle & Walker, *supra* note 201, at 1903.

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* at 1883.

207. Ehrenberg et al., *supra* note 201, at 24.

president compensation is related to their institutions' performance.[208] Wei Song and Harold Hartley conducted a study of general characteristics of university presidents, based on the American Council on Education's American College President Study, a survey of more than 1,600 college and university presidents nationwide. [209] They found in 2006 that the mean age of college presidents in the data set was about 57 years, with 23% being women.[210] Their average job tenure was 7.7 years.[211] One-third were promoted from within the same institution, two-thirds came from different institutions.[212]

V. THE DATA

This Article's dataset is universities ranked in the top 50 by U.S. News & World Report for at least seven years from the period from 1995–2016. An initial challenge was identifying university presidents[213] and categorizing them as external or internal. There is no central repository listing academic leadership, but most school websites identify their previous presidents. For those schools that did not list prior presidents on their website, I identified the current president and performed a series of internet searches to determine the progression for such schools. I then used the school's website or other related sources, such as press releases, faculty biographies, newspaper articles, or—in some cases—obituaries, to identify and document each president's name, the year and month that he or she began serving as president, whether the president was hired internally or externally, and the date month of the president's leaving office. Note that leaders hired from an outside institution are classified as *external* and those hired from within the school are *internal*. While it is true that a recent hire may in certain lights be considered "external" to the institution, delineating the time when an external hire became "internal" seemed a subjective undertaking. Thus, a president who was hired from within the school is marked as internal, regardless of the brevity of that president's prior tenure at the school.

A. Descriptive Statistics

As discussed, the Article's dataset covers universities ranked in the top 50 by U.S. News & World Report for at least seven years from 1995–2016. This amounts to only 57 different institutions, and thus 1197 (57 times 21) possible points at which a transition could occur. In the great majority of cases, there is no change.

The sample covered 108 permanent presidents at these 57 institutions who were hired between 1996–2016 (133 if one counts interims), of whom 22 were women (27 counting interims), and 86 were male (106 counting interims). Women made up 20.4% of the sample. The sample covered 51 universities, of which 18 were public and 33 were private.

208. *Id.* at 34.
209. Song & Hartley III, *supra* note 189, at ii.
210. *Id.* at 5, 6.
211. *Id.* at 9.
212. *Id.* at 25.
213. Since U.S. News began ranking schools, it has separated universities from colleges. In its words, "[t]he universities offer a full range of undergraduate majors, as well as master's and doctoral degrees; many strongly emphasize research." Robert Morse et al., *Best Colleges Ranking Category Definitions*, U.S. NEWS & WORLD REP. (Sept. 11, 2017, 10:00 PM), http://www.usnews.com/education/best-colleges/articles/ranking-category-definitions. They are defined by the Carnegie classification as Doctoral Universities (highest research activity), Research Universities (higher research activity), and Doctoral Universities (moderate research activity). *Id.*

Of those 33 private institutions, four were religious.

B. Methodology

The first hypothesis asks the perennial question: Do internal presidents perform better than external ones? To measure performance, I used the U.S. News and World Report Ranking. The benefit of this approach is that U.S. News evaluates a number of factors, including strength of entering class, student: faculty ratio, and post-graduate employment. Moreover, U.S. News applies its formula consistently to each ranked institution each year. In other words, while its methodology may change from year to year, it applies any changes uniformly to every institution.

The drawback of this approach is the U.S. News ranking system is widely criticized as being fundamentally flawed.[214] By selecting this measure of success, I offer no defense or endorsement of the U.S. News rankings themselves. But their dominance means that, increasingly and for better or worse, they are a popular measure of academic leadership success.[215]

1. Hypothesis One

One challenge the data present is that because U.S. News did not initially rank below the top 50 universities, early in the sample period there are some "non-ranked" (NR) values. In calculating performance, I assume these NR-institutes would be ranked below the lowest-ranked-institute. Suppose that I observe the lower sorted ranks within a year as: 49, 50, NR, NR, NR, so that there are three NR-institutions. In this case, I assume that the 3 missing institutions would have received the ranks 51, 52, and 53, but since I have no information on which of the 3 is better than the others, each of the three 'NR' will be imputed as the average, 52.

A second challenge is that in many years the U.S. News ranks two or more institutions as tied. (e.g., 1, 2, 2, 4, 5, 6). Since the two schools which US news considered 'tied for second' really share the second and third spot, our corrected ranks for these 6 would be: 1, 2.5, 2.5, 4, 5, 6.

Third, the U.S. News ranking masks a key problem: not all changes in ranking are equal. A ranking drop from number 1 to number 2, for example, is far more substantial than a drop from 32 to 33. I use a Blum transformation to weight U.S. News rankings to reflect this reality.[216]

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214. *See, e.g.*, Malcolm Gladwell, *The Order of Things: What College Rankings Really Tell Us*, THE NEW YORKER (Feb. 14, 2011), http://www.newyorker.com/magazine/2011/02/14/the-order-of-things ("[T]he *U.S. News* algorithm relies . . . on proxies for quality—and the proxies for educational quality turn out to be flimsy at best."); John Tierney, *Your Annual Reminder to Ignore the U.S. News & World Report College Rankings*, THE ATLANTIC (Sept. 10, 2013), https://www.theatlantic.com/education/archive/2013/09/your-annual-reminder-to-ignore-the-em-us-news-world-report-em-college-rankings/279103/ ("Using the *U.S. News* rankings for any more exacting purpose [than a rough guide to American higher education] is about as good for you as eating potato chips and Gummy Bears for dinner. With maple syrup.").

215. *U.S. News Breaks Online Traffic Record*, U.S. NEWS (Sept. 12, 2013), https://www.usnews.com/info/blogs/press-room/2013/09/12/us-news-breaks-online-traffic-record.

216. A Blum transformation is a simple generalization to replace ranks by Z-scores in some way such that the ranks are replaced by expected Z-scores of items ranked 1, 2, . . . , n from a normally distributed population. We use an n=100 in this case, since we believe that the rankings covered the top half of Law Schools or

Finally, a key challenge on measuring the impact of new presidential leadership is the fact that the president inherits an institution shaped by her predecessor. In order to measure the impact of leadership change, analysis must discount the early years of a president's tenure.

The most common status, coded as '0' in the data-set, was no change—the current leader was the same as in the previous academic year. Status '1' indicates that an interim leader had been selected, and this status of '1' would continue until either the interim leader became a permanent leader or was replaced by another permanent leader. The status '2' represents the first year of a permanent internal-to-the-institution leader, while status '3' represents the first year of a permanent external-to-the-institution leader.

For example, one pattern of interest would be (0, 3, 0, 0, 0), representing the situation where there is a permanent President in Year 0, followed by an External President in Year 1, with him/her remaining in the position for the next 3 years, i.e., Year 2, Year 3, and Year 4. The weighted Z-score change scheme is shown below.

Table 1: University Leadership Change Pattern: From Permanent to External President

Year	Year 0	Year 1	Year 2	Year 3	Year 4
Pattern	0	3	0	0	0
Rank	Rank 0	Rank 1	Rank 2	Rank 3	Rank4
Z-score	Z0	Z1	Z2	Z3	Z4

Year 0 is the year prior to a new president's ascension to the presidency, and it sets the baseline. I weight the first year of the presidency 10%, the second year 20%, the third year 30%, and the fourth year at 40%. Generally, the four year weighted Z-score change for Universities is calculated as: UnivChange = (0.1 * Z1 + 0.2 * Z2 + 0.3 * Z3 + 0.4 * Z4) – Z0.

Below, I report the seven most interesting patterns, as well as their frequency, mean, and standard deviation. In the coding below, Blue represents the weighted four-year Z-score change when there is no leadership change, Green represents the weighted four-year Z-score change when an Internal President follows either a permanent or interim President, and Red represents the weighted four-year Z-score change when an external President follows either a permanent or interim President.

Universities. Then we use the Blum approximation Phi(Z) = (n-r+0.625)/(n+0.25), for rank r={1, 2, . . . n} to estimate the Z's before calculating differences, where Phi() represents the cumulative distribution function of the standard normal. For example, if one uses n=100, the difference in Z-scores for the 1st and 2nd ranked schools would be 0.361, whereas it would be only .025 for the difference between the 50th and 51st schools.

Table 2: University Leadership and Performance

	n	Mean	Standard Deviation
No leadership change	483	0.005	0.124
New internal	9	-0.019	0.095
Internal following interim	8	0.018	0.105
New external	28	0.056	0.205
External following interim	27	0.022	0.087

The average weighted four-year Z-score change when there was no Presidential change was very close to zero (+0.005), and no group's mean change is significantly different from zero. In other words, there is no statistically significant difference between the performance of internal or external candidates. Total changes are only 72 because the analysis requires four consecutive years of service, preceded by a baseline year, and some instances did not fit—for example, a president did not complete four years or began his term in 2015, at the tail end of the sample period.

2. Hypothesis Two

The literature poses three dominant explanations for favoring internal candidates: firm-specific capital, information asymmetry, and tournament theory. Academia, because of the lack of a tournament, offers the ability to test the relative explanatory power of tournament theory vis-a-vis the other two explanations. If the chief reason for favoring internal candidates is firm-specific capital or information asymmetry, then university trustees will favor internal candidates. The percentage of external CEOs in for-profit corporations centers around 22%. The hypothesis is that, because of the lack of a tournament, external candidates will make up more than 22% of university presidents.

There are several different change patterns in the data set. Ultimately, I created a collapsed version of this variable, called Ultimate Change Type, with levels of Ultimate External (Categories 1 and 3) and Ultimate Internal (Categories 2, 4, and 5).

Table 3: Change Categorization

1=External	2=Internal	3=Interim/ External	4=Interim/ Self	5=Interim/ Internal	Total
62	21	20	3	2	108

There are 133 leadership changes in the sample, and 108 permanent changes. In some cases, an external candidate is selected to begin a term as soon as the current president steps down—classified as a Category 1 change, which occurred 62 times. A Category 2 change is when an internal candidate similarly immediately succeeds the past president (21). When the university interposes an interim candidate before finalizing a successor,

Categories 3 (external, 20) and 5 (internal, 2) apply. Category 4 describes when the interim president is ultimately selected as the permanent president, which occurred 3 times.

Concatenating the five levels above into two, internal presidents constituted 26 presidents during the period, and external presidents constituted 82. External candidates comprise 76% of successful university presidents, and internal presidents 24%. Thus, while for-profit corporations exhibit a bias in favor of internal candidates, top universities exhibit an almost mirror-image bias in favor of external candidates, offering support of the tournament theory in public for profit corporations. The results suggest that tournament theory explains at least part of the bias in favor of internal CEOs.

The literature has discussed this preference for external candidates for the position of university president, but has often conflated process (an outside search) with outcome (selecting an external candidate as president). For example, Lapovsky, as described by Klein and Salk, offers five explanations for why academia favors "outside searches": "(a) multiple stakeholders with dissimilar objectives; (b) the need to mirror faculty search processes; (c) perception that internal candidates may not be able, or hesitant, to make necessary changes; (d) boards' perception of insider loyalty and inability to make personnel decisions; and (e) prestige awarded to the institution for bringing in someone from the outside."[217]

But, the very term "outside search" makes an assumption. A national search does not preordain an outside university president. What separates university president selection from CEO succession planning is the very fact of a formal, openly acknowledged search. Indeed, succession planning is a rare occurrence in academia. Klein and Salk, interviewing presidents, board chairs, and search firms that work with 20 private higher education institutions in Wisconsin, found that succession planning "goes against the beliefs and traditions of the academy."[218] Because of a culture of collaboration and shared governance, no successor can be preselected.[219]

Again, an outside search is not synonymous with an internal hire—internal candidates can, and do, participate in a national search process, and sometimes are selected as president. Indeed, Klein and Salk found in their sample a willingness to consider internal candidates, as long as they competed with external candidates in a national search.[220] In an interesting rejection of the information asymmetry argument, they noted that internal candidates might be handicapped in the process precisely *because* they are better known than external candidates: "internal candidates' weaknesses are already known . . . they have baggage, and because of this, oftentimes the bar is set higher for that candidate."[221] Familiarity may not exactly breed contempt, but it "works against internal candidates, who might be too well known by their peers to be viewed as charismatic or visionary."[222] External candidates are seen as having new energy and charisma. They are perceived to be "wonderful" even before anything is known about them.[223] One board chair stated, "I could

217. Klein & Salk, *supra* note 71, at 338; *see also* Bornstein, *supra* note 190, at 29 (describing a "long-held bias against hiring from within").

218. Klein & Salk, *supra* note 71, at 339.

219. *Id.*

220. *Id.* at 341.

221. *Id.*

222. Bornstein, *supra* note 190, at 31.

223. Klein & Salk, *supra* note 71, at 341.

see the sparkly eyed reactions to some of the external candidates."[224]

Tellingly, one major reason Klein & Salk cite is faculty's lack of interest in administration—coupled, most notably, with a lack of interest on the part of chief academic officers—i.e., provosts—in the presidency.[225] This reason only buttresses this Article's contention that academic leadership does not follow the tournament model.

3. Hypothesis Three

However, the governance structure of a public university introduces two additional layers of complexity. The first problem is a political one. As discussed above in Part IV, public university trustees are chosen by political actors, such as state governors.[226] Thus, their choices for university president may be influenced by political motives wholly apart from selecting the optimal candidate for president. If the university presidency is part of a larger political bargain, I would predict that more internal presidents in these university system schools. External candidates, likely coming from out of state, would have relatively less in-state political capital than outsiders.

Table 4 presents the ultimate external and internal candidates, disaggregating public and private institutions.

Table 4: Private vs. Public Institutions

	Private	Public	Total
Ultimate External	46	36	82
Ultimate Internal	14	12	26
Total	60	48	108

The Pearson X2 = 0.0405, which, with df = 1, yields a P-value of 0.8405, which is not significant at all, indicating that I cannot conclude that the ultimate change type (external or internal) and the University type (private or public) are dependent. That is, the ultimate-external-change and ultimate-internal-change universities are about equally likely (56% and 54%, respectively) to be private.

4. Hypothesis Four

A subset of the public university sample presents a second problem. Of the eighteen public universities in the sample, fourteen are part of a state "system" of universities overseen by a single governing body.[227] This governing body selects the president of each

224. *Id.*; *see also* Bornstein, *supra* note 190, at 30 ("Internal candidates have the advantages of being well known and of understanding the culture of the institution. However, qualified internal candidates often are overlooked because institutions seek to appoint presidential candidates from other institutions to provide 'a fresh vision.'").

225. Klein & Salk, *supra* note 71, at 343 ("[L]ess than one third of chief academic officers are even interested in the role of president.").

226. *See supra* Part IV.A.

227. The state system schools in the sample include the UC schools Berkeley, Irvine, San Diego, California Institute of Technology, Davis, Santa Barbara, and UCLA (University of California System, consisting of a total

university within the state. Thus, for example, the Board of Regents of the University of California oversees nine institutions within the University of California System ("UC System"). The President of the UC System selects a proposed candidate, which she submits to the Board of Regents for approval. Similarly, the Board of Regents oversees twenty-eight institutions within the University System of Georgia. However, the Board of Regents of the University System of Georgia directly selects a university president, rather than having the Chancellor offer one for Board of Regents approval.

Whether by way of direct selection or by affirming the prior selection of the system head, however, the Board of Regents stands once removed from a single-college Board of Trustees. Their attention will be less focused, and there will be more information asymmetry. The firm-specific capital theory will still hold true, however: internal candidates will still have university-specific information, connections, and network that should give them the edge over external candidates. So if information asymmetry (as opposed to firm-specific capital) explains the favoring of internal candidates, then there will be fewer internals at system schools (because they are less well known by the Board of Regents).

Table 5: Sole vs. System Universities

	Sole	System	Total
Ultimate External	54	28	82
Ultimate Internal	16	10	26
Total	70	38	108

The Chi-square test for this table produces a test statistic X2= 0.0275 with df = 1, and the associated P-value is 0.8683. Again, I cannot reject the null hypothesis. The data indicates that I cannot conclude that the ultimate change type (external or internal) and the board type (sole or system) are dependent, even though ultimate-external-change universities are slightly more likely to be sole board types (66%) than are ultimate-internal-change universities (62%).

Religiously affiliated schools have a unique mission, one centered around a particular faith. This limited mission will necessarily limit the pool of available candidates to head these organizations. There are only four such organizations in the sample: Boston College (Catholic), Georgetown University (Catholic), Notre Dame (Catholic), and Yeshiva University (Jewish). I might thus predict that they will have fewer external candidates as compared to the larger sample, because they cannot partake as easily of any market for external presidential candidates. However, the sample size here is so small (only four universities) that it precludes meaningful analysis.

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of nine universities), the University of Florida (State University System of Florida, twelve universities), Georgia Institute of Technology (University System of Georgia, twenty-eight universities), the University of Illinois (University of Illinois System, consisting of three universities), the University of North Carolina (the University of North Carolina System, seventeen universities), Pennsylvania State University (Pennsylvania's State System of Higher Education, fourteen universities), the University of Texas (University of Texas System, eight academic institutions), and the University of Wisconsin (University of Wisconsin System, thirteen universities). Four public universities have separate boards governing themselves alone: the University of Michigan (Board of Regents), the University of Virginia (Board of Visitors), College of William & Mary (Board of Visitors), and the University of Washington (Board of Regents).

Sorokina finds a pay premium associated with women liberal arts college presidents, noting that they made an average of 8% more than male presidents. She speculates that high demand for female presidential candidates might explain the premium, especially given that "there is a growing need to attract women to faculty and administrative positions" despite the fact that women are "still underrepresented among Ph.D. recipients and college administrators."[228]

5. Hypothesis Five

Sorokina's finding suggests the need to examine the sample through a different lens. Women make up only 20.3% of the total sample. They are clearly highly desirable candidates, and their inclusion in the data may well bias the results towards external hires. That is, the pressure on an institution to find a woman might swamp ordinary concerns about lack of firm-specific capital. Hypothesis five thus posits that demand for women candidates may inflate the external market. If so, if tournament theory has explanatory power, then there will be significant numbers of external candidates even when considering just the male presidents.

Table 6: Gender

	Female	Male	Total
Ultimate External	18	64	82
Ultimate Internal	4	22	26
Total	22	86	108

Next, I conducted a Pearson Chi-square test of independence of rows and columns on the data shown in Table 5. This yields an X2 = 0.1980 with df = 1, and P-value = 0.6563, so I cannot reject the null hypothesis in this case. Thus, I do not have enough evidence to reject the null hypothesis. That is, even though ultimate-external changes are more likely to be to females (22%–15%) than are ultimate-internal changes, this difference is not statistically significant.

C. Apples and Oranges: The Generalizability Question

The strength of the study is also its weakness: the academic market removes the tournament variable, allowing us to test it. But, if the academic leadership market is fundamentally different from the for-profit market, then any lessons are of limited utility. There are two answers to this objection. First, the varied settings in which leadership studies have been conducted comparing across a variety of industries, geographical regions, and even into leadership in the context of sports teams and religious institutions. These many studies from disparate disciplines suggest that there is some value in cross industry comparisons. Second, CEO and president selection is actually *more* similar than many of these settings (e.g., managers of sports teams or CEOs of private firms), because both models feature not a single decisionmaker selecting amongst candidates, but rather a board composed of individuals from outside the organization. University governance bears

228. Sorokina, *supra* note 178, at 9.

a striking similarity to the governance of publicly traded U.S. corporations: both are governed by part-time boards composed largely of outsiders to the organization.

As discussed in Part III, independent directors constitute the majority of publicly traded boards. As with their for-profit counterparts when selecting a CEO, so for boards of trustees, choosing a president is the most important job.[229] The governing board of a university (known variously as a board of trustees, board of regents, or board of visitors) is composed largely of volunteers from outside the university that donate their time to its governance. Typically they consist of rich, powerful, and well-connected alums or, especially in the public context, politically important individuals.

Boards tend to be weak because they work part-time, and spend only "a small fraction of their time" in overseeing the university, as opposed to a full-time employee (or prospective employee), who has a clear and deeply personal interest in the question of his compensation.[230] Moreover, these trustees have no immediate economic interest in the transaction—they are, in fact, spending other people's money.[231] Finally, Galle and Walker posit that nonprofit trustees likely have relational ties to presidents that "encourage a culture of deference" to the executive.[232] Thus, the university setting is in this sense remarkably similar to public corporate governance, and may prove a fairer comparison than many others.

Still, a third objection to extrapolating from the university to the for-profit setting exists. Some studies test the hypothesis that external candidates fare better when they come from firms in the same industry. The theory is that, while firm-specific capital might not matter, industry-specific capital does.

If this theory holds, it presents another challenge because it suggests that academic leadership, as a homogeneous industry, may be more conducive to external candidates than for-profit firms in general. In other words, running one university is much the same as running another.

To take one recent example of the perils of cross-industry CEO hires, in 2011 discount retailer J.C Penny's hired Ron Johnson, formerly a "star retailer" of Apple, to be its next CEO. Johnson's bold new strategy, which included ending its traditional practice of regular discounting, failed and led to his ouster two years later. One explanation offered for Johnson's failure was that he came from outside the industry (although he had also worked at Target before Apple). It may be that either university governance skills are more readily transferable and/or that the academic field is a more homogenous one that the for-profit field. Studies in the for-profit world have shown that while external candidates are disfavored, they are more likely in industries with a high degree of homogeneity, because executives will have more of the human capital necessary for the position.[233]

A successful university president at University X may be able to readily translate that success to University Y. If homogeneity of institution explains the dominance of external candidates, then I would expect to find serial presidents—individuals that hop from presidency to presidency. The literature offers some data. Ehrenberg's study of private institutions found that only a minority of their sample (25%) of university presidents had

229. Klein & Salk, *supra* note 71, at 340; *see also* Ferrare & Marchese, *supra* note 194 (sharing that "[f]ew board decisions are more important than selecting a new president or chancellor").

230. Galle & Walker, *supra* note 201, at 1898.

231. *Id.* at 1898–99.

232. *Id.* at 1899.

233. Parrino, *supra* note 110, at 167.

been president at least once before serving in their current role.[234] Of the 57 cases where they were able to identify the prior institution, almost three-quarters were at other private, primarily four-year institutions.[235] The others were at "individual public campuses or statewide public systems."[236] Sorokina speculates that college presidents enjoy more mobility and market demand than mere tenured faculty.[237] Sorokina found that 18 liberal arts college presidents out of 97 (18.6%) had experience as presidents at other higher educational institutions before assuming the presidency.[238]

As for mobility after serving as president, Ehrenberg et al. found that over a four year period, of the 175 who left the presidency, only 13 (0.6%) went on to be presidents of other institutions.[239] Of further interest, only one of the 13 became president of a public college or university.[240]

As for our sample, if highly successful candidates are able to transfer their skills easily, then I would expect to find a high number of candidates with serial presidencies. In the sample of 108, I find four: Gordon Gee was president at Brown and then Vanderbilt. Robert Bergdahl was president at Texas and then Berkeley. Charles Young was president at UCLA and then Florida, and Lee Bollinger moved from the Michigan presidency to that of Columbia. It may be fair to add to this set, however, the number of interim presidents that go on to become presidents at different institutions. There are three of these, James Wagner (interim at Case Western, then president at Emory); Phyllis Wise (Washington interim, president of Illinois), and Carol Folt (Dartmouth interim, president of UNC). It may be that these individuals used their interim year to learn the main skills the job of president requires, and then were able to transfer them to a permanent position. Totaling both figures, 6.5% of the sample presidents have moved from presidency to presidency.

Note finally that one limitation of these data is that they are limited to the 57 institutions which were ranked in the top 50 by U.S News & World Report for at least 7 of the 22 years (1995–2016) examined. It may well be that serving as president of one these institutions tend to represent the pinnacle of one's career, and thus there is relatively little movement amongst positions at this level. Presidents may well move up the "ladder" of institutional hierarchy at a greater rate below the top 50 mark. For example, Gordon Gee served as president of West Virginia University, University of Colorado, Ohio State University, Brown University, Vanderbilt, Ohio State University (again), and West Virginia University (again). President Gee, one of the repeat presidents in the sample, appears to be an outlier in several respects: not only because of the number of institutions he has headed, but also because after his departure from the sample universities he continued to serve as president for several lower ranked institutions.

Other data that might cast light on the question of transferability include the number

234. Ehrenberg et al., *supra* note 201, at 24.

235. *Id.*

236. *Id.*

237. Sorokina, *supra* note 178 ("College administrators often have an opportunity to progress up to a higher position within the academic sector, to become presidents at more prestigious universities, to move to the business sector or to go into teaching. Faculty, on the other hand, especially tenured professors, are more limited in their choices.").

238. *Id.* (noting that no biographical data was available for 3 presidents, reducing the sample to a total of 97.).

239. Ehrenberg et al., *supra* note 201, at 22.

240. *Id.*

of interim presidents that become permanent president of the same institution, or that served as permanent president and then returned to serve as interim president. Each case could suggest the presence of firm-specific capital.

The case of former presidents that return as interims make the clearest case for firm-specific capital. They have done this particular job at this particular institution, and the board selects them on a temporary basis on the strength of their past knowledge. This happens in two cases (1.9% of the sample).

The selection of an interim president as permanent president could suggest that the candidate (who I code as internal in the first year of permanent presidency) has developed valuable firm-specific capital while on the job. This happens on four occasions in the sample period. However, it might also suggest that the candidates have proven themselves to the board that picks them, which supports an information asymmetry theory. The interim position serves as a one-year trial period in which the board gets to know the candidate better. Interims become permanents four times in the sample period, representing 3.7% of the presidents.

Overall, the sample is therefore something of a wash with respect to the transferability question. On the one hand, seven presidents moved from an interim or permanent position to another presidency, suggesting a certain transferability of managerial capital. On the other hand, six individuals moved from interim to presidency, or vice versa, at the same institution, suggesting the importance of institution-specific capital. From these results, it is difficult to conclude much regarding the question whether university leadership is easily transferable from one institution to another. The Ehrenberg and Sorokina studies suggest that university president mobility might be limited, but more study is warranted on this point.

In sum, analysis of the data reveals that most university presidents are external candidates, despite the fact that insiders possess firm-specific capital and pose fewer information asymmetry problems than do outside candidates. Analysis of performance, public versus private institutions, system versus nonsystem institutions, and gender failed to reveal any findings of significance. The dominance of external candidates in a non-tournament setting suggest that tournament theory may be the chief driver for the preference for internal CEOs in the for-profit setting.

VI. IMPLICATIONS

The findings have profound implications for two separate literatures. First, if for-profit boards favor internal candidates for the purposes of fostering competition in the lower ranks, then the search for a link between CEO provenance and performance is doomed to fail. Tournament theory teaches that what matters is not the performance of a particular internal CEO or internal CEOs in general. It is instead the expectation of internal selection, and attendant incentive effect created by the internal preference on the rest of the firm's employees. In other words, even if an internal CEO assumes the helm and runs the corporation poorly, she has already fulfilled her chief purpose—motivating the lower ranks simply by virtue of being selected as CEO.

Tournament theory also casts light on the executive compensation question that has been a major focus of legal scholarship. It predicts, however, that CEO candidates may be willing to defer some of their earnings and compete for the prize of CEO. Tournament theory thus explains "the very large observed differences between CEO salaries and those

of executives of the immediately lower level."[241] Charles O'Reilly et al. called the application of tournament theory to explain executive compensation "intriguing," but observed that "no empirical tests of the tournament model of executive compensation with natural data exist."[242] This Article provides that test.

Tournament theory means that corporations will generally not hire outsiders. Even if viable external candidates exist, the internal cost to the organization in terms of morale and motivation of lower level employees would be too high. This conclusion in turn suggests that the external market for managerial talent does not and cannot exist in a meaningful way. Determining pay levels by benchmarking is thus fundamentally misguided.

The tournament theory model depends upon delayed gratification, which is the ultimate prize of being CEO. It follows that what matters is that the increase in CEO pay is enough to lure potential successors from the temptation to rest on their laurels. Shareholders' concern thus should not be how much their CEO is making relative to peers, but rather to those very potential successors. In other words, vertical pay ratios matter more than horizontal ones.

Circling back to the laws governing executive compensation, Part II deferred discussion of Dodd-Frank's three main provisions: "say on pay" votes, "pay for performance" and "pay ratio" disclosures. This Part will argue that recasting the regulatory framework, in light of Part V's evidence that tournament theory informs the selection of the majority of CEOs, both makes logical sense and provides considerable improvement over the status quo.

Arguably the most successful of Dodd-Frank's three reforms to date has been the "say on pay" rule. Section 951 of the Dodd-Frank Act requires companies to hold a nonbinding vote at least once every three years on the compensation of executives disclosed in Section 402 of Regulation S-K.[243] Currently, Regulation S-K specifies that the corporation disclose the total compensation of the principal executive officer (PEO), principal financial officer ("PFO"), and "three most highly compensated executive officers other than the PEO and PFO."[244]

Dodd-Frank's say-on-pay mandate changed the executive compensation landscape.[245] While it did not trigger widespread outrage over executive compensation levels, it did bring about a more focused dialogue between shareholders and proxy advisory firms. These say-on-pay votes have not always been rubber-stamps. While shareholders have typically endorsed companies' pay policies, there have been some notable exceptions: About 1.3% of Russell 3000 companies experienced negative say on pay votes in 2011, and 2.7 as of June 2012.[246] While these numbers may be low, a failed vote may also signal to activist hedge funds a discontented shareholder electorate and therefore a prime target for attack. Thus, failed votes catalyze corporations' efforts to engage shareholders to

241. Charles A. O'Reilly III et al., *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257, 257 (1988).

242. *Id.*

243. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111–203, § 951 (2010).

244. Executive Compensation, 17 C.F.R. § 229.402 (2015).

245. *See* James F. Cotter et al., *The First Year of Say-On-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 992–93 (2013) ("Some commentators have described the 2011 proxy season as a watershed event in U.S. corporate governance.").

246. *Id.* at 979–80, 1000.

assuage their concerns.[247] The New York City comptroller has initiated the Boardroom Accountability Project that submits nonbinding proxy access shareholder proposals to companies that failed or had low say-on-pay votes.[248]

In short, the results of say-on-pay votes indicate that, at least sometimes, shareholders do care about executive compensation. The question is what information shareholders require in order to evaluate executive pay packages. Dodd Frank mandated two new types of disclosure: the "pay versus performance" rules and the "pay ratio" rule.[249]

The "pay versus performance" rule mandates that the SEC require disclosure "information that shows the relationship between executive compensation actually paid and . . . financial performance . . . , taking into account" the company's stock price performance.[250] In 2015 the SEC proposed rules that included disclosure in table form, as well as a supplemental narrative portion to explain the tabular data.[251] Opposition from Commissioner Piwowar has stymied adoption of final rules.[252]

The findings of this Article suggest that pay-versus-performance disclosure may not be the most crucial element of executive compensation at all. While this information may be useful to shareholders, if tournament theory is correct, then aligning executive pay with performance is not the main point of executive compensation. The goal, instead, should be to incentivize those at lower ranks vying for the position to continue the fight. If tournament theory is the main driver for selecting a CEO, then CEO compensation need be only enough to incentivize the tournament. Disclosure regarding compensation should be tailored to issues that matter, and this Article suggests that *internal* pay scales matter more than external ones.

The final Dodd-Frank executive compensation reform measure, the controversial "pay ratio" rule, may thus be on the right track by focusing on the internal pay equities of the firm. Dodd-Frank requires the SEC to promulgate rules requiring companies to disclose the CEO's total compensation, the median of "total compensation" for all company employees (excluding the CEO), and then disclose the ratio of the two totals.[253] The SEC faced numerous hurdles in the rulemaking process, including identifying who counted as an employee, identifying the median employee and determining that salary, determining which issuers were subject to the rule, and outlining the time period for calculating its workforce.[254] The SEC passed the final rule on party lines, with the two Republican

247. Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1423 (2014) ("[A]ny time a company fails its Say on Pay vote, this is likely to signal to activist hedge funds that it is suffering from poor performance, excess compensation levels, and a high degree of shareholder discontent.").

248. Elizabeth A. Ising & Kasey L. Robinson, *Recent Developments Related to the SEC's Shareholder Proposal Rule*, 2015 BUS. L. TODAY (July 2015), https://www.americanbar.org/publications/blt/2015/07/01_ising.html.

249. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111–203, § 953(a) (2010).

250. Pay Versus Performance, 80 Fed. Reg. 26,330 (May 7, 2015) (codified at 17 C.F.R. pts. 229, 240).

251. *Id.*

252. Michael S. Piwowar, Comm'r, SEC, Dissenting Statement at an Open Meeting on Pay versus Performance Disclosures (Apr. 29, 2015), https://www.sec.gov/news/statement/statement-pay-versus-performance.html.

253. Dodd-Frank Wall Street Reform and Consumer Act § 953(b).

254. *Securities Regulation—Dodd-Frank Wall Street Reform and Consumer Protection Act—SEC Finalizes Regulations Requiring Companies to Disclose Pay Ratio between the CEO and Median Employee*, 129 HARV. L. REV. 1144, 1146–47 (2016).

commissioners issuing separate dissents. Commissioner Gallagher criticized the lack of evidence that a reasonable investor would find the pay ratio useful, and opined that the corresponding cost would be "astronomical"—thus failing the required cost-benefit analysis for rulemaking.[255] Commissioner Piwowar lamented the "name and shame" motive behind the rule, calling it a "blatant attempt to limit executive compensation," rather than a genuine attempt to provide information useful to shareholders.[256]

This Article supports Commissioner Piwowar's position. Disclosure of the CEO/median employee ratio provides no meaningful information to shareholders, and will cost corporations considerable money to generate.[257] As Commissioner Gallagher pointed out, the Commission included in the definition of employee "all employees" in the mandate—i.e., rather than limiting its application to full time U.S. employees, it applied it to "all employees of all consolidated subsidiaries . . . located anywhere in the world, whether full-time or part-time."[258] The prospect of calculating this number, particularly for a large multinational corporation, is a daunting one, indeed.

But, this Article shows that Dodd-Frank's pay-ratio rule got one thing right: the proper place to look for relevant information with which to evaluate a CEO's compensation is within the corporation, not outside it. What makes the most sense is for firms to disclose the ratio of CEO pay to the pay of the rank of subordinates most likely to produce the next CEO candidate.

In practice, requirement disclosures will vary from firm to firm, and the fleshing out of the specific contours of disclosure is beyond the reach of this Article. The easiest course would be to require disclosure of the ratio of CEO pay to the other executive officers already required to be named by Regulation S-K. A preliminary review of the top five Fortune 500 companies reveal CEO pay at a ratio of 1.7 times that of the other named executives. But that number contains several anomalies. At $8.7 million, Apple's CEO Tim Cook makes *less* than the other five named executives, all of whom make around $22.8 million.[259] Similarly, Warren Buffett, Berkshire Hathaway's CEO, made more than four times Vice Chairman of the Board, Charles Munger's $100,000 in compensation.[260] But, thanks to ownership of the company itself, Buffet's net worth is $78.5 billion,[261] and Munger's is $1.51 billion.[262] Annual compensation is therefore likely not their chief motivation or reward for performing for the company. UnitedHealth, another Fortune 10

255. Daniel M. Gallagher, Comm'r, SEC, Dissenting Statement at an Open Meeting to Adopt the "Pay Ratio" Rule (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-to-adopt-the-pay-ratio-rule.html ("I see no credible evidence in the record that a reasonable investor would find the pay ratio to be useful.").

256. Michael S. Piwowar, Comm'r, SEC, Dissenting Statement at Open Meeting on Pay Ratio Disclosure, (Aug. 5, 2015), https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html.

257. Unfortunately, given that Dodd-Frank itself requires this disclosure, and that the SEC has promulgated final rules on the pay ratio disclosure, it would take congressional action or agency rescission to remove its force.

258. Gallagher, *supra* note 255.

259. Apple Inc., Proxy Statement (Def. 14A) (Dec. 30, 2016), http://investor.apple.com/secfiling.cfm?filingid=1193125-17-3753&cik=.

260. Berkshire Hathaway Inc., Proxy Statement (Def. 14A) (Mar. 17, 2017), https://www.sec.gov/Archives/edgar/data/1067983/000119312516501649/d117328dd ef14a.htm.

261. *Warren Buffett Profile*, FORBES, https://www.forbes.com/profile/warren-buffett/ (last visited Mar. 12, 2018).

262. *Charles Munger Profile*, FORBES), https://www.forbes.com/profile/charle s-munger/ (last visited Mar. 12, 2018).

company, lists as two of its named executives its chief legal officer and executive vice president for human capital.[263] Neither position is likely to produce the current CEO's likely successor.

The more useful information for shareholders would be for boards, in the course of the succession planning they typically do, to disclose the ratio of candidates they have identified as potential successors. This information would be far easier to compile than that required by the current pay-ratio rule, which entails cataloging each employee and ascertaining his or her pay. The corporation has, or should have, a short list of internal candidates as part of its succession planning. Given the limited set of candidates, calculating the ratio should be easy. There will be anomalous cases, typically with a founder CEO like Warren Buffett whose net worth far eclipses annual compensation. But such a ratio is a logical part of the corporation's justification to shareholders of its global executive compensation scheme.

Implicit in this suggestion is that it would require boards to disclose that they do, in fact, have a succession plan in place—or explain why they do not have one. The next logical question is, how much more should a CEO make as compared to potential CEOs in waiting? Should CEOs make twice what their would-be-successors make? Is more money needed to provide the appropriate incentive? Disclosure of the "would-be-CEO" to current CEO pay ratio would allow informed debate about this question. Eventually norms would emerge, and shareholders would be able to identify outlier corporations that pay their CEOs well in excess of what appears necessary to motivate the lower ranks.

VII. CONCLUSION

Ronald Coase's central insight in the *Nature of the Firm* is that a manager's decision to "make or buy" determines the boundaries of the firm.[264] Among the most important question a firm's board of directors confronts is whether it should make or buy its CEO. The answer, for public corporations, appears to be that they produce leaders from within.

This Article examined the question of the underlying reasons for the dominance of internal CEOs. Evidence from the academic market suggests that a tournament model, where insiders are promoted to CEO in order to incentivize the rest of the corporation's employees to compete, explains the internal preference better than the competing theories of firm-specific capital or information asymmetry. If corporations favor internal candidates for purposes of internal motivation, then the internal preference is "sticky"—firms will continue to favor internal candidates over external ones, and the market for external CEOs will remain relatively slow.

The lack of a robust external market frees compensation committees from the current pressure to look to external benchmarks when setting pay. Tournament theory suggests that

263. *Notice of 2016 Annual Meeting of Shareholders*, UNITED HEALTH GROUP (2017), http://www.unitedhealthgroup.com/~/media/E9DC3646E15E4DF4B952E7D810CEA6E6.ashx.

264. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 395 (1937) ("[A] firm will tend to expand until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm."); Barak D. Richman & Christopher Boerner, *A Transaction Cost Economizing Approach to Regulation: Understanding the NIMBY Problem and Improving Regulatory Responses*, 23 YALE J. REG. 29, 30 (2006) ("[In 1937 Coase] observed that firms and markets 'are alternative methods of co-ordinating production' and then posed the seminal make-or-buy paradigm . . .").

instead of looking outside the firm for cues on CEO compensation, the board should instead look within it. The CEO's salary should be set high enough to incentivize potential successors to exert their best effort.

Viewed in this light, current securities requirements miss the mark by requiring pay versus performance disclosure, and the pointless disclosure of the relationship of CEO salary to that of median employee. Requiring disclosure of the ratio between salaries of the CEO and next-in-line allow the board to present the shareholders with a full vision of its plan for the future of the corporation and for its broader plan for incentivizing its top talent.