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A Dynamic Model of CEO Turnover in A Multi Factor Environment

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ABSTRACT

To achieve the best firm performance, the board of directors makes two essential decisions in their top tier of governance: Design the executive contract that best provides the incentives for the CEO in charge, and choose the turnover rule of an incumbent executive. However, to boost the performance of the firm, these decisions must take into account an accurate match between the need for a portfolio of managerial skills with the available set of skills of the manager. We develop a continuous time stochastic agency model with hidden actions and hidden savings in a multi-drivers environment, where the firm holds an option to turnover the agent, given performance and market conditions. We find general conditions for the instantaneous compensation wage for both the first best and the moral hazard case. We further characterize the turnover rule which not only accounts for the incumbent CEO's performance but also compares how obsolete her set of skills is against the representative executive skills available in the market for managers. Furthermore, our theoretical model is general enough to be calibrated, extended and adapted to different contexts while providing a more realistic view of these complex contractual relationships.

KEYWORDS CEO turnover; Continuous-time contracting; Moral Hazard

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