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CEO Succession: The Ultimate Measure Of Board Performance

Good succession is a measure of good governance.

by Clarke Murphy

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CEO Succession: The Ultimate Measure Of Board Performance

by Clarke Murphy

Item number one on any description of corporate board duties is hiring and firing of a chief executive. However, success in CEO selection depends in large part on shaping a sound succession process from the board level. Shareholder advocates now see good CEO succession planning as a reflection of the quality of the board itself.

Public debate regarding corporate governance issues tends to focus on one primary topic at a time, depending on the dictates of current events. Classified boards, "overboarding," director compensation, risk management—the attention of the corporate governance community has been focused on each of these matters in turn during the last dozen years. Progressive boards use these attention cycles to periodically reexamine their key responsibilities in light of evolving best practices.

A topic currently moving to the fore is the role of the board in CEO succession. The economic turmoil of 2008 and 2009 resulted in several unplanned CEO departures, which served as a very public test of those boards' CEO succession plans. Some boards passed and some did not. However, all boards were served notice that CEO succession planning must evolve beyond an unread binder in the corporate secretary's office.

This focus of attention became official last October, when the Securities and Exchange Commission issued guidance that companies should no longer expect to be allowed to exclude shareholder proposals regarding CEO succession planning because they dealt with "ordinary business operations." Reversing a long-held earlier position, the SEC recognized CEO succession planning as a "significant policy issue regarding the governance of the corporation." As such, it was an appropriate matter for shareholder concern. It is worth noting that SEC reversals regarding acceptable shareholder proposal topics often signal that an issue has achieved a critical level of public attention.

The first shareholder proposal regarding CEO succession planning to reach a vote took place at the Whole Foods Market annual meeting in March 2010. The proposal, which called for the company to adopt and disclose a written and detailed succession planning policy that included the establishment of CEO job criteria and the development of internal candidates, was defeated. However, it garnered nearly 30 percent of the vote despite unanimous opposition from the board.

While it remains to be seen if any similar proposals will succeed this year (the first year such proposals were successfully introduced), boards need to accept that they will be part of shareholder agendas for the foreseeable future.

How a board handles succession planning is increasingly viewed as a proxy for the competency and level of care it brings to its governance responsibilities.

Shareholders are not the only constituency focused on CEO succession. Ratings agencies (and thus creditors) are incorporating it into their company reviews. They recognize the risk to continuity of operations posed by a poorly handled transition. Shareholders and investors are also concerned that a company caught flat-footed by an unplanned CEO departure is less likely to make the best possible choice of successor. Instead, the company could end up with a cultural mismatch in the CEO they choose, given the time pressure to fill the top slot.

Beyond these specific concerns, how a board

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handles succession planning is increasingly viewed as a proxy for the competency and level of care it brings to its governance responsibilities. According to a recent survey of public company directors by the National Association of Corporate Directors, 43 percent of companies have no formal, written succession plan. Only 16 percent of directors considered themselves to be "highly effective" in succession planning. Clearly, there is a great deal of work to be done.

CEO succession lacks urgency compared with day-to-day tasks, and there is little perceived cost to putting it off.

There are many reasons why CEOs and boards fail to give succession planning the attention it deserves. Because it centers on an event thought to be in the distant future and whose timing is ill-defined, it lacks urgency compared with day-to-day tasks. There is little perceived cost to putting it off.

The inclination to put it off is exacerbated by the Pandora's box of issues that rigorous succession planning forces a board to confront. Identifying the competencies and experiences needed in the next CEO requires solidifying the company's long-term strategic plan, which often involves the painful elimination of options.

Succession planning also shines a bright light on how well the organization develops internal candidates (something explicitly called for in the Whole Foods shareholder proposal). The development of internal candidates in turn requires careful human capital management. Failure here can set off a "horse race," or prompt the loss or demotivation of those executives who are not being considered for the top slot, but are valuable to the company. It also demands the establishment of consistent and objective benchmarking that includes not only internal candidates, but appropriate external candidates as well.

Finally, successful succession planning demands the right attitude from the incumbent CEO. The naming of a successor is viewed by some as a personal prerogative, by others as a threat. Because succession planning is a tangible manifestation of the limited tenure of any CEO, it is naturally an emotionally laden issue even for the most enlightened leaders.

With all of these obstacles, it is not surprising that many boards have yet to design and implement an appropriate CEO succession plan. Given the focus that shareholders, investors and regulators are putting on the issue, however, boards no longer have the luxury of deciding whether and when to address this critical issue.

Boards must take ownership of the succession planning process, and ensure an environment that supports it.

Succession planning comes down to developing, implementing and maintaining a particular set of processes. Before that can take place, however, there are four prerequisites that must exist to ensure the proper environment and resources.

☐ *A strategic plan.* First, boards should ensure that the company's strategic plan is current and detailed. That plan should be fairly specific through the next three to five years, in addition to setting forth objectives in broader terms for the period beyond that. This document is essential for identifying the qualities to be sought in the next CEO.

☐ *The right culture.* Next, boards need to rigorously assess their current succession plan. If a board does not have the thorough plan it should have, why not? Has the board handled its own succession well, or has it become entrenched with long-serving members? How smooth was the company's last succession? Has it established an environment of candor and trust with the CEO so that honest discussions about succession can occur?

These sorts of hard questions need to be asked so that the board can honestly assess how supportive boardroom and company culture is toward the succession process. While the implementation of a succession plan is ultimately a question of process, how effective it will be is a matter of culture. Boards must take ownership of the succession planning process, and ensure an environment that supports it.

Having a solid CEO succession plan is a must for all companies, and it behooves the board to minimize its chances of being caught off-guard. Not all unplanned transitions are unforeseen.

☐ *Know the urgency.* Boards should assess the possibility of an unforeseen transition, and how much pressure that could add to its succession planning. Companies whose CEOs embody the organization to an unusual degree can be seen as carrying "key man risk." Witness the regular hand-wringing over succession directed at firms such as Apple and Berkshire Hathaway. This can be more than just talk; last year, Fitch lowered Berkshire's rating in part because of this issue.

Boards should also take into account the general environment and investor confidence within the company's industry. Under certain conditions, turmoil can spread from one firm to another, as the financial sector experienced in 2008 and 2009. Having a solid CEO succession plan is a must for all companies, and it behooves the board to minimize its chances of being caught off-guard. Not all unplanned transitions are entirely unforeseen.

☐ *A strong HR function.* Finally, boards need to evaluate the company's human resources function. The ability to identify and strategically develop internal candidates is central to a successful secession plan. Many companies do not do this as well or as consistently as they could.

Executive assessment needs to be ongoing and, rather than generic, should be designed to test for the specific capabilities and qualities called for in the business' strategic plan. Assignments should be strategically managed to develop corporate bench strength. This process should become more focused as an executive assumes more responsibility and becomes an internal CEO candidate. The executive who needs more international experience, P&L responsibility or exposure to lenders, shareholders or board members, should be given it.

The evaluation of these succession prerequisites is likely to identify issues for further examination. As long as a current strategic plan is in place to use as a foundation, there is no reason to delay the implementation of a succession plan so long as the issues that are identified are addressed promptly.

With the necessary prerequisites established, the board can begin the task of developing its succession plan. While the entire board should be involved in choosing a successor, custodianship of the plan itself often falls to the nominating committee, or a special ad hoc committee. This is often headed by the lead independent director (in companies where the CEO is also board chairman).

The succession plan, which is maintained as a written document, contains the following:

☐ *CEO specifications.* The first task is to develop a document specifying the experiences and competencies to be sought in the next CEO, based on the company's strategic plan. A good place to start is by identifying the inflection points anticipated in the next three to five years, such as entering new markets, developing new business models or responding to technological shifts. The competencies required to implement the changes called for (as well as to drive the necessary cultural changes) should be at the top of the list.

☐ *Assessments and professional development plans of internal candidates.* The plan should include a summary on each executive who has been identified as a candidate for the CEO slot. That summary should aggregate a wide range of information, including 360° feedback, psychometric testing, and findings from competency-based interviews. This is then distilled into a map of strengths and weaknesses against CEO job requirements, and a development plan for addressing areas where additional work is needed.

☐ *Assessments of external candidates.* There should also be a list of external candidates to be considered, with a summary of information that has been gathered from available sources and professional networks. The strategic challenge in developing and maintaining this list is defining its scope. The default tendency is to look within one's industry. However, a combination of supply-and-demand realities and the dissolving of traditional industry silos is making that a less viable option.

☐ *Succession timetable.* Developed with the incumbent CEO, the timetable should establish a date for the selection of finalists, the selection of a new CEO, and a transition date when the new CEO actually takes office. Ideally, this schedule should stretch over a three-to-five year period to allow time for finalists to be fully evaluated and for a suitable transition period after the successor has been chosen.

☐ *Emergency plan.* In the event of an unplanned vacancy, the board needs to be able to either quickly decide on a successor, or if there is no obvious choice, designate an interim CEO and possibly a temporary reassignment of duties among management. There will be a need for internal, external and regulatory communications.

The emergency plan should determine how these various tasks are to be executed and under whose direction. The emergency plan should also contain the relevant sections of the corporate bylaws, so that there is no ambiguity regarding process and authority.

While we talk about succession plans, it is really the entire succession process that demands attention. The hallmark of a good plan is how consistently it is maintained.

While it is common to talk about succession *plans,* it is really the entire succession *process* that demands attention. The hallmark of a good plan is how consistently it is maintained. Much of succession plan maintenance can be reduced to two elements:

☐ *Regular review.* The succession plan should be reviewed at last twice a year, to ensure that the CEO job description remains current against changes in the strategic plan, and that developments regarding internal and external candidates are monitored (including changes in the candidate list itself).

This ongoing evaluation of internal candidates is essential. If you have to hire from outside the company to provide a sufficiently deep bench, it is necessary to do so far enough in advance that the executive can adapt to the company's culture and be as fully evaluated as an internal candidate.

☐ *Regular contact.* The board should maximize its opportunities for meaningful contact with internal candidates, including board presentations, on-site visits and one-on-one discussions. Some of this should occur without the current CEO present. The lead independent director should also be in regular communication with the CEO for his or her thinking regarding candidates and timing.

Three to five years before the agreed-upon transition date, the board needs to begin the implementation process. The implementation begins with a review of the CEO description, and the list of internal and external candidates so that any needed adjustments can be made. The implementation itself includes the following:

☐ *Baseline benchmarking.* The assessment of internal candidates provides insight to direct their professional development. At the beginning of the succession implementation, however, it is extended to include a formal measurement of where they stand against the specific competencies required by the new CEO. External candidates should be benchmarked as well so that direct comparison can be made among all candidates, and the board can be assured of selecting the best possible CEO.

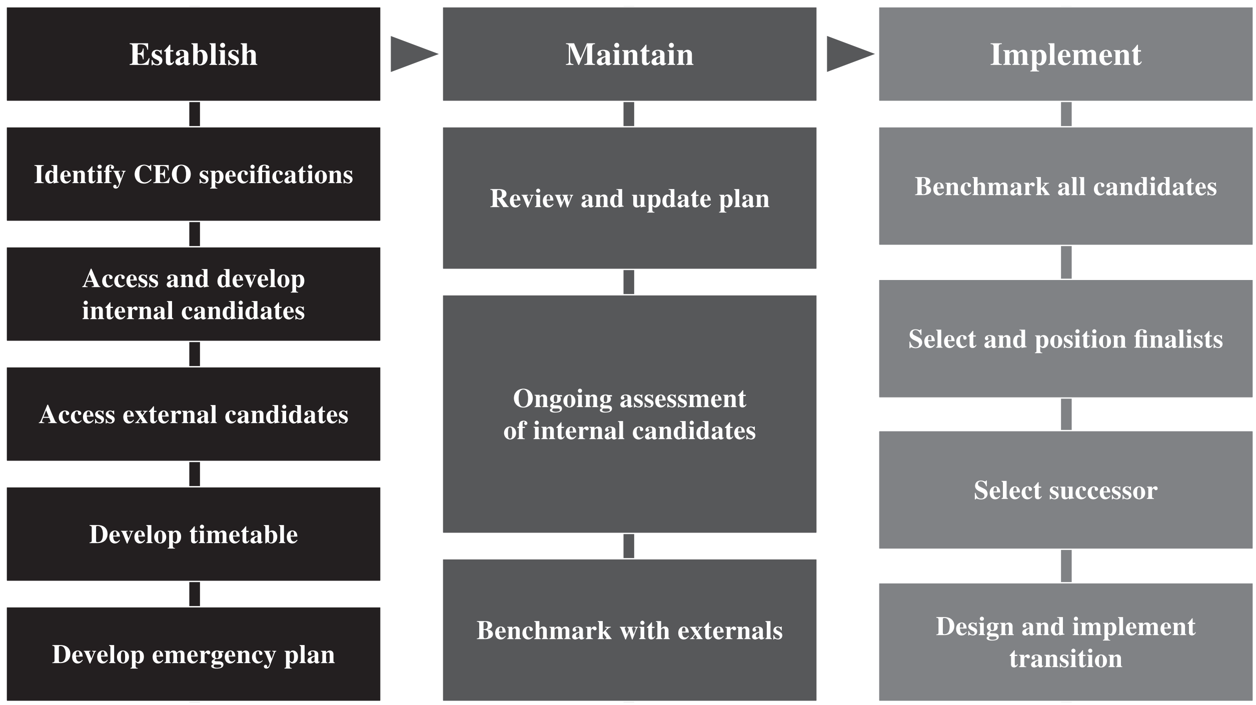
This process is often designed and conducted by third-party specialists to ensure that it is thorough and objective. The results are discussed among the board and the CEO, and individual feedback is then given to the candidates. The board should also decide if the internal field needs to be broadened through external hiring.

☐ *Selecting and positioning finalists.* After enough time has passed to allow for full candidate observation, the board meets to select finalists, typically three or four in number. The board should draw upon a wide array of assessment tools in making its selection, including 360° feedback. While input from the incumbent CEO is important, it needs to be balanced or affirmed by observations of the candidates' peers.

Once chosen, the candidates are, if necessary, rotated into whatever positions will best allow for their final evaluation, without pitting them against each other in direct competition. Attention also needs to be paid to the vacancy that would be created by a finalist's elevation to the CEO slot, with secondary

Changing Of The Guard

Process For CEO Succession Planning



succession planning for each of the finalists' current positions. The selection of the most qualified CEO candidate should not be hampered by difficulty in filling the position he or she is leaving.

☐ *Selecting a successor.* Approximately a year before the scheduled transition date, the board meets to select a successor, either from among the internal candidates, or by making an offer to an external candidate.

☐ *Designing and implementing the transition.* Well-executed transitions can take up to a year. It begins with extensive knowledge sharing by the outgoing CEO so that his or her successor can learn the operating styles, profiles and expectations of the company's various constituencies. The incoming CEO should have an opportunity over time for in-depth, one-on-one conversations with board members, as well as phased-in participation at board meetings. The lead director should provide coaching as needed to maximize the new CEO's chances for success.

It is also essential to work out and agree upon a board transition timetable, as well as the post-transition role of the outgoing CEO. In some cases, the CEO remains as board chair for a specified period of time. In others the outgoing CEO steps down from the board immediately and limits involvement to informal guidance.

CEO succession planning is now and will continue to be on the agenda of shareholders, creditors, regulators and others, not just for its own sake but as a proxy for the board's competence and diligence. Forward-thinking boards will not only meet this challenge but publicly embrace it. Indeed, it represents an opportunity for corporations to both improve their corporate governance and then to build valuable goodwill with important constituencies. ■

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