IN TOUCH WITH THE BOARD

A Russell Reynolds Associates Series

Leadership for a Changing World. One in a series of communications from the Russell Reynolds Associates' CEO/Board Services Practice, *In Touch with the Board* addresses best practices in board composition, assessment, succession planning and other critical corporate governance issues.

"CEO succession is THE number one job of the board."

—McDonald's Chairman Andrew McKenna[1]

CEO succession planning always has been a central focus of our CEO/Board Services Practice. Our ongoing work with CEOs and boards spans sectors and global regions and includes research and trends analysis in specialized situations, such as CEO succession in family-controlled firms. We share these insights with our clients and with the larger corporate governance community through our published research, panel discussions and other venues.

In this issue of *In Touch with the Board*, our CEO/Board Services Practice distills current best practices for successful CEO succession planning into a framework that boards can use in the ongoing evaluation of their CEO and leadership succession strategy.

A generation's worth of lessons

The last four years have provided a generation's worth of corporate governance lessons. Included among the most important is the need for CEO succession planning: There have been numerous high-profile examples of companies—AIG, General Motors, Sears and Yahoo! are just a few—that suffered an unplanned CEO departure and were caught offguard when having to name a replacement. Drawn-out, public or uncertain succession processes also sap investor confidence as evidenced by 3M's recent boardroom debate over whether the incumbent CEO's planned retirement would proceed and his successor named in

[1] Russell Reynolds Associates' "Leadership in the Field" video interview series: http://www.russellreynolds.com/content/mcdonalds-chairman-andy-mckenna-responsibilities-board.

accordance with the succession plan. So while the specifics varied, in each of these cases, the board ultimately was held accountable for a poorly managed transition.

Unfortunately, weak succession planning is more common than these highly visible examples suggest. According to a survey of public company directors by the National Association of Corporate Directors (NACD), 44 percent of companies have no formal succession plan, and only 17 percent of directors consider

"The cost of short-changing succession planning is extremely high."

themselves to be "highly effective" in succession planning.[2] When these findings are combined with the fact that, globally, an estimated 43 percent of large cap company CEO successions are unplanned, it is easy to see that boards continue to carry a high level of "succession risk." Given that CEO transitions generally are vulnerable times for company valuations—investors are twice as likely to sell shares during a CEO transition than buy them[3] —boards have a strong bottom-line incentive to have transitions unfold as smoothly as possible. In addition, rating agencies now factor succession planning into their pronouncements, and the U.S. Securities and Exchange Commission (SEC) no longer allows public companies to disallow shareholder proposals regarding succession planning under the "ordinary business matters" rule. Instead, succession planning is viewed as a "significant policy issue regarding the governance of the corporation" and thus appropriate for shareholder debate.[4]

Create a sense of urgency

Given the greater scrutiny and heightened requirements of regulatory bodies and stakeholders, boards must critically evaluate their current CEO succession plan and determine how well they maintain it. However, there are a number of forces that can keep succession planning from getting the attention it should get. The most powerful is a lack of urgency. Most of the time, the CEO's departure is viewed as a far-off, theoretical event, and it is easy for succession to get neglected in favor of more immediate and tangible issues the board must address. Succession planning also underscores the current CEO's mortality; on an emotional level, active succession planning can be

"Good succession plans don't happen in a vacuum."

seen to relegate the current CEO to lame-duck status. Succession planning almost always stirs up uncomfortable issues, and the board must maintain the commitment to work past them. For example, even though Chad Holliday was only age 49 when he was named CEO of DuPont, within three or four years, the company had developed, at the board's insistence, a pipeline of 15 to 20 potential internal candidates to be nurtured over Holliday's tenure.[5] That process concluded in 2008 when the board elevated Ellen Kullman, then an Executive Vice President, to President in preparation for her to succeed Holliday as CEO.[6]

While increased scrutiny may provide impetus for action, boards should find even stronger motivation in the examples of firms that do succession well. Apple, Disney, General Electric, JPMorgan Chase, McDonald's, Microsoft, Procter & Gamble, United Technologies—each of these companies has smoothly transitioned from one leader to the next and maintained the confidence of investors and others in the process.

2 "2009 NACD Public Company Governance Survey," pages 13 and 34.
3 "Communicating Critical Events: CEO Transitions and the Risk to Enterprise Value," FTI Consulting white paper, pages 2-3. The study examines 263 CEO transitions in companies with market capitalizations greater than $10 billion that occurred between July 1, 2007 and June 30, 2010.
4 SEC Staff Legal Bulletin No.14E (CF), October 27, 2009: http://www.sec.gov/interps/legal/cfslb14e.htm.
5 Russell Reynolds Associates' "Leadership in the Field" video interview series: http://www.russellreynolds.com/content/mcdonalds-chairman-andy-mckenna-responsibilities-board.
6 "DuPont's Board of Directors Appoints Ellen J. Kullman President and Board Member; Will Become Chief Executive Officer Effective Jan. 1, 2009," company press release, September 23, 2008.

Part of that confidence comes from the succession itself, but part also comes from the fact that succession planning is widely regarded as a proxy for overall corporate governance; companies that do the former well are presumed to be strong in the latter.

Review the prerequisites

Good succession plans don't happen in a vacuum; they are unlikely to be established and properly maintained unless certain prerequisites exist. Boards must begin their evaluation by looking at these requirements:

First, there must be a high level of trust and communication between the board and the CEO. The board must be fully apprised of the CEO's plans and expectations, and, at the same time, active succession planning must not be seen to undermine the CEO's position. While the board chair or lead independent director obviously plays the key role here, that trust and communication should extend, as much as possible, between the CEO and the entire board. As a corollary to that trust and communication, there needs to be a clear demarcation of authority between the CEO and the board. While the CEO should expect input into the succession process, that process needs to be driven by the board.

> **“Ask: Has the board handled its own succession well?”**

Second, the board must approach succession planning as an ongoing process rather than as an item to check off on an annual agenda. Good succession planning interacts with multiple elements of the business—especially corporate culture, strategic planning and leadership development—and thus needs to be seen as an integral component in its own right.

Next, the board should examine its own track record on succession. Has the board handled its own succession well or has the board become entrenched with long-serving members? How smooth was the company's last CEO succession? These sorts of hard questions need to be asked so the board can ensure that its own behavior and culture are fully supportive of the succession process.

A current and detailed corporate strategic plan is at the center of the process. That plan should be fairly specific through the next three to five years in addition to setting forth objectives in broader strokes for the period beyond that. Such a document is essential for identifying the qualities to be sought in the next CEO.

Finally, boards need to evaluate the company's human resources department and its ability to operate as a full partner in the succession process. Consistently identifying and strategically developing a pipeline of internal candidates are essential to successful succession, and many human resources departments would benefit from taking a more analytical, process-driven view toward these key tasks.

Developing and maintaining the plan

With the necessary prerequisites established, the board can begin the task of developing the actual succession plan. While the entire board should be involved in choosing a successor, custodianship of the plan itself may fall to the nominating committee or a special ad hoc committee frequently headed by the lead independent director (in companies where the CEO also is board chairman). The plan, which is maintained as a collection of written documents, should include the following five elements:

- **The experiences and competencies to be sought in the next CEO,** based on the company's strategic plan. Competencies needed to implement changes called for in the strategic plan should be at the top of the list.

- **Up-to-date assessments and professional development plans of the various internal candidates,** aggregating a wide range of information, including 360° feedback, psychometric testing and findings from competency-based interviewing. McDonald's, for example, maintains detailed dossiers on not just its current crop of internal CEO candidates but on rising leaders throughout the organization, thus addressing succession throughout the executive team. Many of these executives will be put on a path that could lead to an eventual CEO appointment. This allows McDonald's to continually develop not just a deep bench of internal CEO candidates but a strong senior leadership team reaching several levels below the C-suite.[7]

- **Parallel documents assessing external candidates,** with a summary of information that has been gathered from available sources and professional networks.

- **A succession timetable,** developed with the incumbent CEO, that establishes a date for the determination of finalists, the date of the selection of a new CEO and a transition date on which the incoming CEO actually takes office. Ideally, these dates should stretch over a three- to five-year period to allow time for a full evaluation of finalists and for a suitable transition period after the successor has been chosen.

- **An emergency plan** so that in the event of an unplanned vacancy, the board can either quickly decide on a successor or, if there is no obvious choice, designate an interim CEO and, if necessary, a temporary reassignment of duties among management. This plan should include internal, external and regulatory communications plans. The emergency plan should determine how these various tasks are to be executed and who is to be given the authority to oversee their implementation. The emergency plan also should contain the relevant sections of the corporate bylaws so there is no ambiguity regarding process and authority.

> **"The plan should be reviewed *at least* every six months."**

Having developed a comprehensive succession plan, boards must maintain it. The plan should be reviewed in its entirety at least every six months to ensure that all components—particularly the CEO role description and the assessments of internal and external candidates against that description—are current. The professional development plans of internal candidates should be specific to those assessments, addressing areas where additional experience is needed. It also is important for the board to have meaningful formal and informal contact with internal candidates, both with and without the current CEO, including board and committee meetings, one-on-one conversations and site visits.

Implementing the plan

Approximately one year before a planned transition, the full board should meet to implement the succession plan. The CEO competency list should be given a final review and revised as necessary. The board then should conduct a thorough assessment of the finalist candidates, including in-depth competency-focused interviews that probe for the skills and talents essential for the role; 360° referencing that provides added insight from superiors, industry peers, colleagues and direct reports; and psychometric testing, which gives shape to intangible qualities.

The internal candidates then are measured against their peers at other firms. On the basis of this information and the many other datapoints that have been amassed during the assessment period, internal candidates and the external benchmark candidates are given numerical rankings across the various required competencies that help guide the board's final decision-making process. If the board cannot come to an agreement on an internal candidate, it will need to conduct an external search using the developed list of required CEO competencies

[7] Russell Reynolds Associates' "Leadership in the Field" video interview series: http://www.russellreynolds.com/content/mcdonalds-chairman-andy-mckenna-responsibilities-board.

and the names of executives used in the external benchmarking as a starting point for sourcing candidates.

The successful transition

Once a final candidate has been selected, it is critical that a thorough transition plan be developed so the new CEO has the benefit of a strong start. A solid transition spans a full year and includes the following:[8]

After the successor has been named, he or she should meet frequently with the outgoing CEO for in-depth discussion regarding the operating styles, histories and expectations of board members and senior management, as well as other stakeholder constituencies, including investors, creditors, customers, analysts and regulators. At various points, individual members of the senior management team are included in the discussion. Third-party interviews can help prevent the biasing of information.

“Successful transition provides a sense of stability.”

Following this briefing period, the incoming CEO should be introduced to the company’s stakeholders in a series of information-gathering sessions. This allows the outgoing CEO to gracefully pass the baton and the incoming CEO to build support and goodwill with various key players, especially those he or she has not dealt with before. Even if the incoming CEO is known to board members, it is important that they begin to relate to him or her in the new role through one-on-one meetings. If the incoming CEO is appointed from within, he or she can begin to be phased into board meetings over a period of time prior to stepping into the position.

With the involvement and support of the senior management team, a detailed timeline then is developed to provide the orderly transition of roles and responsibilities. If the appointment is an internal promotion, the timeline includes the elevation of the executive who takes over the new CEO’s former position. If the outgoing CEO is remaining as chairman, that role needs to be clearly defined so as not to interfere with the responsibilities of the incoming CEO. The plan needs to be effectively communicated internally and externally to project a sense of stability and positive perspective. Appropriate recognition of the outgoing CEO is an important component; failing to show appreciation for an outgoing leader’s accomplishments risks alienating his or her supporters in the company and on the board.

The board’s ultimate responsibility

Managing the CEO succession process is a board’s ultimate responsibility. The cost of shortchanging this process is high, but investing the requisite time and attention brings an equally high reward: maintaining momentum as the company transitions from one leader to the next. In addition, ongoing succession planning helps the board to be better informed and aligns the development of the senior management team with the strategic needs of the company. Beyond its usefulness in risk mitigation, CEO succession planning contributes to the successful governance and management of the firm long before a successor is needed.

Author

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[8] Developed in conjunction with Jack O’Kelley of Katzenbach Partners.

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