Chapter 5

CEO Selection and Succession Planning

5.1 CEO Selection: A Key Board Responsibility

Selecting a new chief executive arguably is a board's most important responsibility. Yet, record CEO turnover points to distinct deficits in board performance in this area. The results of the 2007 Spencer Stuart Board Survey of the Standard & Poor's 500 companies provide important clues:

- CEO succession is on the board's discussion agenda annually at 62% of responding companies and more than once a year at 34%.
  - Still, a quarter of the survey respondents said they do not have an emergency succession plan.
- Primary board responsibility for **succession planning**[1] is split nearly evenly between the nominating and governance committee (41%) and the compensation committee (40%). The remaining survey respondents cited a variety of players, including the full board, all independent directors and management development consultants.
  - Remarkably, when asked how the board involves the CEO in the succession-planning process, half of the respondents said that the current CEO leads the process, while a quarter said that he or she is involved at the same level as all other directors.
  - Fifty-eight percent said that the CEO suggests internal candidates to the board or committee handling succession and contributes to their evaluation.
- Of the 53% of boards that use a formal review process to assess potential successors, 44% said the process includes benchmarking of internal candidates against external ones.
- Another study by Mercer Delta Consulting (2006) revealed that almost half of corporate directors surveyed were dissatisfied with their involvement in the succession-planning process.Mercer Delta (2006), Governance Surveys. Time pressures play an important role. Large majorities reported devoting many more hours to more immediate concerns, such as monitoring accounting, the Sarbanes-Oxley Act, risk, and financial performance. They also said they spent less time interacting with and preparing potential successors than on any other activity. This is unfortunate because the board's role in CEO succession is critical to effective governance; choose the right CEO, and all subsequent decisions become easier.

1. Ideally, a process of continuous leadership 'optimization" with the goal to identify and develop a pool of talent with the skills, attributes, and experiences to fill key leadership positions. This process should include plans for coaching a chosen candidate, as well as how the chosen candidate will be evaluated in the future.

The list of high-profile failures is impressive: Gil Amelio of Apple, Durk Jager of Procter & Gamble, Doug Ivester of Coca-Cola, Jill Barad of Mattel, and, most recently, Robert Nardelli of Home Deport, just to name a few. All these former CEOs of major corporations have two things in common: They are talented, intelligent individuals with strong track records as managers and leaders, yet they all failed as CEOs. Some had been promoted from within to the CEO position, whereas others had been recruited from the outside following an extensive search. Some left on their own, whereas others were forced out.

The broader statistics are equally sobering; global CEO turnover set a new record in 2005, with more than one in seven of the world's largest companies making a change in leadership, according to Booz Allen Hamilton's most recent annual study of chief executive succession at the world's 2,500 largest public companies. Fewer than half of the outgoing CEOs left their office willingly, the vast majority left because of poor performance.Lucier, Kocourek, and Habbel (2006).

What accounts for this high failure rate? Clearly, the job of being a CEO has become much more difficult in recent years, which, in part, accounts for their shorter tenures. In recognition of this fact, firms increasingly are splitting the function through a separate, nonexecutive chairman who deals with outside constituencies, such as customers, as Intel's Andy Grove did, or with the financial community, as is the practice of U.K. firms. The model of the imperial CEO who commanded from the executive suite has long given way to the team leader model. In this model, CEOs are no less powerful, but the nature of power and influence has changed. Today's CEOs can only succeed if they enable others around them to succeed. Trust is the new leadership currency. In a world of instant communication, CEOs cannot be everywhere; therefore, they are compelled to rely on others as never before, and others will, in turn, rely only on those with similar core values.

One problem is that the vast majority of board members have little or no experience with CEO selection and succession planning. As a result, search committees often approach their task with only the broadest of requirements rather than with a well-thought out list of a company's real needs. The sociology of the selection process comes into play as well. As they screen candidates, directors may be seduced by reputation, when dealing with a Wall Street or media favorite, for example, or be blinded by charisma. However such inexperience manifests itself, the result is the same: Directors become so focused on what candidates are *like* that they fail to discover what candidates can and cannot *do*.

5.2 Succession Planning Is an Ongoing Process

Effective boards view succession planning as an ongoing activity that is integrated into the broader process of regularly thinking about the firm's evolving strategy and emerging competitive threats and identifying the skills top executives need to execute that strategy. They know which value-creating activities the firm has chosen as the cornerstone to developing a competitive advantage and what skills a CEO needs to implement them effectively. They are not caught off guard when a new chief executive must be selected because, as a matter of principle, they never stop thinking about CEO succession.

Reaching this level of performance is extremely difficult. Large companies perform literally hundreds of interrelated, value-creating activities, making it difficult for even the best boards to clearly understand how these many activities create value and what a CEO can do to affect the success with which they are carried out. To get there, boards must develop better means for systematically obtaining relevant, specific information about how the company creates value. In many firms, their principal source of information is a thick binder of market data and analysts' reports that is distributed 2 weeks before the next board meeting. How many directors have the time or inclination to comb through these binders? How do such masses of ill-digested information help them understand the value-creation process?Khurana, Rakesh, and Cohn (2003, Spring).

An effective succession-planning process does not end with the selection of a new CEO. The board must be ready to coach the candidate it chooses, especially in the first months, and it has to agree on how it will evaluate the CEO going forward. Unfortunately, this rarely happens. More than half of the boards surveyed say they have little or no formal process for evaluating the performance of their CEOs, despite the huge responsibility entrusted to them. Worse, those who do often focus on short-term, easily measured business goals and give little attention to longer term objectives or metrics, such as the ability to lead people and manage stakeholders or professional ethics. This short-term bias is clearly evident when it comes to CEO compensation: Short-term factors continue to dominate the decision process and compensation formulas.Felton and Fritz (2005).

5.3 CEO Turnover: Different Scenarios, Different Challenges

A top executive's departure has a significant impact on a company's operations, culture, morale, and ability to execute against objectives. This is particularly true when the departing executive is the CEO.This section draws on "The board of directors' role in CEO succession," (2006) interview with Heidrick & Struggles, "Building high-performance boards"; and Lucier et al. (2006).

The reasons for a CEO's departure generally fall into one of four broad categories: (a) the CEO leaves to become the chief executive of another company; (b) the CEO retires or takes an extended leave of absence; (c) the board decides to replace the CEO with someone better suited for the current environment or for likely changes in strategy or market conditions; or (d) the company's board fires a failing CEO.

These first two scenarios force a board into a reactive posture; the departing executive initiates the event and the company must respond in some way. A board's ability to effectively respond to such a scenario depends on many factors, but its preparedness and the amount of time it has to react are perhaps the most important. Unless comprehensive succession plans have been in place for a while, boards may have little choice but to recruit an outsider. One of the most compelling reasons for an effective succession-planning process is that the board will have a better understanding of the skills and competencies needed to lead the company going forward, and therefore will be in a better position to decide whether to go with an insider or an outsider and what qualifications the ideal candidate should have. Thus, a well-thought-out succession-planning process enhances the board's ability to make an informed choice among prospects and broadens its portfolio of alternatives.

The last two scenarios involve a proactive change initiated by the board, and therefore represent different challenges. As painful and disruptive as it can be, the dismissal of a CEO often provides companies a much-needed opportunity to reexamine goals, strategies, and values. One scenario involves the replacement of an incumbent CEO who has been successful up to the present time but may not be the best person to lead the company in the future. Examples include the replacement of a company's founder whose decisions have become detrimentally biased by emotion, of a private-company's CEO by a professional manager with experience in taking companies public, of a growth company's CEO in need of a leader familiar with rapid multinational expansion; or of a CEO of a company facing unprecedented competitive demands. A second even more traumatic scenario involves the dismissal of an underperforming CEO or a firing for cause.

A board's decision to appoint transitional leadership during turnarounds, mergers, or acquisitions, initial public offerings (IPOs), restructurings, or other times of substantial change provides another example of a proactive change. The right interim CEO—tested in crisis and trusted by employees, creditors, and shareholders—can steer the company through its volatile period while the search for a permanent successor continues.

5.4 CEO Selection: Common Board Mistakes

Many of the succession failures can be traced to a few common mistakes, all of which are exacerbated by a board's lack of preparedness.This section is based on Lucier et al. (2006) and Charan (2005, February).

The first occurs when emotion wins over reason. There have been several instances in which boards of high-profile public companies over-reacted when challenged with the appointment of a new CEO. One way this can occur is when a board, under strong media pressure and financial analyst scrutiny, feels it needs to act quickly and ends up choosing a well-known "star" rather than deliberately doing homework and carefully defining the specific traits, competencies, and experiences appropriate to the position.

A critical lack of knowledge of what works and, equally important, what does not, is a second factor. A board facing the departure of a CEO has a number of options, each with advantages and disadvantages. Unfortunately, three of the most popular CEO replacement recipes do not seem to work well in practice. The first is selecting a *prior* CEO, someone with experience as the head of another large public company. Prior CEOs appear to bring important advantages. Many of them have a track record of creating shareholder value and already know how to work effectively with a board of directors, communicate with investors and security analysts, and develop and implement strategy. There is compelling evidence, however, that prior CEOs perform no better and sometimes worse than new, previously untested CEOs. This suggests that prior CEO experience may not be as valuable as experience in the company, in the industry, or with the types of challenges the company faces. It also points to the need for candidates to have a high level of energy to take on a major new challenge.

The most popular CEO replacement strategy is *poaching* a currently successful CEO from another large corporation. This strategy also reflects the belief that executive leadership is a generic skill set, not specific to either the industry or company. The current evidence regarding the efficacy of this strategy is thin because only a few of these CEOs have completed their career. If, however, the generally subpar results associated with hiring prior CEOs hold true for active CEOs hired from other companies, poaching may also be a losing proposition.

Both the prior CEO and poaching strategies are based on the idea that bringing in an outsider is better than choosing someone from inside. While there are times when it makes sense to recruit an outsider, for example, when the organization needs to be shaken up, an outside search should not be the only option. Although some outsiders come into a company, rally the troops, and create a following, others are immediately overwhelmed by what they need to learn. Rather than being highly visible and engaged leaders, they lock themselves in their offices with a few key executives and volumes of data. And because they do not spend enough time with key customers, employees, and other significant stakeholders, they risk being viewed as outsiders. All other things being equal, inside candidates, at least, are familiar with the culture and the business, a trait that gives them a leg up on outside candidates. Unfortunately, when inside candidates are automatically ignored, outstanding executives and future leaders one or two layers down in the organization may leave the organization, imperiling succession down the road.

The third common replacement strategy—making the chief executive chairman of the board while promoting a second individual, from inside or outside, to the CEO position—is another example of a seemingly good idea that can be disastrous in practice. This **apprentice model**[2] covers more than one third of all CEO departures in 2005. In theory, the apprentice model sounds great: not only is it consistent with best practice because it separates the roles of chairman and CEO, but it also keeps the skills and experience of the former CEO available and allows for mentoring the new CEO.

The practical evidence is more sobering. The 2005 Booz Allen Hamilton study compared three governance models: the combined chairman–CEO; distinct roles, with someone other than the previous CEO serving as chairman; and the chairmanship held by the former CEO. The results were unequivocal: the best performing companies were those in which the roles were split and the chairman was a true outsider, not the former CEO. The study attributes the apparent failure of the apprentice model to the inevitable ineffective division of responsibility and authority that it promotes. As the company's former CEO, the new chairman for many years set the direction for the company, controlled promotions and compensation, and defined the company's culture to both employees and external stakeholders. In his or her new position, he or she is likely to be approached by anyone who is unsettled by the successor's strategy or actions. In more extreme cases, if the former CEO is unhappy with either the direction of the company or its performance, he or she can get the apprentice fired and take back the CEO title.

There are other shortcomings to this model. Having the former CEO around to offer guidance creates the impression that the new CEO needs more training and is not yet really qualified to do the job, undermining his or her authority. And letting the former CEO manage the board—a board whose members know or appointed the former CEO or worse, were made board members themselves by that CEO—also hampers the new chief executive's ability to develop a good relationship with the board and gain support for his management agenda.

2. A model of making a corporation's chief executive officer the chairman of the board while promoting a second individual, from inside or outside the company, to the position of CEO.

It should also be noted that the apprentice model is inconsistent with the new regulatory climate and the rise of **shareholder activism**[3]. Sarbanes-Oxley stipulates that a majority of board members must be independent, reducing the number of insider slots, and that nominating committees consist entirely of outsiders. At the same time, shareholder activists strongly favor a model in which the chairman is an independent outsider.

A final common mistake in choosing a CEO is an over-reliance on executive recruiters. No executive recruiter can understand a company's challenges as well as the current CEO or the board. In the absence of an effective succession-planning process and a carefully articulated list of desirable qualifications, however, recruiters may be forced to substitute their own, more generic list of desirable CEO attributes. In the absence of specific directions, executive recruiters also tend to gravitate to the prior CEO and poaching strategies for the reasons described above.

3. Activism on the part of shareholders that encourages corporate changes or even turnaround in social and environmental policies.

5.5 Insider or Outsider?

When companies lack the culture or the processes to internally develop their next CEO, they have no choice but to look outside. More than a third of the Fortune 1,000 companies are run by external appointees. Recruiting from outside is almost always more risky than promoting from within because directors and top management cannot know outside candidates as well as they know their own people. Outsiders are often chosen because they can do *a* job, such as turn around the company or restructure the portfolio. *The* job, however, is to provide purposeful leadership to a complex organization over a sustained period of time. But, as noted earlier, the requirements for that larger job unfortunately are often not well defined by the board. What is more, a wrong outside appointment can have a devastating effect on a company's prospects. New leaders bring new talent and different management styles, thereby threatening continuity and momentum. In many such instances—as morale drops—the energy to execute dissipates as employees worry about the security of their job, and, rather than focus on the competition, companies begin to look inward. Bad external appointments are also expensive, since even poor performance is often rewarded with rich severance packages. That does not mean going outside is always wrong. Sometimes an external candidate exists who is, very simply, the best available choice. A skillful, diligent board may discover an outstanding fit between an outsider and the job at hand, as was the case when IBM attracted Lou Gerstner.

Just as going outside is sometimes the right choice, selecting an insider can be a big mistake. In fact, in certain situations, internal candidates present the greater risk. Some concerns about insiders, ironically, stem from their very closeness to the company. As Charan notes,

as "known quantities," they may sail through a lax due-diligence process. Or their social networks and psychological ties may complicate efforts to change the culture. Some will not have had the right experience or been tested in the right ways. Individuals from functional areas may not be up to the task of leading the entire business. Or a shift in the industry or market landscape may render carefully nurtured skills irrelevant. In some cases, the credibility of the outgoing CEO or management team may be so sullied that only a new broom can sweep the company clean.Charan (2005), p. 75.

5.6 Grooming the Next CEO

Effective succession planning requires significant company investment and senior managers who understand and are committed to individual development. In today's ever-changing business environment, where lifetime employment is not necessarily desired and certainly not taken for granted, good succession planning helps high-potential talent acquire key leadership and managerial skills and is a useful way to retain important players.

Few companies are in the enviable position of General Electric or Microsoft, where positions at the director level and above usually have a minimum of two or three people ready to step in when the current jobholder moves on. Many companies do a decent job nurturing middle managers, but as the robust market for senior managers attests, meaningful leadership development stops well below the top. Even in companies with strong development programs, very few leaders will ever be qualified to run the company. General Electric had around 225,000 employees in 1993 when Jack Welch identified 20 potential successors; over 7 years, he narrowed this number to 3. As Charan notes, "In CEO succession, it takes a ton of ore to produce an ounce of gold."Charan (2005), p. 76.

There are many challenges to developing the next CEO. To prepare candidates for a 10-year run in the top job, companies must identify candidates when they are around 30 years of age and expose them to the right challenges and mentors for a period of 15 or more years. Few companies have the skill, resources, or commitment to spot and evaluate potential talent this early and purposefully. What is more, most companies do not know how to provide their most talented managers with the kinds of experiences that prepare them for the CEO role. The development of the next generation of leaders requires creating challenging assignments and "stretch jobs" supported by coaching, mentoring, and action learning. Action learning brings high-potential individuals together to work on a pressing issue, such as whether to enter a new geography or launch a new product. It forces emerging leaders to look beyond their functional silos to solve strategic problems and, in the process, learn firsthand what it takes to be a general manager. Unfortunately, however, many companies still view succession planning as primarily a human resources function and equate leadership development with rotating candidates through multiple functions or cultural assignments. Although valuable, such an approach does not prepare a candidate for the unique challenges associated with being a CEO. Functional leaders learn to lead functions, not whole companies. Moreover, a major drawback of rotation-based development programs is that potential candidates often do not stay long enough in one position to live with the consequences of their decisions. The very best preparation for CEOs is progression through positions with responsibility for steadily larger and more complex profit and loss (P&L) centers. A candidate might start by managing a single product, then a customer segment, then a country, then several product lines, then a business unit, and then a division. Whatever the progression, overall P&L responsibility at every level is critical.

Leadership development is only part of the solution. Boards can greatly improve the chances of finding a strong successor in other ways. Senior executive development should be an explicit element in the charter of the board's compensation committee. The committee should receive and create regular reports on the pool of potential CEOs and spend time getting to know the top contenders. Promising internal candidates should be invited to give presentations at board meetings and meet informally with directors whenever possible. Directors should also be encouraged to meet with and observe candidates in their own business operations. Finally, the full board should devote more time to succession; at minimum, the list of five top contenders, both internal and external, should be reviewed and updated twice a year.

The right process starts with the board's commitment to make succession a permanent agenda item for the board and to meaningfully link succession with strategic oversight. Directors must thoroughly understand how the CEO adds value, what the key strategy levers are that the chief executive has or must create to achieve the company's strategic objectives, and what skill sets and leadership attributes he or she needs to be successful. This requires that directors have a deep knowledge of the firm's competitive position and challenges, its unique competences, as well as its cultural and administrative heritage. Only this depth of knowledge allows a board to focus its search on the key executive skills and past experiences needed to effectively move the company forward.

As noted earlier, no firm can rely exclusively on developing new talent internally. Even in the most talent-rich organizations, fresh ideas and new perspectives are sometimes needed. Executive search firms can help bring in new talent from the outside but can only be effective if the board does its homework. Search firms can open doors; identify and screen candidates; conduct thorough, fact-based due diligence on candidates; and create a bridge between the board and candidates; however, they cannot tell the board what leadership qualities and experiences it should look for. It is incumbent on the board, therefore, to provide the search firm with a detailed profile of the skills, experiences, and character traits it thinks the next CEO needs to have.

In all of this, the role of the outgoing CEO, if he or she has one, should be mainly consultative. He or she must be active in spotting and grooming talent, help define the job's requirements, provide accurate information about both internal and external candidates, and facilitate discussions between candidates and directors. But they have no vote when it comes to choosing the successor: That decision belongs to the board.

5.7 Succession Planning: Best Practices

Succession planning is a dynamic process too often given short shrift when it is regarded as an human resources–led exercise rather than a high-priority, comprehensive board-led process. High-impact succession planning is a continuous leadership "optimization" process with the goal of identifying and developing a pool of talent armed with the skills, attributes, and experiences to fill key leadership positions, including that of CEO, as well as the cultivation of a talent pipeline to meet emerging leadership needs. Succession and development processes that are rooted in best practice principles have the following components:"The Role of the Board in CEO Succession," a best practices study published by the National Association of Corporate Directors (NACD) in collaboration with Mercer Delta Consulting, April 2006.

1. *Plan 5 to 10 years ahead*. A multiyear process is essential to develop and prepare internal candidates versus recruiting from outside the company.
2. *Involve the full board*. The full board is required in critical parts of the process (establishing criteria, evaluating candidates, and making the decision) and should not be relegated to a committee.
3. *Establish an open and ongoing dialogue and an annual review*. The board and the CEO should maintain an open and ongoing dialogue on succession planning. A review of the plan and candidate assessments must be held at least once a year.
4. *Develop and agree on a comprehensive set of selection criteria*. Criteria for the new CEO should be developed with the company's future strategic needs in mind and include bottom-line impact, operational impact, and leadership effectiveness dimensions.
5. *Use formal assessment*. Formal assessment processes from multiple sources provide information that helps boards objectively assess candidates and identify development needs.
6. *Interact with internal candidates*. Board members should be given ongoing opportunities to interact with internal candidates in various settings.
7. *Stage the succession but avoid horse races*. Candidates should be placed in a series of expanding roles that give them the opportunity to learn and grow, and allow directors to assess their abilities. The potential successors should never be publicly announced, so candidates do not feel they are competing for the role.
8. *Develop a good working relationship with an executive search firm to identify, screen, and attract external candidates.* While many boards prefer to

develop internal candidates because they are familiar with the "territory," the pool should be enriched with talented outsiders.

9. *Have the outgoing CEO leave or stay on as chair for a limited time*. The outgoing CEO should either leave the board immediately or stay on as chairman for a transitional period of 6 to 12 months maximum in order to avoid potential leadership conflicts.
10. *Prepare a comprehensive emergency succession plan*. Emergency succession planning should be dealt with as soon as a new CEO takes the helm. The board should review the plan every year thereafter.

For some final wisdom on this subject, consider Warren Buffett's reassuring words to Berkshire Hathaway shareholders in his 2005 annual letter:

As owners, you are naturally concerned about whether I will insist on continuing as CEO after I begin to fade and, if so, how the board will handle that problem. You also want to know what happens if I should die tonight.

That second question is easy to answer. Most of our many businesses have strong market positions, significant momentum, and terrific managers. The special Berkshire culture is deeply ingrained throughout our subsidiaries, and these operations won't miss a beat when I die.

Moreover, we have three managers at Berkshire who are reasonably young and fully capable of being CEO. Any of the three would be much better at certain management aspects of my job than I. On the minus side, none has my crossover experience that allows me to be comfortable making decisions in either the business arena or in investments. That problem will be solved by having another person in the organization handle marketable securities. That's an interesting job at Berkshire, and the new CEO will have no problem in hiring a talented individual to do it. Indeed, that's what we have done at GEICO for 26 years, and our results have been terrific.

Berkshire's board has fully discussed each of the three CEO candidates and has unanimously agreed on the person who should succeed me if a replacement were needed today. The directors stay updated on this subject and could alter their view as circumstances change—new managerial stars may emerge and present ones will age. The important point is that the directors know now—and will always know in the future—exactly what they will do when the need arises.

The other question that must be addressed is whether the Board will be prepared to make a change if that need should arise not from my death but rather from my decay, particularly if this decay is accompanied by my delusional thinking that I am reaching new peaks of managerial brilliance. That problem would not be unique to me. Charlie and I have faced this situation from time to time at Berkshire's subsidiaries. Humans age at greatly varying rates—but sooner or later their talents and vigor decline. Some managers remain effective well into their 80s—Charlie is a wonder at 82—and others noticeably fade in their 60s. When their abilities ebb, so usually do their powers of self-assessment. Someone else often needs to blow the whistle.

When that time comes for me, our board will have to step up to the job. From a financial standpoint, its members are unusually motivated to do so. I know of no other board in the country in which the financial interests of directors are so completely aligned with those of shareholders. Few boards even come close. On a personal level, however, it is extraordinarily difficult for most people to tell someone, particularly a friend, that he or she is no longer capable.

If I become a candidate for that message, however, our board will be doing me a favor by delivering it. *Every* share of Berkshire that I own is destined to go to philanthropies, and I want society to reap the maximum good from these gifts and bequests. It would be a tragedy if the philanthropic potential of my holdings was diminished because my associates shirked their responsibility to (tenderly, I hope) show me the door. But don't worry about this. We have an outstanding group of directors, and they will always do what's right for shareholders.

And while we are on the subject, I feel terrific.