Navigating the barriers to CEO succession

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It is only relatively recently that the task of actively managing the CEO's succession has become recognized as a foremost priority for U.S. boards. With some notable exceptions, many boards are falling short of their responsibility to plan rigorously for a smooth transition at the top.

A number of factors have combined to bring the issue of leadership succession to the fore. First, corporate governance reforms have raised the level of accountability for executives and independent directors alike, making it more difficult to survive a period of poor performance. Second, these same reforms have empowered shareholders to take a more active stance against management failings and boards that do not rectify those failings. Third, the primacy of the CEO in the boardroom has been lessened by the emergence of the lead independent director and, in certain cases, by the appointment of a separate chairman to lead the board. These factors have made the CEO far more vulnerable than in the past.

CEO tenure is getting shorter, but it is not just the CEO who is vulnerable. The early, unexpected departure of a CEO often has a negative impact on the company's share price, as investors speculate on how effective the replacement will be and whether the board is competent to restore stability to the organization. A well-thought-through succession plan will, however, go a long way toward mitigating the negative impact of a CEO's departure.

Perhaps surprisingly, the only corporate governance regulation covering CEO succession appears in Section 303A of the NYSE Listed Company Manual, which states that every company is required to adopt and disclose its own corporate governance guidelines. The manual includes management succession as one of seven subjects that must be addressed in these guidelines:

> *Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.*

With the number of CEO departures in North America on the increase, CEO succession has become of paramount importance.[1] Yet our experience is that some boards are still reluctant to face the issue head on; the gap between intention and execution is sometimes conspicuously wide.

How, then, should boards respond to the succession planning challenge? The ideal scenario is that of a stable company, performing at or above market expectation, whose board takes a well-planned, long-term view of succession and has created the right environment to identify, develop and retain its future leaders. In reality, this rarely happens; no company — even one with a sound long-term succession plan — can afford to be complacent or can escape the possibility that short-term, urgent succession activity may be necessary. A CEO may decide, due to illness or for other personal reasons, to leave earlier than planned, in which case a short-term solution will be needed.

Some boards focus properly on succession only when faced with a performance crisis, in which case it is probably too late — they will almost certainly have to look outside the organization for a replacement CEO. Whatever the situation, a board's ability to handle succession will depend on a combination of structural and psychological factors. So what are the barriers preventing boards from dealing effectively with the issue of CEO succession?

Barriers to CEO succession

Board distractions

Boards have to strike a balance between focusing on matters of immediate concern and considering the long-term goals of the organization. Priority is inevitably given to what appear to be the most pressing issues, such as corporate governance, financial probity, strategy development, M&A, quarterly performance, shareholder demands, CEO compensation — often at the expense of succession planning.

A sensitive subject

Communicating the need for succession planning is psychologically complex and requires delicate handling. Many boards are simply uncomfortable raising the issue for a variety of reasons. They may regard it as insensitive to put succession on the agenda when the CEO is relatively new in the role, or they may be reluctant to exacerbate the pressure a CEO is already under, by asking him to think about his successor.

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The reluctant CEO

The CEO who exerts an overly powerful influence in the boardroom is likely to make it difficult for other board members to raise the issue of his or her succession. Such a situation calls for a strong lead director to ensure that the topic is not overlooked. The more self-confident and politically astute CEO will embrace the development of a succession plan, and participate actively in securing leadership continuity in the best interests of the business and all its stakeholders. However, our experience is that CEOs sometimes are reluctant to raise the topic of their own succession.

The truth is that, as a business evolves, the requirements of its CEO also can change. At some point the experience and ability of the current CEO may not be sufficient to steer the business through its next phase, and so a different set

of leadership skills may be needed. This can be difficult to accept, especially for someone wedded to the power and prestige that comes with the top job. However, as others have pointed out, a CEO's true legacy is determined by what happens to the company after he leaves office. Those CEOs who recognize that they are not weakening their position by embracing the succession issue are doing themselves a favor, as well as benefiting a broad range of stakeholders.

Complacency

Many boards think they are doing well, yet their definition of a good succession plan is often inadequate. Board members may find themselves too close to the CEO, lacking a sufficiently independent or objective mindset necessary to tackle the subject effectively. In addition, the board may not have sufficient experience in overseeing a succession plan. It is good corporate governance for a board to contain at least one person with firsthand experience of senior-level succession planning.

Lack of objectivity

When boards do turn their attention to CEO succession, it is a mistake for board members to rely solely on their own subjective views of possible contenders. For example, there is a commonly held preconception that internal candidates are saddled with too much baggage, unable to approach the challenge of the CEO's job in a fresh manner, or that external candidates lack crucial product knowledge and credibility with customers. Both views can be grossly unfair to potential contenders.

A good starting point is to undertake an objective assessment of potential succession candidates, both inside and outside the organization. In case the CEO has not been entirely forthcoming or accurate in his assessment of senior-level reports, many boards find it extremely helpful to retain external advisers who can conduct a thorough benchmarking exercise early on in the process. Benchmarking potential succession candidates against the best leadership talent outside the organization brings a crucial element of objectivity to the process and ensures that no one is overlooked in the search for a new CEO.

Lack of agreement about the specification

When succession plans fail, it is often because a board does not understand the characteristics of the ideal candidate. The board cannot make a good decision about the future leader without first agreeing to a clearly defined specification for the future CEO role. That spec must take into account the vision of the company, its long-term strategy and any developments taking place in the industry sector. Without a comprehensive spec to work from, the board is going to find it extremely difficult to make the right decision.

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Lack of CEO-ready talent on the inside

Not all companies will be blessed with a crop of potential successors with the talent and experience to assume the CEO role within the given time frame. Demands on CEOs are increasing all the time and, as a result, fewer people are qualified to step into the top role. This is particularly true in organizations comprising few lines of business or little diversity of offerings, where the pyramid of potential successors can be quite narrow. Particular effort must be made to nurture and develop talent in an organization where there are fewer opportunities to put people into general management roles.

CEO-ready talent is more easily found inside a multinational, multi-industry company. This is borne out by the 2006 Corporate Board Member Survey, *What Directors Think*, which found a correlation between the size of a company's revenues and the board's satisfaction with management succession. Potential CEO successors tend to learn general management skills in multi-industry companies such as GE, where there are abundant opportunities for high-fliers to run parts of different businesses at an early stage in their careers. Of course, there are no guarantees, even in these larger businesses — many of the leadership skills required of a CEO are unique to the top role and therefore not easily learned.

The threat of losing good people

Some boards will ask themselves whether openly executing a succession plan is worth the risk that disappointed contenders may decide to leave. For most organizations the loss of a couple of leading figures will be devastating and every effort should be made to avoid this happening. How the board and CEO manage communications with senior executives is critical; if it becomes widely known that there are two or three potential successors to the CEO, people inside the organization may split into camps and this can have a deleterious effect on the culture.

Navigating the barriers

As we have seen, there are a number of barriers that boards must overcome before they are able to develop and implement an effective CEO succession plan. Many of these barriers are psychological, involving perfectly understandable fears, perceptions and sensitivities. The fact that these "soft" factors so often interfere with the task suggests that many boards lack a formal framework for succession planning.

The most effective way to overcome these psychological barriers is to create a mechanism that will enable board directors to apply themselves to the task of succession planning in an objective, emotion-free manner. A robust process matters as much for succession as it does for audit, board nominations and compensation. Indeed, it could be argued that without such a process in place, the board is neglecting its fiduciary responsibility.

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One solution is for the board to set up a committee with explicit responsibility for overseeing the CEO succession planning process. With a mandate to look at short-, medium- and long-term scenarios, the committee membership should be well balanced and capable of covering this task effectively.

The more "matter-of-fact" the process, the less alarming it will be for everyone concerned, including the CEO. Ideally, of course, the CEO would participate actively and enthusiastically in finding his or her successor, but in any case the existence of a committee will ensure that the board is not reliant on the CEO to raise the topic.

No one should be in any doubt that this will involve a serious time commitment. However, the presence of the committee increases the likelihood that board members will invest the time to get to know the pool of potential successors personally. Its value in guiding the board to the right decision, ensuring an orderly transition of power and keeping all the internal candidates motivated can be substantial.

Both the current CEO and the senior human resources officer will have a role working alongside the committee, as will outside consultants who can provide benchmarking and assessment services and potentially act as a catalyst or facilitator for board-level discussion on the topic.

Alternatively, some companies may favor a less formal, more ad hoc approach, creating instead a "task force" of interested directors with no charter. The danger with this approach is that an informal task force might be perceived as acting under the radar, perpetuating the stigma associated with succession planning — making it seem like a delicate topic. Whatever its title, the very existence of a formal board entity sends out an important message about the routine nature of the succession planning process, and automatically overcomes any reluctance to raise the issue in the first place.

To avoid rumor and speculation and to minimize the effect on the company's shares, the board should exercise particular discretion over CEO succession planning. If a proper relationship exists between board, management and shareholders, the latter should be satisfied in the knowledge that a well-thought-through process is in place and in the hands of qualified directors. Institutional investors need to have

confidence that the board is taking care of succession but do not need to have any further window on the process. Similarly, the board must communicate whatever process is in place, but should not feel compelled to divulge particulars.

Finally, it is vital that the successor to the post of CEO is suited to lead the company of the future, not the company as it stands today. The first step towards framing a succession plan is likely to be the board retreat, when directors focus on long-term strategy. With the strategy in place, and a vision for what the company will look like in five to 10 years, only then is it possible to create the spec for the future CEO and start the identification process with confidence.

About the authors

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Footnotes

1. A study by Chuck Lucier, Paul Kocourek and Rolf Habbel of Booz Allen Hamilton, "CEO Succession 2005: The Crest of the Wave," showed that CEO turnover in North America rose from 12.9 percent in 2004 to 16.2 percent in 2005.