NADLER
Advisory Services

The Board and CEO Succession

New Models for a New Era

The Board and CEO Succession

The handoff of leadership from one CEO to another is an important event in the life of any enterprise. "Passing the baton," as it has been called, is a critical challenge, made all the more complicated by the interplay of corporate politics and personal emotion. Additionally, as difficult as the succession process has always been, it has become infinitely more complex in the current corporate environment. Prior to the modern era of corporate governance, no organizational endeavor spoke more clearly to the primacy of the CEO than the succession process.

In hindsight, since the tipping point was reached midway through the first decade of the 2000s, the redefinition of board and management roles has progressed with surprising speed. In a few short years, a process that traditionally amounted to the board routinely ratifying the CEO's personal choice of a successor transitioned first to a shared responsibility and now is rapidly gaining acceptance as the board's responsibility, with important input from the CEO. Indeed, the changing environment is reflected in a parallel shift in who engages us to do this work; these days, more often than not our clients for succession tend to be boards rather than CEOs.

Our purpose here is to describe the emerging model of CEO succession, with particular attention to the critical success factors and the implications both for boards and CEOs as they embark on this all-important endeavor.

The New Environment of CEO Succession

In recent years, the CEO position has attracted unprecedented attention, with each organization's value and stature tightly bound up in its CEO's reputation and performance. Today, CEOs operate in an environment of dynamic global markets, constant changes in technology, continuing economic uncertainty, and the dramatically increased role and influence of external constituencies (interest groups, regulators, etc.).

It's no wonder, then, that the incidence of CEO failure has grown sharply over the past decade. The overall trend is toward a significant and persistent increase in the number of CEOs whose careers are cut short due to performance – either the company's, their own, or both. We are seeing this trend globally, but it is particularly evident in North America and Western Europe. The data indicate that CEO failure is associated with significant decreases in company performance (although it is sometimes difficult to determine which came first).

At the same time, there is increasing disillusionment with the idea of hiring a "celebrity CEO" from the outside. Research has illustrated some serious flaws inherent in the external CEO recruitment process, which might account for the disappointing performance turned in by some "stars" hired from the outside. Instead, there's been a shift toward promoting from within, as many boards have concluded that "the devil you know" is probably a safer bet than the celebrity you don't. At the same time, there is a growing realization that identifying and developing top-level executive talent requires significant time and effort. It can't happen overnight.

Another important change in the succession environment is the role of the board. The fact is that in North America, public company boards have experienced increasing independence and accountability. When a CEO falters, the blame is shared by the board that appointed him and continued to support him as his performance faltered. Beyond that, boards have come to realize that even though the departing CEO traditionally led the way on succession decisions, it was the board that ultimately lived with the consequences long after the CEO was off somewhere else enjoying retirement.

With so many changes in recent years, we have observed some key trends involving boards and the succession process:

- The board is quickly moving toward becoming the overall owner of the succession process, with the understanding that the incumbent CEO has a crucial role to play throughout the process
- Boards want to see a larger slate of potential candidates, and they want to see them earlier in the selection process
- Boards want to see long-term succession planning, involving one or two generations out, to ensure that the leadership pipeline is being developed and managed
- Boards are becoming more focused on factors that contribute to CEO failure and want better information to help predict the performance of potential candidates
- Boards want more exposure to candidates in informal settings that allow for substantial personal interaction, rather than just seeing how potential candidates handle themselves during formal presentations at board meetings

Taken together, these trends signal a dramatic shift in the respective roles of the board and the incumbent CEO in the selection process.

The Changing Model of the CEO Succession Process

For years, the normal approach to CEO succession looked something like this: At some point in his/her tenure, the CEO started to identify potential candidates and, often with the help of internal or external advisors, gradually tested and developed them. In the best cases, the CEO periodically updated the board on the potential successors, how they were coming along, and what was being done to manage their development. As the CEO's tenure drew to a close – usually sometime in the final two years – the CEO selected a successor and informed the board. In all but the most unusual cases, the board gave its assent.

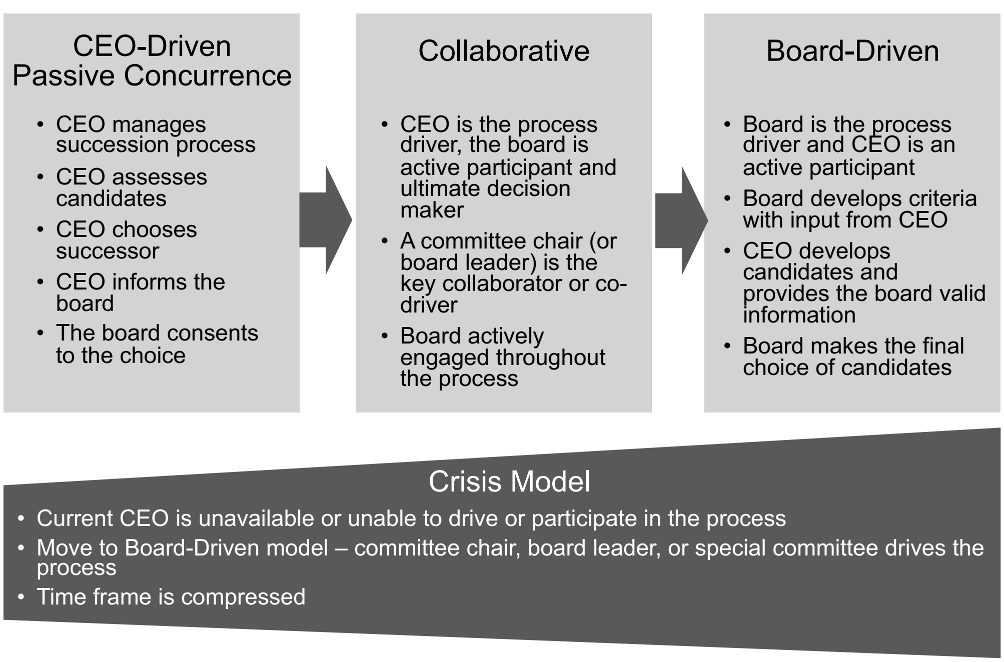
In that traditional process, the guiding principle was board concurrence. The CEO managed the process, made the decisions, provided the board with occasional updates, and eventually sought its approval in an up or down vote. It was very much a CEO-led succession model.

Starting in the 1990s, as boards became more active and engaged, they also got more involved in CEO succession – usually by becoming more assertive in the final stage of the process. Even during that period, however, many boards continued to be passive observers of the process, as we found during our work with directors and our research for the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Board Leadership. In a surprising number of cases, directors were still reporting in 2004 that the CEO managed the succession process alone and informed the board only after a choice had been made.

But at the same time, a new succession model was emerging, which reflected the board's changing role. At more and more public companies, the board began forging a new, collaborative model in which it actively partnered with the incumbent CEO. In many cases, the CEO still drove the process, but there was an assumption that the board would play an active role. A committee chair, or the lead director, would typically partner with the CEO to ensure the board had a voice in critical decisions throughout the process, culminating in the board's ultimate selection of a successor.

What has come as something of a surprise is the swiftness with which the collaborative model is becoming a relatively short-lived transition to what will likely emerge as the prevailing model at most U.S. public companies – the board-led model. A growing number of boards are actively asserting their overall ownership of the CEO succession process, including the design of the process, the timeline, and the respective roles of the board, its committees, and

FIGURE 1: Evolving Models of CEO Succession



management. In these cases, a board leader – the lead director or a committee chair – plays a central role in structuring the process and coordinating the efforts of the board and management.

Yet, it's not quite that simple: There are a few caveats to keep in mind. First, some CEOs remain reluctant to release their traditionally firm grip on the succession process. Some see themselves as infinitely better qualified than their boards to evaluate their potential successors; others view the board's desire to play an active role as an intrusion into one of the most treasured management prerogatives. The trend toward board ownership of succession is clear, but it hasn't always been easy or devoid of conflict. Second, it should be noted that it's not always the CEO who wants to maintain the status quo; over the years, we have encountered plenty of directors – and still do – who find it very comfortable to follow the CEO's lead on choosing a successor. Third, the board-led model is appearing most commonly at larger public companies; at smaller public companies and privately held firms, the collaborative or CEO-led models are still the rule rather than the exception, for now.

Finally, there are some situations that call for a special case of the board-led model – the crisis model. For example, a CEO may have become ill, incapacitated, or died. Alternatively, CEOs may be taken out of their roles because of either external factors (scandals, investigations, etc.), or internal factors (poor company performance, ineffective leadership), or a combination of both. The net effect is that the CEO is no longer capable of being a credible partner in the process, much less its driver. The result is a crisis model in which the board must assume active management of the succession process.

The crisis model can evolve in very different ways, but a constant is that the time frame for making the selection decision is dramatically compressed. One obvious implication is that boards that are actively involved in the succession process on a continuing basis are much less likely to find themselves caught without reasonable options if and when a crisis occurs. That underscores the importance of the ongoing development of succession alternatives through the active management of a talent pipeline.

Critical Success Factors in Succession Management

In the old CEO-led model, the succession process was frequently implicit. The CEO, often acting alone, would sort through the list of potential candidates using a personal set of intuitive criteria. The newer models require a much more explicit approach, and success rests on several critical factors:

CONTEXT

The board, with input from the incumbent CEO, must develop a shared perspective regarding the environment in which the next CEO will operate. They must reach agreement on the most significant strategic challenges the company is likely to face and the leadership capabilities the next CEO will need in order to meet them successfully. This "context" is a collection of predictions and hypotheses about the company's future, and they need to be revisited and tested over time.

CRITERIA

Based on that shared understanding of the context, the board must identify the specific dimensions that will be used to assess and select the candidates. Traditionally, the intuitive approach to succession has boiled down to a belief that candidates had to possess "the right stuff," even though it wasn't specifically defined. The succession process was a single elimination tournament; once a candidate demonstrated through poor performance a serious mistake or inappropriate behavior – that they lacked "the right stuff" – they were out of the game.

Contrast that with an approach that employs explicit criteria and assumes that all candidates either (a) have gaps that come from a lack of experience or capability, or (b) have not had the chance to test and/or demonstrate capabilities. The process assesses candidates against criteria, places them in situations that can help to develop or further test them, and over time, produces a picture of each candidate's relative strengths and weaknesses. The criteria are mixed – some are generic, others are specific to the situation. They should be observable and measurable. They should reflect the required leadership capabilities that were identified in the development of the succession context. They should involve those aspects of each candidate's behavior that are fairly established –what we might think of as "character"– as well as those capabilities that can be enhanced through further knowledge and skill. Figure 2 provides an example – a set of CEO succession criteria used by a technology company.

FIGURE 2: Sample Set of CEO Candidate Assessment Criteria

Strategic Criteria

1. *Strategic Vision.* Is capable of creating and articulating a future shared vision for Company A based on the financial, political, and technical aspects of the business and industry. Is able to deal with the complexity in the business and engage the organization in developing strategies that address key issues. Develops viable strategic alternatives consistent with strategic goals.

2. *Intellectual Capacity.* Demonstrates intellectual depth, agility, and guts. Serves as a source of creative ideas Encourages initiative and innovation. Is willing to challenge the status quo and actively solicits others' ideas for improvement.

3. *Technological Competence.* Keeps up-to-date on leading-edge developments in the high-tech industry. Understands and leads the development of technology and makes that a significant part of the vision for the next generation of Company A.

Personal Criteria

4. *Inspirational Leadership.* Inspires confidence and optimism through effective communication and by personal example. Is able to motivate others through his/her excitement and enthusiasm about the future direction of the company.

5. *Ethics and Values.* Demonstrates high ethical standards. Conveys high personal standards in how he/she behaves. Has a sense of social responsibility and social justice. Engenders trust – people trust his/her judgment. Places the needs of the business ahead of his/her own personal agenda.

6. *Respect for the Company A Heritage.* Embodies what the company represents. Is able to personally demonstrate the values, beliefs, and philosophy of the company. Respects the Company A heritage of success while demonstrating a readiness to keep reconfiguring the company for the future.

Interpersonal Criteria

7. *Constituency Relationship Management.* Seeks out opportunities to represent the company and its leadership in order to develop positive relationships with important constituency groups – external and internal. Easily relates to customers, talks to the analysts, effectively motivates employees, and deals with the board in an open, honest, and forthright manner.

8. *Team Builder.* Encourages and models collaboration across business units. Works effectively with peers. Shares information openly and freely with those who have a need to know. Behaves in a way that supports the team. Focuses on the development of people and recognizes team accomplishments.

Operational Criteria

9. *Breadth of Management Experience.* Has the breadth of business experience and a track record in general management assignments. Demonstrates sufficient knowledge of a wide range of functional areas of the business (finance, marketing, labor relations, IS/IT, manufacturing, engineering, customer service, etc.).

10. *Execution and Operational Excellence.* Translates vision and strategic intentions into concrete objectives and plans. Holds others accountable for performance expectations and plans. Ensures that subordinates have the information and tools needed to achieve goals.

11. *Focus and Delegation.* Focuses time and energy on the most important priorities. Makes clear-cut decisions when they are needed. Grants sufficient authority to direct reports to enable them to make significant decisions within their areas of responsibility. Structures work assignments in a clear manner while providing room for individual initiative.

At a growing number of organizations, the board has now become an active participant in this work. The board may not have full exposure to all the candidates, but it can and should play a major role in determining the assessment criteria and ranking their relative importance.

CANDIDATE POOL

A key to the collaborative model is properly identifying the broad pool of talent from which to draw candidates. It is essential for the board and the CEO to have alternatives at each stage in the process; at all costs, they must avoid finding themselves captive to a single candidate who knows that he/she is the only viable choice.

The initial pool must be sufficiently broad for two reasons. For one thing, the best candidates might not be the most obvious. The situation at Xerox in 2001 remains a classic case. The CEO was removed by the board, which then turned to Anne Mulcahy, the head of one of Xerox's smaller business units who had previously been overlooked for the CEO role. Anne went on to become a stellar CEO who led the company's successful turnaround. Years later, Xerox directors began to wonder whether there might be "other Anne Mulcahys" out there – other talented but overlooked individuals who ought to be included in a broader talent pool.

There's another reason why the CEO and the board should develop a broad talent pool. Ultimately, the board is doing more than selecting the next CEO; it is also responsible for ensuring that the company has a strong array of talent on the executive team. A broader pool gives the board a more complete view of the executive bench's strengths and weaknesses, and gives them an understanding of which executives can help to complement the shortcomings that any CEO is sure to have.

ASSESSMENT METHODOLOGY

Another critical factor is to ensure that the CEO and the board have a process for generating the data they need to measure the candidates against the selection criteria. A variety of methods are available. The CEO or other "older generation" executives can develop and apply rating scales; in some cases, board members with sufficient information might also rate the candidates. In other cases, impartial outsiders have been used to rate candidates based on performance reviews, 360-degree feedback, and other data.

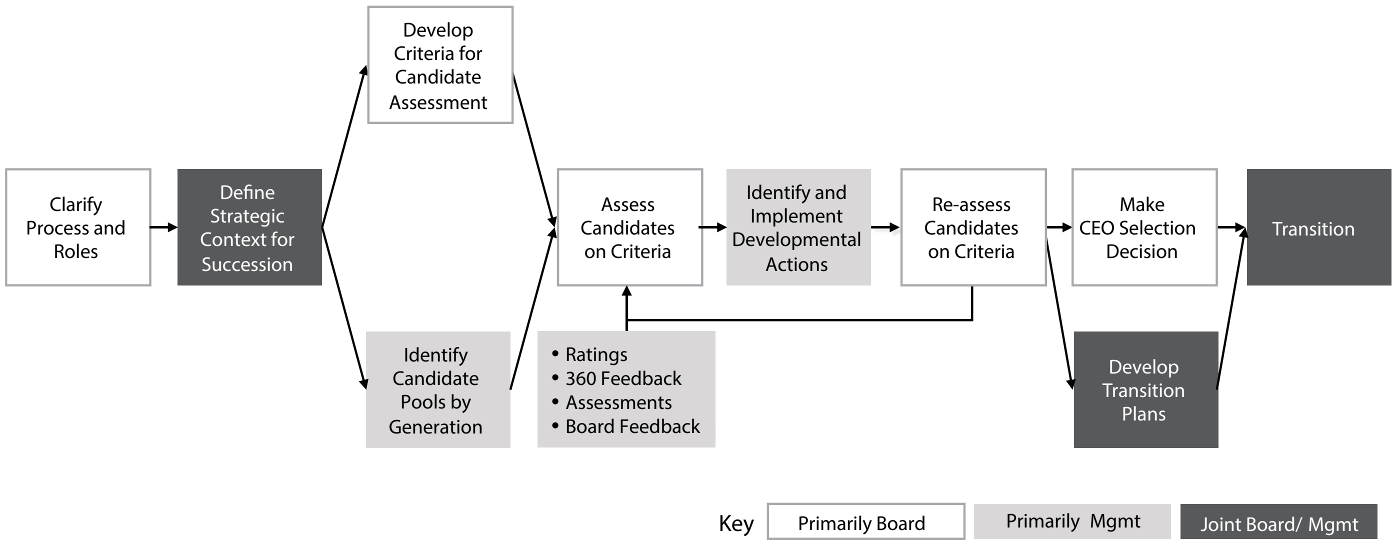
Regardless of the methodology, sound assessment has four objectives. First, the assessment is intended to generate *understanding* of the candidate, particularly with regard to their relative strengths and weaknesses on the specific selection criteria. Second, the assessment should *identify data gaps*. Structured assessment forces raters to confront what they don't know about the candidate and helps to identify experiences and activities that will help to fill in the blanks. Third, the assessment should enable *prediction* and provide some basis for anticipating how a candidate might perform in a particular situation. Fourth, the assessment should identify *developmental priorities* for each candidate. Through the identification of areas of weakness, the assessment should guide the design of assignments, experiences, or activities that might help the candidate to develop his/her capabilities.

Ultimately, a clear, rigorous, and consistent assessment methodology helps to level the playing field between the CEO, who deals with internal candidates on a regular basis, and the board, whose engagement with the candidates tends to be more episodic and, often, in highly structured situations. With the right criteria and assessment data, the board can be much more purposeful in its interactions with candidates, rather than just wondering whether the candidate has "the right stuff."

DEVELOPMENT PLANS

Few candidates emerge from the process fully formed, with all the capabilities in place to become an effective CEO. Even the best candidates with outstanding strengths almost always have areas they need to develop – specific skills, knowledge, or experience

FIGURE 3: CEO Succession – Key Process Elements
Board-Driven Model



they need to round out the profile. Therefore, another element of the CEO succession process is the design and implementation of development plans. Again, this is an area where the board should play an active role. If the directors have a clear set of criteria, a stream of assessment data, and firsthand experience with the candidates, they should be capable of actively contributing ideas about how to develop candidates, based on their experiences in their own companies and others.

TRANSITION PLANS

Ultimately, a choice is made, and the focus turns to "passing the baton" – a plan to bridge the gap between the period when the incumbent CEO is clearly still in charge and when the new CEO is operating effectively in the eyes of the board. The objective is to move the leading candidate (or candidate of choice) into the CEO job in stages while continuing to both develop and assess that candidate. It's crucial for the board to leave itself some room to maneuver – to change its mind if new information or insights suggest that their first choice might actually be a disastrous one, and, to the extent possible, the board should be concerned about retaining key players who might be disappointed about not getting the top job but will be sorely needed on the new executive team.

Transition planning usually requires thinking ahead and designing a number of different steps, with assessment and reflection at each step. Typically, there are three phases. First, the lead candidate is put into a position that will test his/her ability to lead at a more senior level and help prepare him/her for the CEO job. This may be through a role as chief operating officer or a sector executive of the core business of the company. The second phase is the designation of the individual as CEO, and during this period, he/she is engaged in thinking through the structure of the company and the composition of his/her new executive team. The next phase, which may be short, is the official designation of the heir apparent. The fourth phase is the overlap period, in which the new CEO runs the company, but the departing CEO continues in some other role, such as chairman of the board. Again, there are different approaches to this phase, ranging from the incumbent's immediate departure to an overlap lasting several years. The fifth phase occurs when the incumbent CEO is gone and the new CEO is fully in place and working through his/her "freshman year."

The board should be an active participant in planning and executing each of these phases; indeed, at the end of the day, it is the job of the board – not of the CEO – to make the final decisions regarding the shape and timing of the transition. It's not unusual for the incumbent CEO to feel vulnerable and conflicted as the handoff approaches; it's rarely easy to relinquish the reins of power. The board should be working closely with both the incumbent and the heir apparent throughout this period, providing the institutional continuity so critical during the transition. The changing of the guard is sometimes fraught with emotion and steeped in politics, and it is the board's duty to intervene if the process shows signs of going astray.

PROCESS AND ROLES

The CEO succession process requires a clear set of steps and absolute clarity about the relative roles of the board and the incumbent CEO (see Figure 3). It begins with a discussion of context and proceeds to the creation of criteria and the identification of the talent pool. It then moves to successive rounds of assessment, using a variety of appropriate methodologies. The board and the CEO build shared understanding and agreement through iteration. The cycle of assessment, discussion, development, observation, and assessment is repeated a number of times.

At the end of each cycle, the board and the CEO should step back and ask several questions: What are our potential choices? What should we do to further develop each candidate? What information are we missing, and what data should we generate to help us make our choice? What are the trade-offs among the different candidates? Given the relative strength or weakness of the field of candidates, does it makes sense to fill some top jobs with outside recruits who might eventually become credible CEO candidates?

Implications

In today's world, a robust succession model requires time, investment, and if at all possible, the ability of the board and the CEO to work together effectively. The emerging succession models imply several imperatives.

First, it is essential to start the process early. Too often, succession is left until the final year or two – and sometimes even less – of the incumbent CEO's term. Although it may seem very early and even premature, this approach requires the CEO and the board to begin the process early enough to provide time for engagement in assessment, development, and selection – and to leave open as many options as possible for as long as possible.

The second implication concerns talent development. The best succession process in the world will be severely hampered if, five years from transition, the board and the CEO realize the company lacks sufficient talent. To succeed, this approach requires a long-term strategy for developing and, when necessary, recruiting the right talent to fill and strengthen the leadership pipeline.

A third implication is the importance of clarifying the process and the role of the board and individual directors. There are many places for the board to be engaged – in the description of context, in the development of criteria, in reviewing and discussing assessments, in exposure to the candidates, in participation in the choice process, and in planning and overseeing the transition. This requires a continuity of engagement, with constant updates. The collaboration is created through an ongoing discussion over time, one that allows for constructive contention and helps to create a shared understanding and common point of view.

Fourth, transition is important. Frequently, there is a temptation to view the process as finished when the choice is made. How the baton is passed, and what happens during the overlap period, are critical to the initial success of the new CEO. The board has an absolutely crucial role to play as the ultimate designer and manager of the handoff.

Fifth, although it is difficult to contemplate, the board should always be preparing for a sudden departure. It can happen at any time, and it frequently occurs when least expected.

Summary

As a final point of guidance, the board needs to recognize that CEO succession has to be considered from at least three different perspectives. This paper has addressed the *technical perspective*, focusing on roles, processes, and methodologies that can aid in making rational decisions about succession. This perspective is absolutely necessary – but it's not enough. At least two other perspectives must be considered.

One is the *political perspective*. All organizations are inherently political, with various individuals and groups seeking power and influence to advance their interests and ideas. CEO succession is an event that, more than any other, surfaces the political aspects of any organization. Competition – the advancing of either oneself or the champion of one's agenda and interests – becomes intense, and frequently involves the board. Directors must remain acutely sensitive to the political dynamics and manage them, as much as possible, to avoid damage to the enterprise. The other way of looking at CEO succession is from an *emotional perspective*. The transition from one CEO to another can engender a range of different emotional reactions, especially from the incumbent and new CEO. The incumbent CEO must anticipate his/her own organizational mortality and the loss of stature and power. The new CEO is often anxious to take control and set his/her own agenda. Various feelings of anticipation, mourning, anger, elation, envy, and resentment all come into play. These are natural, but they need to be anticipated and managed.

Change in the nature of companies, the demands on leadership, and the shape of corporate governance have all contributed to a new environment for CEO succession. Those factors have combined, we believe, to create an imperative for a new approach to the succession task, one characterized by collaboration, engagement, and clarity.

About Nadler Advisory Services

Nadler Advisory Services offers highly specialized consultation to CEOs, boards of directors, and senior teams to help enhance the quality of executive leadership, corporate governance, and organizational performance. Nadler Advisory Services is firmly focused on high-level, close-in advice and consultation to CEOs, boards and senior teams in the following areas:

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  - Building an effective leadership team
  - Organizing the leadership of the enterprise
  - Collaborative strategy development
  - Effective communications
- Board Advisory Services
  - Assessment of overall board performance
  - Analysis of board composition
  - Evaluation of individual director performance
- CEO Succession Planning Services
  - Navigating all phases of the succession process: initiating the conversation, identifying and developing candidates, selection, transition planning, and supporting the new CEO

To obtain further information about Nadler Advisory Services, please contact us at info@nadleradvisory.com or at 1-917-633-4480.

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