

The Role of the Board in CEO Succession

A Best Practices Study

Marking a dramatic shift in the perceived balance of power between CEOs and boards, half the directors in a new study said the board, not the CEO, should drive the CEO succession process. The directors, who serve on boards of Fortune 500 companies with successful CEO succession records, said they are not only running more rigorous succession processes than they did as recently as five years ago, they are also getting intensely involved in executive assessment and development.

The practices that make these boards more effective at succession are detailed in a 2006 study published by the National Association of Corporate Directors (NACD) in collaboration with Oliver Wyman – Delta Organization and Leadership.

The goal of the research was to identify boards with excellent CEO transition records, find out how they are handling their increased responsibility and accountability for succession, and identify best practices in CEO succession planning—practical approaches that boards, and senior leaders, can introduce to improve their companies' succession processes.

The study draws on in-depth, one-on-one interviews with 23 directors from Fortune 500 companies with 2004 revenues ranging from \$3 billion to \$151 billion. Their boards all played a highly involved role in

CEO succession planning, had a robust CEO succession planning process, and had achieved a smooth and orderly CEO transition between 2002 and the first half of 2005 (post Sarbanes-Oxley). Participating companies came from a spectrum of industries, including airlines, aerospace, technology, retail, healthcare, pharmaceuticals, and consumer goods. They included Starbucks, McDonald's, and Microsoft. (For more information, see box, "Study Approach, Data Collection, and Analysis," on page 3.)

Governance experts asked directors on the boards of Fortune 500 companies with successful succession track records how they do it. How do they structure the CEO succession process? When do they start planning? Who takes responsibility? How do they time the process? What criteria do they use to assess candidates? How do they make the decision? And how do they ensure things don't derail during the critical transition period?

In their interviews, the directors discussed their personal experiences with succession and offered practical advice on how other boards can improve their effectiveness. An exhaustive analysis of their comments identified a number of actions that directors said are essential to succession planning and implementation—the best practices of CEO succession—and several leading-edge practices used by the most progressive boards.

10 Best Practices for Board Involvement in CEO Succession

1. Plan Three to Five Years Out.

Board/CEO discussions on long-term succession planning should begin three to five years before a CEO transition is expected.

Building in enough time to plan and implement a succession process is crucial. Boards prefer internal candidates, and it takes time to identify, develop, and assess them. CEO candidates need to be placed in progressively challenging roles to acquire critical experiences and skills.

Most of the directors said a focused effort requires a lead time of three to five years, beginning with identifying candidates and ending with transitioning the selected heir into the CEO position and, subsequently, the role of board chair. However, they also reported that the more typical time frame is an insufficient two years.

Many directors advocated requiring all directors to interact with the top candidates so they will be better able to discuss the candidates' capabilities and development needs.

2. Ensure Full Board Involvement.

The full board should be involved in CEO succession planning; the process should not be relegated to a committee.

All the directors stressed the importance of involving the full board in critical parts of the process—establishing criteria, evaluating candidates, and making the decision. A board may charge a committee or board member with overseeing the groundwork, and individual directors may be more involved in specific parts of the process. But the consensus is that the full board should participate throughout. Many directors also advocated requiring all directors to interact with the top candidates so they will be better able to discuss the candidates' capabilities and development needs.

3. Establish an Open and Ongoing Dialogue and an Annual Review.

The board and the CEO should collaborate on succession planning and devote substantial time to discussing the topic.

All the directors also emphasized the importance of continually engaging both the board and the CEO in the succession process. The suggested balance of the partnership and the roles each party should play differed, depending on the company. Half the directors in the study said the board, rather than the CEO, should drive the CEO succession process. But only 28 percent of the directors said this is how the process typically works (see figure on page 5).

In addition to regular discussions and updates at board meetings, the board should devote a full- or half-day session annually to reviewing the succession plan and candidate assessments, annually directors agreed. At one transportation company, the board and CEO meet once a year for a half day—with no one else in the room—to talk about succession planning. The CEO reports on the progress and future development plans for each potential candidate.

Study Approach, Data Collection, and Analysis

To identify the best practices in CEO succession planning, consultants from Oliver Wyman – Delta Organization and Leadership targeted boards that played a highly involved role in CEO succession planning, had a robust CEO succession planning process, and had achieved a smooth and orderly CEO transition between 2002 and the first half of 2005 (post Sarbanes-Oxley).

Out of 163 Fortune 500 companies that experienced a CEO transition in that period, 123 (76 percent) achieved routine, orderly successions. A panel of corporate governance experts—including NACD board members, academic thought leaders, and corporate governance consultants from Mercer Delta—nominated 37 as having done an exemplary job in planning for CEO succession; 23 companies agreed to participate in the study.

The consultants sought to speak with directors particularly knowledgeable about the succession process. Of the 23 directors interviewed, 55 percent chaired the board committee responsible for CEO selection and succession, and 27 percent served on the committee. Each discussion took 60–90 minutes and followed an outline of key issues, such as CEO succession planning, candidate development and assessment, and the CEO transition process. While the directors were asked a series of questions, they were free to talk generally about CEO succession and to spend more time on topics that interested them. Directors were told their comments would not be attributed to them by name; this facilitated open discussions and candid responses.

A rigorous process was used to analyze what the directors said in their interviews. Interview notes were dissected into unique comments, each reflecting a single idea or viewpoint. A total of 764 distinct comments were identified; these comments were then compiled and analyzed using content analysis software designed to surface key themes. A statistical analysis determined the relative importance of the themes and the number of people who talked about each one. This exhaustive analysis yielded 10 leading practices that appear to result in a successful CEO succession process.

4. Develop and Agree On Selection Criteria.

Criteria for the new CEO should be developed with the company's future strategic needs in mind.

"My recommended best practice is to get clarity, or better, unanimity, at the full board-member level around what criteria it takes to be a good CEO—not in the past, but going forward," said one director, a view voiced by many of the directors interviewed. The recommended starting point is to think through various scenarios for the future. "You can't just put together a list of attributes," said another director; the question is whether a candidate can "take the company where it has to go."

The key is for the board and current CEO to develop a shared perspective on the future business environment and the strategic challenges the company, and the new CEO, will face. The next step is to define the leadership capabilities the CEO will need to meet those challenges, as well as specific qualities and skills the CEO should have.

5. Use Formal Assessment Processes.

Formal assessment processes provide information that helps boards objectively assess candidates and identify development needs.

Often, the performance appraisals and data that companies generate don't provide sufficient information to adequately evaluate CEO candidates. The directors said that the best assessments rate candidates against the selection criteria for the CEO job, rather than against the candidates' past performance or current jobs. Describing the criteria in terms that are observable and measurable "takes the personality issue out of it," as one director said, "and gets you started from a more objective standpoint."

Many directors reported that they rely on feedback from a number of people within the organization. Conducted periodically, multisource appraisals (also called "360-degree" evaluations) provide information on how a candidate is developing, benchmark performance milestones, and pinpoint further developmental needs.

6. Interact With Internal Candidates.

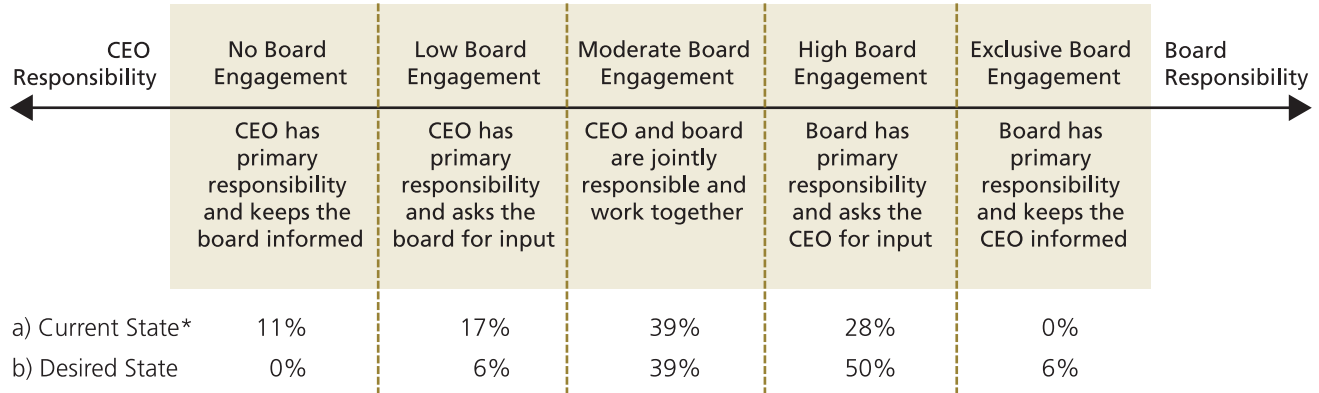
Board members should be given ongoing opportunities to interact with internal candidates in various settings.

Many directors believe they are better equipped to judge candidates when they can see them in action. "There's no substitute for seeing the individual in action, in situ," said one director. "You

"All of the ways of getting to know candidates are important," said one director, "but most important is getting to know the candidates over time."

CEO and Board Collaboration

How do CEOs collaborate with boards on CEO succession planning? Respondents were asked to indicate a) how they typically work together (Current State) and b) how they should work together (Desired State).



*“Current State” responses fall short of 100 because not all respondents answered this question.

Eighteen of the twenty-three directors completed a short survey on CEO succession. Excerpts from the survey findings are used throughout this report. Since the number of respondents is small, the results should be interpreted with caution.

can’t know how they connect with people and lead on a daily basis unless you see them. You can’t measure this by how polished they are in the boardroom.”

Directors described a number of ways to get to know candidates (see figure on page 7). One director is “a big believer in offsites” because they allow him to see how candidates act in a social environment. Another said dinners give him the opportunity to “watch how they answer questions” and observe their strategic-thinking process. A few directors said that seeing candidates working with their own people, without the CEO present, gives them a clearer understanding of a candidate’s leadership style.

One key is to observe candidates regularly. “All of the ways of getting to know candidates are important,” said one director, “but most important is getting to know the candidates over time.”

7. Stage the Succession but Avoid Horse Races.

Place potential successors in progressively challenging roles, but never publicly announce that they are being considered for CEO.

What most feel doesn’t work well is turning the process into what is commonly called a horse race: announcing possible successors and then having them “compete” for the role. Inevitably, people in the organization align with the person they feel loyal to—or the person they think will win. “It politicizes the company and is very divisive,” said one director.

8. Develop Internal Candidates Rather Than Recruiting Externally.

Internal candidates know the company’s culture and people, and directors.

Most of the directors voiced a strong preference for grooming internal candidates for CEO. This assures a board that the candidates will have the necessary knowledge and experience. In addition, years of internal assessments provide a wealth of information on candidates’ strengths and weaknesses. The result: a smooth transition of power, continued support of the corporate culture, and sustained execution of the company’s long-term strategy.

Bringing outside candidates into senior line positions is “very risky in my experience and some-

thing to be avoided,” said one director. They are “unfamiliar with the territory—they don’t know the culture, products, people, anything! There’s no loyalty to these people from the people in line operations. The failure rate is huge when this is done.”

In the few instances where directors reported hiring outside the company, they brought in the candidate years before the expected transition to give him/her the opportunity to learn the culture and the business.

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 chair for a transitional period of 6–18 months, maximum.

Surprisingly, more than half the directors who responded to the survey question on this issue said the outgoing CEO/chair should leave the company and the board at the time of the transition. “No CEO should have his old boss at the table,” said one director. “It’s just too confining.” Another director said it would “cast a shadow” and inhibit the new CEO’s ability to make changes.

If the outgoing CEO stays on as chair, it should be for a limited time; directors recommended a time frame of 6–18 months. They cautioned that this arrangement works best under certain circumstances. In particular, the roles of the outgoing CEO/chair and the successor must be designed with absolute clarity and tailored specifically for the two personalities involved. There should be no question as to who is in charge.

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.

Emergency succession planning is about preparing in advance for the unforeseeable—a health crisis, tragic accident, or even, as one director put it, an “‘Eliot Spitzer scenario,’ where something happens that potentially taints or removes your entire executive team.”

Several directors mentioned McDonald’s as an example of how boards should handle emergency succession. When the company’s 60-year-old CEO suddenly died from a heart attack, the board had “a good plan in place and moved swiftly to implement it when their crisis occurred,” observed one director. By acting immediately and naming a

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respected insider, the board reassured franchisees and investors that the company would continue to execute its strategy.

If a new CEO doesn't broach the subject of emergency succession planning in his or her first 30 days, the board should. In addition, a succession plan should be reviewed annually, as an out-of-date plan is of little use, and include scenarios for the entire executive team.

Leading-Edge Innovations in CEO Succession

Several directors described practices that are more exceptional and forward-looking than the best practices identified in this study. These boards have accomplished the building blocks of the process and, with foresight, are taking additional steps to ensure the success of CEO succession.

Solicit Multiple Perspectives When Making Key Decisions

Reputation is crucial to a CEO's effectiveness, so a board may want to collect feedback on candidates

from external constituents. For instance, a financial institution may want to get input from the government banking authority to make sure officials are comfortable with the choice. If institutional investors hold a major block of stock, the board might want to find out whether they would support a candidate's leadership. A board might also consider getting the opinion of a key vendor or customer whose loss could severely impact the business.

Soliciting feedback from Wall Street analysts is another practice suggested by a few directors. This won't guarantee a positive reaction from the market, but it can help raise a red flag that a candidate won't have investors' confidence. This should be done with caution, however, so as not to cause alarm or trigger a disclosure requirement.

Enhance Board Engagement in Talent Development

One board in the study is taking steps to enhance the caliber of the company's talent by working with management on developing leaders. Strengthening its executive bench is one of the company's top three strategic priorities. Directors have "substantial exposure to senior management." They review the company's "talent man-

Approaches to Meeting Internal Talent

How do board members meet and develop personal insights about the company's internal candidates? Respondents were asked to identify the practices with which they have had experience and rank them in order of helpfulness (with 1 being the most helpful).

I Have Experience With	Rank Order	
67%	1	Executives make presentations at board meetings
67%	2	Executives attend board offsite meetings/retreats
56%	3	Executives meet individually with board member or groups of board members
67%	4	Executives attend board dinners or other social events
22%	5	Other

agement book” annually; they even review succession plans for the top 75 positions.

The non-executive chair visits the company often and invests time in learning about its culture. Interacting with many employees gives him a perspective on how senior executives are perceived within the organization, which he shares with the rest of the board.

The company is now taking steps to amplify the role of directors in leadership development. The non-executive chair and senior executive vice president of HR are working together on a new global leadership development program for the most senior executives. Board directors will personally participate in the program.

Prepare Leaders Through Mentoring and Coaching

Most boards give new CEOs input on their development needs and progress as part of a structured feedback process, but a few directors discussed providing one-on-one mentoring to freshman CEOs and even top executives. In some situations, the primary mentor is the lead director or the outgoing CEO, who remains on as chair for a time. In others, it is one or more directors who have knowledge or personal experience relevant to challenges the CEO is facing.

Having board directors coach top executives is a less common practice. Most often, the goal is to help executives prepare for future senior leadership roles, particularly that of CEO. Individual coaching can be particularly helpful when a top candidate needs to work on interpersonal issues such as leadership style, cultural fit, and communication skills. Directors must avoid usurping the CEO’s authority when coaching executives. It is also crucial that they maintain their objectivity and resist backing a particular CEO candidate.

Build Up the Bench for Growth

A few boards participating in the study use the company’s leadership development and succession processes to guarantee that the company has the executive talent it needs to thrive. As one board member put it, “Talent is both the biggest catalyst and biggest restriction to growth.”

It’s no longer enough to leave talent development to Human Resources alone, according to these directors. The board must ensure that the company is committed to building a strong executive team. One director said his board does performance reviews and succession planning for the top 10 jobs. Another said the board considers the full executive team and a few generations past the current CEO, where

The directors interviewed for this study explicitly said that succession has become the board’s top concern.

The CEO Succession Process



turnover could damage the company's ability to perform. Good talent development ensures that a company has enough candidates to choose from for the next, or even the next two, generations of top managers, including the CEO.

Prepare for the Worst During a Transition

During a transition, other significant issues could arise to derail the succession's success, and even the company's future. Leading-edge boards use executive sessions to surface concerns and "what ifs." For instance, a shift in the market could cause an earnings collapse early in a new CEO's tenure. How would the board respond?

A company may even become vulnerable to a hostile takeover during a CEO transition. One director said that he experienced this twice—a takeover attempt was launched within weeks of a new CEO taking office. A board needs to plan how it will handle the situation before announcing a transition, including deciding who will run the company while the new CEO is fighting the takeover attempt.

Conclusion

Clearly, boards are thinking and behaving differently when it comes to CEO succession. The directors interviewed for this study explicitly said that succession has become the board's top concern. "A board's biggest responsibility is succession planning," said a director of a large technology firm who serves on several boards. "It's the one area where the board is completely accountable, and the choice has significant consequences, good and bad, for the corporation's future."

Several key trends regarding board involvement in CEO succession emerged in our discussions with the directors.

First, the changing context of the corporate governance environment has had a dramatic effect on the board's overall approach to CEO succession. Boards are acutely aware of the cost of being passive about CEO selection. Directors referred to a heightened sense of governance and accountability.

Second, the biggest change is a shift from a CEO-led, board concurrence process to a CEO-board collaborative process. Moreover, the study clearly suggests a continuing evolution toward a third model of succession—a board-run, CEO-input process. Half the directors said that this is how succession planning should work. In addition, while the directors described their engagement in succession as more intense, they were matter-of-fact about it. They stressed that selecting the CEO is their most important job, and it is imperative that the board run the process.

The third trend is that the shift in their role in CEO succession has induced boards to increase the rigor of the process—from creating explicit criteria and assessment procedures to implementing more thorough candidate development programs. They are doing as much as possible to ensure the company has a successful CEO, even exceeding practices considered due diligence.

Fourth, the episodic nature of how boards operate has caused them to engage in the succession process earlier and with greater intensity. Succession is now at the top of the agenda; directors are holding focused board sessions on succession at least

annually and including ongoing discussions in every executive session. They take a long-range perspective, acknowledging that ample time is needed to identify and develop the next CEO. Years before an expected transition, directors are reviewing the company's talent roster several generations below the CEO to identify and create development plans for potential candidates.

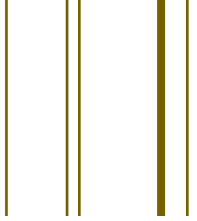
Fifth, there are a number of best practices and innovations being used by boards that have a track record of effective CEO transition to ensure, as much as possible, a successful CEO succession. In addition, they devote substantial time to the succession process as well as to related activities, such as talent management and executive coaching, that help a company develop leaders for the future. Many directors are involved personally, too: They are visiting company sites, working alongside management on development programs, and providing one-on-one coaching to candidates.

The directors we spoke with described their boards as independent and involved, and some acknowledged that their rigorous approach is ahead of the curve. Their commitment and sense of responsibility for the CEO succession process is decidedly intense. At the same time, they emphasized that they cannot imagine doing anything less.

The full study, "The Role of the Board in CEO Succession: A Best Practices Study," is available for \$150 per copy (\$50 for NACD members) by contacting NACD at 202-775-0509 or online at www.nacdonline.org.

About the National Association of Corporate Directors (NACD)

NACD, a national non-profit membership organization, is dedicated exclusively to improving board effectiveness by providing education, information resources, and benchmarking data to corporate boards and individual board members. The organization's 8,500 members and customers represent companies ranging from Fortune 100 public companies to private and closely held businesses.



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To obtain further information about Oliver Wyman – Delta Organization & Leadership, please contact us at deltainfo@oliverwyman.com or the telephone numbers below.

Visit us online at
www.oliverwyman.com

North America

Toll-free: 1.866.909.8239

Atlanta Philadelphia

Boston Portland

Chicago San Francisco

Montreal Toronto

New York

United Kingdom

London: 44.20.7343.9500

France

Paris: 33.1.70.75.01.30

Germany

49.69.710.447.600

Frankfurt Munich

Hamburg

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