

Succession Planning: Halt The Revolving Door

By Chris Clarke

High-profile (and high-cost) CEO departures such as those at Merrill Lynch and Citigroup reveal that even our largest and most sophisticated corporations have neglected sound succession planning. Failure here lies squarely in the boardroom, where boards often avoid pushing a strong succession plan, underestimate the “trickle down effect” of a CEO departure, and fail to fit succession plans into long-term strategy.

Leadership turnover in large firms resembles a revolving door. The media rages about the procession of CEO and chairman failures and their ever-soaring exit packages.

Merrill Lynch’s Stanley O’Neal and Charles Prince at Citigroup are just the latest casualties. O’Neal was allowed to resign and thus preserved his stock benefits, reported as being well over a hundred million dollars. This was not laxity on the part of the board, as it avoids any other severance being paid and expensed. Prince left after an unprecedented weekend of very public coverage and speculation on governance events supposedly conducted in secret and off stage. Boards are increasingly naked to the public gaze when faced with chairman and CEO succession.

Booz Allen Hamilton’s annual survey reported a 59 percent increase in annual CEO turnover over the last ten years.

In Europe, average CEO tenure is only 5.7 years.

In North America, the average tenure of CEOs is 9.8 years.

Thirty-two percent of departing CEOs were forced to resign because of performance.

The Association of Executive Search Consultants reports that 52 percent of chairmen in the UK’s top FTSE firms changed in a three-year period. Term

limits, which are being introduced in many countries including the UK, will help keep such chairman retirements high.

Our experience at Boyden is that a change in chairman or CEO leads to waves of other senior executive losses. Retention measures can help, but the new brooms sweep away those who do not fit their needs or style. Other C-level executives move on, when the top job changes, for the following reasons:

They feel passed over for the top role. GE has a history of departures by the losing contenders for CEO.

They fear that the new boss will bring in his/her own team, which frequently occurs. Headhunters circle such firms, so executives move on while they are still employed.

Some disagree with new directions and strategies.

Others fall to cost-cutting programs.

When the CEO is changed, he will want his own C-level team, who in turn will want their own associates. Damage to the business culture can trickle down throughout management.

These waves of departure then flow on down the organization. Each new C-level person wants their own team. They may recruit trusted associates from prior firms. They may bring in outsiders to change the culture or to add special skills. The latter often happens during turnarounds or changes of strategic direction. Both are common when a CEO is dismissed due to failing business performance.

One question being asked about the 2007 excitement at CitiGroup is whether the board should select a leader who believes in the conglomerate structure

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and can make it work, or should they bring in someone who can create value through a break up. The two options would require very different candidates.

Trickle down can reach even the lower levels of management. Each team leader brings in his or her own people in sequence. Sometimes this can take a year or more to play out. There is a risk that good parts of the business culture can be damaged, if anyone who is not new gets the message that their past careers are worthless.

The consequences of top leadership failure can be billions in lost shareholder value and ruined reputations, often for the entire board.

The time and cost of replacing leadership is significant. Severance packages can run into millions. Executive search fees for C-level hires in larger corporations run into the hundreds of thousands.

However, the time and cost, significant though it is, is not the main concern with high CEO turnover. The consequences of failure in top leadership can vary from a dramatic drop in market capitalization to the disastrous collapses of the recent era of corporate shame. The real cost is not therefore hundreds of millions, but often billions in shareholder value and ruined reputations, often of an entire board.

Even if there is no fraud, CEO failure to manage the risks appropriately can lead to the threat of corporate meltdown. The boards of Citigroup, Merrill Lynch and Northern Rock would attest to that.

Thus, gaps in the CEO, chairman and C-level executive ranks make senior succession planning a vital activity. The consequences of getting it wrong arguably make it the most vital activity for any board.

Before the last decade's wave of board scandals and consequent reforms, the CEO/chairs of many boards in the U.S. packed boards with:

□ *Sympathetic colleagues.* Dick Grasso's NYSE board included some of the highest paid CEOs on Wall Street. Some may have felt that what others considered egregious compensation was mere pocket change.

□ *The great and good.* Conrad Black's Hollinger International board included such luminaries as Henry Kissinger. For many years having a "Lord" or a couple of "Sirs" was a must for any UK board (and still is for some). The struggle for control of UK boards was won on the playing fields of the UK's top private schools and Oxbridge.

□ *Friends and colleagues* from other boards or from the golf club. The sound of these boards was that of mutual back scratching.

To combat these dangers, almost all countries have tried to legislate or introduce voluntary codes. The objective of these rules is to ensure proper consideration is given to independence and a more transparent process. Theoretically, it should now be impossible for a CEO to pack the board with friends or to pick a successor, without the board dominating the selection decision.

Unfortunately, despite the corporate governance reforms, nominations committees often still bring in the usual suspects as CEO or chairman candidates. They are sometimes aided and abetted by executive search firms who are more dazzled by star status than the real needs of the client company.

Some executive search firms keep a stable of friendly candidates ready to trot out for any occasion. Everyone has a candidate database, but the latter approach smacks of a "one size fits all" concept. It is hardly "search," which implies actively seeking a close fit to corporate needs and culture.

CEOs often strangle succession planning at birth, to eliminate rivals and ensure their tenure. One CEO bullied a supine board into rejecting all candidates.

Booz Allen's study found that the selection of outside CEOs reduced stock prices. Elevating an insider CEO boosted them. Of course there are occasions where bringing in an outsider is essential.

CEOs often strangle succession at birth, to eliminate rivals and ensure their tenure. Post-Sarbanes Oxley, this remains commonplace. In one case, an incumbent CEO bullied a supine nominations committee into

rejecting all candidates for CEO.

Searchers should feel less obliged to push the candidates they provide over insiders. It may satisfy headhunter's egos to be the only ones with the good candidates, but this may not be in their clients' best interests. It would help this process if nomination committees gave search firms accolades for approving internal candidates over external ones. Instead, they wonder why they needed to do a search in the first place. The important thing is to have a choice and select the best candidate.

Boards must be in line with governance best practice and effective in selecting the right chairman and CEO. Succession planning for both is the central element of the process.

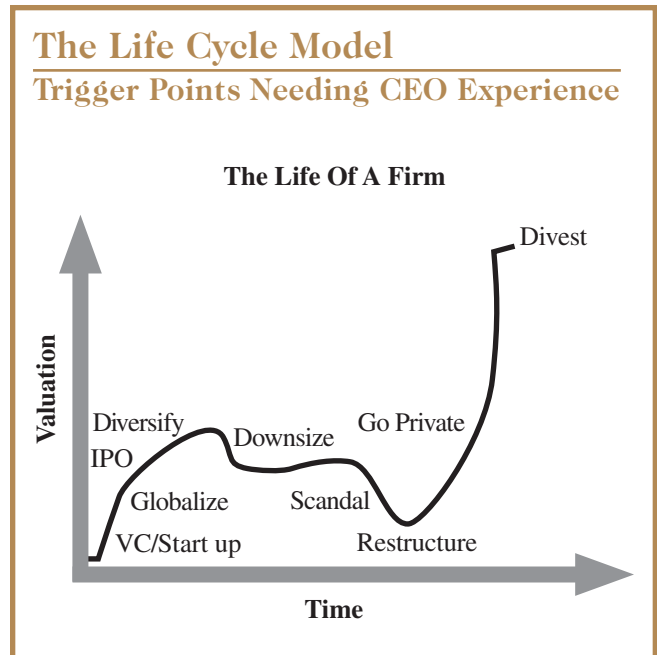
All this proves that the reforms have not fully worked. We still need a better model of chairman and CEO succession. The need is to build boards that are both in line with governance best practice and are effective in selecting the right chairman and CEO. Succession planning for both is the central element of the process.

Before we explore an effective process to do these things, let us consider the latest thinking on the type of leadership an enterprise needs.

According to the Booz Allen study, there is evidence that boards are reducing their dependence on outsiders for CEO succession. The hiring of outsider CEOs has peaked. In 2003, outsiders comprised 30 percent of departing CEOs. In 2006, this figure had fallen to only 18 percent

Bernard Taylor, Vic Dulewicz and Keith Gray, of Henley Management College in the UK, propose that this shift can be tracked in a "corporate governance lifecycle." Igor Filatotchev and Mike Wright proposed a similar approach in their book *The Life Cycle of Corporate Governance*.

The life cycle model above identifies important corporate life events where particular skills or experience are needed. For example, in the growth phase after start-up, a number of serially successful entrepreneurs are being called in. Tom Scott was co-



founder of Nantucket Nectars, a juice company sold to a larger firm and then on to Cadbury Schweppes. Scott has been hired to head up another surging early operation—Plum TV in New York.

Visa International is preparing itself for an IPO. It recently brought in Hans Morris, a veteran Citibank investment banker, as president. In addition to strengthening the team for an IPO, he is also seen as useful in potential M&A expansion. An internal contender for the job decided to resign when the news was announced.

Private equity buys appear to enable the recycling of CEOs who leave public firms under a cloud. Robert Nardelli resigned from Home Depot, with a reputed \$210-million severance package. Nardelli's move to newly private Chrysler allows him the opportunity to demonstrate the undoubted operational talents he honed at GE, but without the public scrutiny and corporate communications issues that he ran into at Home Depot.

Lord John Brown, the able chairman of BP, had to leave early because of perjury issues over a private matter. Brown has re-emerged as European head of private equity firm Riverstone Holdings LLC.

A broken strategy can also lead to the appointment of an outsider. The failed merger talks with Alcoa reportedly led Alcoa to hire Klaus Kleinfeld from

The Model Board

Is Your CEO Vulnerable?

Map your company's succession risks and possible successors from within the firm, for C-level executives and their reports. Consider the following risk criteria:

- How critical is the role?
- Is retirement imminent?
- Health of the CEO/executives?
- Number of potential successors?
- Quality of the incumbent?

Vulnerability Matrix

		Now	1	3	5
Risk	High	X	X	X X X X	X X X X X X X
	Med	X X X	X X X X	X X X X X	X X X X X X X
	Low	X X X X	X X X X	X X X X	X X X X X X X
				3	5
				Years	

Some succession events, like IPOs or going private, can be planned in advance. Others, usually nasty and potentially deadly for the firm, appear suddenly.

Unfortunately, many of the corporate situations described follow different sequences for different companies. All companies have a start up phase and if they survive, they may enjoy a growth phase. The arrival of the growth spurt may be rapid or long delayed. Not all large firms go public, globalize or go private again. If they do, the sequence and timing will vary enormously.

Some situations (such as IPOs and takeovers of other firms or going private) can be planned for in advance. They follow the strategic path of the firm. Needed CEO or chairmanship changes or strengthening of the board can also be planned for and anticipated.

Other events, usually nasty and sometimes potentially deadly for the firm, appear suddenly. These include: exposure of major fraud; environmental catastrophe; the need for urgent restructuring; hostile takeover threats; and the unexpected death of a leader. Waiting for such events to happen means succession planning is far too late.

McDonald's Corporation has an excellent succession planning process in place. In 2003, Jim Cantalupo, the chairman and CEO, had a fatal heart attack. Within hours Charlie Bell was named as his successor as CEO. Tragically, he too passed away shortly thereafter. Jim Skinner, a third inside successor, stepped in to become deputy chairman and CEO.

The timing of emergencies like these is unpredictable. However, this does not mean that we cannot have contingency plans for them.

Boyden calls its approach to overall succession planning "*The Model Board.*" The overarching concept is to evaluate the firm in its environment, understand the risks, and then ensure that the collective board has the skills and experience to understand and handle those risks. The selection of the CEO and C-level succession plan follows the same principles.

Siemens as CEO in waiting.

If a company's reputation is damaged by fraud and the chairman is implicated, a person of impeccable reputation is needed to take over. This is why Stanley Beck, ex-chairman of the Ontario Securities Commission, was brought in to replace Lord Black as chairman of Holinger, a Canadian company.

Meanwhile, Siemens brought in an outsider as CEO for the first time ever, in the wake of its corporate corruption scandal. Peter Loescher, from Merck, is now busy restructuring the global firm with a resulting rise in stock price.

The life cycle model implies a sequential series of events. Describing the various strategic situations in this way is a powerful contribution to corporate governance thinking.

The model board chart can help the firm to map the succession risks and possible successors from within the firm, for C-level executives and their reports.

This approach can deal with the tragic loss of a CEO, but needs additional input to deal with the other unpredictable matters we discussed earlier. We borrow a concept from genetics to do this.

Evolutionary biologists tell us that redundant genes, such as those that appear not to be useful in the current environment, are ubiquitous. They play a key role in natural selection and the survival of a species when the environment changes.

A good example is human fat cells. These are useful in the Kalahari Desert, where food is scarce and can be stored as fat for later use. In the urban environment, they are considered an unfashionable and unhealthy nuisance against which we struggle. Yet if civilization collapsed, such cells could provide an evolutionary advantage once again.

We can apply the redundant gene analogy to the board and C-level management, to deal with the catastrophic shocks, which we discussed earlier. Most larger, well-run firms, have risk management plans to deal with all the major risks inside the firm and in its surrounding environment.

In hiring the chairman and CEO, as well as in building the board, the current situation must be cared for. We then need to ensure that the redundant genes are there, so that the board and C-level management have the skills to deal with potential crises.

Some general principles can be drawn for this concept:

□ First, companies that have a Wall Street savvy director are usually smart. These directors can then offer counsel on such matters as raising funds, bids for the firm, mergers and acquisition proposals and any other funding or ownership transactions. If they are not experts in all fields, they should be well connected enough to know where to go for expertise.

□ Another principle is to have a person on the board of such stature and unquestionable integrity who is able to step in if a fraud or other scandal unseats the chairman.

□ If a business is global or is considering new international moves, it is wise to build a board with one or more directors with true global experience. This may be specific to the major territories in question or relevant to the firm's plans.

□ Another good move is to keep a list of potential outside directors on the radar screen and in touch. Their particular skills may be called on if an emergency situation arises with the chairman or CEO.

All firms need to prepare for chairman and CEO succession. Too many firms have a knee jerk reaction and hire a well-known outsider for these positions, ignoring the inside options. The evidence is that on average this will destroy shareholder value.

Still, there can be seismic changes in the firm or its environment that require an outside leader. These can be planned for. Well thought-through succession plans, based on risk assessment and contingency planning, should build in "the redundant genes," which may be needed. ■