Corporate Governance

How The SEC Just Changed Succession Planning: Part I

Stephen A. Miles and Nathan Bennett 11.17.09, 3:37 PM ET

Director One: *I can't believe this news. Nick was such a tremendous guy. This is just terrible. Have you talked to his wife?*
Director Two: *Yes, this morning. As you can imagine, the family is devastated.*
Director Three: *What do we do now? We need to make some sort of announcement about who's going to lead the company--and we need to do it fast, to make sure things don't get unsettled.*
Director Two: *What choices do we have? This whole thing has been such a surprise. When we announced Nick as CEO last year we all figured we'd have more time before we had to go through all that again.*
Director One: *Do we need to announce someone as interim chief while we find a strong candidate?*

This scenario depicts a situation that every chief executive officer and every board hopes will never come to pass. And if there does have to be a sudden CEO departure, everyone must hope the scene doesn't unfold this way.

Inadequate CEO succession planning has always been poor business practice--leaving a board confused and an entire company in a holding pattern. Now new regulatory developments have added a new level of risks. The Securities and Exchange Commission's Division of Corporate Finance Legal Bulletin 14E, released on Oct. 27, 2009, places a new burden on boards concerning succession planning. It calls for many, if not most, companies to rethink their policies.

In short, the bulletin provides support for shareholders who want to approach a board to demand more transparency about CEO succession plans. The language used in the guidance reveals the growing concern with which the SEC views the matter: "One of the board's key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership. Recent events have underscored the importance of this board function to the governance of the corporation. We now recognize that CEO succession planning raises a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce."

Well-run boards have always labored to develop succession plans that minimize the risks in any CEO succession. Now all boards potentially face much greater scrutiny of their planning efforts.

Some companies are better than others at succession planning--and stakeholders know it. Probably no case illustrates this better than the chain of events the board at McDonald's had to manage a few years ago. In April 2004, McDonald's CEO Jim Cantalupo died suddenly while attending a company convention in Orlando, Fla. He was a long-timer at McDonald's, but had been named CEO just over a year before. The board quickly introduced another long-timer, the president and chief operating officer, Charlie Bell, as the new CEO.

The board's ability to immediately announce a credible successor was the fruit of earlier efforts to deliberately groom Bell for the position that one day was expected to be his. Cantalupo had made a serious effort to involve Bell in meaningful work and had made sure to give him some of the spotlight during meetings with analysts and other constituents. As a result, the appointment was greeted with responses like that of one Standard & Poor's analyst who praised Bell as "an absolutely right choice."

Sadly, the board's work was not over. Charlie Bell had to leave the company after 30 years because of cancer in

November 2004. He died in January 2005. When Bell stepped down, the board announced that Jim Skinner would become CEO--the company's third in a year. Like his predecessors, Skinner had a long history with McDonald's. He has done well. In fact, he was named 2009 CEO of the year by *Chief Executive* magazine.

It is remarkable that the board of McDonald's could announce three new CEOs, all widely perceived as strong choices, in such a short span of time. What is even more remarkable is that the board didn't have to go outside the company to make any of the three appointments.

How many boards are in such an enviable position? Our work suggests that the answer is very few. A survey this year by the National Association of Corporate Directors found that 43% of U.S. public companies had no formal CEO succession plan, and 61% had no emergency CEO replacement plan.

It's one thing to be able to claim you have some sort of succession plan, but it's another entirely to be able to articulate a plan in a way that assuages shareholders, analysts and other interested parties. And it's still a greater challenge to have a plan--really a planning process--that is robust enough to take into account all the complexities and subtleties of CEO succession. Our sense has been that the Sarbanes-Oxley Act of 2002 prompted boards to begin to talk the talk about succession planning, but that the recent SEC bulletin will force them to finally walk the walk. Sarbanes-Oxley may have created a bit of a false sense of security about succession planning. One would presume that before Kenneth Lewis' departure, Bank of America would have said it had a succession plan, but when that announcement hit, the viability of any such plan was quickly called into question. The number of truly robust succession plans, where companies have much more than a name in an envelope, is frustratingly small.

So what is a board to do? What does a strong succession planning process look like? There are four questions, each critical to succession planning, that we advise boards to address. If a board hasn't taken these steps, perhaps the SEC bulletin will make them finally start. If the board has taken these steps, the bulletin should provide an impetus to revisit, refine and reinforce the succession planning process.

Question No. 1: What does our next CEO look like?

The first effort a board must undertake is to work together to develop an image of what the next CEO needs to be. In doing so, the board has to evaluate myriad factors--the company's strategic positioning, the condition of the industry, various macroeconomic variables and so on. Even if the current CEO, with all his skills and abilities, is winning the game today, it isn't necessarily the case that those same skills will win the game tomorrow. This is tough to recognize, particularly when the incumbent CEO is very strong, very well liked or has produced very superior results. What it takes to lead a turnaround, for example, can be quite different from what it takes to lead a global expansion.

Once the board develops an understanding of where the company needs to go and what challenges will be encountered along the way, a clearer picture of the sort of CEO required will emerge. Of course, the events of the last year have reminded all of us how difficult it is to forecast the future. But a rigorous succession planning process accounts for this. Just as the company may have several potential futures, the board should identify several potential future leaders. Additionally, a detailed skills and experience profile will allow candidates to be assessed against the needs of the company rather than simply against one another, which can help reduce the appearance of a horse race.

As you draw up your image of your next CEO, set aside the myth of the ready-now CEO successor. Such a candidacy may exist in theory, but we rarely have seen it in practice. When it does exist, it has typically been identified as such after the fact. When a board looks to identify successors, it should look not for who is ready now but for who can be gotten ready. The better the board understands the demands a company's future will place on the CEO's successor, the better it can prepare potential candidates for that role. In other words, a candidate won't suddenly be "ready" after a period of being "unready"; rather, readiness should be thought of as a risk-reduction process. The better the future is understood, the candidates' strengths and weaknesses are understood and the plans are in place to fill in any gaps in preparation, then the lower the risk in the succession.

The changes brought on by the SEC bulletin should also remind boards of how important it is to look deeper in the company than simply at the CEO position and its direct reports. Savvy boards will invest the time needed to get to know executives who are two or three levels removed from the CEO. A robust succession planning process should be able to think a few leadership generations ahead.

Question No. 2: Where is Our Next CEO Now? And Where Are Two More?

This is a two-part question, and to take the second part first, our overwhelming advice for boards is to be several people deep when it comes to succession. To be sure, there are risks to this strategy. When the succession event ultimately occurs, candidates not selected may feel jilted and depart for opportunities elsewhere. Or if strong contenders stay behind, the new CEO may worry that someone is waiting in the wings to take his or her spot at the first stumble. These risks are real and, as such, must be managed. It is clear, though, that these risks are not nearly as threatening to a company as a board's inability to provide great leadership.

To the former question, our experience is that internal candidates face some common challenges in demonstrating their potential as leaders. First, they rarely have the sort of relationship with the board the current CEO enjoys. They don't know the board members well, and the board members don't know them. As a result, they often pale in comparison with the current CEO in the eyes of board. Board members often forget how the current CEO looked the first day on the job, and they forget how much the CEO has grown in the job. Thus they aren't making a fair comparison. Internal candidates suffer from that unfairness.

A second challenge faced by internal candidates grows out of how the board sees them in their current roles. Strong chief operating officers, for example, are often viewed as "great executors." We've heard board members complain that their COOs aren't strategic thinkers when in fact those COOs have never had a chance to demonstrate that capability.

The third challenge faced by internal successors is the presumption that somehow external candidates are more exciting. If more exciting means riskier, then we agree. But of course the overriding goal of succession planning is the reduction of risk. It almost always makes sense to look outside for potential leaders, but we often see boards mismanage this process. One mistake is failing to shut down the outside process at the right time when there's a strong internal candidate. That can lead to the board's losing its internal candidate to another company as he or she tires of waiting for the external market to be screened. Or an internal successor may ultimately be chosen but be left feeling he was settled on only after the external search was exhausted. That isn't a great vote of confidence for a fledgling CEO.

One way to address this is by making it clear to internal candidates that the board will scan the external market to attempt to identify two or three interesting candidates and that then a selection process including both internal and external candidates will unfold. Boards should use the same extensive assessment and evaluation processes for both internal and external candidates, to ensure that they're compared fairly. Only when an external candidate is demonstrably better than any internal ones should the board entertain taking on the increased transition risk of the former. Exceptions do exist in some special cases, such as a turnaround or when major change is required. Then an external candidate with a clean slate at the company may be better suited to lead than an insider with baggage.

All three of these challenges should remind boards of how important it is to develop a true sense of the capabilities of the leaders who constitute the top three or so levels of a company. Failing to do so will falsely inflate the risk associated with an internal successor when, in fact, an outsider is usually a greater risk. As part of this effort, it is vital that the board and the CEO stay aligned with the viability of each potential successor and with the plans to develop each. But all parties must keep in mind that while the current CEO is an input to the process, he or she should not be allowed to take on the succession process as either a right or a personal responsibility.

Tomorrow, in Part II, questions 3 and 4: How do we begin to develop our next CEO? And what else do we need to do as a board?

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