CEO SUCCESSION PLANNING

PRINCIPLES AND CONSIDERATIONS

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The continued success of a company depends in large part on the effectiveness of its board in developing and executing a CEO succession plan.

CEO succession planning refers to the strategic process by which a company chooses a successor for its chief executive position and transitions to new leadership. The quality of executive leadership is often cited as the number one factor driving company performance, making CEO succession planning arguably the most important function of a company's board of directors. As part of CEO succession planning, the board, working closely with the company's current CEO, must:

- Determine the necessary experience, professional capabilities and personal characteristics of the company's next leader.
- Identify and assess the candidates in light of the company's overall business strategy and corporate culture.
- Select the optimal candidate to take the place of the company's current CEO.

Despite the importance of CEO succession planning, many companies struggle with developing a thoughtful process for cultivating successor candidates and selecting the company's next CEO. This may be at least partially due to the fact that proper succession planning requires:

- Carefully evaluating the company's current needs.
- Predicting the challenges that the company will likely face several years down the road.
- Navigating the internal dynamics of the company and the hopes and fears of the executives most affected by the outcome of the process.

In addition, it can be challenging for many CEOs to actively and constructively plan for the day after their departure.

There is no one-size-fits-all best practice approach to tackling and transcending these issues, nor is there one specific CEO succession planning process that suits every company. Accordingly, a board must thoughtfully take into account its company's particular facts and circumstances when formulating and executing its CEO succession plan. Often, but certainly not always, this will involve consulting expert advisors at some point during the formulation or execution of the CEO succession plan.

There are certain fundamental principles and considerations that should guide those charged with CEO succession planning. Perhaps the most elementary of these principles is that every comprehensive CEO succession plan should address planning for CEO succession both in the ordinary course and in the event of an unforeseen crisis, such as a sudden death or resignation. While these forms of CEO succession planning have several overlapping elements, they each have important, distinct qualities.

Focusing on CEO succession planning in the ordinary course, this article discusses:

- Which individuals should participate in the planning process.
- Key principles at the core of any successful planning process.
- A sample framework of the main steps a company could take to create an effective plan.
- Issues surrounding the transition to a new CEO.
- Required actions triggered by the appointment of a new CEO.

PARTICIPANTS IN THE PLANNING PROCESS

The CEO, who is typically the individual most familiar with the company and what the chief executive position entails, is usually an active and vital participant in the company's CEO succession planning process. In most cases, the company's current CEO can facilitate the process by articulating the company's:

- Short-, medium- and long-term strategies.
- Challenges and opportunities.
- Strengths and weaknesses.

The current CEO is also critical to nurturing internal talent, ensuring that the board has access to the company's senior management team and providing guidance to the board regarding his or her preferred candidates.

However, primary responsibility for developing and implementing the CEO succession plan rests with the board or, at least initially, with a committee of the board, such as the nominating and governance committee. The lead director or chairman of the board, as well as the chair of the nominating and governance committee, often assume leading roles in the planning process. However, the specific individual who takes the lead may depend on the specific circumstances and unique personalities involved. In addition, the directors that the CEO believes to have the best pulse on senior management and the deepest sense of the company's culture, and those with whom the CEO has an open and trusting relationship, will often naturally become most involved in the process.

Search Nominating and Corporate Governance Committee Charter for a form of charter for the nominating and corporate governance committee of the board of a public company.

CEO succession planning does not necessarily require the involvement of an outside consultant. Where it is clear that the company has qualified internal candidates for the chief executive position, it need not hire an outside consultant. However, a company with strong internal candidates may choose to retain an outside consultant toward the end of the process to conduct a "market check" for potential external candidates against whom to measure the company's best internal talent. In cases where it becomes apparent that the company does not have an appropriate pool of internal candidates, retaining an outside consultant at an early stage could be helpful.

GUIDING PRINCIPLES

There are several key principles at the core of any successful CEO succession planning process:

- CEO succession is an ongoing process.
- Succession planning should be focused on long-term corporate strategy.

> Board members should use both informal discussions and formal interviews with candidates to try to uncover the candidates' strategic goals for the company and evaluate whether they have thoughtful and concrete implementation ideas.

- CEO succession planning should be part of a holistic approach to the company's corporate governance.
- The board should lead the succession planning in collaboration with the current CEO.
- Companies should generally favor their own personnel to succeed the current CEO.

ONGOING PROCESS

CEO succession is not a single event. It is a multifaceted, long-term planning process. When conducted properly, CEO succession planning can take years. During this time, the board and the CEO should conduct regular, focused board sessions to discuss:

- The succession planning process.
- Potential candidates.
- The leadership structure during the transition period.
- Any other relevant matters.

When developed over time, the process fosters the creation of a partnership (and perhaps even a friendship) among directors, management and potential internal candidates. Starting the process early also gives the company time to train and develop internal talent to ensure that potential candidates gain experience in the areas that will round out their skills. At the same time, the company will have the opportunity to build a complementary and supportive team around one or more favorite CEO candidates. Consistent, ongoing attention to CEO succession planning is also likely to reduce the company's vulnerability in the case of a CEO's sudden departure or inability to continue to serve in the chief executive role.

CEO succession planning should start from day one of the CEO's tenure. It should be a regular agenda item for the board. The frequency of board discussions regarding succession planning should increase when the company's CEO is close to retirement age, has expressed a desire to leave the company in the near or medium term or is not performing at a satisfactory level.

Because CEO succession planning is fluid and nuanced, companies do not often adopt written succession plans. Reducing a succession plan to writing may not only be limiting, but can also add the unnecessary risk that the leading candidates will be prematurely disclosed. However, for potential emergency succession purposes, it may be advisable for the CEO to prepare and safely preserve a written note identifying his or her preferred candidates for succession, in case the CEO gets hit by the proverbial bus.

Search Corporate Crisis: Board Preparation and Response for information on how boards can prepare for and respond to corporate crises.

FOCUS ON LONG-TERM CORPORATE STRATEGY

Since having the right individual in the company's chief executive position is intertwined with the company's success, CEO succession planning should be viewed as a crucial step toward executing the company's long-term corporate strategy and, in turn, maximizing shareholder value over the long term. Accordingly, the driving force behind CEO succession planning should be the vision of the CEO and the board for the future of the company. Therefore, the board should seek CEO candidates who share the board's strategic vision and have specific ideas regarding how to realize that vision.

Board members should use both informal discussions and formal interviews with candidates to try to uncover the candidates' strategic goals for the company and evaluate whether they have thoughtful and concrete implementation ideas. If the leading candidate is well-known to the board, the board members may already have a good sense of his or her strategic vision as a result of years of interactions. In cases where the candidates are less familiar to the board, board members may consider preparing a list of interview questions that are aimed at assessing how well each candidate's strategic vision aligns with that of the board. These questions could serve as a springboard for deeper discussions on matters that the board deems to be significant to the company.

Questions that board members might consider asking candidates include:

- What do you think are the three primary drivers of the company's success, and do you think those drivers need to change now or in the future?
- What do you think are the greatest challenges and opportunities facing the company?
- What is your strategic vision for the company, and what should the company's top three priorities be to achieve that vision?
- In thinking about the company's current business and future growth, how do you think the company should approach risk?
- How do you view the role of the company's core values, and how would you reinforce those values in such a large and diverse organization?

HOLISTIC APPROACH

CEO succession planning should be regarded as one component of a broader management plan put in place to execute the board's long-term corporate strategy. In the same way that a skilled chess player would not move any piece on the board without carefully considering the implications for the rest of the chessmen and on the player's ultimate goal of winning the game, boards should think strategically about how their CEO succession plan fits into the overall governance and management structure of the organization.

For example, those orchestrating the CEO succession planning process should gauge what impact the selection of certain candidates is likely to have on the morale of the company's other star performers and on the synergy of the management team. Additionally, they should consider whether the CEO should also serve as chairman of the board and, if so, whether this should occur immediately or only after a transition period. Moreover, while outgoing CEOs often leave the company, it may be prudent, in certain instances, for the outgoing CEO to maintain or assume the role of chairman of the board for an interim period to facilitate the company's transition to new leadership.

COLLABORATIVE, BOARD-LED MODEL

Currently, the selection of a CEO successor is most often led by the board, in close collaboration with the current CEO.

This collaborative approach has been rising in popularity in comparison to the "concurrence model," in which the CEO selects a successor and the board approves or disapproves of this choice.

Boards may delegate the authority to conduct the CEO succession planning process to a board committee composed of independent directors, which is most often the nominating and governance committee. Even when a board committee is running the process, the full board should remain actively engaged in the succession planning process, including through:

- Conversations with and reports from the CEO, the chairman or lead director, and the committee members (or other directors, as applicable).
- Exposure to each candidate over time, through formal presentations or informal interactions.

PREFERENCE FOR INSIDERS

While each company's circumstances differ, companies should generally consider and favor internal candidates for the CEO position. This principle does not and should not preclude consideration of outsiders. Rather, those involved in CEO succession planning should avoid the temptation of selecting a "star" from the outside, whose flaws they cannot fully appreciate from afar. Internal candidates are typically a lower-risk proposition than external candidates because:

- Their professional and personal strengths and weaknesses are better known to management and the board.
- They already understand the company's business and strategy and are less likely to cause a change in the company's culture (which may be equally vital to the company's success).

Internal candidates, therefore, tend to perform better and last longer than outsiders. In addition, the rest of the company's employees are often less anxious about the management change if an individual familiar to them becomes the CEO. Therefore, internal talent development, including attracting and cultivating the right individuals, is an integral component of any effective CEO succession planning process.

SAMPLE FRAMEWORK FOR CEO SUCCESSION PLANNING PROCESS

Certain aspects of the CEO planning process depend on the company's specific facts and circumstances. For example, it may or may not make sense for a company to consider external candidates for CEO, depending on the particular situation.

However, one sample framework for effective CEO succession planning could include the following steps:

- Assessing the company's strategic needs.
- Choosing the selection criteria.
- Comparing internal talent to the selection criteria.
- Continuously developing internal talent.
- Identifying potential external candidates.
- Compiling a list of candidates.
- Narrowing the list to one or two candidates to present to the full board.

ASSESS THE COMPANY'S STRATEGIC NEEDS

To devise an effective CEO succession plan, the board must have a well-articulated strategic corporate plan for the short, medium and long term. The company's strategic goals should drive the company's succession plan and the selection of the company's next CEO.

CHOOSE SELECTION CRITERIA

It is important for the board members (or members of a committee of the board) to decide on the most important skills, professional attributes and personal qualities of an ideal CEO candidate. This determination should be made with input from the current CEO.

Selection criteria should focus on the company's immediate challenges, as well as its potential future challenges. In choosing criteria, the board and the current CEO should be informed by corporate strategy and be mindful of any observed and potential trends that may impact the company. The criteria, therefore, should include specific qualifications and capabilities necessary to successfully handle foreseeable issues and events affecting the company.

For example, if the company's future strategy includes expanding into a new line of business, the board might consider candidates with experience in that industry. Similarly, if the board anticipates that the company will grow beyond the US, the board might focus on candidates with experience working for international companies or companies that have expanded to international locations during their tenure.

In compiling selection criteria, the board should recognize that there is no single combination of characteristics that makes an effective leader. Therefore, the board should not limit itself to the characteristics of the current CEO. Moreover, because of changes to the company's strategy, anticipated risks and opportunities or foreseeable trends that could impact the company, the optimal CEO candidate may diverge from the company's current leadership. If the profile of the ideal candidate does not fit the mold of the current CEO, the board may need to complement the selected candidate differently through the supporting management team.

While specific selection criteria will inevitably vary from company to company, there are some general categories of criteria that the board should consider. First and most importantly, the candidate must have integrity. The tone at the top does matter. Other core categories include:

- Leadership style.
- Temperament and motivational factors.
- Insight into oneself and others.
- Interpersonal relations and communication.
- Problem-solving capabilities.

The board should reevaluate the selection criteria annually and revise them as necessary to reflect any changes in the company's needs, challenges and future strategy.

COMPARE INTERNAL TALENT TO SELECTION CRITERIA

Over time, the board should gain familiarity with the company's executives or other leaders who may be strong contenders for the CEO position. The board should be briefed at least annually by the CEO on the development of potential internal candidates. The board should also have the opportunity for personal contact with potential candidates, including through periodic company visits and individual meetings with, and periodic board presentations by, the candidates.

In its evaluations, the board should:

- Compare the potential internal candidates against the selection criteria, which serve as uniform evaluation standards.
- Look beyond the candidates' titles and levels of compensation, focusing instead on their competencies.
- In keeping with the holistic approach, consider whether some of the candidates are better suited for other management positions.

In assessing internal talent, the board should also recognize that the company's star candidates may not be equally strong in their "hard skills" (such as knowledge of the company's business and its industry) and "soft skills" (such as leadership, interpersonal and communication skills). Neither set of skills is inherently more important. Rather, the board should remember that the deficiencies of an otherwise superior candidate can be supplemented through the talents of the rest of the management team. Ultimately, it is the entire senior management team, working together, that will drive shareholder value over the long term.

CONTINUOUSLY DEVELOP INTERNAL TALENT

An important component of a company's successful CEO succession planning process is the continuous development and promotion of the company's strongest employees. Following their periodic evaluations of the internal talent pool as compared to the selection criteria, management and the board should update and adjust the professional development plans for the respective candidates to address any shortcomings in their skills or competencies.

Often, management development is not a formal process, but occurs naturally over time. A talented CEO and an effective board will develop internal candidates in the ordinary course of their jobs and not necessarily as an official agenda item of the CEO succession planning process.

IDENTIFY POTENTIAL EXTERNAL CANDIDATES

While proper CEO succession planning should generally result in the grooming of internal candidates for the chief executive position, the board (perhaps in conjunction with a retained outside advisor) may, in certain cases, choose to identify possible external candidates.

Although it is not always necessary, a company may decide, depending on the facts and circumstances, to conduct a market search for potential external candidates when actual succession is on the horizon. Turning to the outside market could provide a benchmark against which to measure the company's internal talent. A more comprehensive external search may be warranted if the board either:

- Determines that there are likely no qualified internal candidates for the position.
- Cannot make a unanimous decision on an internal candidate.

There may also be company-specific circumstances that could warrant looking outside the company. For example, a struggling company may require a chief executive who is not emotionally invested in the company's failing model of the past, can "think outside the box," and has prior experience transforming an unsuccessful company. In 2006, Ford Motor Company, which had been trying to regain financial stability for years, replaced its CEO with the then-CEO of Boeing, Alan Mulally. The company's outgoing CEO, Bill Ford, stated at the time that the company needed "someone who had extensive turnaround experience" and that the company's efforts to improve its financial condition "required the additional skills of an executive who has led a major manufacturing enterprise through such challenges before." It is widely recognized that bringing in Mulally was critical to Ford's ability to avoid bankruptcy and its subsequent success.

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COMPILE A LIST OF CANDIDATES

The board's ongoing exposure to potential candidates should allow the board and the CEO to agree on a broad list of internal (and possibly external) candidates for consideration. This list may evolve over time.

As the time nears for the current CEO's departure, the CEO and the nominating and governance committee should review the potential candidates and agree on a "shortlist" to be recommended to the full board (which could, depending on the circumstances, be comprised of a single outstanding candidate). If the candidates are not already well-known to the board, the nominating and governance committee should meet with each candidate on the shortlist, and the committee members, the

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current CEO and possibly other senior executives should assess the candidates. If the board members think it is necessary, the candidates remaining on the list should participate in one or more board meetings so that the entire board may provide input on the candidates.

NARROW THE LIST TO ONE OR TWO CANDIDATES

Once feedback on the candidates is received from the full board and advisors, if any, the nominating and governance committee should recommend either a single candidate or a final shortlist of candidates (typically consisting of no more than two individuals) to the board. While the input of the current CEO is undoubtedly valuable and should be given a significant amount of deference, the independent directors should form their own views regarding the best candidate for the position. When the board is ready to select its next CEO, its final decision should ideally be made at an in-person meeting of directors. If scheduling issues make this impossible, the final decision should be made telephonically and not by written consent.

TRANSITIONING IN THE NEW CEO

Following the new CEO's appointment, the board and the outgoing CEO should work hard to ensure that the rest of the management team supports and complements the executive selected as CEO. On assuming the chief executive role, the incoming CEO should continue this consensus-building process. A CEO with strong leadership qualities should be able to create a true partnership among members of management and should be adept at making each team member feel valuable to the joint effort to realize the company's potential. However, it may be at times necessary for the CEO to make certain changes to the management team to be able to execute his or her vision.

Once the company's new CEO is selected, the board must also determine how to complete the transfer of control from the outgoing CEO to the new CEO. The conventional view among governance experts is that the change in control should be abrupt so that the new CEO can feel free to take the reins without any interference from the outgoing CEO. Indeed, the same leadership qualities that contribute to the success of many CEOs can cause some to be overbearing and unable to relinquish control. A company whose outgoing CEO has that type of personality may consider a clean and rapid transition.

However, some outgoing CEOs could be a valuable resource to those replacing them. In such circumstances, the board should consider adopting a formal and gradual transition plan so that the incoming CEO could benefit from the experience and expertise of the company's previous CEO. Regardless of how this transition is structured, it is critical that the board make clear who the company's leader is.

Once the selected candidate assumes the chief executive role, the new CEO should make sure to have a well-articulated "90-day plan" for how to position the company for achieving the CEO's strategic vision. While the nature of the CEO's vision and how modest or radical it is will depend on the company and its current circumstances, the CEO should begin his or her tenure with a clear idea of the steps that must be taken early on to begin to accomplish his or her short- and long-term goals. As part of the 90-day plan, a CEO who joined the company from the outside must get to know the company and its key players. An insider CEO should also spend time meeting with members of the company's management team to instill in them his or her strategic vision and engage them in the efforts to achieve that vision.

REQUIRED ACTIONS FOLLOWING CEO SUCCESSION

The appointment of a new CEO triggers several disclosure requirements and requires certain board actions.

SEC FILINGS

Form 8-K requires disclosure of the departure of the previous CEO and the appointment of the new CEO (as well as departures or appointments of directors and certain other principal officers). A company is obligated to file a Current Report on Form 8-K within four days of the:

- Decision that its current CEO will cease to serve in that role.
- Appointment of the new CEO.

This information can be disclosed in the same Form 8-K report or in multiple reports.

Due to the significance of the appointment of a new CEO, it is common for a public announcement to occur either on the same date that the decision was made or prior to the opening of trading on the next business day.

Section 16 of the Securities Exchange Act of 1934 requires several filings to accompany a change in a company's leadership:

- Form 3 (Initial Statement of Beneficial Ownership of Securities) must be filed within ten days of the appointment of a new executive officer.

- Form 4 (Statement of Changes in Beneficial Ownership) must be filed within two business days of the grant date of any equity awards.
- If not already available, powers of attorney must be executed by the new executive officer.

Finally, the company's next annual proxy statement must include a description of the company's leadership structure.

STOCK EXCHANGE DISCLOSURES

Companies listed on the New York Stock Exchange (NYSE) must disclose certain information to the NYSE upon transitioning to new leadership:

- **Notice of Executive Officer (and Director) Changes.** The company must promptly notify the NYSE of a change in executive officers (and, if applicable, directors).
- **Interim Affirmation.** If the new CEO is added to the board, as is typically the case, the company must supply a written affirmation to the NYSE within five business days of adding the director to the board. In addition, if the outgoing CEO steps off the board, the company must likewise submit a written affirmation to the NYSE.

Companies listed on the NASDAQ Stock Market must:

- Promptly notify the public via any Regulation FD-compliant method of any material information that would reasonably be expected to impact the value of their securities or investors' decisions.
- Notify NASDAQ's Market Watch department in advance of any public disclosure of any information about a material change in senior management or a change in control.

BOARD ACTIONS

In addition to selecting the new CEO and, often, appointing the CEO as a director, the board may also need to:

- Approve the CEO's compensation package or decide to delay that decision until a later date. Typically, the compensation information is disclosed in the Form 8-K that announces the new CEO's appointment, or by amendment to that Form 8-K report.
- Approve revisions to committee charters and corporate governance guidelines (after which the amended documents must be posted to the company's website in accordance with NYSE rules).
- Agree on the roles of the CEO and chairman if the former CEO will remain on the board.

Search Designing, Determining and Disclosing Executive Compensation: A Consulting Perspective for issues boards should consider when designing and determining top executive pay.