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IMPROVING THE PRACTICE OF MANAGEMENT

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By John Swain and Wendy Turpin

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The new world of CEO succession

Despite urgings and admonitions, many boards still pay far little attention to the issue of succession management. The resulting exercises in both bad leadership selection and bad leadership, which are often public, can cripple an organization and its employees. These authors offer up a series of best practices for managing the important process of CEO succession.

By John Swain and Wendy Turpin

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There was a time when boards of directors simply rubber-stamped a CEO candidate that had been anointed by the outgoing CEO. Those times are now over. High-profile cases such as Enron and Nortel are vivid reminders that when CEOs run into trouble, shareholders expect the boards that appointed them to take accountability. The board may end up living with the consequences of choosing the wrong leader long after that CEO has left.

Selecting a CEO is one of the board's most important responsibilities. It's also a task that has, arguably, become more difficult as the complexity of running a large organization in a global economy has increased, and as personal risk involved with taking on the top job has grown. The average tenure of a CEO decreased from 9.5 years to 7.3 years between 1995 and 2001, and the number of CEOs departing because of the company's poor performance increased by 130 per cent. (Booz Allen,

"Why CEOs Fail", 2002).

Yet according to the National Association of Corporate Directors in the U.S., almost half of the corporations with annual revenues over \$500 million have no meaningful CEO succession plan. (NACD, 2004).

Learning the hard way

One of Mercer Delta's clients in the U.S. learned the hard way about the consequences of not paying sufficient attention to CEO succession. The company, which we'll call Arcadia Oil, is a large firm with refining facilities around the world and more than \$20 billion in annual revenue. Founded in the 1890s, Arcadia had been a consistent high performer in the industry for a century. The board and shareholders expected it would continue to deliver strong results.

Approaching retirement several years ago, the CEO informed the board of his succession plan. In his view, only one person was qualified to replace him - and the board agreed. This individual had run one of the largest divisions of the company. He had a technical and a marketing background, as well as international experience and a track record of consistent performance against objectives. His style of leadership was hard-driving and somewhat authoritarian, but he produced outstanding results.

In the first year of the new CEO's tenure, Arcadia ran into serious difficulties because of the convergence of oversupply in the industry, a mild winter, a softening U.S. economy and devaluation of the dollar in European markets. Instead of making

good use of his senior team and board of directors to help him figure out what to do, the CEO withdrew into himself and made a series of decisions that his direct reports thought misguided or insufficient. They lost confidence in him, and began to raise concerns about his leadership to the board through back channels. Alarmed by these reports and the declining stock price, the board voted to remove the CEO. They persuaded the former CEO to move back into the role for at least a year, to turn things around and find a "Plan B" successor.

"Plan B": Engaging the board in a disciplined process

This time, the CEO realized he would have to put more thought and effort into the succession process. He would need to think more about the challenges the company would likely face in the future, and the type of leader who would be best able to deal with them. He would engage the board more closely in the process, so that at the end of the day the board would have confidence in, and a good working relationship with, the successful candidate. He would do more to create conditions conducive to the new CEO's success, including trying to persuade unsuccessful candidates to stay with the company and support the new leader.

Our firm worked with the returning CEO to develop a disciplined road map for the selection process and the criteria he would use to assess the candidates. As these were created, he shared drafts with a subset of the board, to make sure they were comfortable with the criteria and the approach. He then involved the senior vice-president of human resources and the CFO in an initial assessment of five internal candidates. Based on this assessment, the CEO brought a short list of three candidates to the full board, and reviewed with them his plan for the succession process. Board members met with each of the three finalists before the CEO made his recommendation. They agreed with his choice, suggesting, however, that the individual be named president and COO for a year. The retiring CEO

would work closely with the new appointee over this period and assess his readiness for taking over the CEO role. The new president's operational abilities in the company were already well established. His priority, therefore, was to demonstrate that he could also develop and deliver strategy, define the right architecture for the organization, and create a cohesive senior team.

This time the transition was smooth and the new CEO was successful. The unsuccessful CEO candidates supported the process, and only one of them left the firm to take a position elsewhere. No matter how carefully companies manage the selection process there is always a possibility that the unsuccessful candidates will choose to advance their careers by moving on.

Doing it right the first time

Mercer Delta client Defence Contractor Industries (DCI) is a great example of how to manage succession right from the very beginning. (All names in this case study have been changed.)

DCI is a \$30-billion conglomerate that provides state-of-the-art weapons systems to the military; its subsidiary concentrates on the application of this advanced technology to products for the civilian market. When Frank Godwin became CEO of DCI at age 56, he had no personal plans to retire. However, Mercer Delta convinced Godwin that it was in the company's best interests for him to work with the board to identify his potential successors.

Godwin began discussing succession with the board seven years before he actually stepped down. He gave them his opinions on the criteria for a successor, along with his assessment of potential candidates and their developmental needs. Each year Godwin and the board met to discuss the candidates' weaknesses or gaps, and to review the actions the CEO was taking to ensure there were several acceptable choices when the time came for him to retire.

Managing the political dynamics

Godwin was a good mentor and coach, and he actually minimized corporate politics by beginning the succession process early. He did not explicitly tell the candidates they were being considered for the top job - although most of them assumed they had a shot at it. At Godwin's request, they willingly accepted developmental moves because they knew their boss planned to remain in office for some time. They understood he was providing them with growth opportunities, and that the selection of a new CEO would be based on their performance rather than on who he liked best.

Mercer Delta continued to meet with Godwin to review his succession criteria in light of changes in the company and the business environment. As DCI spun off some operations and acquired others, its strategic direction and business model shifted in subtle but important ways-and so did Godwin's preferred candidate for the job. As a safeguard, he secured the identity of his preferred candidate in a letter entrusted to the care of the company counsel. The ideal candidate at the beginning of Godwin's term was not the best candidate at the end of the process.

During the process, two very talented leaders left DCI to take on CEO positions at other companies rather than wait an undetermined number of years for the chance to succeed Godwin. As a result of Godwin's dedication to development of potential successors, both leaders left on good terms and when he retired at a later date, the board could have invited either of these individuals to replace him if there had been no viable internal candidate.

When the time came to make the succession decision, there were at least three internal candidates who had demonstrated they were capable of taking over. Somewhat to the board's surprise, Godwin recommended the youngest of the three. He reviewed with the board his detailed assessment of each of the candidates against the criteria; he saw

dramatic changes ahead for DCI, and explained to the board that his preferred candidate seemed to have a greater appetite for change and ability to manage it than his more conservative competitors. After a healthy debate, the board supported Godwin's recommendation.

Getting the board's backing

About halfway into his first year, the new CEO faced a significant crisis. The company had been developing what seemed to be a promising new weapons system, banking on positive reviews from the government in its early phases. After investing billions of dollars, DCI learned the project would not be receiving the anticipated funding. DCI's stock took a dramatic fall, and analysts questioned the new CEO's ability to lead the company.

Unlike the situation at Arcadia, however, the board had been closely involved in selecting the new CEO, and its members were fully aware of the risks involved in the decision to develop the new weapons system. While a few board members wavered in their support, the majority backed the new CEO both publicly and privately. The failed system was a significant setback, but DCI remained a strong company overall and its stock slowly recovered under the new CEO's leadership.

Best practices

1. Start Early

The DCI story illustrates several best practices in CEO succession. First, start early. Planning your own succession can be an emotional experience for a CEO, and many put off thinking about it to the last possible minute. Good leaders and responsible boards begin the conversation about succession early in a CEO's tenure, to allow time for developing a substantial pool of internal candidates. Leadership development at this level happens largely through on-the-job learning and mentoring, and candidates may need to experience several different roles to attain the depth and/or breadth of knowledge required for a top executive role.

2. Be disciplined

Second, treat succession planning as a disciplined process that includes formal assessment against relevant leadership attributes. Building as much objectivity as possible into assessment and selection can help neutralize-though not eliminate-the political dynamics. It can also help CEOs manage the emotional dynamics involved in succession and justify their choice both to the board and to unsuccessful candidates.

While these are all valid concerns, we believe that "due diligence" in the selection process includes considering at least a few external candidates, to benchmark the strength of the internal team against the broader industry talent pool. At the same time, we do caution against "white knight" thinking-pinning unrealistic hopes on an external hire to transform a company in deep trouble. No matter how strong the new leader is, one outsider coming up against an ingrained company culture is going to have a hard time making significant change. And it's easy to overestimate the strengths of an outsider who you don't see in action on a daily basis, while underestimating the leaders you know well.

3. Ensure board ownership

Third, recognize that while the CEO will normally take the lead in driving the process (except in crisis situations resulting from a sudden, unplanned CEO departure), at the end of the day the board owns the succession decision. Succession planning should start with a discussion between the CEO and the board on the roles each will play in the process, the expected timing, and the criteria against which candidates will be assessed. As both these case studies show, a critical success factor in determining

criteria is to get both CEO and the board thinking about, and aligned on, the company's future strategic direction and anticipated challenges. It may be that the type of leadership required in the next phase of the company's evolution will be very different from what's in place now.

In our work on CEO succession, we have found that boards want to see a larger slate of potential candidates than they have in the past, and they want to see them earlier in the selection process. They also want more exposure to candidates in informal, interactive settings, instead of just watching them give formal presentations. They are becoming more focused on understanding the factors that contribute to CEO failure and the predictive indicators of success or failure. They are also playing a more active role in the actual CEO transition, thinking about how to create conditions conducive to the new CEO's success.

The Case for Considering External Candidates

Some CEOs are strongly set against considering external candidates, believing that they take longer to find, will need more time to learn the business, and might cause key internal talent to leave if they're passed over in favour of an outside hire.

We saw this in the Arcadia case, where the board insisted on the preferred candidate spending a year as president and COO while being groomed for the top job by the CEO.

We saw it at DCI when the board publicly supported the CEO during an early crisis. Some boards Mercer Delta works with develop a formal communication plan for the first 100 days of a new CEO's tenure, to ensure the CEO receives the support of both internal and external stakeholders.

4. Plan communication to fit the context

Fourth, make sure you've thought through a communication strategy that fits the circumstances. At both DCI and Arcadia, constant communication with the board was the key to success. It's also important to think about how and when you communicate with potential candidates about their candidacy and the final decision. Shrouding succession processes in secrecy risks triggering the

rumour mill and heightening the political and emotional dynamics. The wrong communication at the wrong time can do the same, distracting people from their jobs.

Godwin at DCI hit the right strategy for his circumstance by signalling to potential candidates that they were being developed for future leadership positions, without setting off a seven-year horse race for his job. At Arcadia, open communication about the process helped everyone work through a difficult time. The right succession communication strategy for one company at any given time may be absolutely wrong for another, or even for the same company at a different time.

5. Create a succession culture

Finally, we have found that the companies that manage CEO succession best tend to be companies that have made leadership development a priority across the entire company, creating what we call a "succession culture." They have a leadership model that gives the company a shared vocabulary for talking about what it requires of leaders at different levels of the organization. They are disciplined about assessing leadership potential, developing leadership bench strength for the company as a whole, and managing succession for the key positions three to five levels below the CEO. A strong leadership pipeline actively managed from a long-term perspective is a great boost to both CEO and board in CEO succession planning. ■

Best Practices in CEO Succession

- Start early in a CEO's tenure
- Use a disciplined process, including formal assessment against relevant leadership attributes
- Ensure board ownership of, and engagement in, the process
- Plan and implement a communication strategy tailored to the unique circumstances
- Make leadership development a priority and create a "succession culture"