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The Role of the Board in Turbulent Times …

CEO Succession Planning

by Matteo Tonello, John C. Wilcox, and June Eichbaum

Management succession is one of the most critical strategic risks a corporation faces and a favorite topic of discussion on the role of the board in business crises. Similarly, leadership development is germane to the mitigation of uncertainties resulting from the sudden loss of talent and should take center stage in any board agenda. To ensure the effectiveness and objectivity of their role, corporate directors should consider assigning responsibility for the CEO succession plan and top-executive leadership development program to a standing committee under the board's independent chair or lead director. The process should become integral to business strategy, enabling the business enterprise to access the talent necessary to adapt, thrive, and grow, despite changing market conditions.

This report is the sixth in The Conference Board series "The Role of the Board in Turbulent Times."[1] It provides an overview of issues and strategies a board may consider in fulfillment of its succession planning duties.

1 Also see Frederick. H. Alexander, *The Role of the Board in Turbulent Times: Responding to Unsolicited Takeover Offers*, The Conference Board, Executive Action 309, June 2009; Damien J. Park and Matteo Tonello, *The Role of the Board in Turbulent Times: Avoiding Shareholder Activism*, The Conference Board, Executive Action 300, April 2009; Robin Bergen, *The Role of the Board in Turbulent Times: Overseeing Internal Investigations*, The Conference Board, Executive Action 297, February 2009; Mark S. Bergman, *The Role of the Board in Turbulent Times: Assessing Corporate Strategy*, The Conference Board, Executive Action 294, January 2009; and Matteo Tonello, *The Role of the Board in Turbulent Times: Overseeing Risk Management and Executive Compensation*, The Conference Board, Executive Action 292, December 2008.

Business Leadership in Turbulent Times

Due to the strategic challenges posed by the economic downturn, an increasing number of companies have been facing sudden, unforeseen chief executive and senior management departures or dismissals. Estimates for 2008 alone indicate that, in the United States, the chief executive officers of 1,484 public companies left their positions by the end of the year, a record number for the last decade.

The trend has continued into 2009, albeit more slowly, with 607 business corporations announcing the appointment of a new CEO as of June 30 (Chart 1).[2]

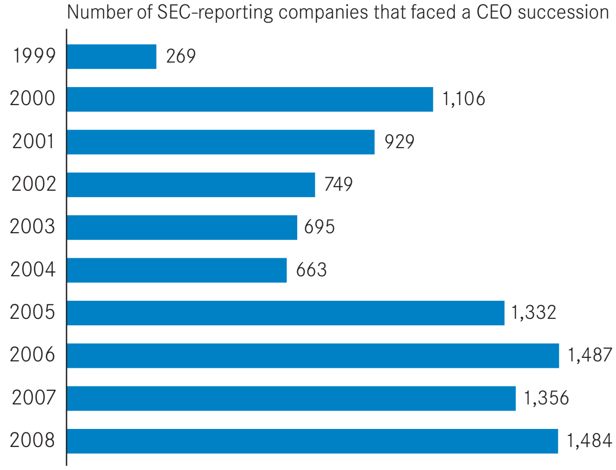
When measured across the S&P 500, the increase in CEO turnover appears to be a generalized phenomenon affecting size groups evenly and averaged 10 percent in 2008 (with 52 new appointments to the chief position) (Chart 2).[3]

However, those industries that suffered underperformance, became the target of government intervention, or found themselves exposed to excess volatility in commodity prices—notably, financial services, energy, and telecom services—were affected more than others (Chart 3).[4]

Chart 1

Annual CEO Departures, 1999–2008

Number of SEC-reporting companies that faced a CEO succession



Source: Challenger, Gray & Christmas, 2009

Chart 2

Turnover Rate by Company Size, 2008

The percentage of companies that appointed a new CEO in 2008 was relatively even across size groups in the S&P500.

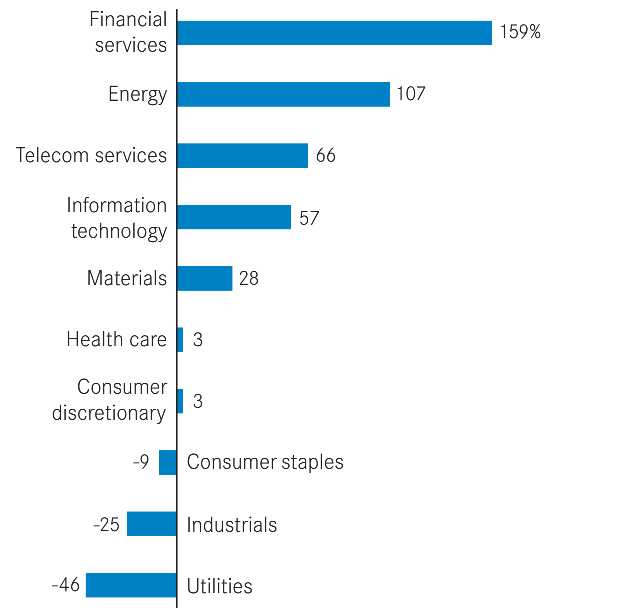
Size group	*Number*	*Percentage*
Overall S&P 500	**52/500**	**10%**
1–100	12/100	12
101–200	7/100	7
201–300	11/100	11
301–400	12/100	12
401–500	10/100	10

Source: "2008 YTD CEO Turnover Based on S&P 500," Spencer Stuart, 2009 (available at http://content.spencerstuart.com/sswebsite/pdf/lib/Updated_CEO_Turnover_Summary_2008.pdf).

Chart 3

CEO Dismissals by Industry Group, 2008

Percentage increase over historical (10-year) average



Source: Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, Booz & Company, 2009 (forthcoming in strategy+business, No. 55, Summer 2009).

2 "1,484 CEOs Leave Their Posts in 2008. 123 December Departures Lead to Highest Annual Total on Record," Press Release, Challenger, Gray & Christmas, January 13, 2009. The 2008 total barely surpassed the high mark set in 2006, when 1,478 CEO departures were recorded.

3 Meghan Felicelli, 2008 YTD CEO Turnover (Based on S&P500, as of December 31, 2008), Spencer Stuart, 2009 (available at http://content.spencerstuart.com/sswebsite/pdf/lib/Updated_CEO_Turnover_Summary_2008.pdf)

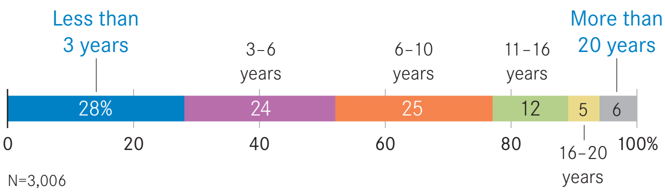
4 Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, Booz & Company, May 2009, p. 4 (available at www.booz.com).

Over time, as expected, the increased turnover rate has curtailed the median tenure of sitting top executives. Today, in the majority of U.S. public companies, CEOs have been on the job for fewer than five years, with 29 percent of companies reporting they hired their chief executive within the last three years (Chart 4).[5] Even more drastic, the Center for Creative Leadership found that, irrespective of whether they leave the company, two out of five new CEOs clearly fail in implementing the business strategy in their first 18 months.[6]

Chart 4

CEO Tenure, 2008

Today, the majority of CEOs have been on the job for fewer than five years.



Source: Annalisa Barrett, Paul Hodgson, Beth Young, and Damion Rallis, *2008 Governance Practices Report*, The Corporate Library, October 2008.

The consequences cannot be overstated:

- It is estimated that the faulty integration of a senior executive can cost a company 10 to 20 times the executive's salary in opportunity costs.[7]
- The securities market takes notice, as shown by several academic studies of the lower cumulative abnormal returns resulting from situations in which there is a public perception of unpreparedness in managing transitions (for example, because of the delay in naming a successor to the departing CEO or the appointment of an acting chief to lead the business ad interim while the search for a successor is occurring).[8]
- When examined collectively, these failures have enormous repercussions on the U.S. economy as a whole, generating a loss of productivity, and social costs valued at nearly $14 billion per year.[9]

Despite this empirical evidence about the importance of ensuring stability during business transitions, an alarming 51 percent of corporate secretaries surveyed in 2008 reported their organizations do not rely on a detailed succession plan for C-suite executives.[10] Of those, 16 percent indicated that they had an existing vacancy in their senior management team, while 37 percent anticipated such vacancy within the following year.

5 Annalisa Barrett, Paul Hodgson, Beth Young, and Damion Rallis, *2008 Governance Practices Report*, The Corporate Library, October 2008.

6 David Berke, *Succession Planning and Management: A Guide to Organizational Systems and Practices*, Center for Creative Leadership, 2005. Also see, for a discussion of the possible reasons why so many CEOs fail, David A. Nadler and Jay A. Conger, "When CEOs Step Up to Fail," *MIT Sloan Management Review*, 2004, Vol. 45, No. 3, pp. 50-56.

7 Constance Dierickx and Joe McGill, "The Dark Side of CEO Succession," *Chief Executive*, April/May 2007, p. 40, also citing a 2007 survey by *Directorship Magazine* and RHR International. Also see Nat Stoddard and Claire Wyckoff, "The Costs of CEO Failure," *Chief Executive*, November/December 2008, p. 68.

8 The literature on this correlation is extensive. See, for example, Jong C. Rhim, Joy V. Peluchette, Inam Song, "Stock Market Reaction and Firm Performance Surrounding CEO Succession: Antecedents of Succession and Successor Origin," *Mid-American Journal of Business*, Vol. 21, No. 1, 2006, p. 21; Bruce K. Behn, David D. Dawley, Richard Riley, Ya-wen Yang, "Deaths of CEOs: Are Delays in Naming Successors and Insider/Outsider Succession Associated with Subsequent Firm Performance?" *Journal of Managerial Issues*, Vol. 18, No. 1, Spring 2006, p. 32; Dan L. Worrell and Wallace N. Davidson, "The Effect of CEO Succession on Stockholder Wealth in Large Firms Following the Death of the Predecessor," *Journal of Management*, Vol. 13, 1987, p. 509; Bruce W. Johnson, Robert P. Magee, Nandu J. Nagarajan, and Harry A. Newman, "An Analysis of the Stock Price Reaction to Sudden Executive Deaths," *Journal of Accounting and Economics*, Vol. 7, 1985, p. 151.

9 Stoddard and Wyckoff, "The Costs of CEO Failure," p. 70.

10 "Lack of Succession Planning Negatively Impacts American Businesses," AchieveGlobal, 2009 (available at www.achieveglobal.com/report/c-suite). Also, see *What Directors Think 2008,* PricewaterhouseCoopers/Corporate Board Member, December 2008 (available at www.cfodirect.pwc.com), reporting that 47 percent of survey directors consider their boards ineffective in succession planning. Similarly, in 2008, 44 percent of directors participating in the annual survey of governance practices by the National Association of Corporate Directors (NACD) responded that CEO succession is not a regular agenda item; see 2008 Public Company Governance Survey, National Association of Corporate Directors, 2008 (available at www.nacdonline.com).

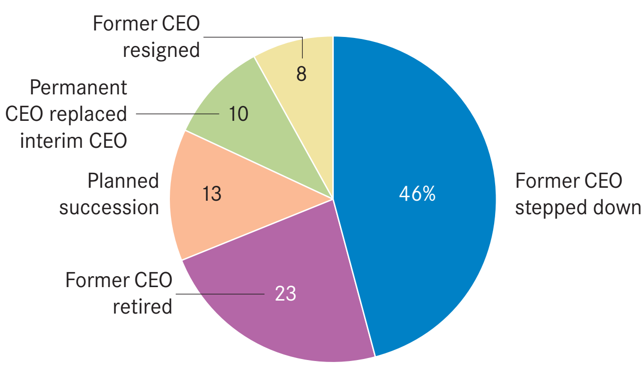
Unlike in previous years, when the prevalent explanation provided by the company for the turnover was CEO retirement, in 2008, as many as 46 percent of successions were unplanned and took place upon (more or less disclosed) dismissal of the incumbent CEO by the board of directors (presumably, reacting to underperformance or following a new strategic plan or a business combination transaction) (Chart 5).

When compared to other leading professionals, CEOs are unlikely to retire of their own volition. Even after retirement, they tend to remain closely affiliated to the business, with 57 percent retaining an office at the firm for at least two years.[11] This is consistent with data showing that outgoing CEOs are leaving at older ages. In 2008, chief executives departed office at 59.4 years of age, a record high for the last decade.[12]

Chart 5

Stated Reasons for Turnover, 2008

Based on newly appointed CEOs in S&P 500.



Source: "2008 YTD CEO Turnover Based on S&P 500," Spencer Stuart, 2009 (available at http://content.spencerstuart.com/sswebsite/pdf/lib/Updated_CEO_Turnover_Summary_2008.pdf).

The following factors may help explain why many boards of directors inadequately address CEO succession planning.[13]

- **No one "owns" succession planning** While other important board duties are specifically assigned to standing committees, succession often is not. Without a defined place in the governance structure of a business corporation, succession planning can become free-floating, orphaned, and neglected, waiting uneasily in the background until a crisis compels the board to attend to it in an ad hoc manner.

- **Boards tend to give priority to compliance and "deadline-driven" duties** Boards are often pressured to give priority to deadline-driven compliance requirements and short-term crises. As a long-term process, succession planning does not fit well into the "multi-tasking" and quick decision-making style characterizing many of today's board activities. It requires a solid understanding of business operations and strategic goals, it must be self-initiating and, when undertaken properly, should function without a deadline.

- **Boards are reluctant to be perceived as disloyal to the CEO** Board members can be reticent about raising the issue of CEO succession. Intent on preserving collegiality in the boardroom, they are concerned that a CEO who is otherwise performing well may be insulted by any attempt to discuss a transition or that a CEO who is underperforming will feel threatened and respond defensively. When the roles of CEO and board chair are combined, the board simply may not have the power to raise the issue until the chairman chooses to do so.

- **Boards suffer from time constraints** Boards increasingly complain that their work resembles cleaning the mythological Augean stables. Directors can easily find themselves inundated with time-consuming, repetitive, and reactive tasks that demand immediate attention. Many of these recurring tasks cannot be neglected – executive compensation, internal controls, risk management, disclosure procedures, legal and accounting matters, and many more. Due to time restraints, succession planning is delegated to headhunters.

- **Succession planning is more art than science** Succession planning, like business strategy, is as much art as science. But unlike business strategy, succession planning may not lend itself to conventional business metrics, templates, forecasting methods and analytical tools. Having to make subjective judgments that are qualitatively different from many day-to-day business and strategic decisions may take directors out of their comfort zone.

11 Jeffrey Sonnenfeld, *The Hero's Farewell: What Happens when CEOs Retire*, (New York: Oxford University Press, 1991).

12 Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, p. 4.

13 For a comprehensive review of the history of research related to executive succession, see Idalene F. Kesner and Terrence C. Sebora, "Executive Succession: Past, Present, and Future," *Journal of Management*, Vol. 20, 1994, pp. 327–372.

Tables 1a and 1b

CEO Succession Cases, 2008–March 2009

Table 1a: First Quarter 2009

S&P 500	Company	New CEO	Age	Old CEO	Age	Reason for change	New CEO start date	Placement	CEO/ chair split?	Former CEO new chair?
301–400	Amphenol	Adam Norwitt	38	Martin H. Loeffler	64	Planned succession	1/1/2009	Internal	Yes	Yes
101–200	Conventry Health Care	Allen F. Wise	65	Dale B. Wolf	54	Former CEO resigned	1/30/2009	Internal	No	–
1–100	DuPont Co.	Ellen J. Kullman	52	Charles O. Holliday Jr.	60	Former CEO stepped down	1/1/2009	Internal	Yes	Yes
1–100	General Motors Corp.	Frederick A. Henderson	49	G. Richard Wagoner	56	Former CEO stepped down	3/30/2009	Internal	Yes	No
401–500	Huntington Bncshares	Stephen D. Steinour	49	Thomas E. Hoaglin	58	Planned succession	2/28/2009	External	No	–
101–200	Integrys	Charles A. Schrock	55	Larry Weyers	63	Planned succession	1/1/2009	External	Yes	Yes
401–500	JDS Uniphase	Thomas Waechter	55	Kevin J. Kennedy	51	Former CEO resigned	1/1/2009	Internal	Yes	No
401–500	MEMC Electr. Materials	Ahmad R. Chatila	42	Marshall Turner	66	Former CEO was interim	3/2/2009	External	Yes	No
1–100	Murphy Oil Corp	David M. Wood	50	Claiborn Deming	54	Former CEO stepped down	1/1/2009	Internal	Yes	No
201–300	Pepco Holdings, Inc	Joseph M. Rigby	51	Dennis R. Wraase	63	Former CEO to retire	3/1/2009	Internal	Yes	Yes
401–500	Rowan Companies	W. Matt Ralls	59	D.F. McNease	56	Former CEO to retire	1/1/2009	External	Yes	No
201–300	Smith International	John Yearwood	48	Doug Rock	61	Former CEO stepped down	1/1/2009	Internal	Yes	Yes
301–400	Spectra Energy	Greg Ebel	44	Fred Fowler	62	Former CEO to retire	1/1/2009	Internal	Yes	No
1–100	Tyson Foods	Leland Tollett (Interim)	71	Dick Bond	61	Former CEO resigned	1/5/2009	Internal	Yes	No
1–100	Walgreen Co.	Gregory D. Wasson	50	A.G. McNally	63	Former CEO was interim	2/1/2009	Internal	Yes	Yes
1–100	Wal-Mart Stores Inc	Mike Duke	58	H. Lee Scott	59	Former CEO stepped down	2/1/2009	Internal	Yes	Yes
201–300	Yahoo! Inc.	Carol Bartz	60	Jerry Yang	38	Former CEO stepped down	1/13/2009	External	Yes	No

Note: : In the case of Rick Waggoner, while the Obama Administration asked that he step down, it is noted here that he stepped down, as per GM's press release.

Table 1b: 2008

S&P 500	Company	New CEO	Age	Old CEO	Age	Reason for change	New CEO start date	Placement
1–100	Alcoa	Klaus Kleinfeld	50	Alain Belda	64	Former CEO stepped down	5/8/2008	Internal
201–300	Advanced Micro Devices	Dirk R. Meyer	46	Hector Ruiz	62	Former CEO stepped down	7/17/2008	Internal
1–100	Altria Group	Michael Szymanczyk	56	Louis Carey Camilleri	52	Former CEO stepped down	3/1/2008	Internal
						(Spinoff: Philip Morris International)	3/1/2008	Internal
401–500	Ambac Financial	Michael A. Callen (interim)	66	Robert J. Genader	61	Former CEO to retire	1/16/2008	Internal
1–100	American International Group	Robert B. Willumstad	62	Martin Sullivan	53	Former CEO stepped down	6/15/2008	External
401–500	Apollo Group Inc.	Charles B. Edelstein	48	Joseph L. D'Amico	58	Former CEO was Interim	8/26/2008	External
201–300	Assurant Inc.	Robert B. Pollock	51	Kerry J. Clayton	62	Former CEO was Interim	1/28/2008	Internal
301–400	Bemis Co.	Henry J. Theisen	53	Jeffrey H. Curler	58	Former CEO stepped down	2/1/2008	Internal
301–400	Cameron International Corp.	Jack B. Moore	54	Sheldon R. Erikson	66	Planned succession	4/1/2008	Internal
301–400	Cincinnati Financial Corp.	Kenneth William Stecher	62	John Schiff	63	Former CEO stepped down	7/1/2008	Internal
1–100	Coca-Cola Co.	Muhtar Kent	55	Neville E. Isdell	65	Planned succession	7/1/2008	Internal
201–300	Dover Corporation	Robert A. Livingston	55	Ronald L. Hoffman	60	Former CEO to retire	12/1/2008	Internal
401–500	E*TRADE Financial Corporation	Donald H. Layton	57	Robert Jarrett Lilien	46	Former CEO was Interim	3/3/2008	Internal
101–200	Edison International	Thoedore F. Craver	56	John Bryson	65	Former CEO to retire	7/31/2008	Internal
101–200	Eli Lilly & Co.	John C. Lechleiter	54	Sidney Taurel	59	Former CEO to retire	4/1/2008	Internal
401–500	First Horizon National Corp.	D. Bryan Jordan	46	Gerald L. Baker	65	Planned succession	9/1/2008	Internal
201–300	Fortune Brands	Bruce A. Carbonari	51	Norman H. Wesley	59	Former CEO stepped down	1/1/2008	Internal
201–300	GameStop	Daniel A. DeMatteo	60	R. Richard Fontaine	66	Former CEO stepped down	9/7/2008	Internal

[Table continued on page 6.]

Table 1b: 2008 (continued)

S&P 500	Company	New CEO	Age	Old CEO	Age	Reason for change	New CEO start date	Placement
301–400	Hasbro Inc.	Brian Goldner	44	Alfred J. Verrecchia	64	Former CEO stepped down	5/22/2008	Internal
301–400	Hershey Co.	David J. West	43	Richard H. Lenny	56	Former CEO stepped down	1/1/2008	Internal
401–500	Intuit	Brad Smith	43	Stephen M. Bennett	54	Former CEO stepped down	1/1/2008	Internal
301–400	Juniper Networks Inc.	Kevin R. Johnson	47	Scott Kriens	49	Former CEO stepped down	7/24/2008	External
101–200	Kohls	Kevin Mansell	56	Larry Montgomery	59	Planned succession	8/21/2008	Internal
301–400	Legg Mason	Mark R. Fetting	52	Raymond A. Mason	71	Former CEO to retire	1/29/2008	Internal
101–200	Marsh & McLennan	Brian Duperreault	60	Michael Cherkasky	57	Former CEO stepped down	1/30/2008	External
301–400	McCormick & Co.	Alan D. Wilson	49	R. J. Lawless	61	Former CEO to retire	1/1/2008	Internal
401–500	MEMC Electronic Materials	Marshall Turner (Interim)	66	Nabeel Gareeb	43	Former CEO resigned	11/12/2008	External
201–300	Molson Coors Brewing Company	Peter Swinburn	55	Leo Keily	60	Former CEO stepped down (will lead spinoff: joint venture Molson Coors and SABMiller)	6/10/2008 6/10/2008 6/10/2008	Internal Internal Internal
1–100	Motorola	Gregory Q. Brown	46	Edward J. Zander	61	Former CEO stepped down	1/1/2008	Internal
301–400	Noble Corp.	David W. Williams	50	William A. Sears	57	Former CEO was Interim	1/3/2008	Internal
301–400	Northern Trust Corp.	Frederick H. Waddell	53	William Osborn	60	Former CEO to retire	1/1/2008	Internal
401–500	PerkinElmer	Robert F. Friel	51	Gregory L. Summe	50	Former CEO stepped down	2/1/2008	Internal
101–200	Principle Financial Group	Larry Donald Zimpleman	56	John Barry Griswell	59	Planned succession	5/1/2008	Internal
301–400	ProLogis	Walter C. Rokowich	50	Jeffrey H. Schwartz	48	Former CEO resigned	11/12/2008	Internal
1–100	Prudential Financial	John R. Strangfeld	53	Arthur F. Ryan	65	Former CEO to retire	1/1/2008	Internal
1–100	Sears Holdings	W. Bruce Johnson (interim)	55	Aylwin B. Lewis	53	Former CEO stepped down	2/2/2008	Internal
201–300	Starbucks Corp.	Howard D. Schultz	51	James L. Donald	53	Former CEO stepped down	1/8/2008	Internal
1–100	Target Corp	Gregg Steinhafel	52	Robert J. Ulrich	65	Former CEO to retire	5/1/2008	Internal
401–500	Tellabs	Robert W. Pullen	44	Krish A. Prabhu	53	Former CEO stepped down	3/1/2008	Internal
301–400	The Charles Schwab Corporation	Walter W. Bettinger II	47	Charles R. Schwab	70	Former CEO stepped down	10/1/2008	Internal
1–100	Time Warner	Jeffrey L. Bewkes	54	Richard D. Parsons	59	Former CEO resigned	1/1/2008	Internal
1–100	United Parcel Service	D. Scott Davis	56	Michael L. Eskew	56	Former CEO to retire	1/1/2008	Internal
1–100	United Technologies	Louis Chenevert	50	George David	66	Planned succession	4/9/2008	Internal
401–500	Verisign	James D. Bidzos (interim)	53	William Roper	60	Former CEO resigned	6/30/2008	Internal
201–300	VF Corp	Eric C. Wiseman	51	Mackey J. McDonald	59	Former CEO stepped down	1/1/2008	Internal
201–300	W.W Grainger, Inc.	James T. Ryan	49	Richard Keyser	65	Planned succession	6/1/2008	Internal
101–200	Wachovia	Robert K. Steele	56	Lanty L. Smith	n/a	Former CEO was Interim	7/9/2008	External
1–100	Walgreen Co.	Alan G. McNally (interim)	62	Jeffrey A. Rein	56	Former CEO to retire	10/10/2008	External
101–200	Weyerhaeuser Co.	Daniel S. Fulton	59	Steven R. Rogel	65	Former CEO stepped down	4/17/2008	Internal
401–500	Xilinx	Moshe Gavrielov	53	William P. Roelandts	63	Former CEO stepped down	1/7/2008	External
201–300	XL Capital	Michael S. McGavick	49	Brian M. O'Hara	59	Former CEO to retire	5/1/2008	External
201–300	XTO Energy	Keith A. Hutton	49	Bob R. Simpson	59	Former CEO stepped down	12/1/2008	Internal

Note: Apollo Group, AIG, and Wachovia experienced two transitions in 2008, but are each counted as one complete case of turnover.

Dates for Sovereign and Tyson CEO turnover were unclear, therefore they were not counted as part of the analysis for 2008.

Source: Spencer Stuart, 2009.

The State of the Plan, 2009

Listing standards by the New York Stock Exchange (NYSE) require boards to explicitly address CEO succession plans in their organizations' corporate governance guidelines. Specifically, guidelines should include policies for:

- the selection of the executive;
- the performance review of the executive; and
- the description of a general transition roadmap to follow in the event of an emergency (including a sudden departure or need for dismissal and the unexpected death, disability, or other impediment).[14]

To comply with these requirements, a large majority of public companies now report assigning formal responsibility for succession planning to the full board or a standing committee.[15] Aside from this structural aspect, however, succession plan disclosure is often little more than generic, boilerplate language denoting the company's commitment to develop a skilled, experienced management team.[16]

Practical guidance is also available through leading shareholder organizations and other business interest groups, including TIAA-CREF, CalPERS, The Business Roundtable, and The Conference Board's Commission on Public Trust and Public Enterprise.[17]

In general, under these recommendations, a succession planning process should be driven and controlled by the board (possibly through the more efficient coordination by a board committee) and be:

- tied to the company's strategic business goals;
- continuous, coherent and sustainable;
- transparent, both within the company and to the public;
- incorporating input from the CEO, human resources, and key senior managers;
- readily executable in the event of a crisis;
- focused on selecting the right leader at the right time and adaptable to changing circumstances;
- providing a clearly defined career path for high-potential candidates; and
- conservatively designed to avoid an excessively competitive mentality among candidates.

Reports from the last few proxy seasons have been showing an increasing interest by institutional shareholders in enhanced disclosure on succession planning, inclusive of a more detailed corporate policy as well as a description of allocated resources. However, aside from a few sporadic cases in which the company voluntarily agreed to meet some of the investors' demands, the U.S. Securities and Exchange Commission (SEC) has been dismissing these proposals based upon "rule 14a-8(i)(7), as relating to [the company's] ordinary business operations (i.e., the termination, hiring, or promotion of employees)."[18] On this ground, corporations have been excluding them from the voting ballot.[19]

14 Section 303A.09 of the NYSE *Listed Company Manual*. Succession planning is not directly addressed under NASDAQ rules nor is it covered by federal regulation in the United States.

15 *Board Practices: Trends in Board Structure at S&P 1,500 Companies*, RiskMetrics Group, Inc., December 17, 2008 (available at www.riskmetrics.com/knowledge/2009bp).

16 See, for example, Damion Rallis, *CEO Succession Planning: Quelling Market Uncertainty*, Analyst Alert, The Corporate Library, March 21, 2008, p. 3, who bases his analysis on the succession plan disclosure made by 92 companies in The Corporate Library governance database with CEOs age 70 or older.

17 See *Commission on Public Trust and Private Enterprise: Findings and Recommendations*, The Conference Board, SR-03-04, 2003; *Principles of Corporate Governance*, The Business Roundtable, November 2005; *Corporate Governance Policies*, Council of Institutional Investors, May 1, 2009; *Global Principles of Accountable Corporate Governance*, California Public Employees' Retirement System, March 1, 2009; *Report of the NACD Blue Ribbon Commission on the Governance Committee: Driving Board Performance, Best Practices and Key Resources*, National Association of Corporate Directors, 2007; *Policy Statement on Corporate Governance*, Teachers Insurance and Annuity Association–College Retirement Equities Fund, March 2007.

18 See, for example, the correspondence between the SEC and Whole Foods Market Inc. with respect to the proposal submitted on September 29, 2008, to the food distribution company by the Central Laborer's Pension, Welfare and Annuity Fund (available at www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/centrallaborers112508-14a8.pdf).

19 *2008 Postseason Report*, RiskMetrics Group, October 16, 2008 (available at www.riskmetrics.com/docs/2008postseason_review_summary).

Succession Fiascoes

In the last few years, some large, high-profile companies made headlines for their unpreparedness to navigate a leadership transition:

Citigroup In November 2007, Charles Prince resigned from his post as CEO of Citigroup after the company reported billions in write-downs due to the failing mortgage industry. He was later named by *Fortune* magazine as one of the "eight economic leaders who didn't [see] the crisis coming," noting the overly optimistic statements he had made as late as July 2007.* Unprepared to face the transition, Citi resorted to an interim CEO until the search for an outside successor was completed and Vikram Pandit was hired.

Merrill Lynch In November 2007, CEO Stanley O'Neal stepped down after his boardroom colleagues lost confidence in his risky strategy of betting billions on American mortgage-backed securities. O'Neal walked away with a golden parachute compensation package that included Merrill stock and options valued at $161.5 million. However, he left no succession plan. The board eventually chose as new CEO John Thain, who announced that he would slash expenses, cut thousands of jobs, and exit businesses to fix the ailing securities firm. But not before spending over $1 million of company money to refurbish his office.

Morgan Stanley In 2001, Morgan Stanley president John Mack was forced out after a power struggle with Philip Purcell. But employees disliked Purcell's abrasive leadership style, and shareholders were not pleased either. In June 2005, after a tumultuous proxy season for the company, the board asked John Mack to come back and take the helm.

Boeing In 2003, CEO and chairman Philip Condit resigned amid allegations that one of his direct reports had engaged in unethical conduct and extended a job offer to a government official in return for a profitable contract with the U.S. Department of Defense. Despite the scandal, the board was not scrupulous enough in vetting the succession candidate's moral profile. The successor, Harry Stonecipher, did not escape Condit's fate and stepped down two years later due to an affair with a company executive. The board, citing a new code of conduct instituted by Stonecipher, demanded his resignation.

The Coca-Cola Company After the death of CEO Roberto Goizueta in 1997, Coke's board picked his designated successor, Doug Ivester, only to realize that Ivester did not have his predecessor's leadership skills. Two years later, Ivester was replaced by Douglas Daft, an Australian who had run Coke's Japanese operations but had little or no familiarity with the corporate culture in Atlanta. In February 2004, Daft publicly announced his retirement and said that his chief operating officer would be the best candidate to succeed him. It took the board four months to appoint a new CEO, and he was not Daft's choice.

Home Depot In December 2000, the board chose Bob Nardelli, an outsider with no prior retail experience, over several internal candidates to the CEO post. Once in place, Nardelli overhauled the organization's decentralized decision-making structure and consolidated several divisions. His blunt and autocratic management style turned off employees, alienated the public, and drew attention to his excessive compensation (which was well in excess of past company standards). The board asked him to step down in January 2007, paying a severance estimated at $210 million.

Procter & Gamble (P&G) The board of directors had to choose between two insiders—Durk Jager and Alan Lafley—when it appointed a new CEO in 1999. But it made the wrong choice. In June 2000, CEO Durk Jager was ousted after a consecutive series of missed quarterly earnings projections. He had been on the job for just 17 months. The board then chose Lafley, who went on to become *Chief Executive* magazine's "CEO of the Year 2006."

* Fortune/CNNMoney.com, August 6, 2008.

Source: Wikipedia.org.

Board practices Through its annual survey of governance practices, The Conference Board has found that a growing number of companies formally assign to the nominating/corporate governance committee the task of advising on and overseeing CEO succession planning issues. Typically, based on an analysis of their charters, nominating/governance committees investigate and discuss the topic for the purpose of making recommendations to the full board, which retains ultimate authority for selecting the new business leader.

Despite the expanding range of responsibilities a governance committee is charged with in today's regulatory environment, only a very small group of companies in the financial services industry has instituted a separate succession planning committee. A standing board committee dedicated to ensuring leadership development is virtually absent in other business sectors (Table 2).[20]

Since it requires leadership assessment and development, succession planning should be an ongoing concern. Nonetheless, only 34 percent of corporate boards in the S&P 500 regularly include it on their agenda, while as many as 40 percent admit discussing it less than on an annual basis. Furthermore, boards report heavy reliance on the incumbent CEO to develop and lead the process.[21] Involvement by the CEO may encompass:

- drafting the job description and identifying needed skills and credentials;
- deciding whether to recruit from outside the company;
- hiring a search firm; and
- selecting the final candidates.

More than 60 percent of surveyed companies report that, at a minimum, their CEO recommends candidates to the board and participates in the evaluation. By contrast, as many as 25 percent of corporate directors report not having had the opportunity to know personally company leaders two or more layers below the CEO.[22]

Table 2

Types of Board Committees by Industry

Most companies' boards have audit, compensation, and nominating/governance committees.

Company has committee	Manufacturing	Financial services	Nonfinancial services
Audit	100.0%	96.6%	100.0%
Compensation	97.7	95.8	89.1
Nominating/Governance	95.3	83.1	87.0
Executive	36.5	44.9	58.7
Succession Planning	0.0	2.5	0.0
Finance	25.9	34.8	26.1
Ethics	1.2	0.9	2.2
Human Resources	3.5	5.1	6.5
Pension and Benefits	4.7	1.7	4.4
Stock Option	3.5	1.7	4.4
Environmental and Corporate Responsibility	15.3	6.8	2.2
R & D / Innovation	5.9	0.0	0.0
Political Contributions	1.2	0.9	2.2

Source: The Conference Board, 2008.

20 Kevin F. Hallock, Matteo Tonello, and Judit Torok, *Directors' Compensation and Board Practices in 2008*, The Conference Board, Research Report 1439, 2008.

21 *Board Index 2008*, Spencer Stuart, November 2008, p. 30.

22 Dierickx and McGill, "The Dark Side of CEO Succession," p. 41.

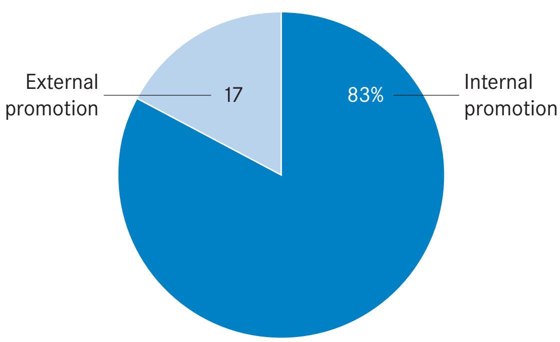
Internal promotion and outside recruitment Boards may use a variety of approaches to the CEO selection process. Their choice generally reflects the culture and characteristics of the organization, the skills required for the job, and the available market for business executives.

Promotion from within tends to be the preferred route (Chart 6), especially for companies that can rely on well-developed senior executive talent pools. Many advisers consider internal promotion the most efficient approach, especially for well-performing corporations, as it can promote generational change and innovation while ensuring business stability and a smooth transition.[23] Influential long-term investors also emphasize the importance of this method: TIAA-CREF's *Policy Statement on Corporate Governance*, for example, recommends that any succession plan be based on the notion of talent development and continuity of leadership.[24]

Chart 6

Internal versus External Placement

Based on newly appointed CEOs of S&P 500 companies, 2008.



Source: "2008 YTD CEO Turnover Based on S&P 500," Spencer Stuart, 2009 (available at http://content.spencerstuart.com/sswebsite/pdf/lib/Updated_CEO_Turnover_Summary_2008.pdf).

To train internal candidates for the CEO role and test their preparedness, directors may use a variety of techniques. Most ask candidates to make presentations to the board (88 percent) or to attend board meetings regularly (70 percent). A quarter of S&P 500 corporations encourage candidates to serve on the board of other public companies as a means of gaining broader leadership exposure. Some companies (17 percent) rotate candidates through a number of senior-level positions and evaluate their performance with respect to each function. To decide on the most suitable selection technique and implementation, one-fifth of the S&P 500 boards of directors avail themselves of outside advisors; in particular, search firms may be hired, even in the context of an internal succession plan, for their expertise in benchmarking and assessment.[25]

However, some boards remain skeptical about internal placement, citing evidence that this practice may politicize the process, encourage a "horse race" mentality among executives, and possibly harm the organization's cohesiveness and strategic focus. In addition to the risk of losing key senior managers not selected for the chief post, this approach may force other employees in the lower ranks to choose which "horse" to back and possibly compromise their standing within the company if it turns out they made the wrong choice.[26] Finally, internal promotions may not be an option for organizations with poor leadership management, for businesses with a high degree of functional specialization in the senior executive team,[27] or in those situations in which the company is caught unprepared by an emergency succession or business crisis.

23 See again, for example, Ram Charan, "Ending the CEO Succession Crisis," *Harvard Business Review*, February 1, 2005 (available at harvardbusiness.org), arguing that "[t]he CEO succession process is broken" because "[t]oo many companies' succession pipelines are bone dry."

24 *Policy Statement on Corporate Governance*, Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF), March 2007.

25 *Board Index 2008*, p. 30.

26 See, for example, Dan R. Dalton and Catherine M. Dalton, "CEO Succession: Some Finer, and Perhaps Provocative, Points," *Journal of Business Strategy*, Vol. 28, No. 3, 2007, pp. 6–8.

27 Deepak K. Datta, James P. Guthrie and Nandini Rajagopalan, "Different Industries, Different CEOs? A Study of CEO Career Specialization," *Human Resource Planning*, Vol. 25, No. 2, 2002, pp. 14–25.

It is well recognized that hiring a new CEO from outside can be much more expensive, as it often involves offering signing bonuses, large initial equity grants, and make-whole payments.[28] Data for 2007 show that externally hired CEOs in the S&P 500 Index received a median total compensation package of approximately $12.1 million, a 51.1 percent premium over their peers with at least two years of tenure in the chief executive office (who earned approximately $8 million each). Internally promoted CEOs were paid much less, pulling a median pay package of approximately $6.9 million.[29] In addition to the recruitment expense, outside hiring generates additional transition costs that are difficult to quantify, given the need for the incoming leader to become familiarized with the business practices and culture of the organization. Often, according to some academic studies, these transition risks lead to inefficiencies and financial underperformance.[30]

The Profile of the New CEO

Based on 2008 data for 47 newly appointed CEOs in the S&P 500:

- Collectively, they make up 10 percent of the S&P 500.
- They are all men.
- The majority are between 50 and 59 years old. Their median age is 53, one year less than the median for all S&P 500 CEOs.
- Their business leadership background consists of having performed in functional roles, such as operations (31 percent), finance (21 percent), and marketing (12 percent).
- Their international experience has increased in the past five years from 26 percent to 34 percent.
- Only 2 percent serve on three or more external boards (down from 8 percent three years ago), due to corporate policy restrictions. Overall, nearly half of S&P 500 CEOs do not sit on any outside for-profit board.

Source: Meghan Felicelli, *2008 Route to the Top*, Spencer Stuart, November 5, 2008 (available at http://content.spencerstuart.com/sswebsite/pdf/lib/2008_RTTT_Final_summary.pdf).

28 See *Final Report of the Task Force on Executive Compensation*, The Conference Board, 2009 (forthcoming), for a discussion of controversial pay practices (including generous severance packages, golden parachutes, and bonus banking arrangements). Under the recommendations of the high-level group of industry representatives convened under the auspices of The Conference Board, those boards that decide to adopt such practices while hiring new top executives should thoroughly elaborate on their rationale in public disclosure documents.

29 See "CEO New Hire Compensation," *Executive Compensation Trends*, Equilar Inc., July 2008 (available at www.equilar.com). Also see, for a discussion of these findings, Cari Tuna, "Hiring a CEO from the Outside Is More Expensive," *Wall Street Journal*, July 28, 2008..

30 Behn, et al., "Deaths of CEOs," p. 32; Beni Lauterbach, et al., "Internal versus External Successions and Their Effect on Firm Performance," *Human Relations*, Vol. 52, 1999, p. 1485. For research suggesting that insiders tend to deliver better results than outside successors, see Yan Zhang and Nandini Rajagopalan, "When the Known Devil is Better Than an Unknown God: An Empirical Study of the Antecedents and Consequences of Relay CEO Successions," *Academy of Management Journal*, Vol. 47, 2004, pp. 483–500; and Wei Shen and Albert A. Cannella Jr., "Power Dynamics within Top Management and Their Impacts on CEO Dismissal Followed by Inside Succession," *Academy of Management Journal*, Vol. 45, 2002, pp. 1195–1205, which also objects to criticism based on the assumption that insiders who assume the CEO position continues the policies of its predecessors. Contra, Katherine Zoe Andrews, "The Performance Impact of New CEOs," *MIT Sloan Management Review*, Vol. 42, No. 2, 2001, p. 14, which found that company performance rose by more than 4 percent in the three years following the replacement of a fired CEO with an outsider, and suggested that choosing the best performing successor may depend on why the incumbent left. Finally, see Rakesh Khurana, "Finding the Right CEO: Why Boards Often Make Poor Choices," *MIT Sloan Management Review*, Vol. 43, No. 1, 2001, pp. 91–95, arguing that the value of the choice between inside and outside succession is often overestimated, as there is no reliable empirical research supporting the thesis that either solution is always preferable and a guarantee of success.

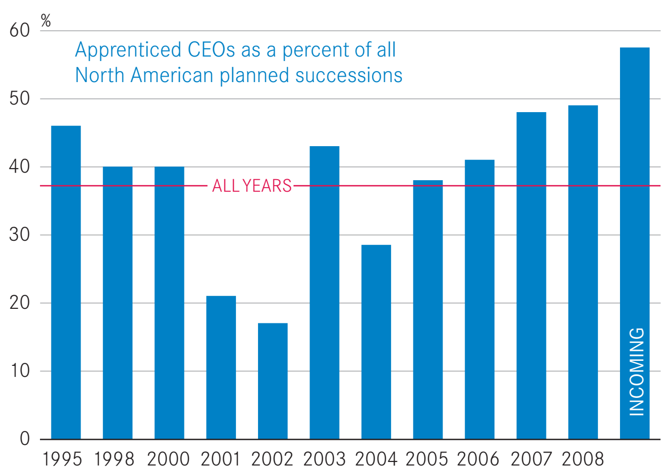
CEO auditioning and apprenticeship Some analysts have reported an increasing use by boards of directors of a CEO "auditioning" practice, which may minimize some of the concerns about internal succession plan while addressing the limitations of the outside recruitment model (notably, higher recruitment costs and transition risks). Under the auditioning practice, instead of placing an outsider directly into the CEO slot, boards first train and test the candidate as chief operating officer or chief financial officer for a period of one to three years.[31]

In addition, research shows that more than half of public companies in North America choose to establish an "apprenticeship," whereby the CEO predecessor assumes the board chairmanship and continues to be involved in the business leadership for a limited time following the appointment of a new CEO.[32] The apprenticeship model is widely documented (Chart 7) and has become increasingly popular over the years. The risks of this practice are also well understood, since the new CEO could be constrained by an overzealous chairman. However, the governance implications of this model can be positive when it reinforces the separation between the two positions, in compliance with international best practices.[33] In fact, in 2008, within the incoming class of CEOs, only 18 percent also held the title of board chairman (compared to the 50.5 percent reported in 2001; see Chart 8).[34]

Chart 7

Use of CEO Apprenticeship Model

Driven by U.S. companies, the practice of appointing the former CEO to stay on as chairman continues to climb in North America.

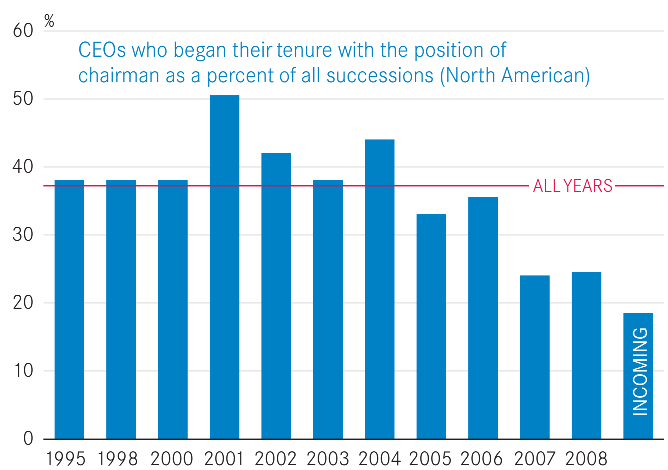


Source: Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, Booz & Company, 2009 (forthcoming *strategy+business*, No. 55, Summer 2009).

Chart 8

Departure from the Duality Model

A declining number of U.S. companies award the board chairman title to new CEOs.



Source: Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, Booz & Company, 2009 (forthcoming *strategy+business*, No. 55, Summer 2009).

31 Per-Ola Karlsson and Gary L. Neilson, *CEO Succession 2008: Stability in the Storm*, p. 4.

32 Ibid., p. 8.

33 For numerous references to such international practices, see *Chairing the Board: The Case for Independent Leadership in Corporate North America*, Policy Briefing No. 4, Millstein Center for Corporate Governance and Performance, Yale School of Management, March 2009 (available at http://millstein.som.yale.edu).

34 Ibid., p. 7.

A Succession Planning Roadmap

The Conference Board recommends that corporate directors dedicate full attention to their succession planning duties and use the challenges posed by the economic crisis as an opportunity to improve their companies' leadership development programs.

Responsibility for succession planning belongs in the boardroom and nowhere else. The board of directors is legally authorized, temperamentally suited, and in possession of the authority, experience, and wisdom needed for effective succession planning. The problems that can lead to neglect of succession planning by boards are primarily organizational—and, to a lesser degree, political, psychological, and cultural. However, boards should be able to overcome them if they are willing to objectify the process and make it integral to and continuous with their duties of governance, business oversight, risk management, and strategic decision-making.

It takes time to develop corporate leaders and choose the right chief executive. No decision that is so crucial to the long-lasting success of a business should be rushed. The steps that follow offer a roadmap to help directors organize succession planning, integrate it with existing board responsibilities, make it transparent both within and outside the company, and ultimately define it as an ongoing element of business strategy. The approach is intended to be straightforward, practical and efficient, transforming succession planning from a responsibility avoided to one embraced. Because succession planning is not a process in which "one size fits all," flexibility is built into the guide, consistent with the complexity, sensitivity, and customized leadership demands individual companies face.

Step 1: **Assign responsibility to a standing board committee of independent directors**

As the principal driver of succession planning, the board must ensure that business transition matters are frequently included in meeting agendas and that a governance structure is in place to oversee an enterprise-wide leadership development program. In smaller companies, it may be sufficient to assign this role to the lead independent director, who will rely on support from the organization and coordinate communications on this issue to and from senior management. Other corporations may find it practical to include succession planning in the charter of the nominating/governance committee or the compensation committee. However, due to the multiplication of today's board activities, when the size or the complexity of the organization warrants it, the board should consider instituting a dedicated standing committee on succession planning and possibly have the lead director chair it.

By delegating succession planning to a standing committee, the board elevates it to the level of its other primary duties. The workings of a standing committee bring focus, diligence, and expertise to the task of designing a CEO succession and leadership development program suitable to the organization's strategy and culture. However, the board, as a whole, must retain full responsibility—overseeing the program structure, setting selection criteria, evaluating candidates, and making the final choice of a CEO—while delegating the practical work to the committee and, under the committee coordination, to functional and line managers. Periodic reports to the full board should be mandated to acquire comprehensive and detailed information essential to informed decision-making.

It is imperative that boards ensure full independence of the oversight process in this area. In particular, independence should be an eligibility requirement to sit on any board committee involved in the leadership development program, as these members need to retain the degree of objectivity and autonomy that is needed to avoid conflicts of interest with senior management and, when needed, suggest dismissals at the top executive level.

Should the former CEO continue to serve on the board of directors for a period of time after departing from the management team, the board needs to remain vigilant and prevent any situation in which the authority of the new chief executive could be undermined. In particular, should the board opt for an apprenticeship model, in which the outgoing CEO is asked to serve as board chairman and mentor the successor through the transition, the board should establish specific safeguards by clearly defining the role of the chairman and limiting the apprenticeship to no more than eight to 12 months. In case of conflict, the succession planning committee chair or the lead independent director should be responsible for mediating and reaffirming the authority of the new CEO. Under no circumstance should the CEO or former CEO be appointed to a dedicated committee responsible for succession planning.

The board may fear that, if retained as a board member or chair, the former CEO would be too confining and undermine the successor's ability to bring necessary changes. In those cases, the board should consider ensuring an orderly transition through alternative development techniques, including:

- first promoting the CEO successor to a series of progressively challenging leadership positions (such as CFO or COO) that would provide the opportunity to gain sufficient exposure to strategic issues and enterprise-wide managerial challenges; and
- having the lead director or head of the succession planning committee provide individual coaching sessions to the newly appointed CEO. This mentoring role may prove particularly effective when the successor has the knowledge and expertise required to manage the organization but needs additional guidance to improve his or her communication skills or adjust certain aspects of his or her personality to the business culture.

To put teeth into its commitment to drive the succession planning effort, the board should include in its annual self-assessment (both individual and collective) a set of quantitative and qualitative measures of progress in this area.

Step 2: **Make succession planning continuous and integral to business strategy and corporate culture, while monitoring the role of the CEO**

The board of directors should view succession planning as an integral part of long-term strategy. The process should be continuous, not reactive or ad hoc. It should be a key element in achievement of the larger goal of "sustainability," in the sense of enabling the business enterprise to adapt, thrive, and grow in response to changing market conditions and other challenges.

To align leadership criteria with business strategy, directors must be fully informed about the company's competitive position, as well as the strengths and weaknesses of the management team. For this purpose, the board should avail itself of adequate resources to benchmark internal candidates against industry peers and assess executive talent available outside the company.

Defining CEO skills in terms of objective business criteria helps depersonalize succession planning, steering it away from a political campaign, popularity contest, or secretive back-room deal. It also avoids an unhealthy "brass ring" competition among internal candidates by focusing attention on the company's business goals rather than the personal qualities of individual candidates. As a result, if the board does not yet have a clear front-runner and is developing multiple candidates, it should seriously consider abstaining from any public announcement of who is being vetted. When the focus is on what—rather than who—the board wants in the company's leadership, candidates are not made any promise, but given tangible milestones and metrics with which to work. Similarly, directors are encouraged to think about future long-term performance rather than trying to "replace" the current CEO to recreate the past.

It is equally important to note that a board cannot determine the qualities it wants in a CEO without detailed knowledge and understanding of the organization's culture and values. This can be achieved by ensuring that each director, irrespective of his or her role in overseeing succession planning, is in a position to interact extensively with senior managers, both formally and informally, and assess such dimensions as current leadership skills, strategic thinking, and operational knowledge.

An Etymological Concern

Over time, as companies develop their succession planning programs, they should consider changing the current terminology from "succession" to "leadership." This report refers to "succession planning" because it remains the most widely used denomination of the process of planning for leadership continuity. However, the term connotes replacement and may put too much emphasis on the incumbent rather than the new leadership. It also carries a hint of its historical linkage to inheritance, royalty, and birthright. A board planning for a "successor" may therefore be overly deferential to the sitting CEO. Similarly, the incumbent may feel a sense of entitlement in the selection and appointment of new leaders.

Non-executive directors, in particular, should often visit the company's facilities and obtain a perspective on how senior managers are perceived by other employees. Off-site events and casual gatherings should also be organized and used by board members to observe how candidates interact in a more informal social environment. It is this human dimension of succession planning that breathes life into an otherwise conceptual process, by making it creative, customized, and stimulating to the business at all levels.

Similarly, the board should engage with the company's human resources department to make certain that internal candidates are given enough opportunities to develop their skills, test their business judgment, and receive exposure within and outside the organization. Progress against development plans should be discussed in internal reports to the board, which should become an integral part of a senior executive's annual performance evaluation conducted at the board level.

Finally, especially when directors have divergent opinions about certain candidates, the board may consider prudent and discrete ways to assess their reputation among external constituents of the company, including large institutional investors, major lenders, and financial analysts.

The CEO and other top executives should actively participate in the succession planning and leadership development program and be expected to cooperate fully with its implementation. In designing the program, the board or a designated committee should delicately balance their oversight role and the need to avoid usurping the CEO's authority within the organization. However, the board should not hesitate to move the incumbent CEO or other members of the management team to a non-developmental role in those cases in which it appears that they are impairing the company's initiatives to groom new leaders. In particular, directors should remain aware that current management could be induced to acts of ego or self-preservation that are not in the best long-term interest of the corporation and its shareholders. It may occur, for example, in those situations in which the board concludes that there is a need to revisit the strategic direction or reevaluate the company's ability to achieve its business objectives. For this reason, directors should acquire their own personal knowledge of the talent pool available at various levels within the organization and feel confident about the effectiveness of the leadership development program. Considering that the final decision on issues of succession resides with the board as a whole, each director should be able to contribute to the debate his or her informed opinion about the preparedness of internal candidates.

For the same reason, succession planning can also be used as a method to reshape or strengthen business values and behavioral standards in those situations in which directors share concerns about the current corporate culture. In particular, a succession plan can influence the behavior of senior executives and other key employees by explicitly tying career paths, leadership development metrics, and succession criteria to adherence to the highest ethical principles. Aside from the CEO succession plan, the board should be comfortable with the integrity of any process—usually implemented by the CEO—for the selection of other key executive officers, such as the chief financial officer (CFO), the chief operating officer (COO) and heads of major business units. This is accomplished with the understanding that the newly appointed CEO and other senior executives should be granted sufficient discretion in retaining other members of the management teams.

The board may seek external expertise to advise on the various phases of the succession planning process and assist in thoroughly evaluating candidates. If the company engages an executive search firm for this purpose, it is imperative that the advisor be required to report directly to the board of directors to avoid any undue influence by current management. If no specific reason precludes either the internal promotion or the external recruitment approach, companies should consider adopting a transparent method for benchmarking internal candidates against outside ones. In general, considering the need to base the succession on concrete business strategy objectives, the board should be very cautious in hiring for the chief executive position an outsider with no relevant industry experience.

Step 3: Integrate succession planning into the top-executive compensation policy

The board of directors should review the company's executive compensation policy to ensure that it fully promotes talent development and enables relatively seamless leadership transitions.

Given the important correlation between leadership management and remuneration policy, the board should give careful consideration to the role of the compensation committee in succession planning. The compensation committee has overall responsibility for determining the financial incentives that drive value-creation at the corporate officer level. Additionally, the compensation committee regularly evaluates objectives and achievements of corporate officers for the purpose of awarding certain performance-related elements of a compensation package. Since those corporate officers are likely to be among the internal candidates under consideration for CEO succession, the compensation committee has the knowledge base and technical tools for assessing their strengths and preparedness for the top job. In particular, in the assessment context, the committee is familiar with benchmarking studies of competitors and peers—a skill that proves highly relevant to the CEO succession process.

Succession planning entails a variety of organizational tasks that aim at optimizing leadership development throughout the various ranks of the corporation. Although its oversight would not extend to the execution of such tasks, it does require focus and time commitment to design a program that is coherent with the company's strategy, risk level, and culture. Due to the complexity of many larger organizations and the expansion of compensation committee duties (resulting from recent public scrutiny on top-executive pay), delegating succession planning in its entirety to the compensation committee may be impractical. However, the compensation committee charter should reinforce the notion that compensation is central to talent development and should explicitly call for collaboration on issues of succession planning with the full board or a dedicated committee. Some companies have formally done so and reinforced this broader strategic role of their compensation committee by renaming it: General Electric, for example, has instituted a Management Development and Compensation Committee "…to assist the board in developing and evaluating potential candidates for executive positions."[35]

Especially when the company has witnessed a trend of declining senior executive tenures, the board's concern should be to properly counterbalance short-term inclinations with a set of long-term behavioral incentives. Long-term performance goals should include intangible assets, such as workforce expertise and professional development, and be accompanied by effective measures of performance. Achievement of such goals should constitute the basis of the board-level assessment of CEO performance and should be conducted at least annually.

Step 4: Integrate succession planning into risk management

Management literature shows that failing in leadership transition can be deadly to even the most successful business. Since they can be a source of business uncertainty, CEO succession and leadership development should be fully integrated into an enterprise-wide risk management (ERM) program. As part of ERM, succession risk should be included in a company's risk inventory, where it is scientifically measured and prioritized based on factors such as its likelihood of occurrence and its impact on the execution of the company's strategy.

35 The committee's charter is available at www.ge.com/pdf/company/governance/board/ge_management_dev_comp_charter.pdf.

Depending on the level of tolerance that the company determines for this type of risk, adequate resources should be allocated to risk mitigation strategies.

The board of directors should constantly monitor the transition risk the company is facing, especially in light of current strategic and financial conditions, and determine the need to trigger an emergency succession plan before the organization suffers inefficiencies or reputational damage. For this reason, board members should expect to be constantly informed on the impact of the economic downturn on the daily conduct of the business, including senior management turnover, and be confident that the risk management program is adequate to promptly detect and elevate to the board level any occurrence that may affect succession risk. Succession risk may also increase the company's vulnerability to hostile takeover attempts and shareholder activism demands, therefore requiring the board to adopt appropriate defense strategies to fend off attacks motivated by speculative interests.[36]

When the board believes that the circumstances command the destitution of the CEO or other events trigger the execution of the emergency plan, directors should fully analyze and discuss the possible effects of the succession on the company's main stakeholders. Based on this discussion, the board should require management to cooperate in handling critical aspects of the communication strategy chosen to ensure that the transition does not compromise relations that are key to the company's long-term business objectives (e.g., with customers, suppliers, investors, or local communities and interest groups). The communication initiative should be used as an opportunity to reassure stakeholders of the corporate strategy and the degree of control retained by the board.[37]

Step 5: **Make succession planning transparent, internally and externally, and describe it in the company's annual disclosure**

Succession planning works best when it is conducted openly and transparently, both within the organization and to its outside stakeholders. Transparency can be achieved by establishing proper communication channels through the ranks of the organization and by including selected information in disclosure documents filed annually with the SEC. It should encompass:

- the description of the role of the board, board committees, committee chairs, the CEO, and key senior executives in the succession planning and transition process, including governance structure and corporate policies on board chairmanship and CEO apprenticeship;
- an overview of the main features of the company's career development program as well as (human and financial) resources deployed to this effort;
- an objective assessment of the current leadership skill set;
- an analysis of selection criteria and assessment metrics (including market benchmarks) the board relies on, as well as their respective rationale in light of the company's business strategy;
- if the company is opting for an outside succession, and the reason why the board believes that this decision best serves the interests of shareholders; and
- whether the company engaged any outside advisors to assist in the process, what fee was awarded to such advisors, and whether they report directly to the board or senior management.

Transparency does not require disclosure of sensitive data or other proprietary information that could undermine the company's competitive position. In particular, the names of prospective CEO candidates would not typically be disclosed.

36 For a discussion of these strategies, the authors refer to two reports in the "Turbulent Times" series by The Conference Board: Alexander, *The Role of the Board in Turbulent Times: Overseeing Responding to Unsolicited Takeover Offers*, p. 10; and Park and Tonello, *The Role of the Board in Turbulent Times: Avoiding Shareholder Activism*, p. 12.

37 See Matteo Tonello, *Reputation Risk: A Corporate Governance Perspective,* The Conference Board, Research Report 1412, 2007. On board practices in ERM oversight, see Matteo Tonello, *Emerging Governance Practices in Enterprise Risk Management,* The Conference Board, Research Report 1398, 2007.

By including succession planning and leadership development information in annual disclosure documents, the board of directors accomplishes two important goals. First, such information corroborates compensation policy disclosure and opens a window into the boardroom for stakeholders to better evaluate the soundness of the strategic decision-making process. Understandably, owners and other gatekeepers expect to fully appreciate what motivates crucial business decisions taken at the board level. If the disclosure is truly insightful, it will be clearer how the board resolves conflict, balances competing interests, and oversees the implementation of strategy.

Second, the mechanics of the annual disclosure procedure set a compelling timeframe for the company to advance its succession planning exercise. Even though it is not mandated by regulation, such voluntary disclosure becomes an essential part of the company's relations with stakeholders, helps manage their expectations, and reassures that the company's board and senior managers are accountable for the long-term performance of the enterprise.

The foregoing is not intended to be an exhaustive list of all considerations for boards of directors of companies facing situations of top-executive succession and leadership management. This report is not intended to provide legal advice with respect to any particular circumstance and no business decision should be based solely on its content.

About the Authors

Matteo Tonello is Associate Director, Corporate Governance, at The Conference Board in New York City. Tonello has conducted for The Conference Board corporate governance and risk management analyses and research in collaboration with leading corporations, institutional investors and professional firms. He also regularly participates as a speaker and moderator in educational programs for corporate executives and directors. Before joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell.

John C. Wilcox is chairman of Sodali Ltd., a firm providing consulting and transactional services to listed companies in Europe, Asia, and developing markets. He served as head of Corporate Governance at TIAA-CREF, from 2005 through 2008. Prior to joining TIAA-CREF, he was chairman of Georgeson & Company Inc. During his career, he has specialized in corporate governance, investor relations, proxy voting, corporate control transactions, capital markets regulation, and director education.

June Eichbaum has written and advised on corporate governance in conjunction with her work as an executive search consultant. A partner at two global recruiting firms, Heidrick & Struggles and, most recently, Russell Reynolds, she led search teams on assignments for corporate officers. She first became involved with corporate governance while leading searches for general counsel at the legal search firm, Major, Lindsey & Africa, where she was a founding partner in New York. Previously, she practiced law with Coudert Brothers and Time Inc. She is currently an advisor to the board of The Cooke Center for Learning and Development, where she was a founding director.

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For more information on this report, please contact Matteo Tonello, associate director, Corporate Governance, at 212 339 0335 or matteo.tonello@conference-board.org

The Conference Board, Inc., 845 Third Avenue, New York, NY 10022-6600
Tel 212 759 0900 Fax 212 980 7014 www.conference-board.org