GOVERNANCE CHALLENGES 2019

CEO Succession Planning

A Publication of the National Association of Corporate Directors and Its Strategic Content Partners

Heidrick & Struggles

KPMG Board Leadership Center

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NACD

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Foreword

It is my pleasure to introduce the National Association of Corporate Directors' (NACD's) eighth edition of *Governance Challenges*.

Each year, NACD collaborates with our five strategic-content partners—Heidrick & Struggles, the KPMG Board Leadership Center, Marsh & McLennan Companies, Pearl Meyer, and Sidley Austin LLP—on the exploration of a timely and important governance topic. This year, our focus is on CEO succession planning.

Effective leadership development processes, including CEO successions, are one of the key legacies of high-performing chief executives—and many directors tell us they consider CEO succession to be their most critical responsibility. While the task may not be new, the environment continues to evolve:

- Median CEO tenure for large-cap companies has been shrinking, and it has dropped by one full year between 2013 and 2017.[1] CEO turnover hit record high levels in 2018, including a large number of retirements.[2]
- Demographics for the new CEO class are changing: in 2017, two-thirds of the 54 new S&P 500 CEOs were under 55 years old, according to research conducted by Heidrick & Struggles, and 2017 was also a high point in outside CEO hires.[3] Women are stepping into CEO roles in increasing numbers.[4]
- Activist-investor challenges that seek a change in the CEO (and/or other officers) have seen an uptick in recent years.[5]

The process is not always easy: according to NACD's latest public-company governance survey data, nearly three-quarters of the directors responding cite maintaining the CEO pipeline as their top succession-planning challenge.[6] About 80 percent of directors told us that their boards have recently discussed long-term (three to five years) succession planning—yet less than 19 percent have done an analysis of desired CEO competencies as compared to their firms' future strategic needs.[7] And the cost of getting it wrong is high: one study estimated the global cost of forced CEO turnover to be as high as $112 billion in 2018.[8]

At a recent NACD chapter roundtable, Kimberly-Clark Corp. CEO and chair Thomas Falk remarked, "The process of CEO succession planning is like creating a sculpture."[9] *Governance Challenges 2019* features current insights and practical advice that will help board members hone their skills at the art of CEO succession planning.

Peter Gleason
President and CEO, NACD

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[1] Dan Marcec, "CEO Tenure Rates," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), Feb. 12, 2018.
[2] Jacob Passy, "CEO turnover is the highest it's been in 8 years," *MarketWatch* (online article), Feb. 24, 2018, and Emma Hinchliffe, "CEO Turnover Reached An All-Time High in August," *Fortune* (online article), Sept. 12, 2018.
[3] Matteo Tonello and Jason Schloetzer, "CEO Succession Practices in the S&P 500," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), Oct. 25, 2018, and "CEO Succession Trends in 2017," Heidrick & Struggles (online article), Oct. 3, 2018.
[4] Emma Hinchliffe, "CEO Turnover Reached An All-Time High in August," *Fortune* (online article), Sept. 12, 2018.
[5] David Benoit, "Activist Investors Have a New Bloodlust: CEOs," the *Wall Street Journal*, May 16, 2017.
[6] National Association of Corporate Directors, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70.
[7] Ibid.
[8] Elena Lytkina Botelho, Kim Rosenkoetter Powell, and Benjamin J. D. Wright, "The cost to shareholders of picking the wrong CEOs is a stunning $112 billion a year," *MarketWatch* (online article), March 21, 2018.
[9] Kimberly Simpson, "Succession Planning Best Practices from Kimberly-Clark," *NACD BoardTalk* (blog), Feb. 4, 2019.

A Renewed Focus on Continuous Improvement of CEO Succession Planning Processes

Findings From NACD's Public and Private Company Governance Surveys

By Barton Edgerton, Senior Manager, Governance Analytics, NACD

As median CEO tenures shrink and turnover rates increase,[1] boards are devoting attention to enhancing the effectiveness of their current CEO succession planning processes. The *2018–2019 NACD Public Company Governance Survey* and its private company counterpart reveal that directors now regard CEO succession planning as a more important improvement priority than they did two years ago. What are boards doing to strengthen their practices in this critical governance area? Several findings stand out:

- **Public company boards are more focused on long-term succession planning now than in years recently past.** This year, 80 percent of public company respondents to the survey reported discussing long-term (three to five year) CEO succession plans in the previous 12 months.[2] This is a 20 percentage point increase compared to two years ago, when 60 percent of directors reported to NACD that their boards used this time horizon. For public companies, this emphasis on long-term succession planning may be part of a broader shift of board focus toward long-term strategy and value creation. For example, 45 percent of public company boards now discuss their oversight of long-term strategy with institutional investors.[3]
- **More boards are making emergency plans in case of a sudden CEO departure**. Despite the existence of robust succession plans, sudden, unexpected CEO departures can create significant challenges as both boards and staff adjust to new leadership. Two years ago, 59 percent of public company directors reported that they had identified an individual who would serve as interim CEO in case of an emergency. This year, that number rose 15 percentage points to 74 percent.[4]
- **Challenges remain in building an internal leadership pipeline.** Both public (74%) and private (52%) company directors reported that maintaining a robust leadership pipeline of internal talent is the most challenging aspect of CEO succession planning. This was followed by developing a long-term succession plan (50% public, 46% private), and aligning succession with the strategic needs of the organization (38% public, 38% private). Finally, fewer boards surveyed have formal written CEO succession plans—a 13 percentage point drop from 36 percent in 2017 to 23 percent this year.[5] The absence of such a plan can make it difficult to maintain a strong pipeline of candidates.
- **Boards see room for improvement in CEO succession planning**. Despite recent improvements, further enhancing the succession planning process remains a priority for many

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[1] Dan Marcec, "CEO Tenure Rates," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), Feb. 12, 2018.
[2] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70.
[3] Ibid., p. 28.
[4] Ibid., p. 70.
[5] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70, and unpublished data from a survey of private company directors that was in the field June–August 2018.

boards. Fifty-six percent of public directors report that CEO succession planning is an area where improvements are important or very important over the next 12 months.[6] Fifty-two percent of private directors report the same.[7]

- **Private company boards lag behind in both long-term and emergency succession planning**. Compared to their public company peers, private company directors were less likely to consider long-term succession planning or to have identified a person to serve as an interim CEO in case of an unexpected departure. Sixty-eight percent reported that they had discussed long-term succession planning, a figure 12 percentage points lower than the average public-company director response. Further, 63 percent of private company directors indicated that they had identified an individual to take the helm of the organization in the case of a sudden executive departure—11 percentage points lower than the figure for public company board members.[8]

Although CEO succession planning is a long-standing core board responsibility, directors of both public and private companies clearly feel more urgency to review and improve upon their boards' processes in this area. To improve the rigor around CEO succession planning, NACD suggests that directors and their boards take several action steps. Three of them are highlighted below, and further details can be found in the Related Resources section.

- **Integrate succession planning into long-term strategy.** Rather than treating CEO succession as a stand-alone process, boards should integrate the conversation into long-term strategy discussions. The succession process should be viewed as a full-board responsibility with the nomination and governance committee taking the lead. This can help ensure that the process is aligned with the evolving needs of the organization.
- **Pressure test the CEO succession pipelines.** Evaluate existing internal and external succession pipelines to ensure that they remain fit for purpose. Pipelines should be flexible enough to match candidates to the current and future needs of the organization. Candidates should reflect the evolving needs of the organization. The pipelines should not be blocked by candidates who do not see a true opportunity to advance to the CEO chair, nor should the pipelines leak, allowing preferred candidates to leave before an opportunity is available.
- **Identify and mitigate risks in the succession process.** A thorough evaluation of the goals, objectives, and process involved in CEO succession planning and transition can help to highlight potential trouble spots and allow the board to take action before these problems become true challenges. These challenges may include potential destabilization of the leadership team during a transition or a pipeline of talent that no longer reflects the needs of the organization. Unexpected CEO departures can be especially destabilizing. For this reason, boards need to work to ensure that they have a potential temporary successor in mind.

RELATED RESOURCES

NACD Nominating and Governance Committee Chair and Risk Oversight Advisory Councils: CEO Succession Planning

NACD Nominating and Governance Committee Chair Advisory Council: The Board's Role in a New CEO Transition

NACD Director's Handbook Series: "Success at the Top: CEO Evaluation and Succession"

NACD Online Resource Center—CEO Succession Planning and Talent Oversight

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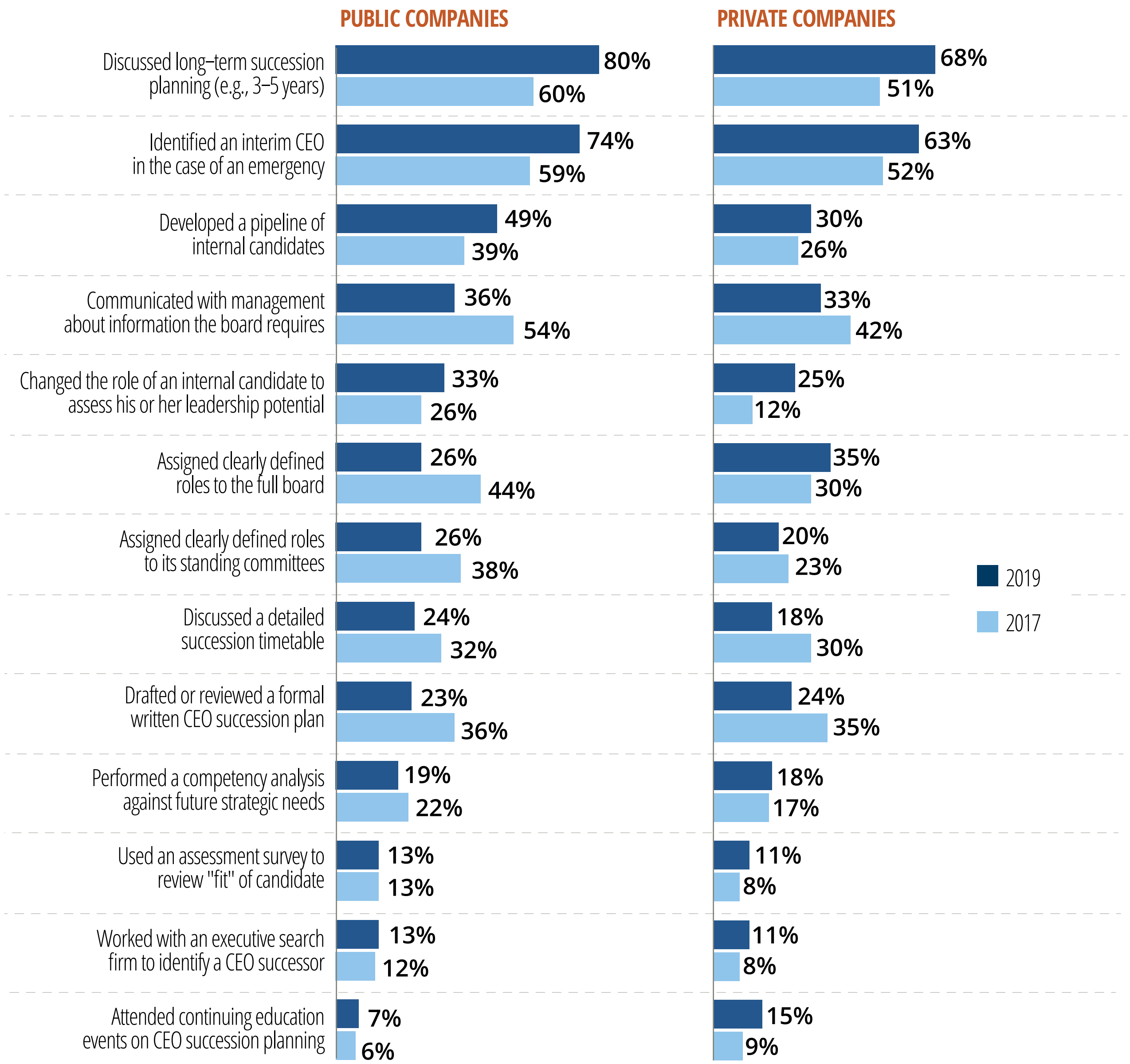
[6] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 13.
[7] Unpublished data from a survey of private company directors that was in the field June–August 2018.
[8] Ibid.

FIGURE 1

CEO Succession Practices Performed by the Board (2019 and 2017)



Sources: *2018–2019 NACD Public Company Governance Survey*, unpublished data from the *2018–2019 NACD Private Company Survey*, *2016–2017 NACD Public Company Survey*, and *2016–2017 NACD Private Company Governance Survey*

FIGURE 2

The Most Challenging Aspects of CEO Succession Planning (Select all that apply)

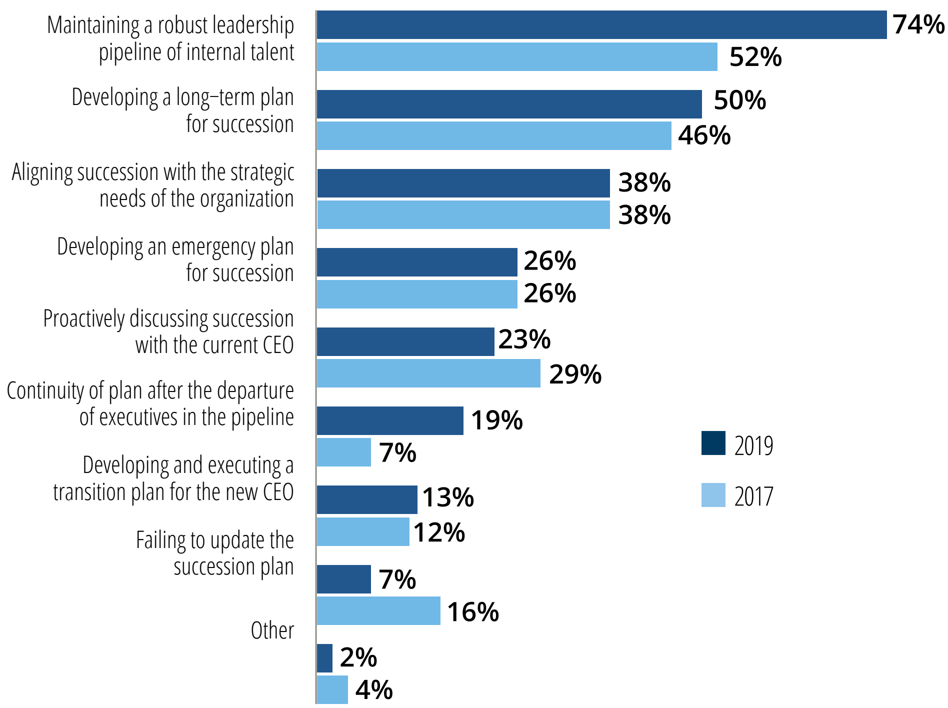
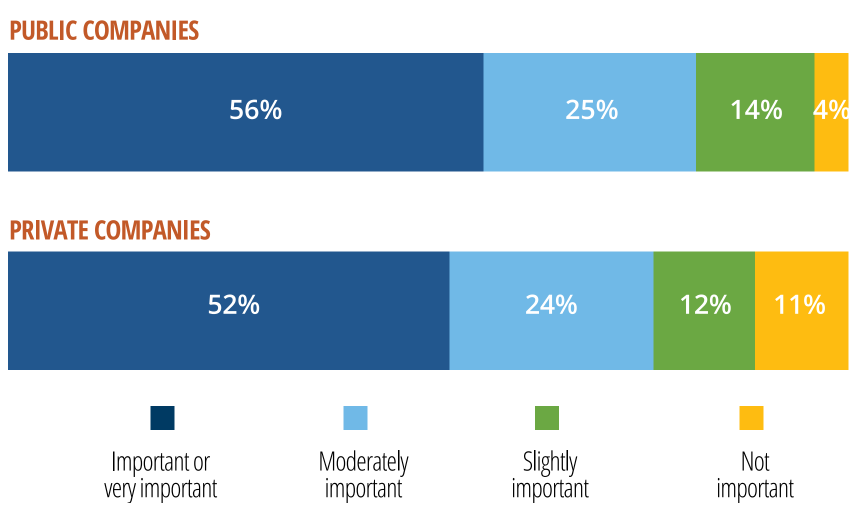


FIGURE 3

How important it is to improve CEO succession planning over the next 12 months?



Sources: *2018–2019 NACD Public Company Governance Survey* and unpublished data from the *2018–2019 NACD Private Company Survey*

CEOs in the Crosshairs of Activist Investors: Considerations for Boards

Heidrick & Struggles

Boards should be fully prepared for activists looking to oust the chief executive officer, no matter how unlikely the prospect may seem.

A CEO succession driven by an activist investor is something of a black swan. Of the 174 activist campaigns initiated around the world through the third quarter of 2018, only 10 included "management change" among their announced objectives.[1] (Board change, M&A, and divestiture are the most common objectives.) Of the 54 successions among S&P 500 companies in 2017, only 5 were notable for involvement by activists.[2]

But like black swans in other fields—scientific discovery, finance, or geopolitics—these unexpected occurrences can have outsize impact, despite their rarity. For a company, the impact can range from a dramatic improvement in stock performance to an extended period of uncertainty and increasing investor dissatisfaction. Given the potential magnitude of the impact, boards should be fully prepared for activists looking to oust the CEO, no matter how unlikely the prospect may seem.

Several conditions could indicate an increased likelihood of such activist challenges. For example, the sensitivity of CEO succession to company performance grows when there are large outside shareholders or institutional investors, and they are increasingly likely to ally themselves with activists.[3] Conversely, large cash reserves, accumulated because the company is performing well, may make a tempting target for activists. Further, the number of public activist campaigns rose in 2018, after lagging somewhat during the previous two years, which means that more CEOs could be in the crosshairs.[4]

Directors, compelled by their fiduciary responsibility to carefully weigh the soundness of activists' proposals—including those that recommend a change at the top—must respond appropriately. Here are some guidelines, based on our extensive experience advising boards, that can help boards prepare for an activist campaign and make sure their response puts the well-being of the company first:

Don't automatically demonize the activist. Calling for the CEO's dismissal may seem particularly aggressive, tempting the board to assume the worst about the activist. Directors should resist that temptation. Activists run the gamut from those who have only their own short-term interests at heart to those who are aligned with the broader shareholder base. The board should first determine where on that spectrum the activist falls, seeking references and examining the activist's track record in other campaigns.

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[1] Lazard's Shareholder Advisory Group, *Review of Shareholder Activism - 2018 3Q YTD* (Lazard, October 2018).
[2] Jason D. Schloetzer, Matteo Tonello, and Gary Larkin, *CEO Succession Practices: 2018 Edition*, The Conference Board, October 2018.
[3] Schloetzer et al., *CEO Succession Practices: 2018 Edition*, The Conference Board, October 2018.
[4] Gail Weinstein, Warren S. de Wied, and Philip Richter, "Shareholder Activism: 1H 2018 Developments and Practice Points," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), October 14, 2018.

Defuse the emotions. Directors often first learn of an activist's intentions from news reports or highly critical open letters published in the business press. Being held up to public criticism—and sometimes outright insults—can hurt. Further, the assertion that the CEO must go calls into question the board's competence in what is arguably its most important responsibility: choosing the chief executive. Board members' first instinct may be to react defensively, and sometimes rashly, especially if encouraged by an imperiled CEO. The wiser course for directors is to maintain their objectivity, even if they, like the CEO, are among those the activist is specifically targeting for removal.

Seek input from outside sources. Both the activist and management have analytic resources and personnel the board lacks. To help objectively assess the merits of the activist's case and management's response, the board should ask long-term investors (not allied with the activist) for their perspectives. A number of directors we have talked with believe that the board might also consider enlisting the services of an analyst who is beholden to neither the activist nor the CEO. Such objectivity is especially critical in regard to the CEO, with whom directors may have warm personal relationships.

Manage the CEO's role in deliberations. From the outset, the board should clearly lay out roles and responsibilities for dealing with an activist and ensure that the company speaks with one voice. A CEO under threat should be neither shut out of the discussions nor given free rein to lead them. If the chair/CEO roles are split, the independent chair should lead the engagement with the activist; otherwise, the role should fall to the lead independent director.

Treat an activist on the board as you would any other director. Sometimes the call for the CEO's removal may come from an activist or an activist's surrogates who are already on the board. They should be accorded the same respectful hearing that all board members receive. At the same time, it should be remembered that they, like other directors, are entitled to only one vote.

Aim to shorten the period of turmoil. Prolonged uncertainty about who will be leading the company is destructive. It worries investors, employees, and customers and hinders decisive action. The board should seek to shorten the time between the demand for management change and a return to stability, whether that means retaining or replacing the incumbent CEO.

The assertion that the CEO must go calls into question the board's competence in what is arguably its most important responsibility. Board members' first instinct may be to react defensively. The wiser course for directors is to maintain their objectivity, even if they, like the CEO, are among those the activist is specifically targeting for removal.

Consider the overall context. Activists rarely call only for management change. Among the 10 calls for management change tracked by Lazard's Shareholder Advisory Group in the first three quarters of 2018, only 2 came with no other demands.[5] Such demands may include a new strategic direction, a return of cash to shareholders, changes on the board or in governance, a breakup, and more. Assuming that the board neither acquiesces entirely nor rejects all of the activist's proposals and opts for a proxy fight, some of those proposals may be accepted, some rejected, and some accommodated through compromise. A new path forward will begin to emerge that does not conform exactly to the initial wishes of either the board or the activist. How the incumbent CEO fits in this evolving context should be carefully assessed and not treated as a bargaining chip.

Depersonalize the choice of CEO. Too often, CEO succession planning is viewed as an event about an individual rather than about readiness to lead under various circumstances. Sometimes, an activist will have in mind a particular candidate to replace the CEO, while the board may be inclined to fiercely defend

[5] Lazard's Shareholder Advisory Group, *Review of Shareholder Activism - 2018 3Q YTD* (Lazard, October 2018).

the incumbent. Instead of arguing the relative merits of these two individuals, the board should develop a profile of what the chief executive should look like that is independent of any specific individual. That requires that the board first align on what elements of the activist's strategy it is willing to accept and how they fit into the company's short-, medium-, and long-term strategic planning. The board can then include in the CEO profile the skills required to execute the overall strategy, as well as general leadership competencies and cultural fit.

Approach the decision as you would any other CEO succession. Using a consistent assessment process, the board should evaluate the merits of all potential candidates—the incumbent, the activist's nominee, internal candidates, and candidates from outside the company—against the general profile that defines the core capabilities that the right CEO should have. (Boards that have conscientiously maintained an emergency succession plan will already be ahead of the game.) The right CEO may be the incumbent or someone else; it may lie in an interim appointment. In any case, the rigor and objectivity of the process should provide the board with the ammunition it needs to persuade the activist to accept the board's preferred candidate.

Although the odds of your board facing an activist's call for a new CEO may be low, you should be fully prepared. Make sure you regularly update your emergency succession plan and your crisis management plan. And stay in contact with institutional investors. (According to the *2018–2019 NACD Public Company Governance Survey*, only 58 percent of boards report that a board representative met with institutional investors over the 12 months prior to the survey.[6])

As a director, you should periodically ask yourself how the company looks through the lens of an activist. Consider, also, having a board member periodically play the role of activist, probing for vulnerabilities and making the case as persuasively as possible for the kinds of dramatic strategic options an activist might advocate—divestiture, acquisitions, and board and management changes. Assigning a devil's advocate depersonalizes strategic discussions, opens them up to a wider range of possibilities, and inoculates the board against the destructive emotions that the appearance of a real activist can provoke.

The idea is not to prepare in proportion to the likelihood of an activist's campaign, but in proportion to the magnitude of its consequences.

[6] National Association of Corporate Directors, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 28.

Championing Successful CEO Succession

By Claudia H. Allen, Senior Advisor, KPMG Board Leadership Center

Few board responsibilities are more important than hiring and firing the CEO. Independent lead directors and independent chairs play a pivotal role in helping ensure the board is prepared for a CEO change—planned or unplanned. Our recent conversations with independent board leaders offer practical insights into succession processes and strategies these directors have championed to have the right person at the helm, and at the ready.

Several trends help underscore the importance of proactively planning for a CEO transition. Median tenure for CEOs at large-cap companies dropped to five years at the end of 2017 from six years in 2013, according to a 2018 study by Equilar.[1] Average tenure also dropped (although to a lesser degree as the result of several lengthy tenures). Put another way, a plurality of large-cap CEOs had a tenure of one to five years, according to the report.

Looking at CEO changes through September, 51 S&P 500 CEOs stepped down in 2018, with a number of those exits being abrupt,[2] in some cases due to activism and #MeToo type issues. The provocative title of an October 4, 2018, *Wall Street Journal* article analyzing recent research on CEO tenure questioned whether a short tenure is necessarily problematic: "CEO Tenure is Getting Shorter. Maybe That's a Good Thing."[3]

Additionally, there appears to be a forthcoming wave of CEO retirements, according to The Conference Board's 2018 *CEO Succession Practices* report. Approximately 17 percent of S&P 500 CEOs reached retirement age (64 or older) in 2017, the highest percentage on record, with over 61 percent of CEO exits in 2017 resulting from retirement.[4]

Have a clear plan and process. CEO succession planning is an ongoing, dynamic process, and boards must always be thinking about developing potential CEO candidates. This effectively means that boards should start planning for succession the day a new CEO is appointed. However, that is not always the case, particularly at smaller companies. In *The CEO: A Personal Reflection*, Egon Zehnder's survey of more than 400 CEOs, nearly two-thirds of respondents said there was some succession planning underway at their companies, but only 32 percent reported that a clear process was in place. Additionally, 11 percent reported there was no succession planning process underway, although there should be.[5] The report's authors focused on three resulting implications: boards should spend more time on succession planning, CEOs are not adequately focused on the growth and development of their successors, and/or that both the board and CEO think the other is handling succession, suggesting a gap in communication.

The bottom line is that advance planning and a process are necessary. Moreover, a succession plan should address emergency succession, which has recently been a high-profile issue, with several unanticipated CEO departures. Boards should have a process in place to address emergency succession and the disruption it may cause. To the extent an appropriate candidate has not been identified in advance, or there is no candidate that the board believes is ready, the board may appoint an interim CEO while it searches for a permanent replacement. According to "Corporate Governance Failures and Interim CEOs," a January 2019 blog post by George Mussalli and Sevinc Cukurova of PanAgora Asset Management, 8 percent of successions in the United States involve an interim CEO.[6] The authors found that there were often signs of poor corporate governance

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[1] Dan Marcec, "CEO Tenure Drops to Just Five Years," Equilar.com, January 19, 2018.
[2] John D. Stoll, "CEO Tenure Is Getting Shorter. Maybe That's a Good Thing," *Wall Street Journal*, October 4, 2018.
[3] Ibid.
[4] Jason D. Schloetzer, Matteo Tonello, and Gary Larkin, *CEO Succession Practices 2018 Edition*, The Conference Board, 2018, p. 11.
[5] Dick Patton and Kati Najipoor-Schütte, *The CEO: A Personal Reflection*, Egon Zehnder, May 2018, p. 26.
[6] George Mussalli and Sevinc Cukurova, "Corporate Governance Failures and Interim CEOs," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), January 14, 2019.

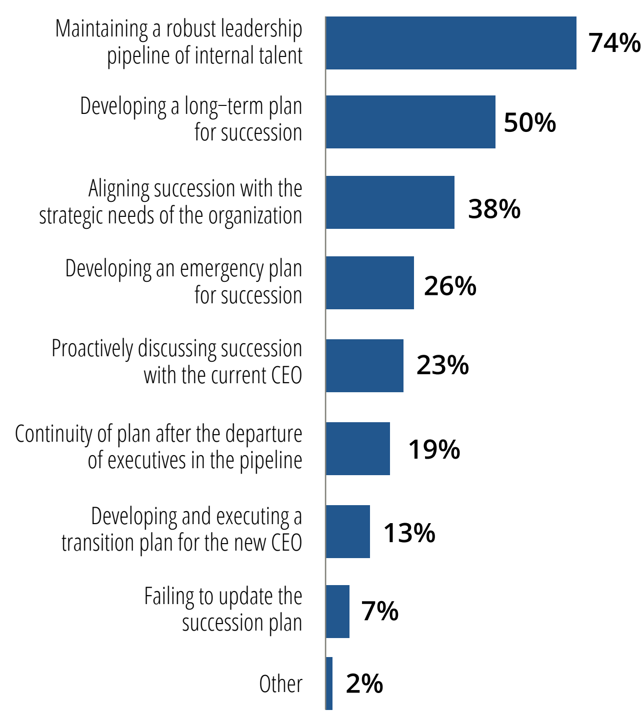
at boards that make such appointments, and noted prior research indicating that interim appointments lead to worse financial performance than permanent appointments. According to the authors, the inferior performance is explained by the limited managerial discretion afforded interim CEOs and by the management process being politicized by disruptive events.

Regularly review the succession plan—and the pipeline. Lead directors also emphasized the importance of the board formally reviewing the succession and development plan for the CEO and his or her direct reports at least annually, and being clear with management that the board wants exposure to high-potential candidates. As part of the review, high-potential employees can be categorized based upon their readiness to move into more senior roles, for example: ready now, ready in 12 to 18 months, and ready after more development. This process allows the board to work with management in an intentional fashion to help ensure that the candidates receive assignments that enable them to develop the skills necessary to advance; the board should be updated on how candidates are progressing against their development plans. The review process also helps ensure that if the CEO wants to make a change in senior leadership, the board has likely already had exposure to the candidate.

Boards ranked leadership development, succession, and the talent pipeline as the most challenging areas of human capital management within their companies in JWC Partners' *Corporate Board Survey Results: 2018 Trends & Insights.*[7] In a similar vein, 74 percent of respondents to the *2018–2019 NACD Public Company Governance Survey* identified maintaining a robust leadership pipeline of internal talent as among the most challenging aspects of CEO succession planning, and half put developing a long-term plan for succession in the same category.[8] In our discussions, several lead directors commented on the challenge of getting visibility into high-potential candidates two or three levels down from the CEO. Some suggested that this can be facilitated both formally, for example, through presentations by such individuals to the board, and informally, through dinners, other social activities, and mentoring. Asking management to assign high-potential candidates to cross-functional projects provides candidates with broader internal experience while offering the board exposure to the candidates through their presentations. Pairing a director with a member of the senior leadership team can also give the board direct insight into a candidate's strengths and weaknesses. In such an arrangement, the executive might meet periodically with the assigned director, who might also attend business meetings run by the candidate to observe the candidate in action. This arrangement could be structured to include mentoring.

Map future CEO skills to the long-term strategic plan. In thinking about the skills that future CEOs will need, some lead directors emphasized mapping

The Most Challenging Aspects of CEO Succession Planning (Select all that apply)



Source: *2018–2019 NACD Public Company Governance Survey*

[7] JWC Partners, *Corporate Board Survey Results: 2018 Trends & Insights*, March 2018, p. 16.
[8] *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70.

to the company's long-term strategic plan, recognizing that the skills the current CEO has and needs may not be the same as those of a future CEO, in light of company, strategy, and industry changes. Yet, according to NACD's *Public Company Governance Survey*, less than 20 percent of the directors surveyed reported having done an analysis of desired CEO competencies tied to future strategic needs.[9]

Consider an independent evaluation of potential candidates. In evaluating potential CEO candidates, lead directors also noted the value of a deep, independent evaluation of the strengths, weaknesses, and development needs of potential succession candidates. An outside perspective can surface weaknesses that may not be apparent to the current CEO. Such an analysis can also help the board plan how to support the new CEO and his or her transition, understanding that first-time CEOs may require more support. In that regard, Egon Zehnder's study reported that internal hires demonstrated less confidence in their overall preparation for the role than external candidates (who may be more likely to have had prior CEO experience).[10] While boards choose an internal candidate in the majority of cases, some explore external candidates to get a sense of whether internal candidates measure up—this type of benchmarking can yield valuable insights. Notably, The Conference Board's 2018 *CEO Succession Practices* report found that an unusually large number of companies changing CEOs in 2017 chose an outside candidate: "Many of those companies are in embattled business sectors. . . . In these circumstances, boards of directors executing their responsibility of delivering shareholder value often choose to bring in outside talent groomed in a different business culture to help to navigate sharp strategic corrections or accelerate organizational changes."[11]

Think about retention plans. When naming a new CEO, one potential challenge for the board is retaining valued executives who have been passed over. As a practical matter, CEO succession is typically accompanied by other high-level changes. For example, *CEO Succession Practices 2018 Edition* found that over 90 percent of 2017 succession announcements indicated there would be additional changes at the senior executive or board level, up from approximately 24 percent in 2013.[12]

Some lead directors noted the benefit of conversations between the board and CEO candidates about who they envision as becoming part of their teams. With that knowledge, the company may seek to enter into retention agreements with certain executives before or after naming a new CEO, and to identify roles that would be appealing to such executives. In "The Four Biggest Hidden CEO Succession Risks and How to Avoid Them," Spencer Stuart recommends providing insiders with transparency into the succession process and having open lines of communication so that "directors can have authentic conversations with runners-up about their value to the company, increasing the chance that they will be willing to stay."[13]

SIX KEYS TO SUCCESSFUL CEO SUCCESSION

1. Have a clear plan and process.
2. Regularly review the succession plan—and pipeline.
3. Map future CEO skills to the long-term strategic plan.
4. Consider an independent evaluation of potential candidates.
5. Think about retention plans.
6. Communicate a clear transition plan.

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[9] *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70.
[10] Dick Patton and Kati Najipoor-Schütte, *The CEO: A Personal Reflection*, Egon Zehnder, May 2018, p. 19.
[11] Jason D. Schloetzer, Matteo Tonello, and Gary Larkin, *CEO Succession Practices 2018 Edition*, The Conference Board, 2018, p. 12.
[12] Ibid, p. 74.
[13] Cathy Anterasian, Jonathan Smith, and Robert Stark, "The Four Biggest Hidden CEO Succession Risks and How to Avoid Them," *Spencer Stuart Point of View*, 2016, p. 4.

Communicate a clear transition plan. After the board has settled on a new CEO, it is vital that the leadership transition be carefully communicated to the market, employees, and other constituencies. Many companies choose to emphasize the board's role in succession planning in the announcement.

Lead directors noted that, during the period between naming a new CEO and when that individual assumes the role, there could be confusion over who is really in charge. As Spencer Stuart stated, "Without an engaged board to provide guidance, the outgoing CEO may become too hands on—interfering with the transition or acting out in other ways as the organization pivots to the new leader—or too hands off, not providing the necessary support to the new CEO."[14] The appointment of a new CEO, particularly a first-time CEO, also raises the question of whether it is advisable for an outgoing CEO to serve as chair for a defined interim period to facilitate a transition, or whether this structure will lead to the new CEO being second-guessed. This question elicits strong sentiments on both sides of the debate, and some companies require that CEOs relinquish their board seat when stepping down.

While the full board is ultimately responsible for succession, each board must structure its own process. Some boards will use key committees, such as the nominating and governance committee or the compensation committee, to do much of the heavy lifting. But for all boards, advance planning and a well-defined transition process providing for a clear time frame and clear communication are vital to a smooth transition.

[14] Cathy Anterasian, Jonathan Smith, and Robert Stark, "The Four Biggest Hidden CEO Succession Risks and How to Avoid Them," *Spencer Stuart Point of View*, 2016, p. 9.

The CEO as 'Culture Champion'

By David H. Jackson, PhD, Partner, Mercer

Overseeing CEO succession is one of the central strategic and fiduciary roles of the board of directors. How the role of the CEO plays as the "Chief Culture Officer" of the organization must be a critical consideration for the board as they undertake CEO succession and transition planning activities.

The CEO influences culture to such a degree that she or he may be thought of as the key factor that determines the culture of a corporation. In a workforce context, culture is about behaviors that deliver business outcomes and how operational drivers are leveraged to reinforce those behaviors across the workforce. (*See Sidebar: Organizational Culture Defined*)

As the ultimate "culture champion," the CEO drives the employer brand so that her or his organization prevails in the talent wars, and, over time, builds a workforce and working environment in which people are not only engaged but thriving, both today and in the future.

With guidance and accountability by the board, the CEO is the ultimate owner of culture alignment, and it is therefore essential that cultural factors are considered in CEO succession and transition. As noted in a report by Marsh & McLennan,[1] the board's main instrument by which they can influence culture is through the selection of the CEO, and in turn, the team the CEO develops.

Indeed, as recommended by a recent NACD Blue Ribbon Commission, "directors should make culture an explicit criterion in the selection and evaluation of the CEO and set the expectation that the CEO and senior leaders do the same in their identification and succession planning activities."[2]

CULTURE IS CRITICAL TO ORGANIZATIONAL SUCCESS AND A RISK FACTOR IN STRATEGY EXECUTION

An organization's culture is recognized as vital for success and differentiation and can be viewed as the "rocket fuel" for delivering value to stakeholders.[3] Successful businesses show time and again that possessing the right culture that enables employees to thrive can prove to be a source of competitive advantage. One study found that companies with

ORGANIZATIONAL CULTURE DEFINED

Organizational culture can be defined as the organization's shared and experienced values, beliefs, and behaviors. Pragmatically, it can be understood as the organization's operating environment. It is what people say and what people do, day-in, day-out, and it is revealed in individual actions that deliver business outcomes, and also in an organization's norms, working language, systems, and symbols. From a business context, culture should align with the strategy of the organization as well as with market and regulatory factors. From an organizational context, culture is reflected in policy and procedures, and every level of the governance structure should buy into and live the culture. From a people context, the culture enables people to do their jobs, supporting talent acquisition and team effectiveness.

[1] WomenCorporateDirectors and Marsh & McLennan Companies, *Identifying and Responding to a Dysfunctional Culture – Key Actions for Boards*, 2019.

[2] National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset* (Washington, DC: NACD, 2017), p. 20.

[3] Ibid., p. 7.

practices that established them as "talent management maturity leaders" outscored peer companies on 18 different performance measures, and in some cases by triple-digit percentage margins. Specifically, they showed 54 percent greater net profit margin and 18 percent better earnings before interest, taxes, depreciation and amortization (EBITDA).[4]

For example, consider the criticality of culture alignment to the success of merger and acquisition (M&A) transactions, which so often represent the biggest capital and branding bets a CEO undertakes. Recent Mercer research found that 43 percent of M&A transactions worldwide experienced serious cultural misalignment, causing deals to be delayed or terminated, or negatively affecting the purchase price.[5] In the same study, culture issues were cited as the reason 67 percent of M&A transactions experienced delayed synergy realization. Leaders also noted that 30 percent of deals fail to ever achieve financial targets due to cultural misalignment and subsequent problems, such as productivity loss, the flight of key talent, and customer disruption.

WHY IS CULTURE ON THE BOARD AGENDA?

Boards of directors have a responsibility to bring rigor to cultural oversight. It is generally recognized that the board is responsible, alongside management, for setting the "tone at the top" and overseeing management's strategy to promote a culture that aligns with the organization's overall strategy. Indeed, the 2018 UK Corporate Governance Code puts a renewed emphasis on calling on boards to assess and monitor culture. [6]

There is also a rising board focus on culture and how the organization operates and achieves its goals. Three trends are driving this:

1. **Increased focus on environmental, social, and governance factors** (ESG) by stakeholders and investors that includes an emphasis on understanding how organizations treat their employees. Investors are also paying greater attention to culture-related performance metrics.
2. **Acceleration of social activism (e.g., the #MeToo movement)** has pushed cultural issues to the forefront of directors' minds and has reinforced to board members that they can no longer afford a reactive approach to monitoring culture.
3. **The amplifying effects of social media** and websites that include company reviews by employees (such as Vault and Glassdoor), or customer review sites (such as Yelp), have made organizational cultures increasingly transparent to outsiders. The speed with which information spreads, enabled by social media technologies, has changed the time line of traditional corporate communication processes.

THE CEO AS 'CULTURE CHAMPION'

Despite the important role of organizational culture and of the CEO as the "Chief Culture Officer," research suggests that in many instances cultural elements are not formally or clearly embedded in the CEO succession and transition process. For example, survey data suggest that over the past 12 months, nearly 40 percent of boards have formally evaluated the CEO as a leader of organizational culture but just 22 percent have assessed executive candidates for cultural/values fit. However, while assessment for cultural fit is important when reviewing internal and external CEO candidates, according to NACD only 13 percent of boards have used an assessment survey to review the candidates' "fit as part of their succession planning."[7]

Poorly managed CEO succession and transition plans pose a serious threat to business performance and, ultimately, to shareholder value.[8] When a CEO transition goes awry, the collateral damage can be enormous—creating a leadership vacuum, the defection of quality talent, increased internal and external uncertainty, interruptions in normal decision making and business processes, and the loss of shareholder and stakeholder confidence.

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[4] The Hackett Group, Talent Management Performance Study, 2009.
[5] Mercer, *Mitigating Culture Risk to Drive Deal Value*, 2018.
[6] Jessica Fino, "Business world reacts to new Corporate Governance Code," *Economia*, July 16, 2018.
[7] National Association of Corporate Directors, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 70.
[8] Mercer, *CEO Succession Planning That Works*, 2012.

GETTING STARTED

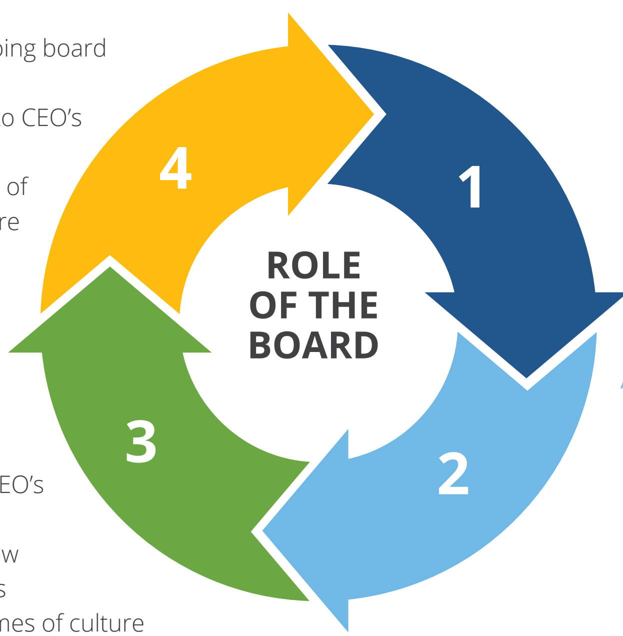
How should the board approach the all-important role of CEO succession and transition and ensure that critical considerations about culture are part of the process? Below are a series of specific concrete steps directors can take. (*See Exhibit 1.*)

1. Determine the desired culture that will catalyze business results as defined by the business strategy, and ensure effective competition for talent recruitment and retention.
   - The board—via the executive, nominating and governance, or compensation/human resources (HR) committee—works with the CEO and the chief human resource officer (CHRO) to select a cultural definition and assessment tool.
   - The kickoff should start with a workshop with the board and senior management, often externally facilitated by culture/organizational design experts, to define the desired culture given the business strategy, evolving business model, and workforce and leadership talent requirements.
   - The compensation/HR committee members, along with the CHRO, compare the desired culture to established skill and competency profiles for the CEO and his/her executive leadership team to ensure the two frameworks meaningfully sync up (i.e., that expected CEO behaviors and areas of acumen will support the delivery of the desired culture). For example, if collaboration is a key characteristic of the desired culture, then the CEO's leadership profile should explicitly include collaboration as a behavioral expectation, as a criterion for CEO selection, and as part of the ongoing annual board evaluation of the CEO.
2. Assess the incumbent's fit with the desired culture.
   - Identify the specific behaviors explicitly in sync with driving the desired culture. Then, the compensation/HR committee should

EXHIBIT 1

Key Steps In Incorporating Culture Into CEO Succession Planning

DETERMINE DESIRED CULTURE
- Define culture
- Select assessment tool
- Compare CEO and executive leadership against competency profile aligned with desired culture



ASSESS INCUMBENT'S FIT
- Identify behaviors required to drive desired culture and communicate expectations to CEO
- Annually evaluate CEO with 360-assessment and interviews with senior management and the board
- Conduct periodic workforce surveys

APPLY CULTURE CRITERIA TO SUCCESSION PLANNING
- Share statement of desired culture with candidates for CEO's role and search firm
- Use behavioral event interview methodology with candidates
- Incorporate expected outcomes of culture championship into annual goals, and measure and reward accordingly

TRACK & SUPPORT CEO WITH CULTURE CHAMPIONSHIP
- Track and discuss as an ongoing board agenda item
- Embed culture leadership into CEO's annual evaluation
- CEO and CHRO share results of employee engagement/culture surveys with board

Source: Mercer

communicate the board's expectations to the CEO as the foundation for subsequent performance evaluations. The board should emphasize the critical importance of the CEO acting as a driver and champion of the desired culture.

- Annual evaluations of the CEO will reveal the success of the CEO as culture leader and champion, and this should be part of her/his annual feedback. This is most effectively done via an online 360-degree assessment of the CEO's performance that includes the following:
  - Views of directors and members of management. The recommended, empirical, candid mechanism for gathering feedback is the 360-degree review. Interviews with directors and senior management, informed by the 360 findings, will yield actionable insights, and culture should be explicitly referenced in the interviews.
  - Views of the workforce. This can be done with a culture or employee-engagement survey that includes questions about the degree to which the desired culture is manifested in their day-to-day experience as employees.
- Feedback on the CEO's performance related to supporting and championing the desired culture should be shared in the review process and should influence rewards.

3. Apply the definition of culture, assessment discipline, and associated tools when planning for and executing a CEO succession.
   - Document a statement of the desired culture that can be shared with internal and external CEO candidates, and with executive search firms. Ensure that the statement, along with the profile of prospective CEO behaviors that the board believes will drive and sustain the desired culture, is used throughout the succession process, including performance assessment and leadership-development discussions by the board about in-house candidates (facilitated by the CHRO and/or external experts as needed).
   - Use behavioral event interviewing (BEI) methodology with internal and external candidates to ensure that conversations are concrete and specific.[9]
   - Incorporate the definition and expected outcomes of effective cultural championship into the annual goals for the incoming CEO, to ensure that cultural considerations are reflected in performance assessment, measurement, and rewards as described in #2 on the previous page.
4. Support the new CEO as he or she carries out the critical responsibility of culture championship.
   - Make culture—including how to steward, track and demonstrate it—an ongoing agenda item in board meetings. Engage the CEO and CHRO in these discussions.
   - Weave measurement of cultural championship, using the CEO leadership profile, into the annual CEO evaluation and make it a part of compensation discussions and decisions. If the board believes that the CEO's leadership style is getting in the way of his or her ability to deliver the desired culture, the board should consider approaches such as retaining an executive coach for development purposes.
   - Request regular reports from the CEO and CHRO on the results of employee engagement/culture surveys.

The job of CEO has always been challenging, and adding a cultural dimension to the CEO's responsibilities could be seen as too subjective, too hard to measure, or too difficult to incorporate into succession-planning processes. But society and organizations today are so dynamic, fast-changing, and stakeholder-driven that a higher degree of cultural rigor is now required for CEOs and boards alike—and a CEO with the right cultural fit can make a transformative difference to an organization's performance over time. When boards ensure their C-suite, leadership bench, and CEO transitions consistently support the organization's desired culture, they will help energize the entire workforce to deliver business results both today and in the future.

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[9] See Libby Anderson's article, "Using Behavioral Interviewing Techniques to Select the Right Employees," July 20, 2008, on the Society for Human Resource Management's website.

The Compensation Committee's Role in Strategic Succession Planning

Pearl Meyer

Naming a successor to the CEO is one of the board's primary functions. However, boards can do more than simply identify a single next-in-line successor. More strategically minded boards actively guide the organization's leadership development process and focus on recruiting, motivating, and retaining high performers on a broader scale than just the chief executive's office.

The compensation committee increasingly bears much of that responsibility. Through its primary function, it can effectively serve the company's leadership strategy by structuring and managing pay programs relative to both planned and unplanned CEO changes, as well as by taking into account a longer-term and a more holistic view of the company's talent management philosophy.

THE INHERENT RISKS IN THE C-SUITE

We are seeing more turnover than usual among CEOs in recent years. This trend is both voluntary and involuntary and driven by internal issues of performance, as well as by issues of individual behavior. It is exacerbated by the current economy and employment rates, which have provided a certain level of freedom for executives to move. In this current environment, the already tough endeavor of naming a successor is even more uncertain.

While each presents a unique set of challenges, there are two types of transitions that the board should be preparing for: expected and unexpected.

First, it is vitally important for a board to identify its plan of action for an unanticipated executive departure. This may be what immediately comes to mind when thinking of succession planning. There should be at least one individual in whom the board has confidence to step in and run the company successfully in its current state. Retention of this individual is key; therefore, how they will be compensated for assuming the helm should be planned by the compensation committee in advance. Structuring the compensation plan that kicks in with this kind of transition should reward the individual for a willingness and ability to "save the day," as well as acknowledge the potential short-term nature of the assignment and the possible lack of a long-term CEO role, if that is indeed the case. The discussion about backfilling any key role left open is also part of this process.

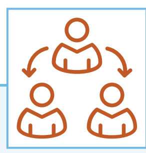
It's highly likely your strategic CEO replacement will not be the same individual as has been identified for your "emergency" plan. Looking carefully at both scenarios ensures boards are not going through a simple check-the-box exercise.

The second category—the planned-for succession—is notably more strategic and works hand in hand with the organization's business strategy. It's highly likely your strategic CEO replacement will not be the same individual as has been identified for your "emergency" plan. In preparing for a planned succession, the committee will be thinking about such things as how a shifting product mix, a geographic expansion, or an anticipated merger or acquisition will reshape the company. How does that affect the profile for the ideal executive who will lead what may be a very different organization than what exists today?

Looking carefully at both scenarios ensures boards are not going through a simple check-the-box exercise.

The danger to your succession planning, however, may go beyond your top executives. Consider that by the time someone has reached the C-suite, they likely have a lucrative and at least somewhat long-term compensation structure that provides the company with a certain level of protection against their voluntary departure. (The organization will, of course, have other compensation-based protections in place designed to thwart behavior-related departures, such as change-in-control provisions and clawback policies.) It is in the ranks below senior management where there is considerable risk of departure for more clear advancement opportunity.

Companies can mitigate the risk of a potentially weak C-suite pipeline by recruiting and developing high-potential employees in a manner that builds a strong executive team several levels below the most senior. This is the talent pool from which, in time, you can begin to pull up those with demonstrated talent, considerable institutional knowledge across a variety of functions, and a commitment to the organization.



A TALENT DEVELOPMENT CONVERSATION BETWEEN THE COMMITTEE AND MANAGEMENT

The following questions can help facilitate a collective understanding among the board/compensation committee and management on matters of succession and development.

- Does our plan cover the next-in-line CEO, an interim person who will ascend in an unplanned event, and how we build bench strength over the long term?
- What is our process to identify high performers below the C-suite? Is it consistently applied?
- Do we have a stated talent-development philosophy?
- Are succession paths clear and communicated?
- Does our talent recruitment profile map to the business strategy?
- Does our compensation structure and how we administer it create a winning team, versus focusing on the compensation of individual executives?
- Are the types of actions and achievements that result in rewards or recognition consistent with those actions that may lead to identification as a successor?

THE ROLE OF THE COMPENSATION COMMITTEE

The compensation committee has clear responsibility for guiding development of the pay philosophy and the specific compensation tools that enable a company to retain and motivate high performers. While it's unrealistic—and potentially overstepping—to expect to have a considerable amount of input below the named executive officer level, the board can be appropriately involved in a deeper discussion of the succession pipeline overall.

The compensation committee can be active in ongoing discussions with management about the kinds of programs that are put in place to encourage development and retention among the next ranks. Providing board oversight of the process, more than tracking individuals, helps management to maintain a consistent level of focus on the issue and to incorporate ongoing identification and nurturing of high performers into processes and the culture at large.

There are several probing questions that will help the compensation committee understand what the organization is doing to identify, develop, and reward future leaders. Because it must be clear how the company supports career progress, the board can guide management toward ensuring employees understand what it takes to be successful in general and, if so inclined, how one moves up the career ladder.

FUNDAMENTAL COMPENSATION CONSIDERATIONS

Compensation committees should have a strong sense of all the forms of recognition—monetary and otherwise—that matter to and motivate its particular employee base, both at a broad and executive level. Generally speaking, it's important for the compensation opportunity to be reasonably competitive. This frees employees to focus on what really matters to them and the company—performing personally rewarding work, contributing to the positive aspects of the corporate culture and the working environment, improving the quality of their leadership, and uncovering future opportunities for the business and themselves.

Beginning with base pay, the salary level as compared to market sets the tone for how competitive the pay package will be. Regular salary increases over time that recognize growth and progress in their position are extremely important in signaling to high performers that they are moving ahead and viewed as successful in the organization. In fact, it is the regular cadence of the increases and the clear communication that those increases are a result of the individual's rising star that can be more important than the specific amount.

When it comes to incentive programs, a level of variability is important, not just organizationally when the company does well (which is a plus), but also across individuals where it makes sense in order to clearly differentiate and reward identified leaders. The amounts, vesting, and payout periods can be tailored to address a particular succession need. For example, they can be structured to address retention risk among those identified as possible successors, or conversely to accelerate retirement. Some compensation-plan components that could be used to achieve succession objectives include these:

- Multiyear performance periods for long-term incentives
- A regular cadence of equity grants that vest over time (such as restricted stock), which can reward executives for long-term share price growth
- Supplemental equity grants that vest over multiple years can offer additional retention hooks
- Judicious use of above-market compensation elements, including base salaries, long-term incentive grants, and/or supplemental executive retirement benefits, can signal the recognition of an employee's importance to the organization
- Clear and simple cash retention programs that pay over a defined time period

Benchmarking pay also has a role to play. Ensuring high performers are paid at or above market overall can hedge against them leaving the organization for better compensation elsewhere. Consistent compensation program design further down into the organization can also reinforce the company's succession planning efforts by ensuring "ready-soon" employees who begin attaining leadership roles within the company are rewarded appropriately given their performance and future potential with the organization.

Of course, all of this is within the context of understanding that money alone will never hold a key employee; if and when another company wants your player, they will pay what they need to. There must always be reasons beyond pay that create loyalty and retention.

Consistent compensation program design further down into the organization can also reinforce the company's succession planning efforts by ensuring "ready-soon" employees who begin attaining leadership roles within the company are rewarded appropriately given their performance and future potential with the organization.

THINKING BROADER AND LONG TERM: LEADERSHIP DEVELOPMENT, RETENTION, AND MOTIVATION

Boards—and particularly the compensation committee—should be conducting an annual assessment of the "ready-now" and "ready-soon" leaders in key management positions throughout the company. An organization-wide skills matrix may help in this determination and is even more useful if it is arranged to look at current business conditions and operations, as well as at the skills needed to support the future state of the company.

In this age of Big Data, there are likely analytics tools and related insights that can be made available to the compensation committee. Look for information in aggregate at the more senior levels, such as turnover and promotional statistics. (Your board may already be looking at this in the context of diversity and inclusion endeavors.) What does the data say about the company's ability to retain high–potential employees? Is the turnover wanted or unwanted? How is management handling the unwanted departures? In this data-based exploration of the leadership pipeline, you may also focus on building a diversified set of future leaders based on gender, race, age, and/or background.

For those future leaders, developing mentoring relationships, offering regional or global assignment opportunities, or supporting executive education programs can both signal their value and offer important non-pay-based retention hooks. Evaluating how the company encourages and values innovation and ensuring high performers are included in that process is another key learning experience and reward.

While inside promotions are generally less expensive and more likely to succeed than outside hires, do be planful in thinking about inside talent versus outside. There may be some positions that, under examination, don't require internal bench strength and may be better served by an influx of new ideas and fresh perspectives.

Finally, what do you do for the also-rans? In the age of transparency, the succession is often a fairly public process. Ensure the committee has thought about how to minimize the unintended consequences when there is a need to retain key talent that may not be just right for the top role.

CONCLUSION: CULTURE AND COMPENSATION

While a structured compensation philosophy doesn't typically have detail on leadership development or even succession planning, this is something for the committee to weigh. Given the expanding role of compensation committees' responsibilities—that, for many companies, now go beyond a focus on pay programs for named executive officers to include oversight of the organization's human-capital strategy—documentation of the approach to leadership development may help boards organize and explain their roles in a more coherent way.

Compensation programs best serve the corporate culture when they focus on the foundational goals of compensation: attract, retain, and motivate—and then reward. This holds true for leadership development and succession as well.

LEADING COMPENSATION COMMITTEES

- have identified an "emergency" successor, as well as a longer-term, possibly more strategic candidate;
- take into account the company's long-range business strategy and incorporate the necessary skill sets of its future CEO into the succession-planning process;
- work with management to mitigate retention issues among identified candidates;
- provide opportunities for up-and-coming stars to have board exposure or even active mentorship;
- consider corporate culture and team dynamics, in addition to compensation structure, in the leadership-development process;
- understand the retentive value of non-compensatory actions such as coveted assignments, educational opportunities, and expanded responsibilities;
- take a holistic view of talent assessment, leadership strategy, and succession planning; and
- plan for succession long before it's needed and nurture the process continuously.

Planning for CEO Succession

By Holly J. Gregory and Kai Liekefett, Sidley Austin LLP

How well the board of directors handles a CEO succession will likely have a profound impact on the company's success. Smooth, thoughtful leadership changes can provide performance momentum for the company while galvanizing the board. Awkward or contentious transitions, and those that fail, can lead to investor frustration and leave a company vulnerable to shareholder activism and performance problems.

Successful CEO transitions require forethought and planning, yet few boards are fully prepared for a particularly difficult, protracted, or unexpected transition. This article explores the following, with a focus on issues that may surface during difficult CEO successions:

- Director fiduciary duties in connection with CEO successions
- The elements of an effective CEO succession planning process
- Effective communication with shareholders during a CEO transition

FIDUCIARY DUTIES

In fulfilling their duty of care, directors need to address major business risks, including the loss of a senior executive, whether through a planned or an unexpected transition event. Decisions about who should lead a company and how to manage leadership changes are among the most important and challenging duties of a board. Effective succession planning requires regular, ongoing attention to internal management development so that the board is well positioned to assess—and if possible select from—strong internal candidates when a change in leadership is needed. It also requires regular scans of the external environment, both to understand where an external candidate might come from and to identify potential external candidates.

Selection of a CEO is among the most critical decisions that a board will make, and planning for and undertaking a CEO transition is among the most important board activities. However, the legal obligations that surround these decisions are essentially the same as for most board actions. Directors must act

- with appropriate diligence,
- in good faith, and
- in the best interests of the company.

The board's approach to succession planning and unexpected transitions should be reasonable under the circumstances. The board must not ignore the known risks associated with a potential gap in leadership. It needs to have a sense of when the CEO's service is likely to end in the normal course of events, and it should have plans in place to address this situation. Because an emergency could arise to disrupt the current CEO's leadership, the board should also have in place an emergency plan for the "hit by a bus" scenario or a "#MeToo" situation, including having in place appropriate powers and protections to effectuate a CEO termination.

Boards, CEOs, and inside counsel may find it difficult to raise certain succession planning issues, such as the expected time frame for succession, how the next leader will be chosen, and who the leading candidates are likely to be. However, if a board does not adequately address these issues, it will be unprepared when illness or scandal arises and may be hesitant to make a change when it is called for in instances of poor performance.

In addressing their succession-planning duties, directors should focus not only on the CEO position, but also on other internal senior executives to

- assess their capacities to step into the CEO role, and
- develop any leadership skills and qualities they might be lacking.

Reframing the issue as oversight of management development, rather than simply preparing for a CEO change, will help to address inherent planning challenges and expand the board's understanding of internal capacity.

Using a broad approach enables the board to identify high-potential internal candidates who are capable of advancing into positions of greater responsibility, and ensures a systematic process for their continued development. This will expand the pool of internal leadership talent, while also helping to identify potential gaps. It will also help prepare the board to assess internal candidates quickly in the context of an unexpected CEO transition.

The vast majority of CEO transitions occur in the course of a planned retirement. However, in 2018, 22 percent of CEOs resigned under pressure, according to Spencer Stuart's report on 2018 CEO transitions—up from 15 percent in 2017—and another 5 percent resigned due to health reasons. This data underscores the importance of planning for both unplanned and normal course succession events through a focus on internal management development.

THE SUCCESSION PLANNING PROCESS

Developing an Effective Succession Plan According to the *2018–2019 NACD Public Company Governance Survey*, public company directors have consistently identified CEO succession planning as a top area for board improvement over the last few years.[1] New York Stock Exchange-listed companies are required to adopt and disclose corporate governance guidelines which address, among other things, management succession, which "should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO."[2] In evaluating and developing an effective succession plan, the board has the flexibility to adopt a succession planning process that best suits the particular needs of the company. For example, the board should consider whether or at what point to

- retain advisors for assistance,
- consider internal candidates,
- conduct an external search, and
- determine that enough information has been obtained to support an informed judgment.

Because succession planning is a central component of the board's role, generally the full board maintains responsibility for, and is involved in, succession decisions. However, boards routinely delegate responsibility for specific tasks to board committees. Frequently, the nominating and governance committee or the compensation committee is tasked with hiring a search firm to assist in identifying candidates and specifying desirable candidate criteria. Often, given its role in performance evaluations of top executives, the compensation committee is involved on an ongoing basis in assessing potential internal candidates, identifying their leadership capabilities, and pinpointing areas for further development.

The board or a board committee should consider, at least annually

- the likely time frame in which succession will be called for in the normal course of events;
- the potential internal candidates, if the current CEO
  - leaves in the likely time frame,
  - takes on another role at the company, or
  - leaves immediately; and
- the skills and qualities each potential internal candidate needs to develop to be the leading candidate.

Along with regularly evaluating the strengths and weaknesses of members of the senior executive team, the board (or a delegated board committee) should establish plans for individual development designed to prepare these executives to advance. The views of the CEO often drive much of this discussion, especially about the CEO's direct reports, but the board should also interact with each individual and form an independent view. In addition, the board (or a delegated board committee) should consider on a regular basis where to find ideal external candidates.

Preparing for an Unexpected CEO Succession No matter how much attention a board gives to succession planning for the leadership of the company, a board

[1] National Association of Corporate Directors, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 46.
[2] New York Stock Exchange Listed Company Manual, Section 303A.09, "Corporate Governance Guidelines."

should expect that at some point a CEO change will occur within a different time frame than planned. This may occur because the CEO decides to pursue another opportunity, becomes incapacitated or dies, or because the board decides that it is time for a change due to performance concerns. While many boards have an emergency plan in place (in terms of having identified a potential successor, an interim candidate, and a plan for an expedited selection process), in the case of an unexpected CEO transition event, boards often overlook the need to have in place a decision process and a crisis management plan.

The independent directors should have outside counsel that they can turn to for advice and assistance in facilitating a transition, given the general counsel's sensitive position as the board determines whether and when to take action. Generally, the independent directors will select outside counsel at a law firm that has corporate governance, SEC reporting, and employment law capabilities.

If there is no readily apparent successor candidate, a search firm will also be needed. The board should seek a search firm that knows the company and can work on an expedited basis. In some circumstances it may be necessary to also reach out to a crisis management firm, preferably one that can provide interim leadership.

SHAREHOLDER COMMUNICATIONS DURING A CEO TRANSITION

SEC Disclosures Required for a CEO's Departure Upon the CEO's retirement, resignation, or termination, a Form 8-K must be filed within four business days (although it may be advisable to file as soon as possible). This reporting obligation is triggered by a notice of a decision to retire or resign, or of a refusal to stand for reelection (in the case of a CEO director), whether or not the notice is in writing, and regardless of whether it is conditional or subject to acceptance. This includes formal notice of the decision regarding retirement, resignation, or termination even if there is a significant period of time between the notice and the planned departure. No disclosure is required solely by reason of discussion or consideration of the event. Whether communications represent discussion or consideration, on the one hand, or notice of a decision, on the other hand, is a facts-and-circumstances determination. (See Item 5.02(a) or (b) of Form 8-K, as relevant.)[3]

Depending on the relevant facts and circumstances, it may be necessary to take the following steps:

- Include the date of the resignation on the Form 8-K, if the departing CEO also resigns as a director (see Item 5.02(b)).
- Add certain additional information to the Form 8-K, if the departing CEO is also a director and resigns due to a disagreement with the company on any matter relating to the company's operations, policies, or practices, or if the CEO was removed for cause. In these cases, the departing CEO director must be given an opportunity to respond to the Form 8-K disclosure, and any written response would be filed as an amendment to the Form 8-K (see Item 5.02(a)).
- File a Form 4 for the departing CEO in connection with any equity plan forfeitures or accelerations related to the termination.
- File any agreements with the departing CEO as exhibits to the company's next Form 10-Q or Form 10-K, as applicable (unless these agreements are filed as exhibits to the relevant Form 8-K and incorporated by reference into the next Form 10-Q or Form 10-K).

Managing Shareholder Communications During an Awkward Transition In light of the SEC's reporting rules, it is sometimes necessary to announce the planned departure of a CEO months in advance. The board may also be forced to announce an immediate departure due to an unexpected succession event. In either case, if a successor candidate has not already been identified, the company may either appoint an interim CEO or publicly announce that the board is engaged in a CEO search process. These types of transitions have become more common and less

[3] United States Securities and Exchange Commission, Form 8-K, p. 15.

controversial, with boards increasingly choosing to appoint an interim CEO. However, interim CEO periods if extended may lead to negative inferences about the management development and succession planning processes of the board, and may also draw greater scrutiny to both board and company performance.

In navigating an unexpected transition, careful attention should be given to crafting a communications plan to reassure shareholders that the board is actively engaged with all due speed in identifying the right leader, while also emphasizing that the board has put in place a strong interim leader as a steward. Consideration should also be given to active, ongoing engagement with the company's key shareholders throughout the CEO transition. Boards are generally well served by identifying in advance of a transition event (or other unexpected crisis) the team of board legal counsel and other advisors who might assist the board with public relations and investor relations.

The Increased Risk of Shareholder Activism CEO successions are a challenging and pivotal time for any company. Activist investors often seek to take advantage of these transitional periods, when the board might be more vulnerable to influence or criticism. Even companies with strong performance are at risk of activism under these circumstances, as activists may see the CEO transition as a rare opportunity to target a company where it might otherwise be difficult to find fault.

Activist shareholders may capitalize on the uncertainty created by a CEO transition to launch a campaign for change at the board level or to push publicly for the sale of the company (or at least an evaluation of "strategic alternatives"). Activists may also agitate in less aggressive, but still damaging, ways, such as privately threatening a proxy contest if the board does not make certain strategic decisions or by filing a Schedule 13D and alerting the market that the company is a potential target for shareholder activism.

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While even well-managed CEO successions can attract activists, a poorly managed process creates a significantly heightened risk of shareholder activism. If a board is forced to announce a CEO departure without the ability to quickly name a successor or appoint a strong interim CEO, activist shareholders may see an opportunity to push their way into the conversation on the next CEO and, frequently, to advocate for their own candidates. An awkward process may also emphasize the company's vulnerabilities to larger calls for board change, as activists targeting the company are likely to argue that the apparent lack of CEO succession planning is an indication of a more pervasive lack of attention, direction, or competence on the part of the board.

ABOUT THE CONTRIBUTORS

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PEARL MEYER is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Jose. For more information, visit www.pearlmeyer.com.

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