

CEO succession: the times they are a-changin'

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Even a cursory review of corporate governance documents provided by US publicly-traded companies shows that they include the primary roles/responsibilities of members of boards of directors. These will invariably require that boards:

- set the tone and culture of the enterprise;
- ratify the strategic initiatives of the enterprise;
- evaluate and compensate senior management;
- are the stewards of enterprise risk; and
- facilitate executive succession.

We focus on the latter responsibility for several reasons. First, the *Harvard Business Review* has recently suggested that "The greatest challenge looming over corporate America is finding replacement CEOs" (Ciampa, 2005). Also, and somewhat less charitably, we are reminded of Stewart's (2001) admonition in *Wealth of Knowledge* that "The average board handles succession planning as well as the average American handles estate planning." Finally, there have been a host of conspicuous changes in the corporate environment in the post-Sarbanes-Oxley (SOX) era that will fundamentally challenge boards to meet their self-proclaimed duty to successfully plan and execute CEO succession. Before we address those challenges, however, we should consider an even more basic question.

Changes or no changes, are boards ready for CEO succession?

Apparently not – in a recent survey conducted by the National Association of Corporate Directors (NACD), it was reported that nearly half of the companies with revenues greater than \$550 million have no meaningful CEO succession plan in place. This is consistent with another survey (of over 1,000 directors) by *Corporate Board*. a total of 47 percent of the respondents reported that they were not satisfied with their company's succession plans.

Indeed, it seems that there is little consensus about who should have the responsibility for CEO succession planning and implementation. The NACD survey noted the manner in which boards manage CEO succession: The group or individual responsible for CEO succession evidently takes several distinct forms – the full board (39.3 percent), a special committee of the board (24.3 percent), the independent directors of the board (12.8 percent), the CEO of the firm (15.6 percent), and an "other" category (8 percent). In a related survey of directors, Korn/Ferry reported that 42.8 percent of board members thought that CEO succession should be the responsibility of a special committee, 41.3 percent were in favor of making the entire board responsible, and 11.4 percent thought the CEO should have the lead on such initiatives.

This overall lack of preparedness and lack of consensus with regard to who is responsible for CEO succession

Authors' note. This is the first of a two part commentary on CEO succession. This first part addresses a series of changes in the governance environment in the post-Sarbanes-Oxley (SOX) era that has substantially affected boards of directors' planning and execution of CEO succession. The second commentary provides some practical guidelines that may facilitate CEO succession in this challenging new environment.

planning does not promise to position boards effectively for the challenging environment we live in. There are several elements that comprise this new, inhospitable environment.

CEOs are leaving in droves

A vexing issue for those tasked with managing CEO succession is the escalation in CEO turnover rates. A recent Booz Allen Hamilton study, adding some perspective to this trend, referred to CEOs as “The World’s Most Prominent Temp Workers” (Lucier *et al.*, 2006). In 2003, the annual turnover rate for CEOs was 9.8 percent; a year later that rate increased to 14.2 percent. The most recent Booz Allen Hamilton (2006) study notes a 16.2 percent turnover rate for US CEOs. This is an increase of over 300 percent in the last decade. At these turnover rates, the average tenure for a CEO would be on the order of just over six years.

Why are these CEOs leaving?

Clearly, not all CEO departures present the same succession issues. Presumably, most boards will not be – certainly should not be – as seriously challenged by an expected retirement of its CEO. Other transitions do not have this character. The death, disability, or indictment of the CEO, or an unexpected “early” retirement, or a resignation to take a leadership role at another firm are examples. Most troublesome, however, are those transitions generated by the board itself.

Consider, for example, that the Center for Creative Leadership reported that 40 percent of newly appointed CEOs fail within their first 18 months in their positions. There is another aspect of this failure rate which is even more sobering. If the replacement CEO was an inside succession (i.e. a person selected from within the firm), the 18-month failure rate is 34 percent. For outside successions (i.e. a person selected who was not in the employ of the firm), the 18-month failure rate is 55 percent. This is one of the great ironies of CEO succession. In

principle, inside successors are appointed to facilitate continuity. With inside successions, the signal to the market is that all is well and that the board is committed to keeping the course. A board decision to select an outside successor provides a distinctly different signal. In that case, the board’s message is that change is in order and that an outside person has been appointed to lead those initiatives. The irony, of course, is that these outside successors – those presumably enabled to deliver the company to the proverbial promised land – have a sobering failure rate. Apparently, a board referendum for change is a perilous mandate for an outside CEO.

Another irony is implicit in the answer to the question “Why are these CEOs leaving?”. It seems that boards, for whatever reasons, are not successful in replacing their CEOs. Another troubling aspect of these high CEO replacement rates and the concomitant failure rates is that any notion of five-year planning horizons and similar approaches are likely to be severely compromised. Apparently, newly appointed CEOs will have to adopt much shorter performance horizons, or they will be seeking employment elsewhere.

Are boards dooming new CEOs from the onset?

There is yet another aspect of CEO succession planning that has received very little attention. Under the auspices of SOX and the guidelines of the listing exchanges (e.g. NYSE, NASDAQ), the notion of independence is repeatedly underscored. Included in such discussions is whether CEOs of publicly-traded firms should serve simultaneously as chairpersons of the board. Many observers suggest that it is naïve to believe that boards of directors can dispassionately evaluate CEOs’ practices, policies, and performance when the same CEOs are the presiding officers of the board.

Notably, despite this criticism, most large publicly-traded companies (71 percent) have retained the combined structure. The balance of these companies (29 percent) has adopted a structure that formally separates these roles. But a leadership structure with a separate CEO and board chairperson is not necessarily indicative of independence. In fact, according to a Spencer Stuart (2005, p. 9) report, in the clear majority of cases (67 percent), the person who is the “separate” board chairperson is the former CEO of the company. Actually, even the “67 percent” is understated because the misspecification is even broader. Not only are these “independent” chairpersons former CEOs, they are also company founders, and former CEOs of acquired/merged companies. In fact, of the 29 percent of S&P 500 firms that have a nominally separate CEO/board chair structure, Spencer Stuart (2005) reports that “only 9 percent of the boards . . . have a truly independent chair.”

This lack of independence is a potentially important factor in succession planning, and the subsequent high failure of successor CEOs. There are many observers who are very critical of what has been referred to as the “apprentice CEO” syndrome. Those who are responsible for CEO succession planning for the firm must be very cautious when they appoint a CEO, presumably strongly enabled to lead the firm, who remains under the potential influence of the firm’s founder(s) and/or past CEOs. This may be a recipe for failure.

Obvious replacements are not what they used to be

The “independence” principle to which we earlier referred has also had a major, adverse impact on what was the primary track for CEO successors. The road to the CEO suite was most often open to officers of the firm who were inside directors of the board. Notably, however, this dominant pipeline for CEO successors is now severely constricted in the post-SOX

period because the number of inside directors is down dramatically. In 2001, there were an average of 3.1 inside directors on *Fortune* 500 boards. That has been reduced to 1.65, but even this number is misleading. All CEOs serve on the board and are inside directors. Accordingly, on average there are only 0.65 non-CEO inside directors on modern boards. In fact, many companies now restrict inside board membership to only the CEO. For most firms this essentially means that their CFO, COO, and other senior corporate officers are not on the board. Critically, then, these officers no longer receive the on-the-job training that would have otherwise facilitated their candidacy and ascension to the CEO suite.

And speaking of training

The dearth of inside directors may be a detriment to CEO succession planning, but there is another aspect of the traditional queue for potential CEO candidates that is rapidly changing as well. It is apparent that firms are selecting younger executives as successor CEOs. A total of 20 percent of the CEOs in the

S&P 500 are under 50 years of age. Given that, when is the appropriate time for the CEO succession committee to begin formal assessments of potential successors? What is the right time for assigning “seasoning” opportunities?

It should also be noted that there is yet another trying irony in the development of younger successors. When a board has selected a relatively younger CEO, and that CEO survives those apparently brutal first few years as CEO, what will become of the firm’s CEO heir apparents? With a CEO in his or her late 40s, the upside within the company – if any – for potential successors is limited and long-range. Accordingly, they will leave. The younger a CEO replacement is, the more probable that the firm will lose its stable of successors.

Forward

It has been increasingly argued that the formal CEO succession process is in disrepair. The post-SOX dynamics described in previous sections promise to even further confound boards of directors’ responsibilities

for succession planning and execution. In part two of this commentary in the next issue, we will provide some practical guidelines that may facilitate effective CEO succession planning even in this more challenging governance environment.

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