Directors & Officers

Chief Executive Officer (CEO)

Making Succession Planning a Success

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When it comes to CEO succession planning, the stakes are high. Inadequate planning can lead to prolonged and expensive executive searches, downward pressure on stock prices, loss of investor confidence, and an adverse impact on employee morale. Additionally, a successor who is out of step with the company’s strategy and culture can cause significant business and management challenges. Recent high-profile CEO transitions have highlighted these risks and prompted a renewed focus on succession planning at the board level.

Investors Focus on CEO Succession

As it turns out, shareholder proposals seeking disclosure on the succession planning process since 2009 have been largely successful. Such proposals tend to arise at high-profile companies, companies with long-tenured CEOs, those with family control or those where CEOs are closely identified with company prospects.

In the last two years, shareholder proposals seeking disclosure of the succession planning process that came to a vote received relatively high levels of support; the seven proposals on this topic averaged support from just under 30 percent of the votes cast. This level of support is considered high for a board-focused shareholder proposal. However, many companies that received these proposals responded by entering into substantive dialogue with shareholders, focused on the key areas highlighted by investors, and consequently avoided having the proposal come to a vote altogether. The key areas have been developing the internal leadership pipeline, integrating succession planning with the longer term strategic plan and compensation program, and putting the board in control of the process. In fact, 13 of the 15 resolutions submitted in 2011 were withdrawn by their proponents following such engagement.
Planning for the Future, Building for the Present

Developing long-term and emergency succession plans is a fundamental board responsibility, one that should be addressed on a regular basis, in advance of when it is actually needed and regardless of CEO health or tenure. While an appropriate level of CEO input is valuable, it is important that the process be led and managed by the board.

Long-term succession planning is significantly more complex than simply identifying the next CEO. Leading practices approach succession planning as an integral part of long-term strategic planning and development of executive talent—one that should include flexibility for changes as corporate strategy shifts. Leading boards regularly re-evaluate their succession planning practices not only to mitigate the risks associated with CEO transitions but also to capitalize on strategic and developmental opportunities.

At its best, effective long-term succession planning involves an organizational commitment to developing a robust leadership pipeline and reinforcing the company’s strategic plan with all such goals integrated into the company’s compensation program.

Leading practices for CEO succession planning include:

- Reassessing the succession plan as the company’s long-term corporate strategy shifts;
- Identifying upcoming leaders and having the board interact with them to directly assess the talent;
- Assessing and developing internal candidates at least two ranks down;
- Customizing leadership development goals that link to the long-term strategic plan; and
- Integrating succession planning with the compensation program by including pay incentives tied to leadership and development goals.

Ensuring smooth succession by providing promotion opportunities, including identification and development of internal candidates, is important: among 291 succession events in 2010 assessed by Booz & Company in its annual study of turnover among chief executives, insiders ascended to the CEO spot 81 percent of the time. The study found that insiders last longer (with average tenure of 7.1 years, compared to 4.3 years for outsiders) and have historically produced superior returns for their shareholders. An increasing number of companies also appear to be disclosing key features of their succession planning policies to shareholders (excluding candidate names or other sensitive data). Without disclosing confidential information that could compromise strategy, a board can disclose substantive information to demonstrate that it is actively managing succession and has a formal process in place to identify, evaluate and develop internal candidates, as well as to identify external contenders. Such disclosure can demonstrate a company’s commitment to transparency—a key concern of stakeholders on this and other corporate governance matters.

Integrating Succession Planning and Executive Compensation

Succession planning creates a unique opportunity to strengthen the company’s compensation program by tying pay directly to leadership development goals. Long-term compensation programs should support internal promotions and build a deep bench for the C-suite and should consider the magnitude of pay gaps between the chief executive and other executive officers. High pay differentials may cause other officers to feel their efforts and responsibilities are devalued, resulting in retention issues. Such differentials also could create pay issues when it comes time for promotion or recruitment as the incoming executive may expect to receive compensation at similar levels.

Further, significant pay increases for internal promotions—or excessive sign-on compensation that may be paid in connection with the recruitment of an external candidate—will likely draw the attention of investors and the proxy advisory firms. Pay jumps, even in connection with a promotion to CEO, should be explained clearly in the proxy statement.

State of Play—CEO Transitions in Sight

The average tenure for a sitting CEO is currently 10 years. With approximately 40 percent of sitting CEOs having held the top rank for 10 or more years, many boards may find the need to execute on succession plans in the coming years. Although boards understand the importance of having a robust succession plan ready to put in place at any time, recent findings indicate most do not actually have such a plan on which they are ready to act. A 2010 survey of 140 CEOs and directors of North American companies found the following:

- More than half of respondents could not name a replacement in the event of an unexpected departure of the current CEO;
- 39 percent of respondents had no viable internal candidates immediately ready to assume the CEO position;
- Only half of the respondents had a written policy detailing the skills required for the next CEO; and
- Boards spend on average only two hours a year on CEO succession planning.
**Director Succession: Seizing Succession Opportunities on the Board**

Director succession planning must go beyond the C-suite to include the board itself. Market challenges and strategic goals also drive the need for distinct skill sets and expertise at the board level and require that board succession planning be an ongoing and dynamic process.

Change in the composition of the board should not be considered only when forced (e.g., a director meets a mandatory retirement age, has a change in employment, or retires at his or her option). The process of board renewal must be proactive and facilitate discussion around the skill sets that will support corporate growth priorities and address chief areas of stakeholder concern, including risk management, board leadership, and social and environmental matters. This process should achieve a balance between the need for institutional experience from current board members and the need for renewal and new perspectives.

Leading board succession practices:

- Use a skills matrix to shape the composition of the board to reflect strategic direction and opportunities, regulatory and industry developments, challenges, and transformation;
- Establish and enhance written director qualification standards to align with the company’s business and corporate strategy and include these standards in corporate governance policies and bylaws as appropriate;
- Consider evolving committee and board leadership needs, including the time commitments required by committee membership and chairmanship;
- Give regard to whether long-tenured directors’ relationships on the board and with management compromise director independence and ossify the board in the face of evolving business challenges;
- Consider annual director election results and engagement by investors regarding board independence, leadership, composition, and diversity; and
- Prioritize diversity in order to foster debate, challenge norms, and invigorate board oversight processes and strategy development.

The CEO transition period may also be a good time to evaluate board structure and leadership. There is an increasing trend toward independent board leadership, and boards may consider a time of transition as an opportunity to consider the appropriate structure given a company’s particular circumstances. Many investors support the appointment of an independent board chair, and absent that, an independent lead director assigned specific duties including setting board meeting agendas and controlling information flow to the board. Approximately 22 percent of S&P 500 boards currently have independent chairs compared to only 1 percent in 2000.7

**Conclusion**

Effective succession planning, whether for the executive team or the board of directors, creates strategic opportunities to define the company’s long-term strategic goals and challenges, identify the qualifications and expertise required to meet the company’s needs, and actively develop the diverse teams required to achieve success and build sustainable shareholder value. As recent lessons demonstrate—and with CEO successions an inevitable scenario—the stakes are too high for boards to make succession planning anything less than a top priority.

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1 SEC, Staff Legal Bulletin No. SLB-14E (Oct. 27, 2009).
2 Statistics from Ernst & Young’s corporate governance database, which is based on SEC filings. “Votes cast” is defined as votes for and against the proposal, excluding abstentions and broker non-votes. This is the standard for determining eligibility for resubmission of a shareholder proposal as defined by the SEC. As a result, it has become the standard for assessing support for shareholder resolutions.


5 Statistics from Ernst & Young’s corporate governance database.
7 Statistics from Ernst & Young’s corporate governance database.