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Corporate Governance Update: Advice for the Board in CEO Selection and Succession Planning

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Selecting the chief executive officer and planning for CEO succession are among the most important responsibilities of a company's board of directors. In ideal circumstances, the succession process will be managed by a successful and trusted incumbent CEO, with the board or a board committee overseeing the process, reviewing the candidates and providing advice throughout. However, in exceptional circumstances, such as when the board lacks full confidence in the incumbent CEO or when a crisis occurs and the normal succession process cannot be utilized, the board will need to take the lead in managing this crucial task. The challenge of CEO turnover is one that boards may face more often than they would like. One source estimates that 40 percent of new CEOs depart within 18 months of their appointment, while 64 percent depart within four years.[1] Nor is the transition inexpensive: The cost of replacing a CEO can range from several million dollars for small-cap firms to tens of millions of dollars for large-cap firms.[2]

In 2011, the CEO turnover rate increased as compared to the previous two years.[3] High-profile resignations and hirings occurred at household-name corporations such as Hewlett-Packard, PG&E, Yahoo!, Costco, and Sara Lee. With the recent publicity surrounding the resignation earlier this month of Yahoo! chief executive Scott Thompson, CEO selection and succession issues have come once again to the fore. Directors facing these challenges should keep in mind that the attitude and smooth functioning of the board are crucial to a sound process and good result, and that the fates of the board and its chosen CEO often are inextricably entwined.

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[1] Nat Stoddard and Claire Wyckoff, "Pick a CEO Who Truly Fits the Company," Forbes.com, Apr. 9, 2009 ("Some 40% of new CEOs are fired, or "retired," within their first 18 months, and 64% of them never make it to their fourth anniversary on the job. The average cost of replacing a CEO after 18 months ranges from $12 million for small-cap firms to $52 million for large ones. And not having the right leaders costs American industry an estimated $14 billion a year, not even counting the price to shareholders in lost market capitalization and increased stock volatility, and to businesses themselves in being left demoralized, floundering and ripe for the picking.").

[2] *Id.*

[3] *See* Crist Kolder 2011 Volatility Report, available at www.cristkolder.com/VolatilityReport2011.pdf.

Process Is Key

CEO selection is, first and foremost, about the future. As the adage goes, one picks a general for the next war, not for the last one. When a company has a successful CEO in place who has the full confidence of the board, the incumbent CEO will be in the best position to manage the succession process and determine the right person to lead the company through the challenges it may face in the future. The incumbent CEO should involve the lead director[4] in the process by providing regular updates, and the lead director should update the remainder of the board during the board's executive sessions. Most boards review succession planning with the incumbent CEO on a regular basis. We advise that there be a comprehensive discussion at least annually regarding internal candidates and planning for emergency circumstances. One of the ways that a CEO can maintain the confidence of his or her board is by providing transparency as to the succession process on an ongoing basis.

Breakout sessions of the independent directors should include regular discussions of the succession plan, so that the lead director can hear the views of the other independent directors privately. Boards should be active in identifying talented leaders so that there is a bench of qualified internal and external candidates at the ready. The directors may wish to seek first-hand exposure to the company's most promising executives at board and company functions and may consider working with the CEO to establish policies and procedures for the development and evaluation of internal candidates.[5]

Where circumstances arise that cause the board to lack confidence in the incumbent CEO, or when there is a corporate crisis that raises succession issues, the lead director should take charge of the succession process. Generally, this process will be managed by the nominating committee, but it is important that the entire board have the opportunity to provide input. One of the most important things a board can do at the outset of a CEO search process is to identify the challenges that the company will face in the applicable upcoming timeframe. At that point, the board can then consider the appropriate traits, experiences and characteristics in a CEO candidate that would be most useful in meeting these challenges and guiding the company to future success. The board should recognize that these may or may not be characteristics possessed by the incumbent CEO. It is important for the board to narrow down the necessary requirements to a small and manageable number, as this will enable the board to find candidates

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[4] Some companies use the term "presiding director" instead of "lead director" but their duties are the same. *See, e.g.*, "Defining the lead director role," PwC View, Issue 13, available at www.pwc.com/us/en/view/issue-13/defining-the-lead-director-role.jhtml. To the extent that a company has a non-executive chairman of the board, there is no need for a lead director. In this article, where we refer to a "lead director" taking action, those same actions would be taken by the non-executive chairman where the company has one in place.

[5] For a discussion of this topic and other key issues facing boards of directors, *see* Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, "Some Thoughts for Boards of Directors in 2012," WLRK Publication, Dec. 7, 2011.

who excel at the most important skills rather than candidates who may be moderately capable across the board but lack excellence in the most key areas.[6]

In the situation where the lead director and the board need to take direct control of the succession process, it is important for the lead director to define the necessary steps for the remainder of the board. In order to set priorities and find candidates who meet their requirements, directors must first establish a well-designed selection process, which may include the advice of counsel and other external consultants. A sound process will enable the board to achieve its goals while at the same time providing a roadmap to keep the directors on course through the inevitable difficulties they will encounter. In the event of disagreements, the process stands as the neutral, pre-agreed path to which the directors and any advisors can return in order to continue progress toward the final selection.

An organized, careful process is necessary to undertake the substantive evaluation of candidates' capabilities. There is no better guide than past performance; however, in many situations, red flags from top executives' pasts have been ignored by boards in their selection process, and the choice has, to some extent predictably (in hindsight), been a mistake. When boards feel rushed into selecting a new CEO—which can happen when the company faces a crisis or lacks a succession plan—due diligence can suffer. The board should look for examples in each candidate's past that bear directly on how the candidate will cope with the future challenges identified by the board.[7]

Two Elements to Consider

There are two key corporate-governance related elements that should be near the top of a board's list for evaluating potential CEO candidates, particularly when the board is not able to rely on the incumbent CEO to lead the succession planning process. The first is that the new CEO should be a good fit culturally with the board and the company. The statistics on CEO turnover cited above indicate that a newly hired CEO, even if he or she is eminently qualified and charismatic, can often turn out to be a poor fit for the company. Typically, every candidate on a board's short list will possess adequate skills and experience to fill the CEO position. However, while a positive organizational culture is an important source of competitive advantage, cultural incompatibility can be a talented leader's downfall. One example is the resignation of William Perez as the CEO of Nike in 2006. His departure after just over one year in the position was described by company founder Philip Knight as "a situation where the

[6] *See* John M. Simonds, "How To Select Your Next CEO," an industry white paper published by Martin-Simonds Associates, Inc. (no date), available at www.martin-simonds.com/pdf/howtoselectyournextceo.pdf.

[7] *See id.*

cultural leap was too great."[8] Perez was succeeded by an insider who had been with Nike for more than 25 years.[9]

One of the new CEO's most important responsibilities will be to set the appropriate "tone at the top" in accordance with the board's long-term strategic vision for the company. It is important that the board establish the appropriate tone by way of example for the new CEO. The tone set by the CEO helps to shape corporate culture and permeates the company's relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents.[10] This element of corporate culture, though hard to quantify, nonetheless is essential to both the board's and the company's abilities to function effectively, to meet all of their responsibilities, and ultimately to achieve success in their ventures. Establishing a consistent and positive tone will be difficult or impossible if the CEO does not fit well with the corporate culture created and espoused by the board.

The second key element is that the CEO should have a long-term vision for the company that accords with that of the board. A crucial aspect of this is the ability to resist the powerful forces of short-termism. Sheila Bair, in her final speech as FDIC Chairman last June, opined that "the overarching lesson of the [financial] crisis is the pervasive short-term thinking that helped to bring it about."[11] She cited short-term incentive compensation as a factor, along with modern technology that enables a "constant flow of information [that] only heightens [corporate executives' and investment managers'] obsession with short-term performance at the expense of longer-term goals."[12] This obsession is fed as well by the practice of issuing quarterly earnings guidance and the relentless pressures faced by management to meet that guidance every quarter.[13] Daniel Vasella, chairman of Novartis, once famously described the "tyranny of quarterly earnings" as "a mindset that can hamper or even destroy long-term performance for shareholders."[14]

CEOs must be prepared to deal with pressure from activist investors, who push for forecasts and earnings guidance in order to capitalize on profitable trading and arbitrage opportunities and who have been empowered by evolving corporate governance best practices

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[8] Michael Barbaro and Eric Dash, "Another Outsider Falls Casualty to Nike's Insider Culture," N.Y. Times, Jan 24, 2006. *See also* Nat Stoddard and Claire Wyckoff, *supra note 1*.

[9] Barbaro and Dash, *supra note 8*.

[10] *See* Lipton et al., *supra note 5*.

[11] Remarks by FDIC Chairman Sheila C. Bair to the National Press Club, Wash., D.C., June 24, 2011, available at www.fdic.gov/news/news/speeches/chairman/spjun2411.html.

[12] *Id.*

[13] For a discussion of the practice of issuing quarterly earnings guidance, see David A. Katz and Laura A. McIntosh, "Companies Consider Ending Quarterly Earnings Guidance," N.Y.L.J., July 26, 2007, at 5.

[14] Daniela Vasella and Clifton Leaf, "'Temptation is all around us' Daniel Vasella of Novartis talks about making the numbers, self-deception, and the danger of craving success," Fortune, Nov. 18, 2002, available at www.money.cnn.com/magazines/fortune/fortune_archive/2002/11/18/332268/index.htm.

and reforms. Hedge funds and other activist shareholders frequently agitate for stock buybacks, special dividends, spin-offs and other corporate transactions to improve their immediate returns. They are not the only ones; even the more traditional investors reportedly have shortened their investment horizons. Boards that rightly strive to focus on long-term strategy and profitability must hire a CEO who shares that goal and has the strength and credibility to hold the line against the forces of short-termism.

It is worth noting that both of the elements above—that the CEO be a good fit culturally with the company and that the CEO share the board's long-term vision—depend entirely on the ability of the board and CEO to communicate and collaborate effectively. It is important that a CEO understand that he or she works for and under the authority of the board, which has the ultimate responsibility for overseeing the management of the company. However, the day-to-day business of the corporation is the responsibility of the management team led by the CEO. With this understanding, the CEO and board can and should engage in ongoing, substantive cooperation based on mutual respect and trust.

Recognize Interdependence

The recent departure of CEO Scott Thompson from Yahoo! illustrates a number of issues in CEO selection in the context of a crisis. The Yahoo! situation also shows the extent to which a company and a board are vulnerable to activist shareholders if their CEO selection process has resulted in an unfortunate choice.

Third Point, a hedge fund holding over 5 percent of Yahoo! stock, began earlier this year to demand board seats for Third Point founder Daniel Loeb and two others. When Loeb and Yahoo! were unable to reach an agreement, the company appointed three independent board members in March. Third Point then threatened a proxy fight.[15] A few days later, Third Point launched a website detailing all of its complaints about Yahoo! and publicizing the biographies of Loeb's proposed slate of three directors.[16] The board and Thompson attempted to stay focused on their strategy, including job cuts and a new leadership structure, but they were forced to respond to Third Point's proposed slate with a letter to shareholders and a new website promoting the board's director candidates and future plans.[17] All this was indeed distracting and negative for the company, but it turned catastrophic in early May when Third Point unearthed an inaccuracy on the resume used by Thompson to obtain the CEO position. The directors, presumably unaware of this when they hired Thompson, initially portrayed it as an inadvertent error and attempted to stand behind their CEO as still highly qualified and the right leader for the company.[18] Third Point raised the stakes, demanding under Delaware General Corporation Law

[15] David Benoit, "Yahoo! Going To Face 'Distracting' Proxy Fight from Loeb," WSJ Deal Journal, Mar. 26, 2012.

[16] David Benoit, "Third Point Creates Website for All Things Wrong With Yahoo," WSJ Deal Journal, Apr. 2, 2012.

[17] David Benoit, "Yahoo: Our Board Is Better Than Loeb's Suggestions," WSJ Deal Journal, May 2, 2012.

[18] Amir Efrati and Drew Fitzgerald, "Yahoo! Cites 'Inadvertent Error' in CEO Academic Record," WSJ, May 4, 2012.

§ 220(b) the books and records from Yahoo! relating to the hiring of Thompson and the nomination of Thompson and six other directors to the Yahoo! board. Third Point's goal was to demonstrate that the Yahoo! board had been mismanaged and did not adequately assess Thompson's credentials.[19] Third Point continued to call for Thompson's resignation, the appointment of an interim CEO, and the appointment of Third Point's slate of board candidates, as well as the installation of a Third Point candidate as chairman of a new CEO search committee.[20] Finally, just over a week after the resume discrepancy was revealed, Thompson resigned as CEO. The precipitating factor appeared to be the board's obtaining evidence that led them to believe that Thompson had deliberately falsified his academic record.[21] Concurrently, the board agreed to give Third Point three board seats, including one for Loeb, and in exchange Third Point dropped its proxy fight.

The board's failure to discover Thompson's resume deception may have resulted from a poor selection process, from board dynamics that hampered a thorough vetting of candidates, or from a combination of causes. Some industry insiders have noted that specialized search firms typically are responsible for extensive background checks and education verification; others argue that no background check can be exhaustive.[22] While it is not necessary to hire a search firm to lead the CEO search process, it is important that an outside party be retained to lead the verification and background check process, and spend the time necessary to perform a complete check, so that the board can reasonably rely on their expertise when making their decision. The director who led Yahoo!'s CEO search committee in the selection of Thompson announced, amid the furor, that she would not run for reelection at the end of her term; she also was alleged to have had a discrepancy on her resume.[23]

One lesson to be drawn from this episode is that a weakened CEO can be a target for aggressive stakeholders. Yahoo! unwittingly hired an executive whose personal failings created significant corporate vulnerability to an activist investor. Third Point was an aggressive stakeholder to begin with, but the board might have been able to survive the proxy fight and the negative publicity. The resume scandal gave the hedge fund the opening it needed to undermine the credibility of the CEO and drive a wedge between the CEO and the board.

A further lesson is that the success of the board and the success of the CEO can be deeply intertwined. Not only was the revelation of Thompson's deception profoundly embarrassing to the board, which was forced to contend with allegations of mismanagement and poor judgment, but more substantively, the outcome of the scandal was that the CEO is gone and three activist investors now have seats on the board. This is the very result that the board was

[19] Maxwell Murphy, "Third Point Goes After Yahoo! Records with Legal Maneuver," WSJ, CFO Journal, May 7, 2012.

[20] Ben Fox Rubin, "Third Point Presses Yahoo! for New CEO," WSJ, May 9, 2012.

[21] Amir Efrati and Drew Fitzgerald, "Thompson Resigns as CEO of Yahoo" WSJ, May 13, 2012.

[22] *See, e.g.*, Julianne Pepitone, "Should Yahoo!'s CEO Be Fired for Lying?" CNNMoney, May 9, 2012.

[23] *Id.*

prepared to engage in an expensive and protracted fight to prevent. After this blow to the board's credibility and reputation, it is likely that the Third Point directors, despite representing a minority of the board, will have a greater say in Yahoo!'s future than their proportional membership would suggest.

Healthy Board Dynamics

A healthy board dynamic is essential to an effective succession process and positive result. There is no question that the best situation is one where a successful CEO can manage the succession process while involving the board in an appropriate and transparent manner. Any other process will be a poor substitute if the incumbent CEO, who should be in the best position to understand the company's challenges and the skills best-suited to navigate them, is not an integral part of the succession process.

There are a few common ways in which a board working on CEO succession without CEO leadership can be dysfunctional. First, a board can have deep-seated personal animosities or recurring substantive disagreements that prevent it from reaching consensus on priorities or candidates. This can mean that the quality of the candidates who manage to survive the crossfire is lower than those that would be considered by a united board. Second, a board can have one dominant personality, often a former CEO or company founder, whose influence is so strong, and whose preferences so particular, that other directors are effectively excluded from the decision-making process. This director's hand-picked CEO may not receive adequate scrutiny, as other directors defer regardless of any misgivings they might have. Third, the relentless focus on director independence in the last decade has resulted, in many cases, in boards that lack depth of experience and expertise in the company's business and industry. A 2009 working paper published by the Harvard Business School's Corporate Governance Initiative observed: "As a practical matter it is difficult, if not impossible, to find directors who possess deep knowledge of a company's process, products and industries but who can also be considered independent."[24] This lack of deep experience and expertise can make it more difficult to identify and evaluate candidates from other companies in the relevant industry or even from within the company.

A board that has not committed itself to developing and reviewing its succession plan on a regular basis can find itself in a situation where it must hire a CEO quickly and without sufficient time for a proper process. Active and ongoing engagement on succession planning between a trusted incumbent CEO and the lead director will avoid this result. Where there is a dysfunctional board, there is more likely to be a dysfunctional succession process lacking adequate due diligence and the substantive involvement of all the directors. In a crisis situation, without an operational succession plan, there can be a protracted delay in finding a successor, or the hasty appointment of an interim CEO, either of which can negatively affect the company's stability and its ability to react quickly and decisively to evolving challenges. There is some evidence that the length of the succession period, *i.e.*, the period between the incumbent CEO

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[24] Jay Lorsch et al., "Perspectives From the Boardroom 2009," Harvard Business School Working Paper, at 9, Sept. 9, 2009, available at http://www.people.hbs.edu/jlorsch/BoardroomIssues.pdf.

announcing plans to step down and the new CEO being selected, is negatively correlated with the future operating results of a company.[25] In addition, the lack of a clear succession plan, or a delay in appointing a permanent CEO, may result in the company being particularly vulnerable to a hostile takeover attempt or the focus of activist shareholders.

Surveys indicate that directors are well aware of both the importance and the difficulty of succession planning: A 2011 PricewaterhouseCoopers survey of 834 corporate directors found that 59 percent believed that more time should be spent on succession planning in the upcoming year,[26] while a recent Corporate Board Member survey reported that 43 percent of those polled believed CEO succession was the responsibility for which the board was least effective.[27]

CEO selection is one of the most formidable, as well as one of the most consequential, decisions a board must make. Using a thoughtful selection process, a well-functioning board that has taken the time to consider CEO succession on a regular basis will be in a good position to identify its top priorities and the best-suited candidates should a crisis present itself. Where the sitting CEO has the full confidence of the board, the process is likely to lead to the best result when the board remains actively engaged. In less than ideal circumstances, the board must devote the necessary time and energy to understand and manage this issue before it becomes a crisis, so that it is able to act decisively in its oversight role.

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[25] *See* David F. Larcker and Brian Tayan, "Sudden Death of a CEO: Are Companies Prepared When Lightning Strikes?" CGRP-24 at 2 (citing Bruce K. Behn, David D. Dawley, Richard Riley, and Ya-wen Yang, "Deaths of CEOs: Are Delays in Naming Successors and Insider/Outsider Succession Associated with Subsequent Firm Performance?" Journal of Managerial Issues (Spr. 2006)), available at www.boardmember.com/Article_Details.aspx?id=7648. Disturbingly, a 2011 Stanford business school study found that 46 percent of companies do not engage in succession planning at all. Stanford Graduate School of Business, Corporate Governance Research Program, 2011 Corporate Board of Directors Survey, at 2, available at www.gsb.stanford.edu/cgrp/research/surveys/directors.html.

[26] PricewaterhouseCoopers Annual Corporate Director Survey 2011 Findings, at 14, available at www.pwc.com/en_US/us/corporate-governance/assets/annual-corporate-director-survey-2011.pdf.

[27] *See* Lipton et al., *supra note 5.*