



Seven Myths of CEO Succession

By David F. Larcker, Stephen A. Miles, and Brian Tayan

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INTRODUCTION

The chief executive officer of a company is responsible for a long list of decisions that impact corporate performance, including strategy, organizational design, and incentives. He or she also brings to bear a managerial and leadership style that has a considerable influence on workplace productivity and culture. As such, many believe that the selection of the CEO is the single most important decision that a board of directors can make. In recent years, several high profile transitions at major corporations such as Procter & Gamble, Microsoft and JC Penney have cast a spotlight on succession and called into question the reliability of the process that companies use to identify and develop future leaders. We examine seven common misconceptions relating to CEO succession.

MYTH #1: COMPANIES KNOW WHO THE NEXT CEO WILL BE

Every year, approximately 10 to 15 percent of companies change CEOs either because of retirement, recruitment to another firm, resignation following poor performance, or for health-related issues.¹ For this reason, shareholders expect that companies have a chosen successor identified at all times to immediately assume the CEO position should the need arise. Unfortunately, research data indicates that this is often not the case. According to a 2010 study by Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, only 54 percent of companies state that they are grooming a specific successor to the CEO position, and 39 percent claim to have *no* viable internal candidates to permanently replace the CEO if required to do so immediately. Companies estimate that it

would take 90 days on average to name a permanent successor.² These results are surprising, given the importance that reliable succession planning has on corporate performance. For example, Behn, Dawley, Riley, and Yang (2006) find that corporate performance is inversely correlated with the length of the succession period (i.e., the longer it takes a company to name a successor, the worse it subsequently performs relative to peers).³

MYTH #2: THERE IS ONE BEST MODEL FOR SUCCESSION

There are four general approaches to selecting a CEO:

- *CEO-in-Waiting.* The company promotes a leading candidate to the position of president or chief operating officer where he or she is groomed to eventually become the CEO. This approach allows the board to observe first-hand how an executive performs when given CEO-level responsibility before having to commit to the appointment.
- *Internal Development.* The company identifies potential internal candidates and establishes a development plan for each. In time, the most promising (viable) candidate is promoted to CEO. This approach allows the company to groom and evaluate multiple executives before settling on a favorite.⁴
- *External Recruit.* The company recruits an executive from outside the organization. This approach is preferable when the company lacks qualified internal talent, or the company is in a turnaround situation that requires significant strategic, operating, or financial change.

- *Inside-Outside Approach.* The company combines an internal development plan with an external search. This approach allows the company to compare leading internal candidates against the external market and select the most qualified individual.

There are tradeoffs to each of these approaches. The correct model for a given company will depend on a variety of factors, including its current strategic and operating condition, the quality of the senior management team, the reliability of its internal talent development program, and the quality and availability of external talent. One reason that companies fall short at succession planning is that they often select the wrong model for their current situation. For example, a director with previous succession experience at Company A will advocate that Company B adopt the same model even when its situation calls for a different approach. Furthermore, the board and management often underestimate the difficulty, time, and cost of succession. Succession is a process not an event, and irrespective of the specific model that the board adopts, it is important that the process is managed well.

MYTH #3: THE CEO SHOULD PICK A SUCCESSOR

Succession planning involves two distinct activities. The first is the identification and development of candidates. The second is the selection of a successor. Many people associate “succession planning” with the selection event, but the majority of the work takes place identifying and grooming candidates before the selection event takes place. Because the CEO tends to be heavily involved in the development of these individuals, the board often defers to the CEO in the choice of his or her successor. This is particularly true when the outgoing CEO has had a successful career.⁵

There are several reasons, however, why the CEO should not be responsible for choosing a successor. First, the board has a fiduciary duty to make this decision. Even though the CEO has considerable direct knowledge of the candidates and their capabilities, it is the responsibility of the board, as representatives of the shareholders, to make this decision in an independent and objective manner. Second, the CEO does not have the same perspective on

the company as the board. The board is responsible for *future* performance and strategy, while the CEO has devised the current strategy and has a vested interest in its continuance. The board needs to determine whether future operating conditions will require a change in direction and a leader with a different perspective and skill set than the current CEO. Finally, the CEO is not always objective in the evaluation of talent, having biases and preferences that have built up over many years of working closely with certain individuals. He or she might advocate on behalf of a favored colleague or obstruct a disfavored colleague even though this is not in the best interest of the organization (see Exhibit 1). The CEO should advise on succession, but the final decision rests with the board.

MYTH #4: SUCCESSION IS PRIMARILY A “RISK MANAGEMENT” ISSUE

A fourth myth is that CEO succession planning is primarily a “risk management” issue. This perspective is summarized by the Securities and Exchange Commission:

One of the board’s key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership. Recent events have underscored the importance of this board function to the governance of the corporation. We now recognize that CEO succession planning raises a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce.⁶

While it is true that failure to plan for a change in leadership exposes an organization to considerable downside risk, succession planning affords companies the opportunity to *build* (and not just preserve) value. Successful companies map their succession plans to a forward-looking view of the organization. They identify critical positions, including members of the senior management team and below. Leadership and operating skills are determined for each position, and every executive is benchmarked against these skills. Development plans are crafted for each, and potential successors are identified. At its best, succession planning is as

much success-oriented as it is risk-oriented. While risk management is an important element of succession planning, the primary focus should remain on building shareholder value (see Exhibit 2).

MYTH #5: BOARDS KNOW HOW TO EVALUATE CEO TALENT

Another myth of CEO succession is that boards know how to evaluate CEO talent. In practice, boards are not always adept at evaluating the current CEO or potential successors. For example, a 2013 survey by The Miles Group and the Rock Center for Corporate Governance finds that CEO performance evaluations place considerable weight on financial performance (such as accounting, operating, and stock price results) and not enough weight on the nonfinancial metrics (such as employee satisfaction, customer service, innovation, and talent development) that have proven correlation with the long-term success of organizations. Furthermore, a significant percentage of directors (21 percent) report having only moderate or little understanding of the strengths and weaknesses of the current CEO, while over a third of CEOs (35 percent) do not believe that the performance evaluation process is a meaningful exercise.⁷

The board of directors is also generally not very skilled at evaluating potential CEO candidates. With external candidates, boards tend to put considerable weight on financial track records and perceived “leadership qualities,” without enough consideration of how the operating conditions of the two companies might differ or how the executive’s leadership style might translate to a new environment. Similarly, internal candidates who are untested and unproven in a CEO role are even more difficult to evaluate (see below). As a result, boards often take a “rearview mirror” approach in choosing a successor: if the outgoing CEO was successful, they gravitate to a candidate (internal or external) with similar skills and characteristics; if the outgoing CEO was unsuccessful, they gravitate toward someone starkly different. Deep experience and a rigorous, thoughtful process help to mitigate these tendencies.

MYTH #6: BOARDS PREFER INTERNAL CANDIDATES

Most newly appointed CEOs are internal executives. According to Spencer Stuart, 74 percent of CEO transitions among S&P 500 companies during the ten year period 2004–2013 involved an internal replacement (see Exhibit 3). Research shows that companies that promote insiders to the CEO role tend to perform better, on average, than companies that recruit external replacements.⁸ As such, many shareholders and stakeholders believe that boards prefer internal candidates.

However, this is often not the case. First, internal candidates have never actually *been* CEO. No amount of observation, coaching, and development will give the board 100 percent assurance that an untested executive can handle the complete responsibility until he or she assumes the role.⁹ Second, directors tend to view insiders as junior executives and therefore less qualified than external candidates that currently have CEO experience. They often forget that all CEOs had to work their way up through the ranks and at some point make the leap to the CEO level. Finally, directors do not have sufficient exposure to senior executives below the CEO, making it difficult to accurately assess their capacity for leadership and growth. According to one survey, only slightly more than half of directors understand the strengths and weaknesses of the senior executive team “extremely” or “very well.” Less than a quarter of directors (23 percent) formally participate in senior executive performance reviews, and only 7 percent act as a professional mentor to these individuals (see Exhibit 4).¹⁰ Without more regular exposure, it is difficult for the board to fully appreciate the leadership potential of internal candidates.

MYTH #7: BOARDS WANT A FEMALE OR MINORITY CEO

A final misconception about succession is that boards truly want to recruit a female or ethnic minority executive to the CEO position. “Diversity” ranks high on the list of attributes that board members formally look for in CEO candidates, and yet female and ethnic minorities continue to have low representation among actual CEOs. For example, only 5 percent of CEOs of Fortune 500 companies are women and 1 percent African-American.¹¹

It is unclear why diversity candidates are not more regularly selected for the CEO role. Interviews with executive recruiters indicate that female executives and executives with ethnic backgrounds might exhibit leadership styles that are different from what directors are used to seeing. In making a final decision, it might be that boards are more comfortable selecting an executive whose behavioral attributes more closely match personal stereotypes of CEO leadership. There is some empirical support for this explanation. Rudman and Glick (1999) find that female executives are evaluated negatively for exhibiting traits that, in a man, are seen as positive (such as being action-oriented, decisive, and leader-like).¹² Professor Deborah Gruenfeld of the Stanford Graduate School of Business explains that people prefer behavior that is consistent with perceived roles or stereotypes and are uncomfortable with behavior that is inconsistent with these. Women who are perceived as displaying masculine leadership traits are seen as violating expected norms of behavior, while at the same time, women who are perceived as displaying feminine traits are judged as less competent than male counterparts. This double-edged sword might work against successful female executives.¹³ Similar dynamics are potentially in play when it comes to evaluating executives who are ethnic minorities.

WHY THIS MATTERS

1. A viable succession plan is critical to the long-term success of any organization. To be effective, succession planning should be a continuous and ongoing activity rather than a one-time decision that is required when a CEO resigns or is fired. Succession is a *process* rather than an event. Why aren't more companies prepared for a change at the top? What organizational and cultural impediments stand in the way?
2. The board of directors, and not the CEO, is responsible for driving the succession process at companies. While recent regulatory changes have helped to focus attention on the need for boards to develop a viable succession plan, more work can be done. For example, survey data suggests that boards are not very knowledgeable about the qualifications and leadership skills of internal candidates. Why not? Wouldn't directors make better hiring decision if they were? Would the board be more likely to promote an internal candidate rather than look outside? Would they be more likely to promote female and minority candidates?
3. Board composition matters. Boards need to ensure that they have directors with succession experience who can work with management to establish best practices for succession planning and talent management. How many succession processes should a director participate in before he or she is considered "qualified" to lead one? Is there a difference between participating in a succession process as a CEO and as a director? How does the perspective change? ■

¹ Ken Favaro, Per-Ola Karlsson, and Gary Nielson, CEO Succession Report, Booz & Co. (2012).

² Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, 2010 CEO Succession Planning Survey, (2010).

³ 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* (Spring 2006).

⁴ There are two varieties of the internal development model. In the first, a formal competition (or "horse race") is established between leading internal candidates. The classic example is General Electric, where three senior executives (Jeffrey Immelt, Robert Nardelli, and James McNerney) were identified as potential successors to outgoing CEO Jack Welch before Immelt was given the job. Because the formal horse race invites considerable outside scrutiny, fewer companies today designate a formal competition. Instead, companies identify promising executives and assign development plans to each without a formal designation that they are competing for the CEO job. This approach reduces scrutiny and increases the chance that a company can retain the executives who "lose out" in the race. For example, Intel and General Motors both employed this model in recent years, and each successfully retained several of the executives who were not given the CEO job. By contrast, Nardelli and McNerney both resigned from GE shortly after losing out to Immelt.

⁵ For example, a recent *Wall Street Journal* about succession at the Walt Disney Company says that, given the successful tenure of CEO Robert Iger, "whomever Mr. Iger... endorses as his favored successor will likely have a strong shot at earning the approval of Disney's board as well." See: Ben Fritz and Joann S. Lublin, "Who Will Replace Iger? Disney CEO Battle Looms," *The Wall Street Journal* (March 15, 2014).

⁶ SEC Staff Legal Bulletin 14E (CF), "Shareholder Proposals," (Oct. 27, 2009). Available at: <http://www.sec.gov/interp/legal/cf-slb14e.htm>.

⁷ The Miles Group and the Rock Center for Corporate Governance at Stanford University, 2013 CEO Performance Evaluation Survey, (2013).

⁸ Note that research results might be confounded by the fact that companies that require external CEOs tend to be in worse financial condition. See: Ken Favaro, Per-Ola Karlsson, and Gary L. Neilson 2010, "CEO Succession 2000-2009: A Decade of Convergence and

Compression,” Booz & Company Inc., strategy+business (Summer 2010); and Mark R. Huson, Paul H. Malatesta, and Robert Parrino, “Managerial Succession and Firm Performance,” *Journal of Financial Economics* (2004).

⁹ Directors often mistakenly use the phrase “ready now” to describe an idea candidate, when, by definition, an internal candidate cannot be “ready now.” Instead, “viability” is a better litmus test for evaluating successors.

¹⁰ The Conference Board, The Institute of Executive Development, and the Rock Center for Corporate Governance at Stanford University, “How Well Do Corporate Directors Know Senior Management?” The Conference Board Governance Center, *Director Notes* (2014).

¹¹ See: “A Look at 23 Women CEOs Running Fortune 500 Firms,” The Associated Press (December 10, 2013); and “African American Chairman & CEO of Fortune 500 Companies,” BlackEntrepreneur-Profile.com (March 11, 2014).

¹² Laurie A. Rudman and Peter Glick, “Feminized Management and Backlash toward Agentic Women,” *Journal of Personality and Social Psychology* (1999).

¹³ Deborah Gruenfeld, “Having Power and Influence,” (June 4, 2013), Available at: <http://www.trendhunter.com/keynote/body-language-speech>.

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EXHIBIT 1 — SIX COMMON CEO BEHAVIORS DURING SUCCESSION

The cooperation of the outgoing CEO can have an important impact on succession. Below are six observed behavior groupings that CEOs tend to exhibit during the succession process.

THE ACTIVE ADVISOR

The sitting CEO accepts that it is time to step down and is ready to do so. The CEO provides thoughtful insight into the selection process but does not overstep his or her role. The CEO limits opinions to when they are solicited and does not impose his or her “will” on the board. Disciplined, self-aware, and satisfied with the role as advisor, the CEO has full acceptance that the board will make the final decision.

THE AGGRESSOR

The sitting CEO is relatively overt in his or her attempt to influence the selection decision. This type of CEO will “play nice” for most of the process only to attempt to steer the selection toward a handpicked candidate at a key decision point, undermining other candidates in the process. The CEO will take a strong position with the board and try to force the outcome he or she favors.

THE PASSIVE AGGRESSOR

The sitting CEO tries to influence the selection process in a covert manner. The CEO subtly undermines certain candidates by the way he or she positions them to the board. He or she will come across not as manipulative but instead as an advisor. If this behavior is undetected until late in the process, the board might have to start from the beginning and exclude the CEO.

THE CAPITULATOR

When the board is close to making the final decision on a successor, the CEO changes his or her mind about retirement and requests to stay longer. This behavior essentially forces the board to choose between the present and future leadership of the company. A nonexecutive director will need to meet with the CEO and firmly inform him or her that the board is moving forward with a successor.

THE HOPEFUL SAVIOR

The sitting CEO largely identifies with the role of CEO and does not really want to retire. The CEO might actively promote successors in his or her own likeness. Alternatively, he or she might promote someone less capable in the hope that the successor will fail so that he or she can be swept back in to “save” the company.

THE POWER BLOCKER

The sitting CEO does not want to leave. He or she will throw up obstacles to slow or derail the process. The Power Blocker is different from the Hopeful Savior in the aggressiveness of approach. Whereas the Hopeful Savior is subtle, the Power Blocker is overt. He or she calls in favors with the board, makes direct personal appeals, or demands to stay.

Source: David F. Larcker and Stephen A. Miles (2011), cited in: David F. Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New York: FT Press, 2011).

EXHIBIT 2 — SENIOR EXECUTIVE DEVELOPMENT AND SUCCESSION PLANNING

SIX KEY ELEMENTS OF SUCCESSFUL SUCCESSION PLANNING

1. **STRATEGIC PLANNING.** Determine what capabilities, roles, and talent are needed to execute the business strategy today and in the future.
2. **TALENT ASSESSMENT.** Gauge the executive team’s bench strength. Do we have who we need (now and in the future) and if not, how do we get there?
3. **RECRUITING.** Develop a talent pipeline for key roles/jobs.
4. **PERFORMANCE ASSESSMENT.** Let people know they are valued contributors and provide them opportunities for development, exposures to executives, networking across divisions, etc. Get them on the corporate radar screen.
5. **DEVELOPMENT.** Create development plans for individuals (e.g., leadership workshops, classes, on-the-job learning, assignments, special projects, 360s, external classes, etc.)
6. **RETENTION AND ENGAGEMENT.** Reward and recognition, work environment, opportunities for development, job autonomy and scope of responsibilities, etc.

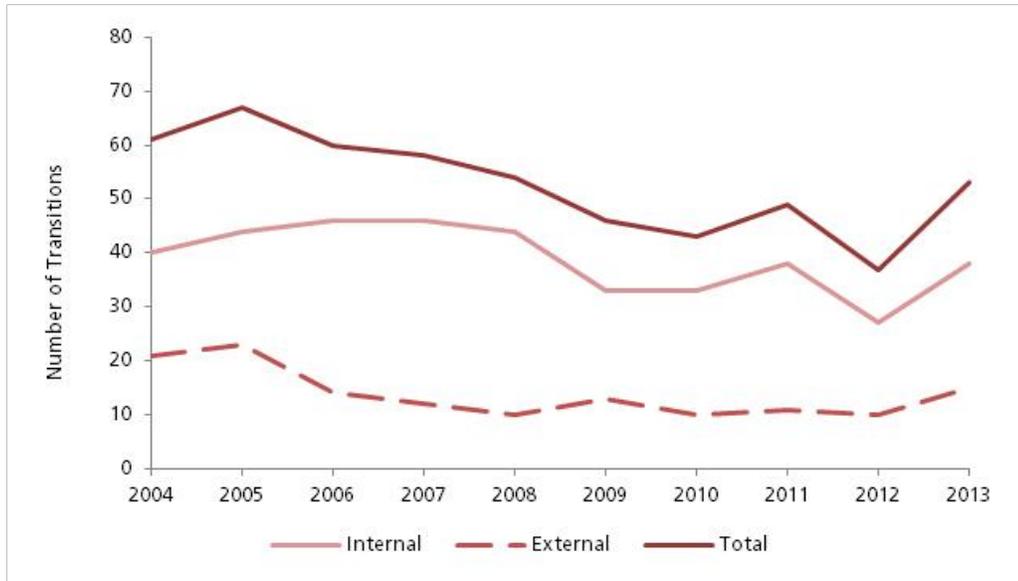
SAMPLE QUESTIONS TO CONSIDER BEFORE AND DURING MEETINGS

1. Current Organization Structure	2. Current Leadership Team	3. Identified Successors / Replacement Plans	4. Additional Talent Pipeline
Is the current structure working?	Who are your key players?	Succession plan, restructuring, eliminate job, etc.	Who are our high potentials? Focus on women and minorities
The right direct reports? Too many? Too few?	How are they doing?	Who are internal successors	What are their performance capabilities, potential?
Any job that isn’t but should be reporting to top executive?	What are their performance, career potential, & interests/aspirations?	Who are external successors?	What should we do to develop them?
Any missing capabilities that we need to recruit for?	Strengths, weaknesses, development needs?	Are they ready to step up? If not, what are we doing to help develop them?	
Critical jobs?	What are we doing to help develop them?	Retention risks (if no bigger job opens up or passed over)?	
Any other structural concerns?	Any retention risks?	Development thoughts/plans?	
	Any missing talent?		

Source: The Institute of Executive Development and The Rock Center for Corporate Governance at Stanford University, 2014 Report on Senior Executive Succession Planning and Talent Development, (2014).

EXHIBIT 3 — CEO TRANSITIONS: INTERNAL V. EXTERNAL SUCCESSORS

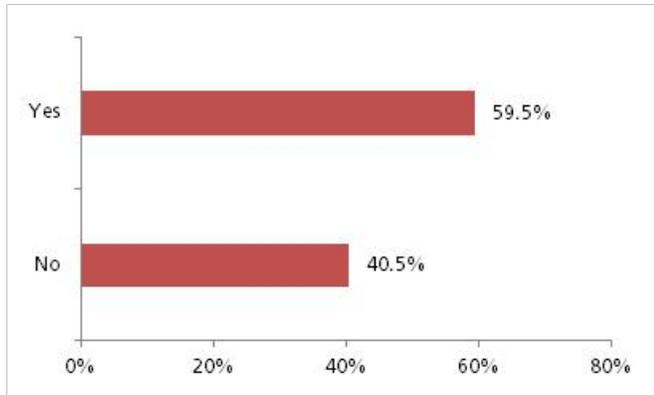
S&P 500 CEO TRANSITIONS (2004-2013)



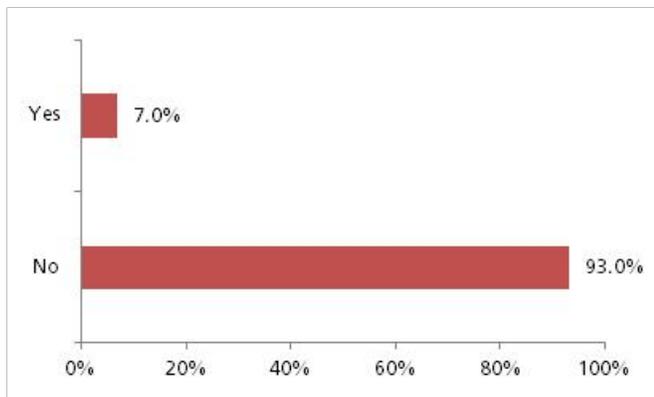
Source: Spencer Stuart, 2013 CEO Transitions.

EXHIBIT 4 — DIRECTOR KNOWLEDGE OF SENIOR EXECUTIVES

DOES YOUR COMPANY HAVE A FORMAL TALENT DEVELOPMENT PROGRAM FOR SENIOR EXECUTIVES BELOW THE CEO?



DOES YOUR COMPANY ASSIGN A BOARD MENTOR TO SENIOR EXECUTIVES BELOW THE CEO?



DO NON-EMPLOYEE DIRECTORS RECEIVE UPDATES OR PROGRESS REPORTS ON THE DEVELOPMENT OF SENIOR EXECUTIVES BELOW THE CEO?

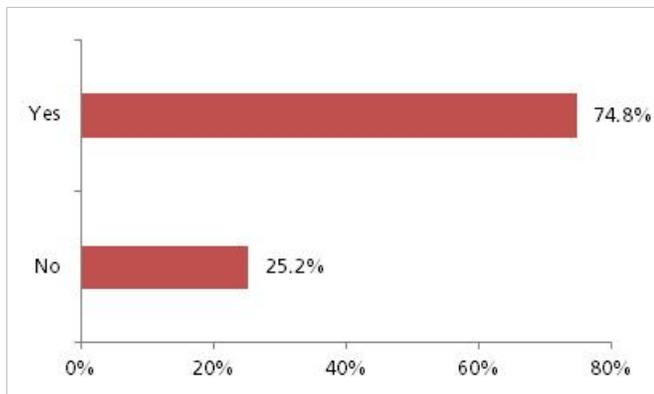
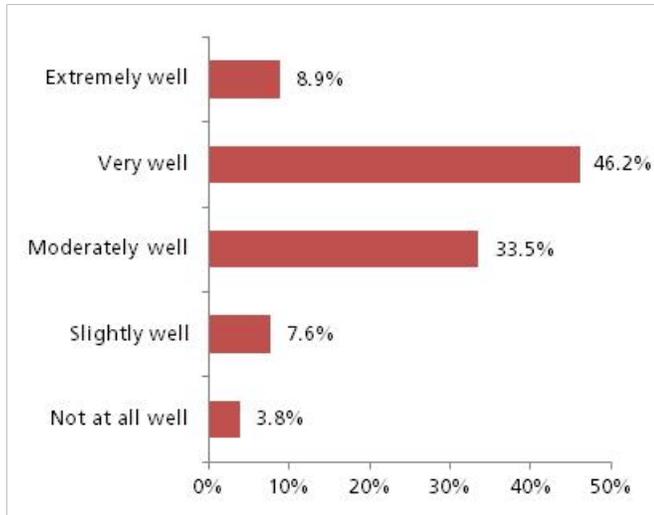
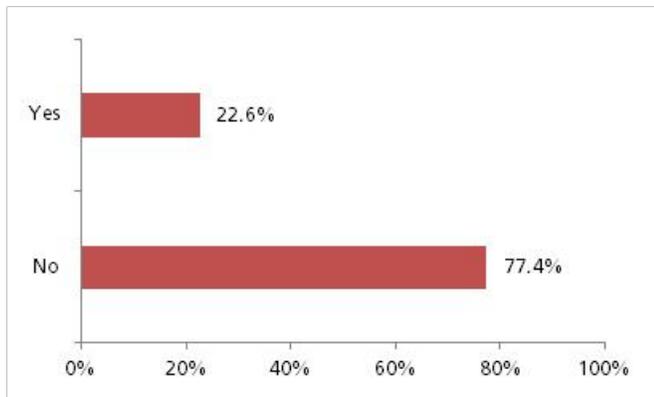


EXHIBIT 4 — CONTINUED

HOW WELL DO NON-EMPLOYEE DIRECTORS UNDERSTAND THE STRENGTHS AND WEAKNESSES OF SENIOR EXECUTIVES BELOW THE CEO?



DO NON-EMPLOYEE DIRECTORS FORMALLY PARTICIPATE IN THE PERFORMANCE EVALUATION OF THE SENIOR EXECUTIVES BELOW THE CEO?



Source: The Conference Board, The Institute of Executive Development, and the Rock Center for Corporate Governance at Stanford University, "How Well Do Corporate Directors Know the Senior Management Team?" (2014).