Boardroom Supports

Directors play a crucial role in selecting, training, and nurturing a new CEO.

by Ram Charan

Early in 2003, a director I know made headlines in the *Wall Street Journal* by stepping down from the board of a Fortune 50 company. Why did he leave? Did he suspect fraud in the company's accounting? No, the real reason was far less nefarious: The director stepped down because the CEO was not forthcoming about succession plans, despite the board's requests for information.

This director recognized that the CEO wanted to leave the company in good hands, but also wanted to choose his own person for the job. The director, a very well-regarded CEO in his own right, no longer felt comfortable representing shareholders under these conditions. He took a stand on a basic principle: It is the board's job — its most important job — to select the company's CEO.

He's not the only director who feels this way. Indeed, while regulators ponder corporate governance policy, many boards are quietly pursuing their own reforms. More directors recognize you can't legislate the skill, intensity, and dedication required of the board in selecting and working with a CEO.

Some of the rise in CEO turnover around the world is the result of malfeasance and abuses of power that keep the regulators busy. But crooked CEOs make up only a small number of CEO failures. Increasing turnover is also a reflection of boards' collective inability to select the right CEOs in the first place — and support them in their early years. When a board of directors has hired three CEOs in eight years and then asked each of them to leave, as happened at the U.S. retailer Kmart Corporation, you have to wonder what the board could have done differently to help these CEOs.

Illustration by Lars Leetaru

Succession Success

More than anything else, the boards I see now expect a robust, active CEO-succession planning process, one that may even begin many years ahead of the expected transition. This trend is becoming particularly prevalent in large companies. One of the two questions I hear most frequently from new directors of the giants is this: What is the succession process? (The other question: Is the strategic direction of the company clear?) Directors want to know whether the board is in control of succession. In the past, more often than not, CEOs handpicked their successors, and directors spent little time or effort on succession. Of course, CEO input in selecting successors is critical; nobody knows the business or the internal candidates better than the CEO. But boards are beginning to act more independently, especially when it comes to the final decision on CEO selection. And they're working more closely with their new CEOs once they're in.

A robust succession process, such as General Electric Company's well-documented search for Jack Welch's successor, involves a decade's worth of work. At GE, all directors personally visited and assessed candidates during that period. Over time, the pool of candidates evolved as the directors drew their own conclusions. No one would argue with the subsequent selection of Jeffrey Immelt to succeed Jack Welch. GE executives, directors, employees, and outside analysts believe that Mr. Immelt is taking GE to the next level in a steady and resilient fashion, despite the challenging business environment. He has put the company on an accelerated path to profitable top-line growth, while maintaining the intensity of everyday productivity improvement. Such focused management has enabled the firm to maintain very respectable growth in earnings per share.

The Right Stuff

How can boards translate their increased engagement into improved CEO selection? First, directors should avoid searching for a renaissance leader. Versatility and range of skill should be expected, but they are not enough. Most failed CEOs are meticulous, ethical, hardworking executives with a broad base of knowledge, experience, and skills. But they weren't right *for their company, at that time.*

When selecting a new leader, directors need to articulate very specific criteria. The reliance on a classic leadership boilerplate — e.g., strategist, tough negotiator, change agent; decisive, smart, inspirational, visionary, full of integrity — is not enough. Every company also has its own specific needs and faces a unique and continuously changing environment. A company like the energy firm Dynegy Inc., which confronted a deep cash crunch, clearly requires a CEO who brings the credibility with creditors that is needed to restructure the company's balance sheet.

On the other hand, a company that has grown too rapidly through acquisitions, and needs to take a breather to integrate those mergers, requires very different skills from its CEO, such as the ability to generate organic revenue growth. The boilerplate shouldn't be ignored, but skills specific to managing merger integrations need to dominate.

Consider the Bank of America Corporation's promotion of veteran Kenneth Lewis to CEO in 2001. Former CEO Hugh McColl was a superb deal maker who used dozens of acquisitions to transform the unknown small bank NCNB into the regional powerhouse Nationsbank and, following the merger with California-based BankAmerica, into Bank of America, the largest consumer bank in the U.S. But the bank experienced growing pains with the integration of various acquisitions and was underperforming.

As the succession process came

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to a head, the board began to crystallize its thinking around that one issue, acquisition integration. One director told me at the time that the right person for the job was someone who could bring everything together into a coherent whole, and build a trajectory of long-term value creation based on the corporation's strong U.S. consumer franchise.

Mr. Lewis, a company veteran who had joined NCNB as a credit analyst in 1969 and led several divisions, was the natural candidate. Since his ascension, the bank has temporarily halted its acquisitions and dramatically shifted its focus to organic growth, market segmentation, and cross-selling, and with great success. Mr. Lewis was named by *Fortune* in August 2003 as one of the 25 most powerful businesspeople in America, even though he had been in office for only two years.

Recently, we've seen a multitude of companies dismiss CEOs after short tenures, as happened at Kmart. In this case, the directors identified strong leadership skills, a past record of achievement, and restructuring abilities, but not the essential operational skills that the Kmart position required at the time. If the CEO could not master the supply chain, recruit the right merchandising executives, and differentiate the company against its archrival Wal-Mart Stores Inc., there would be little chance of success. Those criteria should have taken precedence over others, but the board seemed to repeatedly define the wrong criteria, so it failed to find the right match.

The damage to Kmart in terms of shareholder value, brand image, and employee sentiment has been very high. The board's failure to find the right CEO allowed management to drive this legendary mass retailer and American brand icon into bankruptcy.

Insider or Outsider?

Another step boards should take is to adopt best practices in leadership development, like those at GE. GE's approach to succession planning draws on its ability to identify and develop leaders internally. GE's leadership development processes help to maintain high-quality management throughout the organization. They also ensure that the board is able to select a CEO from among several strong internal candidates — which seems to be the best method, especially given today's CEO tenure patterns. Booz Allen Hamilton's CEO turnover research for 2002 reveals that insider CEOs have a tenure that is more than 50 percent longer than those of CEOs hired from the outside. (See "CEO Succession 2002: Deliver or Depart," by Chuck Lucier, Rob Schuyt, and Eric Spiegel, *s+b*, Summer 2003.)

During at least two board meetings per year, the best boards study the quality and depth of the executives in the leadership pipeline. They also ask how the company is filling its pipeline, and what mix of skills and geographical experience the up-and-coming managers possess. Companies with best-in-class leadership programs, such as GE, Colgate-Palmolive, and Johnson & Johnson, continually identify their next generation of leaders at all levels and give them opportunities to grow through management rotations and by having them participate in carefully designed, selective programs that sharpen their leadership skills. Years down the road, the directors who know the people in the leadership pipeline will have a leg up in the CEO selection process. The board will already be personally familiar with the skills and abilities of leading internal candidates.

Despite the preference for an internal candidate, however, boards shouldn't accommodate one by weakening their selection criteria. A board I worked with came to this conclusion during its recent CEO selection process. The board's search committee of six outside directors listened to lobbying from colleagues as well as managers in favor of one or the other of two internal candidates. Although this is a healthy and typical situation, the board ultimately acted independently when interviewing the prospective CEOs over a weekend. The committee broke into two groups, both of which separately interviewed each candidate. They met in the evening to talk about what they heard from the candidates. There was a remarkable consensus that the internal candidates, including those whom members of the search committee had earlier advocated, weren't qualified for the job.

The search committee also applied tough selection criteria when it interviewed three external candidates that same weekend. Earlier there had been a heated debate within the search committee over the critical attributes of the new CEO. Some criteria were quickly identified. For instance, the board decided to look for a steady performer (as opposed to a fast grower), someone who could bring a sense of urgency into the existing culture (as opposed to a radical change agent), and someone who could build a deep executive pipeline over time.

But the most important question the committee faced was, Should we substantially broaden the scope of the landscape in which we compete, or should we stay within the existing boundaries of the industry and design and execute a more aggressive strategy? In the end, the committee decided on the latter. Because of that decision, the leading external candidate was also eliminated because his claim to fame had been broadening the scope of his current company's businesses dramatically — and the directors were clear that was not what they were looking for. By the end of the weekend, the board rejected all five candidates, including the CEO's suggestion, and decided to seek out others.

After interviewing a second round of candidates, the search committee zeroed in on a successor. The directors interviewed the candidate twice more and personally checked his references in detail. The directors took the task very seriously and invested enormous amounts of time in it. They are confident their choice for a CEO will succeed because the directors were personally engaged with all aspects of the process, because they used selection criteria specific to the company and the time, and because they didn't compromise their criteria to accommodate candidates.

At least twice a year, the best boards study the quality and depth of the leadership pipeline.

Stand By the CEO

The collective judgment of the directors on a search committee is very powerful; equally powerful is the collective ability of directors to ensure that the CEO succeeds after appointment. First of all, boards that hire CEOs to execute a strategy should show backbone and stand up for CEOs when they do what they were hired to do.

When Vance Coffman was elevated to the CEO post of Lockheed Martin in 1997, he had to focus on finishing the integrations stemming from the 1995 merger of Lockheed with Martin Marietta and the 1996 acquisition of Loral. It was a difficult time for defense and aerospace, and Lockheed's stock price languished for several years as Mr. Coffman stuck to his integration timetable. His execution was not readily apparent to outsiders, but it was clear to the board. The board resisted outside calls to replace Mr. Coffman because it was confident in his plan. This confidence was rewarded when the business turned around in 2000. Mr. Coffman did for Lockheed Martin what Ken Lewis is now doing for Bank of America.

Boards also need to directly support incoming CEOs, both informally and formally. Directors should make themselves available to the CEO for informal dialogue, especially when they have specific expertise to offer. An outside director who is also a sitting CEO could be a sounding board on strategy and organization issues. A politically astute director could offer insights on legal and political issues. (I know one firm that hired a key executive for environmental affairs on the advice of a director who was a former regulator.) Some boards go so far as to appoint a director, usually a former CEO at a different firm, to be a coach for the new CEO.

The board should have formal mechanisms in place for presenting constructive feedback to the CEO. One opportunity to develop such feedback is through executive sessions, the closed-door meetings of nonexecutive directors that are now mandated by the Sarbanes-Oxley regulation. These boards pose hypotheses about people, strategy, acquisitions, and risks. And they debate them vigorously. Some turn out to be naive and are quickly discarded, but others carry more weight. Hypotheses I commonly hear include: The CEO's acquisitions and vision are good, but his team has not delivered on promises of execution. The CEO's focus is diluted. Our heavily loaded balance sheet and fast pace of acquisitions will come back to haunt us in a slow economy. Turnover among senior executives has been too high. When hypotheses such as these stand up to scrutiny among outside directors, it usually means they're important and need further examination. Why are these things happening? What are their effects? How can the board help? The discussion should then be communicated to the CEO in a constructive manner that enables action.

Of course, the best board advice is of no use if the CEO does not listen. Those who do will realize that directors are smart and experienced executives, and their talents and wisdom are invaluable resources that will strengthen the company's management and support its long-term success. The few who don't listen are the likely candidates to join the ranks of failed CEOs. +

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