



# CEO Succession Planning: Ready, Set...Pay!

Compensation Series

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**August 11, 2011**

Pearl Meyer & Partners  
*Comprehensive Compensation*<sup>®</sup>



ADVANCING EXEMPLARY BOARD LEADERSHIP



## Meet the Presenters



**Richard Goeglein** (moderator), Chairman of the Board, Pinnacle Entertainment; Vice Chairman, The Board of Veteran CEOs; Trustee, Board of Volunteers in Medicine of Southern Nevada



**Yvonne Chen** is a managing director in the New York office of Pearl Meyer & Partners, consults with companies ranging from Fortune 50 to pre-IPO, subsidiaries and joint ventures in the development of compensation objectives, value-based performance measurement and incentive plan design.



**Matt Turner** is a managing director in the Chicago office of Pearl Meyer & Partners specializes in executive compensation strategy, incentive plan design, tailoring of performance measures and assisting Compensation Committees in setting shareholder-focused performance targets.





## CEO Succession Today

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Our topics for today's webinar:

- **Who is focused on CEO succession?**
- **Why is it so important?**
- **What are the challenges?**
- **What are “best practices” for CEO succession planning?**
  - Who's involved, when/timing, scope of review process and how companies prepare for contingencies
- **Which compensation tools are effective?**
- **Questions?**





## Who is focused on CEO succession?

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**Everyone is focused on CEO succession, especially when it's a failure**

- **Shareholders and potential investors: lack of a CEO successor presents uncertainty and risk (Apple, Disney)**
- **Employees: the business and employee morale may suffer if top executives are distracted with a race to be the next CEO or if a new CEO is not selected quickly**
- **The media: extensive public scrutiny of prolonged Board deliberations is embarrassing (Hewlett-Packard; B of A)**





## Why is CEO succession planning so important?

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- **Because it happens with some frequency**
  - 48% of PM&P survey participants experienced a CEO succession within the past 5 years
  - CEO turnover is almost 20% per year among the PM&P Top 200 largest companies
- **Because it's the Board's responsibility**
  - Shareholders and proxy advisory firms expect the Board to have a robust CEO succession plan
  - Increasingly, Boards are disclosing their process in the proxy filing
- **Because the cost/negative impact of poor planning is high**
  - Reputational risk and loss of shareholder credibility
  - Selecting a CEO “under a microscope” may lead to poor decisions
  - Evidence that poor planning negatively impacts market value





# It's important, so how do you measure success?

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- **Successful outcomes**

- External: “the succession plan was so smooth that the change in CEO was a non-event in the media”
- Empirical data: strong stock price performance immediately after the new CEO announcement and 2-3 years later<sup>(1)</sup>
- Internal: new leader is quickly embraced by the management team

- **Avoiding visible problems**

- New external hire CEO can't take the job until his non-compete is litigated in court (Sprint)
- The Board didn't name a new CEO for months (Bank of America)
- New CEO leaves in less than one year (3Com)

(1) Deaths of CEOs: Are Delays in Naming Successors and Insider/Outsider Succession Associated with Subsequent Firm Performance? Behn et al, Journal of Management Issues, Spring 2006





## What are the challenges?

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- **CEO succession situations viewed as most challenging:**
  - Possible loss of candidates not chosen
  - No viable internal candidates
  - Iconic or owner/founder CEO is difficult to replace
  - Some situations are less frequent, but quite challenging when they occur, e.g., primary candidate is much less experienced, potential adverse impact of succession-related compensation
- **Although there is concern about loss of “runner ups”:**
  - 60% do not have a plan for retaining these internal candidates
  - 32% of these internal candidates left the organization
  - 31% stayed, but their pay and/or position was adjusted
- **Which was least challenging? Having too many CEO succession candidates**





## Case Example 1 – Growing Pains

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- **Public company with founder CEO**
  - Successful entrepreneurial firm has experienced multiple growing pains since IPO five years ago
  - Board “discovers” that there is no viable internal succession candidate and external recruitment suffers from perception of company risk
  - Direct reports are “under-experienced”
  - Board negotiates CEO departure and names an interim CEO from the Board
  - Significant recruitment and talent development challenges
  - Significant compensation gaps between old-guard and new-guard as new-guard is recruited into organization





## What are “best practices”?

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### “Best practices” framework for CEO succession planning

- **Who: establish who leads and who else is involved**
- **When/timing:**
  - Establish frequency of CEO succession plan review process
  - Determine which CEO succession time horizons to consider
  - Plan schedule for Board interaction with key internal candidates
- **Scope of review process:**
  - What information is needed (“tool kit”)?
  - What actions need to be taken based on the review?
  - What about internal vs. external candidates?
- **Contingencies: the emergency plan and managing the communication process**





## What are “best practices”?

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- **The “ideal” CEO succession planning process**
  - **Who:** is led by a Board Committee (Compensation or Nom/Gov)
  - **Who:** includes the current CEO and draws support from internal and external compensation experts
  - **When:** is conducted at least annually in executive session, even if a new CEO was just named
  - **When:** considers CEO succession scenarios over multiple time horizons (e.g., emergency, near-term, mid-term, long-term)
  - **Scope:** identifies 2-3 internal CEO candidates for each scenario, but also reviews availability/quality of external CEO candidates
  - **Scope:** proposes development opportunities for internal CEO succession candidates, including frequent Board interaction
  - **Contingencies:** formulates an internal communication strategy and prepares proxy disclosures to help shareholders understand the company’s process/preparedness





## What are “best practices” – Who?

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- **Who is leading the CEO succession planning process?**
  - Full Board of Directors
  - Compensation (and Management Development) Committee
  - Nominating/Governance Committee
  - Chairman (non-CEO)
  - Current CEO
- **Who is providing critical support for the Board?**
  - Compensation resources: Compensation Committee, Top Human Resources Executive and the External Compensation Consultant
- **Who is typically not involved?**
  - Other Advisers: Succession Expert or Executive Search Consultant
  - Other Executives

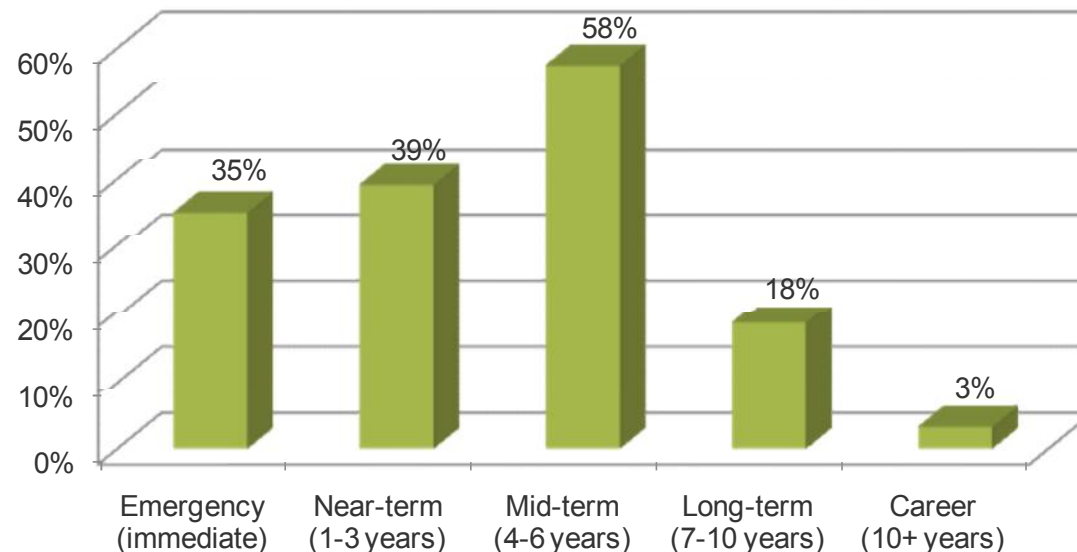




## What are “best practices” – When?



- **What CEO succession time horizons are considered?**
  - Most companies look 4-6 years into the future, but many companies also look at shorter time frames



- Surprisingly, almost one-third of companies have not identified an emergency CEO replacement to serve on an interim basis





## What are “best practices” – Scope?

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- **What should be in the CEO succession “tool kit”?**
  - Anticipated Time Horizon
    - Current CEO’s future plans
    - Board’s views on the CEO’s ongoing tenure (does the Board want the CEO to stay/leave?)
  - New CEO Position Profile based on future business needs
    - Leadership style – conservative vs. risk-taker; hands on vs. delegator, “me” vs. team, etc.
    - Leadership and business experience – P&L responsibility, industry expertise, financial acumen, international background, etc.
  - Leadership Ladders that identify internal CEO succession candidates for each potential time horizon/succession scenario
    - CEO succession candidates are likely to differ at different future dates
    - Also include list of candidates who would replace the CEO successor in their existing position (“cascade effect”)





## What are “best practices” – Scope?

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- **What should be in the CEO succession “tool kit”? (cont’d)**
  - Candidate Portfolios
    - “Gap Analysis” – evaluation of each candidate’s strengths and development needs
    - Identification of career “blockers” and plans to move those individuals
    - Analysis of retention risk – “snapshot” of current value and dynamic modeling over the succession planning time horizon
  - Competitive Assessment
    - Availability/quality of external candidates
    - Comparison with internal candidates
  - Action Plans
    - Development plans for key internal candidates
    - Approaches for addressing any “blockers” or significant retention risks
    - Strategy for gaining market intelligence on external candidates

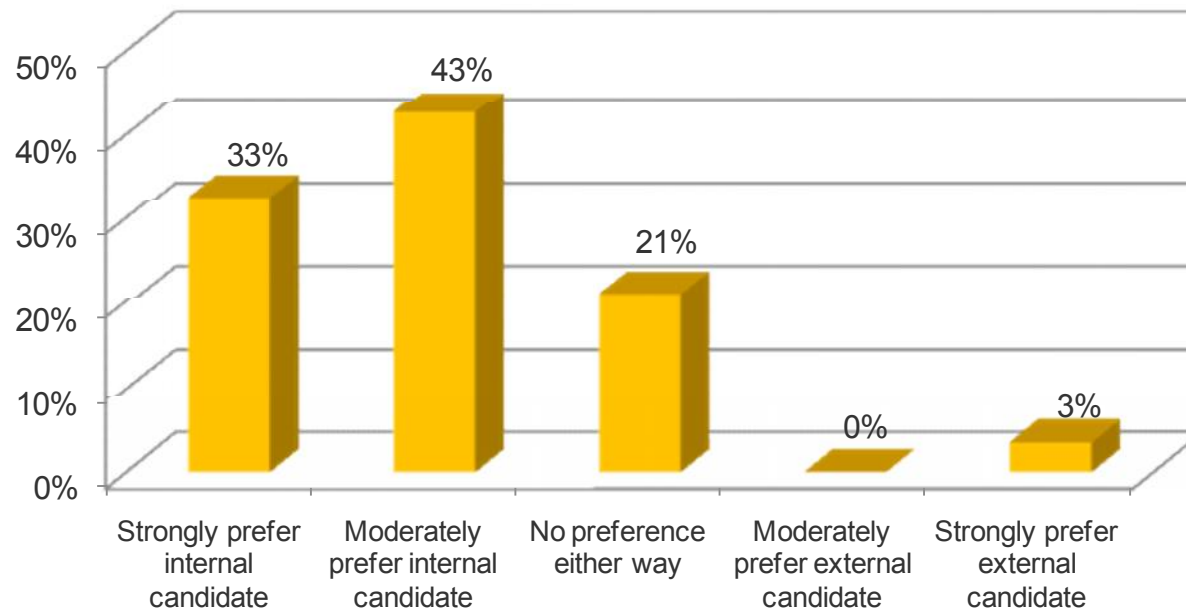




## What are “best practices” – Scope?



- **What about internal vs. external candidates?**
  - Over 75% of Boards prefer an internal candidate...



- However, only 54% of companies that experienced a CEO succession in the past 5 years chose an internal candidate

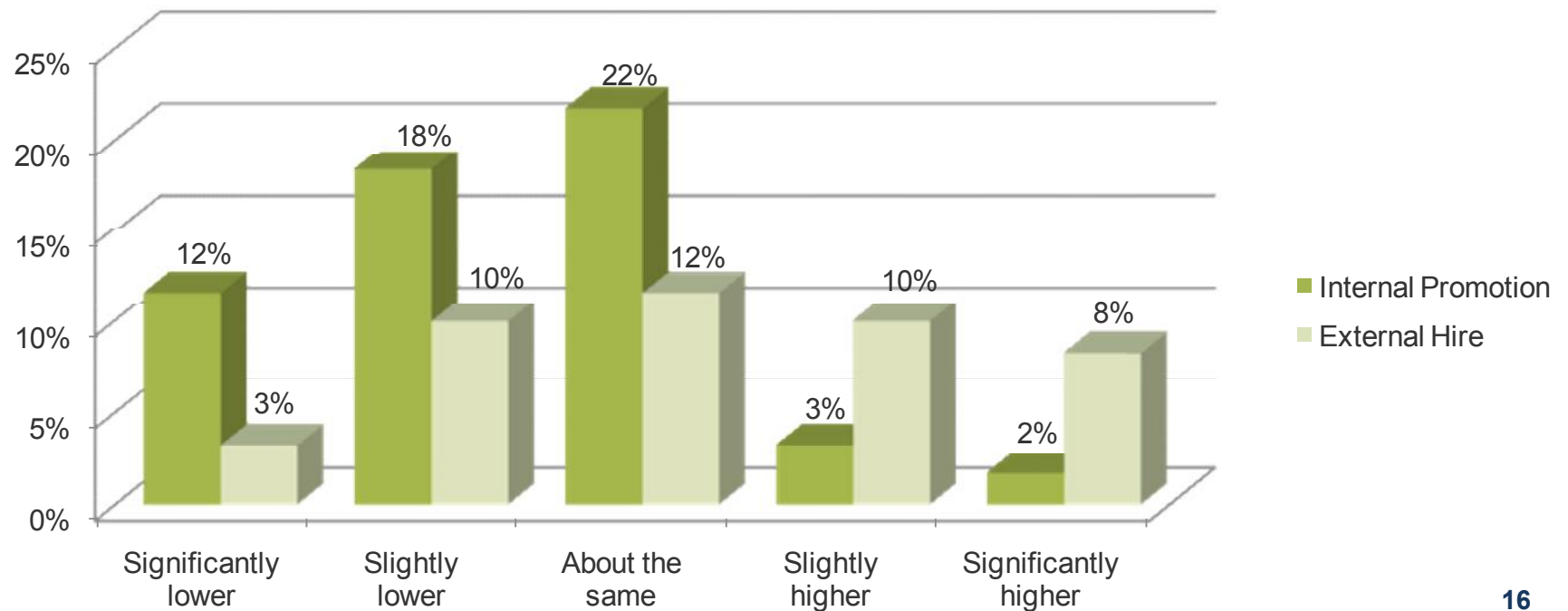




## What are “best practices” – Scope?



- But external hires can be costly. About 23% of new CEOs are paid slightly or significantly more at target than the previous CEO and 79% of those are external hires
- About 43% of new CEOs are paid lower and 69% of those were internal promotions

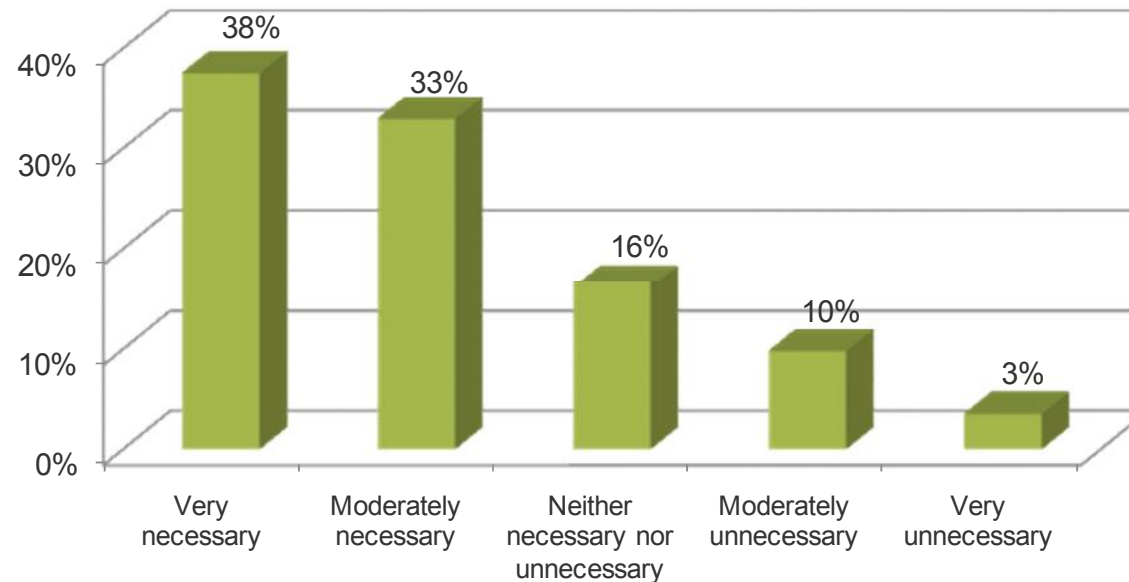




## What are “best practices” – Scope?



- **Despite Board preferences for internal candidates, 71% of Directors would still conduct an external CEO search**



- **In contrast, there is a knowledge gap about the availability/quality of external candidates outside of an active search**
  - Only 5% of Directors review external candidates at least annually
  - 32% never review external candidates outside of an active search





## What are “best practices” – Scope?

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- **How are companies developing internal CEO candidates?**
  - 86% are giving internal candidates more leadership roles
  - 66% are providing “face time” with the Board at least 4 times a year
  - 48% are giving internal candidates more exposure to the public
  - 31% are rotating jobs
  - 30% are providing an executive coach
  - 13% are asking a Board member to act as a mentor





## Case Example 2 –Special grant and company commitment to executive development

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- **Privately-held manufacturing company CEO retires**
  - Two internal candidates nearly the same age
  - Runner-up (CFO) has strong desire to be a CEO; believes that his next few years are critical in his career path
  - Company wants to retain CFO, but also wants to be fair to his career desires
  - Supplemental cash retention grant with long-term vesting
  - CFO named EVP and is given some operations responsibilities
  - Contract modified to trigger accelerated vesting if CFO is not named successor in two years or has not become CEO in three years





## What are “best practices” – Contingencies?



- **What should be in an emergency plan “tool kit”?**
  - Name of interim CEO replacement
  - Definition of what constitutes an emergency (e.g., CEO is incapacitated/unavailable for 12 hours/3 days?)
  - Emergency “call chain” – who should be called, who will make those calls, in what order, within what time frame, list of emergency phone numbers/contact information
  - Board resolutions authorizing interim CEO replacement to assume the CEO responsibilities
  - Draft press release(s) to be filled in with nature of emergency
- **Other emergency plan preparations?**
  - CEO’s family members should know who/when to call
  - Emergency plan process should be tested as a “fire drill”
  - Maintain backup outside the company (e.g., outside counsel)





## What are “best practices” – Contingencies?

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- **Not everyone knows the CEO succession plan details**
  - 45% of companies have not told their internal candidates
- **Even in an emergency plan, not everyone knows...**
  - At 13% of companies, some Board members don't know who the emergency interim CEO replacement is
  - At 19% of companies, the individual doesn't know
- **Confidentiality vs. potential disaster?**
  - Confidentiality may be more important for succession candidates in the mid-term (4-6 years)
  - However, companies should have private conversations with the emergency and near-term candidate(s)
  - One Board was caught off guard when the “name in the envelope” decided he wasn't interested in the job

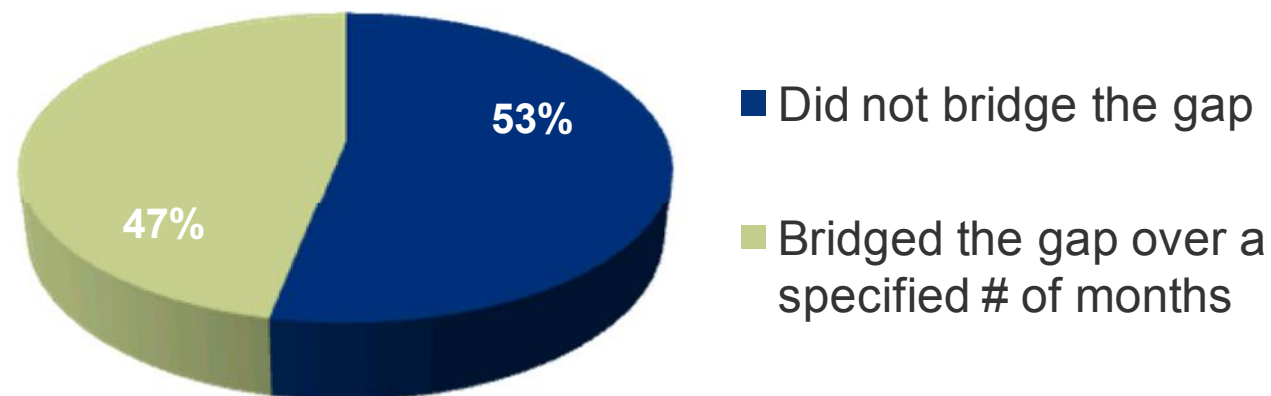




## Which compensation tools are effective?



- **Compensation tools fall into two broad categories:**
  - The “Regular” Program: use elements from existing plans
  - Special Pay Arrangements: tailored to the individual/situation
- **The “Regular” Program is typically used to bridge the gap once an internal candidate is promoted to CEO**
- **However, a new CEO is not immediately bumped up to market median, contrary to the “Lake Wobegon effect”**

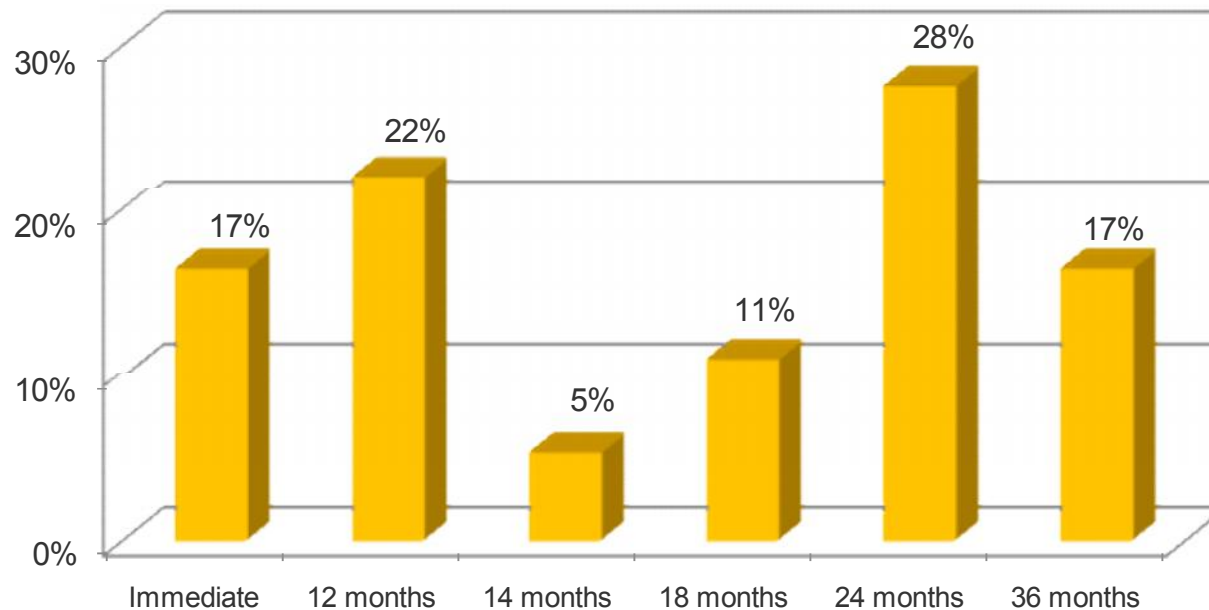




## Which compensation tools are effective?



- Companies that bridged the gap for a new CEO mostly did so over 18 months or longer
- Higher prevalence of 24 months may be an unintended consequence of ISS's 2-year "window" for new CEOs under their CEO pay-for-performance test





## Case Example 3 – Retaining Runner Ups

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- **Special pay arrangements may be necessary when the regular compensation program is not enough**
  
- **Technology company CEO retires**
  - Three strong internal candidates
  - Board double promotes one candidate (business leader) over CFO and head of sales
  - Multiple compensation tools used to help retain runner-ups
  - Issue: base salary increases have ripple effect on other senior hires in following years
  - Issue: New CEO has a significant gap to market median; ISS concerns and recent business results make CEO and board reluctant to make-up the gap





## Which compensation tools are effective?



### ▪ Consider the potential impacts of compensation tools

The "Regular" Program	Special Arrangements
<ul style="list-style-type: none"><li>• Use elements from the existing compensation program</li></ul>	<ul style="list-style-type: none"><li>• Tailor special compensation to the individual and the specific situation</li></ul>
<b>Advantages:</b>	
<ul style="list-style-type: none"><li>• Pay element is already understood</li><li>• No misalignment with existing program</li><li>• May be less visible to shareholders as extra pay</li></ul>	<ul style="list-style-type: none"><li>• May be tailored to match the situation</li><li>• Sends clear signal to the individual</li><li>• May be used to signal to investors who will be next CEO</li></ul>
<b>Disadvantages:</b>	
<ul style="list-style-type: none"><li>• May not match specific situation, e.g., succession timing</li><li>• Usually not tied to development goals</li><li>• Individual may not fully value the pay action as special</li></ul>	<ul style="list-style-type: none"><li>• Potential for misalignment with existing compensation program</li><li>• Adds complexity/another layer of pay</li><li>• May be more visible to shareholders as extra pay</li></ul>





## Which compensation tools are effective?

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- **Lessons learned about using compensation to support CEO succession planning**
  - An ounce of prevention is worth a pound of cure. Make sure the “regular” program is aligned with the succession plan and builds sufficient retention value for key internal candidates
  - Large pay gaps between internal succession candidates and the CEO may signal:
    - Lack of near-term candidates in C-suite roles
    - Need to bring the new CEO to market over a longer time period
  - CEO succession planning is not aligned with internal pay parity
  - Compensation should not be the first or only solution
    - Career path and development experiences matter to candidates
    - Extra pay won’t keep a “runner up” who really wants to be CEO now
    - Not everyone is a retention risk





## Appendix: Proxy Disclosure Rules and “Best Practices”

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- **Proxy disclosure is not required by the SEC**
- **Also not required as part of Committee and Board charters**
- **However, disclosure is required by NYSE Section 303A.09**
  - Listed companies must adopt and disclose corporate governance guidelines which must include succession planning:
    - Policies and principles for CEO selection and performance review
    - Policies regarding succession in the event of an emergency or the retirement of the CEO
  - The guidelines must be available on or through company website
  - Proxy statements must indicate that guidelines are available on the website and provide website address
- **Disclosure is not required by NASDAQ, but many NASDAQ companies follow NYSE rules as best practice**





## Appendix: Proxy Disclosure Rules and “Best Practices”

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- **Companies are starting to include discussion of their CEO succession planning process in the proxy filing**
  - 26 of the Dow 30 companies provide some disclosure, with 9 companies providing discussion on CEO succession planning
- **Two companies (Apple and Kohl’s) received shareholder proposals in 2011 regarding CEO succession planning (neither passed, but ISS typically supports this proposal)**
- **Disclosure language may include:**
  - Whether the full Board or a Committee has been delegated responsibility for CEO succession planning
  - How frequently CEO succession planning is discussed
  - Whether executive sessions (without management) are held
  - What role(s) the CEO or other managers have in the process
  - What is the scope of the process (e.g., types of positions, etc.)





**Thank You**

