The Handpicked CEO Successor

By David F. Larcker, Stephen A. Miles, and Brian Tayan
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The shareholders of public corporations have considerable interest in the choice of individual to serve as CEO of their company. They want to be assured that the company has a viable plan in place to replace the current CEO if necessary, either because an emergency arises or in the event of a scheduled transition. A viable succession plan includes knowing that potential candidates have been thoroughly vetted in terms of their strategic vision, operating skill, leadership, and cultural fit with the organization.[1] Indeed, a 2013 survey by PricewaterhouseCoopers finds that shareholders rank CEO succession planning among the most important issues facing boards of directors, along with strategy, risk management, and executive compensation. Eighty-six percent of respondents consider CEO succession "the most important" or a "very important" issue for the board.[2]

That said, it is not easy to determine which individual is best suited to serve as the next CEO. Historically, boards have not had detailed knowledge of the leadership skills of the senior management team and therefore tended to defer to the judgment of the outgoing CEO in the choice of a successor. The assumption was that the CEO has the closest working relationship with internal candidates and therefore is in the best position to assess who should succeed him or her going forward. To this end, the towering CEOs of a generation ago—including William Graham at Baxter International, William Spoor at Pillsbury, and Donald Kendall at PepsiCo—handpicked their successors at the end of their long tenures.

Because selecting the CEO is one of the key tasks for a board of directors, it is not surprising that current governance standards have moved away from this practice. Today, the board is expected to be heavily involved in succession planning for top executives. This includes ensuring that the company has a reliable program in place to develop internal executives, establishing a sound process for evaluating their progress, and consulting with third-party advisors to gain an objective assessment of the skills of internal managers relative to the external market. However, when it comes to actual *selection*—the specific act of deciding who will serve as the next CEO—some boards still defer to the recommendation of the outgoing CEO.[3] This is often determined by their success and tenure, with successful CEOs receiving greater deference from the board to participate in or make the decision. General Electric, where Jack Welch was responsible for selecting Jeff Immelt in 2001, is a classic example of a company where the CEO was given discretion to make the selection decision.[4]

In some circumstances, this approach might be warranted. The CEO can contribute positively to selection if his or her recommendation is based on the results of a robust evaluation, if the CEO is fully transparent with the board on each executive's progress, and if he or she is open-minded about the ultimate outcome. It is important that personal biases that come from day-to-day interactions with close associates do not influence the decision.[5] The CEO's judgment is also more likely to be objective when he or she has previously participated in the selection process as the director of an outside corporation. For example, Alan Boeckmann, former CEO of Fluor Corporation, gained experience in succession while a director of Archer Daniels Midland, participating in the selection of Patricia Woertz as CEO in 2006, before participating in the selection of his own successor in 2011.

At the same time, there are many reasons why the CEO should not be responsible for selecting a successor. First, most CEOs have minimal experience in evaluating CEO talent. The decision to promote or reassign a senior executive to a new functional area is very different from a decision to give that individual primary responsibility for the entire organization. Many senior executives perform well their entire careers only to fail as CEO because they lack the leadership or managerial qualities necessary to succeed at the very top. For this reason, previous experience in CEO selection is critical.

Second, despite their interest in the long-term success of the organization, CEOs are also concerned with their personal legacy. A retiring CEO might want to ensure continuity of the strategy that he or she has put in place, when instead the company requires change. Other CEOs might actually want their successor to fail—or at least perform worse than they did—as validation of their importance to the organization or so that they might be invited to return and "save" or "fix" the company. To this end, the motivations of the outgoing CEO need to be taken into account.[6]

Third, strong and successful CEOs often believe that it is their right to handpick a successor, given their contribution to the company and the belief that the board of directors does not know the company well enough to make the correct decision. For example, Zajac and Westphal (1996) find that powerful CEOs play an integral role in the selection of their successor, and that they are more likely to steer the choice of a successor toward one who has characteristics similar to themselves.[7] However, these individuals, because of their long association with the company, might lack perspective on how the organization needs to change going forward.

There is little rigorous research to establish whether CEO-selected successors perform better or worse than board-selected successors. The problem is primarily methodological: it is difficult to establish from external sources—such as press releases, corporate disclosure, or the media—whether the outgoing CEO or the board of directors actually made the selection decision.[8] Still, the nonscientific evidence is not promising. Among a sample of clearly identifiable handpicked successors at Fortune 250 companies between 2000 and 2011, almost *80 percent* underperformed the S&P 500 Index during their tenure. The average amount of underperformance was 24 percentage points (see Exhibit 1). While the results of this sample are obviously not based on rigorous methods, they nevertheless suggest reason for caution before abdicating the selection decision to the CEO.

WHY THIS MATTERS

1. Outgoing CEOs have many useful insights into the executives in consideration as potential successors. They also have personal biases that can impair their judgment. How does the board gain access to the valuable information that a CEO can offer without it being inappropriately "filtered" by these biases?
2. An outgoing CEO might exhibit behavior that is detrimental to the succession planning and selection process—such as blocking a disfavored candidate, or advocating on behalf of a favored candidate or candidate similar to him or her. These behaviors can be very difficult to detect when done well. What conditions would lead the board to *exclude* the outgoing CEO from the selection process? What are the "tells" that the board needs to proactively reduce his or her influence?
3. The companies listed in Exhibit 1 include examples of both successful and unsuccessful handpicked successors. Under what conditions are handpicked successors likely to succeed? When are they more likely to fail? Should CEOs who are a founder of the company or a founding family member have greater latitude to choose their own successor? Or do they too lack perspective on needed change? ■

[1] For more on CEO succession see: David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and their Consequences*, Chapter 7: Labor Market for Executives and CEO Succession Planning (New York, NY: FT Press, 2011).

[2] PricewaterhouseCoopers, "2013 Investor Survey: Through the Investor Lens; Perspectives on Risk and Governance" (2013).

[3] According to a 2010 survey of corporate directors, 11 percent of companies assign primary responsibility for succession planning to the chief executive officer. This is a self-reported number, and

the actual prevalence of CEO-led succession is likely higher. See Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, "2010 CEO Succession Planning Survey" (2010).

[4] According to Welch: "Making the pick was not only the most important decision of my career, it was the most difficult and agonizing one I ever had to make." For a full account, see Jack Welch, *Jack: Straight from the Gut* (New York, NY: Grand Central Publishing, 2003).

[5] A common bias is that the CEO has observed the internal candidate in a junior executive role along with all their successes and, more importantly, failures. It can be difficult for the outgoing CEO to envision this person taking his or her place. Conversely, the CEO might look favorably on a direct report with whom he or she has a close working relationship even though this person is not well suited to become CEO.

[6] For more on CEO personality types, see David F. Larcker, Stephen A. Miles, and Brian Tayan, "Seven Myths of CEO Succession," Stanford Closer Look Series No. 39 (March 19, 2014).

[7] Edward J. Zajac, and James D. Westphal, "Who Shall Succeed? How CEO/Board Preferences and Power Affect the Choice of New CEOs," *Academy of Management Journal* (1996).

[8] Corporations tend to avoid using language that suggests CEO influence, while the media tends to use the phrase "handpicked successor" more liberally.

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EXHIBIT 1 — HANDPICKED CEOS: PERFORMANCE VERSUS S&P 500 INDEX

Company	Outgoing CEO	Successor CEO	Year	Tenure (years)	Still CEO?	Stock Price Change	S&P 500 Index Change	Difference
Apple	Steve Jobs	Tim Cook	2011	3.2	Yes	101%	71%	30%
Bank of America	Hugh McColl	Ken Lewis	2001	8.9	No	-68%	-13%	-55%
Carnival	Micky Arison	Arnold Donald	2013	1.3	Yes	15%	25%	-10%
Citigroup	Sandy Weill	Chuck Prince	2003	4.1	No	-24%	48%	-71%
Dell	Michael Dell	Kevin Rollins	2004	2.6	No	-32%	31%	-62%
General Electric	Jack Welch	Jeff Immelt	2001	13.2	Yes	-35%	86%	-121%
Honeywell	Larry Bossidy	Dave Cote	2002	12.7	Yes	179%	84%	95%
Marriott	Bill Marriott Jr.	Arne Sorenson	2012	2.6	Yes	99%	42%	57%
Men's Wearhouse	George Zimmer	Douglas Ewert	2011	3.4	Yes	50%	59%	-9%
Microsoft	Bill Gates	Steve Ballmer	2000	14.1	No	-35%	26%	-61%
Northrop Grumman	Kent Kresa	Ronald Sugar	2003	6.8	No	28%	30%	-2%
Staples	Thomas Stemberg	Ronald Sargent	2002	12.7	Yes	7%	84%	-78%
Target	Robert Ulrich	Gregg Steinhafel	2008	6.1	No	7%	34%	-26%
Xerox	Anne Mulcahy	Ursula Burns	2009	5.3	Yes	101%	119%	-18%

Note: Sample includes CEO succession among Fortune 250 companies between 2000 and 2012. All CEOs in the sample were described as a "handpicked successor" by one or more press articles and had explicit evidence that the outgoing CEO had considerable influence over the selection process through direct statements or accounts. Stock price change measured over the tenure of the CEO or until October 31, 2014 for those still serving as CEO.

Source: Research by the authors. Share price information from Center for Research Security Prices (University of Chicago) and Yahoo! Finance.