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Succession Planning and Crisis Management

2008 NATIONAL DIRECTORS INSTITUTE

SUCCESSION PLANNING AND CRISIS MANAGEMENT

INTRODUCTION

"Succession Planning and Crisis Management" was a featured breakout session at the seventh annual National Directors Institute hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The panel discussion was led by Foley Commercial Transactions and Business Counseling Partner Gregory Monday, along with Robert Hallagan of Korn/Ferry International, Betsy Neville of FD/Ashton Partners, Damian Walch of Deloitte & Touche LLP, Jason M. Wortendyke of UBS Securities LLC, and Edward Pendergast of Pendergast & Company.

THE PROBLEM AND ITS CONSEQUENCES

Succession of leadership is a natural part of the life cycle of a company, and it is likely that a director will experience a leadership succession several times in his or her tenure on a board of directors. While gradual and deliberate succession is ideal, the problematic nature of leadership succession arises when the leader (i.e., the CEO) is lost suddenly.

Many circumstances can lead to a CEO succession crisis. Heart attacks, car accidents, and similar traumatic events are situations that tend to come to mind, but there are many more common circumstances that can lead to a CEO succession crisis such as when the CEO is attracted away from the company for a different job, when the CEO commits an actual or an alleged breach of ethics or legal duty, cases of fraud, and situations involving CEO underperformance. Interestingly, studies show that the percentage of boards that engaged in CEO leadership crisis planning more than doubled following the events of September 11, 2001. While this is a normal human reaction to a traumatic event, a prudent board of directors really needs to focus on the myriad less dramatic ways that can result in the need to replace a CEO.

A succession crisis involving the CEO can very quickly result in long-lasting damage to profitability and share price if a company is unprepared and not able to respond swiftly and effectively. A so-called death spiral can occur if the loss of the CEO results in the departure of other executives or key employees and a subsequent message of chaos at the top to such external constituencies as customers and large shareholders.

Research suggests that in the event that a CEO is lost suddenly, there is a direct correlation between the amount of time that a company takes to name a new CEO and the subsequent performance of that company. Research also suggests that in the long run, the naming of a company insider, as opposed to an outsider, has a positive effect on both subsequent actual performance and stock price.

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Despite this empirical evidence, experts suggest that subsequent performance by a company following a leadership succession is largely dependent on the company's fundamentals at the time of the succession crisis. If the company has strong fundamentals, the ability of the board of directors to rapidly put in place a successor CEO may not be as important as the empirical evidence would suggest. A strong company can probably operate for a fairly significant amount of time in the absence of a chief executive without losing too much momentum, or at least can preserve the status quo. This view as to the importance of swiftly replacing the lost CEO should not be misconstrued, however. A company needs to have and to communicate an immediate succession and crisis management plan in order to address the sudden loss of leadership.

IMPLEMENTATION OF A PLAN

The market abhors uncertainty, so a company needs to come forward quickly with an effective plan to address the leadership vacancy. Coming out quickly probably means to do so within six hours of the loss of the CEO. The company's various constituencies need to be reassured that the board is organized and well prepared to deal with the crisis (i.e., that the company has not become a rudderless ship).

Naming a new CEO immediately need not necessarily be included in the rapid response plan, however. The more prudent approach may be to name an interim CEO immediately in order to calm the company's various constituencies and then to proceed with the deliberate process of finding the right person to permanently replace the lost executive. The worst scenario is a board that rushes to a conclusion and then finds itself with the wrong person in the CEO position several months or a year later.

In some cases, a ready replacement from inside the management team may be obvious, but as discussed in more detail below, it is rare for there to be such an individual prepared to immediately take over the job. Regardless of the process that the board determines to use, and to what extent that process is informed by counsel from the outgoing CEO, it is the board's ultimate decision as to who will fill the vacated position.

THE PLANNING PROCESS

It is unequivocally the responsibility of the board of directors, as fiduciaries, to make sure that a company is prepared to respond to a leadership contingency in a way that protects the company's share price and its goodwill. A director is elected to the board in order to preserve the long-term shareholder value of the company, and good leadership is clearly correlated to the overall success of a company. Thus, there is really no more fundamental responsibility of a board of directors (i.e., there is no better way for a board to add value to a company than to focus on creating an effective leadership succession plan).

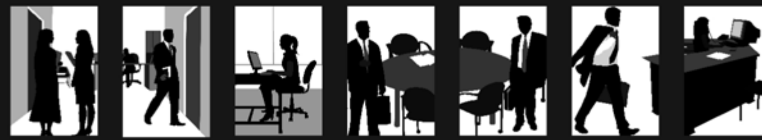
Notwithstanding the value of succession planning, boards of directors as a whole spend precious little time on the issue. Perhaps one of the reasons that CEO succession planning often does not appear on the agenda when it should is the nature of the job of chief executive. CEOs tend be insular, type A individuals. They want to focus on running the day-to-day operations of their businesses, and they want their teams to do the same. Rarely do CEOs naturally share information in a way that would create an heir apparent, as this is commonly viewed by them as a cession of power.

To a CEO, a clear heir apparent waiting in the wings means that upon any change in the company's performance, the board could easily begin to look to that successor. In contrast to what a board of directors may prefer, a CEO in most cases probably would not appreciate the knowledge that a successor exists with the ability to take over his or her job within a few short hours. In other words, if the matter is left exclusively to the CEO, a very weak successor may be the result.

Board oversight and control of the CEO is thus required to ensure that he or she is not only running the business but also developing people to be possible successors. The board's goal is to be sure that the CEO has a robust talent team. Ideally, there should be somebody identified by the board and the CEO who has the potential to ascend. Of course the flip side of that scenario is a case where that potential successor appears to be ready to go at a moment's notice. That situation, clearly, can create friction with the existing CEO.

One task that boards of directors should undertake in crisis succession planning is to make a list of the various things that could happen and attempt to plan for them. As discussed above, the sudden loss of a CEO can occur in many forms, including physical or mental incapacity, ethical breaches, or even the sudden departure of a CEO for another job. A board of directors should proactively determine, to the extent possible, what action it will take in each possible scenario. Thinking through the various scenarios may enable the board to engage in valuable crisis prevention measures as well as crisis management. For example, in order to engage in preventative planning for incapacity issues, the board may decide to require the CEO to have an exhaustive yearly physical examination and discuss the results with the lead director.

In undertaking these discussions and planning exercises, as well as in the effort to create a leadership contingency plan, a board of directors should allow professional advisers to be involved in the succession process before a crisis occurs. Public relations firms, executive search professionals, and corporate counsel find that their services are more effective and easier to perform if they are involved in the proactive planning process, and thus have a deeper understanding of the culture of a company, before a company finds itself with an immediate need to respond to a crisis. A board should consider the value that can be added by engaging these professionals early and often.



SUMMARY

Unexpected succession of leadership should not, in fact, be unexpected. The sudden loss of a CEO, as a result of one of a variety of circumstances, is a common and natural occurrence. A company that is not prepared for this contingency risks long-lasting damage to profitability, share price, and constituent relations. The manner in which a company creates and implements a succession plan, whether it be by communicating the identity of the heir apparent to its various constituencies ahead of a leadership crisis or by appointing a trusted insider as an interim CEO speedily following the sudden loss of a CEO, is a fundamental duty of the board of directors. Thus, a company's investment of time and money now in the proactive planning process will prevent a loss of company value when CEO succession inevitably occurs.

FOR MORE INFORMATION

For more information on the "Leadership Succession and Crisis Management" session, please feel free to contact the speakers directly:

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