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Board and Management Succession Planning

NATIONAL DIRECTORS INSTITUTE

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On March 25, 2009, Foley & Lardner LLP presented "Board and Management Succession Planning" as part of its National Directors Institute — 2009 Web Conference Series. Foley Transactional & Securities Partner Steven W. Vazquez moderated the panel, which included Cindy Burrell, Vice President, Corporate Relations and Referrals at Boardroom Bound, and Evelyn Dilsaver, Director at Aeropostale, Tamalpais Bank, and High Mark Funds. The panel discussed the importance of devising board and management succession plans, the core elements of such plans, and the issues and obstacles that boards of directors can expect to encounter during the planning process.

Management Succession Planning

The CEO and other senior corporate officers typically possess a valuable combination of intelligence, skills, and experience. Because they play roles of obvious importance within a corporation, the loss of a senior officer can have a profound impact on the corporation's short-term operations and long-term prospects for success.

Boards of directors have a fiduciary duty to address major business risks to which the corporation may be exposed, including the inevitable loss of senior corporate officers. Addressing the loss of senior corporate officers on an ad hoc basis can prove unwise and costly. Without proper planning, boards often find it exceedingly difficult to attend quickly and effectively to all of the tasks associated with replacing a senior officer. Such tasks include, but are not limited to, assigning executive search functions to committees or external recruiting firms, identifying qualified candidates to succeed the departing officer, interviewing and negotiating with such candidates, communicating the officer's departure to the corporation's constituents, and addressing numerous administrative and legal matters, including securities filings. Accordingly, every board of directors must develop — and regularly review and revise — detailed and carefully crafted management succession plans.

Assign Responsibility for the Plan

Management succession planning is a board-driven process. However, the identity of the entity responsible for drafting and refining such plans will vary from corporation to corporation. In some corporations, the full board of directors will participate in the formation of the plan. To some extent, full board participation in the planning process is sensible. After all, the full board will ultimately supervise and work with the officers appointed in accordance with the management succession plan.

However, the board of directors of some corporations should delegate the responsibility of forming the management succession plan to a committee of independent directors. For example, founder-based boards often struggle with management succession planning. Preparing for the arrival of the corporation's second generation of senior officers can be an emotional and difficult process. However, founder-based boards can, to some extent, circumvent such difficulties by delegating responsibility for developing the management succession plan to a committee of independent directors.

Identify "Springing Events"
The board of directors should identify the various events that would spring the plan into action. The planned retirement of a senior corporate officer is the springing event that most directors associate with management succession plans. However, the plan should anticipate the occurrence of other springing events such as the unexpected death, incapacitation, or resignation of a senior officer, or any other event that would have a material impact on the officer's ability to fulfill his or her job duties such as scandal or criminal charges.

The board of directors also should tailor the management succession plan according to the nature of the various springing events. For example, with respect to the incapacitation of an officer, the plan should specify what constitutes "incapacitation" and whether the officer may reassume his or duties. Additionally, a plan may dictate that a senior officer provide training or mentoring to his or her successor in the months immediately preceding such officer's retirement. Obviously, such training would not be possible where the officer unexpectedly dies or becomes incapacitated.

Identify Covered Officers
The board of directors should develop a management succession plan for all officers who play a critical role within the corporation and who may be particularly difficult to replace. Such persons typically include the CEO, COO, CFO, and senior vice presidents, but also may include department or division chairs and other key personnel exercising control over large numbers of employees or aspects of the business.

Identify Company Insider Successor Candidates
Most boards will find that company insiders are better suited than outsiders to succeed senior officers for several reasons. First, the board can readily interact with promising company insiders to determine whether such individuals possess the requisite intelligence, professional skills, interpersonal skills, and understanding of the relevant markets and the corporation's business plan. Second, company insiders are familiar, and presumably compatible, with the corporation's culture. Third, the corporation's other employees will be familiar with and, hopefully, more comfortable working with the company insiders. Accordingly, the board of directors should identify company insiders who may be qualified to succeed the corporation's senior officers.

Reduce the Plan to Writing
Although some corporations, particularly closely held corporations, do not reduce their management succession plans to writing, it is a good idea to do so. A good management succession plan will account for a variety of scenarios and address various issues. As a result, it will likely be difficult to describe the plan orally in a clear, consistent, and accurate manner.

Regularly Review and Refine the Plan
The board of directors should review the management succession plan quarterly or, at the very least, annually. In doing so, the board should consider whether the management succession plan needs to be revised in light of any changes to the corporation's business strategy and recent experience. For example, the board might review the list of individuals identified by the plan as potential successors and determine whether they remain viable candidates. The board also might revise the

qualities and skills they desire in senior officers based on developments in the marketplace or changes to the corporation's strategic business plan.

Board Succession Planning

Selecting individuals to serve on a corporation's board of directors is as important as selecting the corporation's senior officers. Directors must be intelligent, understand the corporation's strategic business plan and the relevant markets, and, perhaps most important, be able to work well with other members of the board. Moreover, identifying the right director candidates cannot be accomplished without careful consideration and planning. Accordingly, boards of directors must develop — and regularly review and revise — detailed and carefully crafted board succession plans.

Identify Desirable Director Qualities and Skills
The most critical step in board succession planning is identifying desirable director qualities and skills. In doing so, the board should review the current directors' professional skills in light of the corporation's strategic business plan, and determine whether the directors lack skills that may prove critical to understanding and managing the corporation's current and future business operations. The board also should ensure that more than one director possess skills that are critical to the corporation's current or future business operations. Such redundancy helps the corporation sustain the loss of directors and, if the board maintains specialized committees (e.g., an auditing committee), permits the corporation to rotate committee chairs.

Although the board should ensure that it maintains adequate depth of critical skills, the board also must look for candidates who offer diversity of experience, skills, and viewpoint. For example, the board should consider whether a director candidate's background makes him or her well-suited to speak for an underrepresented class of stakeholders. The board also should consider whether a director candidate's gender or ethnicity offers certain viewpoints that are currently underrepresented on the board. Although most boards try to ensure that they comprise diverse individuals, boards should draft written guidelines and goals to help them promote diversity.

Consider External Recruiting Firms
Approximately 80 percent of board seats are filled by friends or associates of directors or senior corporate officers. Selecting friends and associates to serve on the board may foster collegiality, but doing so also raises questions about director independence.

Director independence is, of course, important to various corporations and their constituents. Director independence is important to public corporations and corporations intending to go public, which are subject, or will become subject, to the corporate governance standards of various exchanges. For example, to be eligible to trade on the NASDAQ Stock Market, companies must have a minimum of two independent directors at the time of listing. Director independence also is important to corporations with institutional shareholders, which tend to pay close attention to corporate governance and prefer for corporations to fill board seats with objective and unbiased director candidates.

Boards that need to fill board seats with independent directors should give strong consideration to enlisting the aid of external recruiting firms. Recruiting firms conduct extensive due diligence of director candidates, which, at least to some extent, should help assuage fears associated with filling a board seat with someone who is unfamiliar with the directors and senior officers. Moreover, recruiting firms can interview directors and officers, review the corporation's strategic business plan, assess board dynamics, and ensure that the corporation has identified the qualities and skills it seeks in a director candidate.

Be Honest With Director Candidates

The board of directors should be honest with director candidates about the corporation. If the corporation is engaged in activities of a sensitive and confidential nature, the board should consider whether, how, and when it will disclose such matters to director candidates. For example, if the corporation is engaged in merger negotiations, the board should consider whether a) the board is prohibited from disclosing the negotiations under the terms of a nondisclosure agreement; b) the negotiations have reached the stage where there is a reasonable likelihood that the parties will close the transaction; and c) to disclose the negotiations to all, some, or none of the director candidates. Additionally, the board should consider protecting the confidential or sensitive nature of these matters through such means as a nondisclosure agreement.

Consider Director Age Limits

The board of directors should consider whether to force directors to tender their resignations upon reaching a specified age. Approximately 80 percent of S&P 500 companies have adopted director age limits, which typically compel directors to resign upon reaching 70 – 72 years of age. Although fewer privately held corporations maintain director age limits, such limits are becoming increasingly popular.

Director age limits may be useful insofar as they give boards "cover" to remove underperforming directors with minimal confrontation. On the other hand, director age limits are fairly arbitrary and often result in the loss of valuable and productive members of the board. According to Institutional Shareholders, Inc., "[a]lthough establishing a retirement age or limiting the number of times a director may be elected to the board provides a mechanical or 'bloodless' means for addressing a real or potential performance issue with a director, it does not take into consideration the fact that a board member's effectiveness does not necessarily correlate with the length of his board service or his age." Retiree directors — those without full-time jobs — can fill critical roles for the board, as they normally can spend more time on their board duties than directors with full-time jobs.

If a board finds director age limits appealing but is worried about losing productive directors, it should consider adopting a director age limit that is subject to waiver. For example, the board might require directors older than a certain age to tender their resignations annually, but permit the board to either accept or reject such resignations. The board might permit directors older than a certain age to retain their titles as directors and attend board meetings, but prohibit them from casting their votes on some or all matters. The board also might require directors older than a certain age to tender their resignations, but then hire them as consultants.

Consider Director Term Limits
The board of directors should consider whether directors should be subject to term limits. On the one hand, director term limits may result in the loss of valuable and productive members of the board. Moreover, term limits may inhibit the growth of close ties between a director, the corporation, and the other members of the board.

However, director term limits may be useful. Director term limits may help to ensure that the board is regularly infused with fresh outlooks and perspectives. Moreover, although time may serve to foster close ties between the directors and the corporation, those ties may limit the directors' ability to exercise independent judgment in evaluating officer performance and otherwise managing the business affairs of the corporation.

Prepare for Changes to a Director's Primary Employment
The board of directors should prepare for material changes to the directors' primary employment. When directors experience changes to their primary employment, they may no longer have the time to fulfill their director duties. Moreover, the interests of a director's new employer may be directly or indirectly adverse to the corporation's. Thus, changes in a director's primary employment may necessitate the removal of that director from the board.

Because boards often struggle to decide whether to remove a director from the board, they should devise rules governing changes to a director's primary employment. For example, some corporations require directors to resign upon any changes to their primary employment. Other corporations require such directors to tender their resignations to nominating committees, which will then recommend that the board either accept or reject the director's resignation. Such rules give clear notice to directors that changes in employment may result in their removal from the board, give directors cover for removing a colleague from the board, and help ensure that the board comprises individuals who are capable of fulfilling their director duties.

In conclusion, failing to engage in adequate board and management succession planning exposes the corporation to major risks and constitutes a breach of the board of director's duties. Accordingly, boards of directors should carefully plan for the inevitable loss of directors and senior officers by devising and regularly reviewing and revising board and management succession plans.

For More Information

For more information on this session or Foley's National Directors Institute — 2009 Web Conference Series, visit Foley.com/ndi or contact the panelists directly.

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