

AGENDA

THE WEEK'S NEWS FROM OTHER BOARDROOMS

SPECIAL ISSUE: CEO SUCCESSION PLANNING

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Boards Take More Control of Succession

Hiring internal candidates and tying CEO pay to succession are rising



Directors who perceive succession planning as a perennial board weakness can take heart in two emerging trends that show significant progress in paving the way for a smooth leadership transition.

For one, the number of internal candidates being appointed to the corner office—consid-

ered by many directors to be the key yardstick of a successful succession—has climbed sharply in the past several years. Last year, of the 72 new CEO appointments among Fortune 500 companies, only 15% were outside recruits, according to executive recruiting firm **Spencer Stuart**. That compares favorably with the prior year in which 40% involved a CEO picked from outside company ranks.

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SEC Equity Rule Change Inflates Total Comp

The SEC's controversial eleventh-hour change to its equity disclosure rule last year boosted total compensation at almost two thirds of Fortune 100 companies.

The result runs contrary to media and shareholder forecasts that the revision would reduce total comp, toning down seemingly egregious payouts in the process. How wrong they were. In some cases, the increase in total comp as disclosed in the

Summary Compensation table was so extreme — a roughly \$43 million swing in the case of **Merrill Lynch's** CEO — it sent boards scrambling to offer shareholders detailed explanations of their stock grants.

And with no change expected by the SEC, directors should prepare for more of the same next year.

Of the Fortune 100 companies that have

Inflates continued on page 10

ON THE AGENDA

Audit Directors Hunt for IT Risk Solutions

Better communication with key employees is essential to audit committees' increasingly vital IT risk oversight duties. This could include bringing chief information officers into committee meetings.

There's a greater sense of urgency among audit committee members to improve their oversight of information tech-

nology risk as threats to companies grow more and more malicious.

Online fraudsters, for instance, have redoubled their efforts to fool company officials into downloading software programs that can hack into vital company data, *PC World* reports.

E-mail security vendor **MessageLabs**

IT Risk continued on page 9

The other new development which holds a lot of promise: The ranks of companies tying a percentage of their CEOs compensation to their help developing and overseeing succession plans is on the rise. CEOs have sometimes dragged their feet in developing internal talent. By tying a percentage of their pay to succession, boards give CEOs an incentive to keep their egos in check and find the best person to replace them.

The latest company to join the trend is \$590 million industrial hoist and chain manufacturer, **Columbus McKinnon**. The board linked 20% of CEO **Timothy Tevens'** variable pay to succession in order to "encourage and enhance his focus on the development and maintenance of sound succession plans," according to the company's proxy filed late last month.

That follows similar steps taken by other noteworthy companies including **Alcoa**, **CBS**, **Harley-Davidson**, and **Clorox**. Harley-Davidson, for example, awarded former CEO and Chairman **Jeffrey Bleustein** \$2 million under a deferred long-term incentive plan for "his successful completion of his goals and objectives including... executive succession planning."

Peter Browning, a director at several companies including **Wachovia** and **Lowe's**, says succession planning has evolved in the past several years into a formalized process that includes all of the board members.

Despite the progress, many directors continue to view CEO succession as an area of a board weakness. Last year the issue was cited by directors responding to a **National Association of Corporate Directors** survey as their boards' top weakness. The prior year's succession was the second biggest weakness cited by directors.

Directors' perceptions may be stuck in the not-so-distant past, however. A

decade ago, the CEO succession process was largely driven by the CEO, and the board would often rubber stamp any protegee the CEO suggested.

That has quickly changed as a host of factors has ratcheted up pressure on boards to create and maintain a succession plan that establishes deep bench strength, says **Barbara Hackman Franklin**, a director with **Aetna**, **MedImmune** and **Dow Chemical**. Management and boards are getting squeezed by shareholders to deliver strong performance, which has fueled a steady rise in CEO turnover, she says.

"If you're heading any kind of organization, your performance is affected by the quality of your bench... and [that] is the reason why more energy is being placed on people succession," she says.

Scrutiny on pay-for-performance has also helped drive the push to develop internal talent. In fact, a recent a study by executive comp research firm **Equilar** found that CEOs hired in 2005 from internal ranks earned \$3.1 million less than CEOs recruited from outside.

The lesson for many boards and management was to find their successor from within company ranks. Not only are those candidates cheaper, but they have a better understanding of the company's business, its culture and its people, says Browning. "You're always better off finding that person from within. You know that person better than any time you go outside," he says.

It's important, however, for boards to know when to look outside company ranks. **James Boone**, a managing partner with recruiting firm **Nosal Partners**, says external candidates are good in situations involving buyouts, a fundamental strategic shift or a significant turn in the economy.

"There are going to be storms and sometimes you need a different captain than in fair weather sailing." ■

Six Steps to a Successful CEO Transition

Dayton Ogden, the chairman of executive recruiter **Spencer Stuart's** global CEO practice, has worked with many Fortune 1000 companies in developing succession plans. He lists six key steps boards need to take that are vital to leadership development and transition.

1. Form a board task force or special committee that will spearhead and drive leadership succession.
2. The committee should consult with the CEO on successors and leadership development, but the CEO should not have voting power.
3. Succession planning should start with strategic vision. The selection criteria for potential candidates should reflect how the board envisions the company several years down the road. Any potential successor should be able to take the business to that next level.
4. Assess top internal candidates (usually one to three) against selection criteria to identify talent gaps. Candidates should then be given a chance to close those gaps.
5. Assess how internal candidates stack up on paper against the talent pool in that particular industry.
6. As the date of succession approaches, boards need to regularly update benchmarks and assess how internal candidates have developed and how they measure against outside candidates.