

Finding the right CEO:

Why Boards Often Make Poor Choices

Thanks to entrenched practices that are rarely questioned, boards often fail to choose the right CEO. Here are suggestions on how to avoid common pitfalls in CEO searches.

By: Rakesh Khurana

Decisions on CEO succession have never been more critical to an organization's success. No wonder, then, that boards are insisting on being involved in the process and not leaving the choice up to a departing chief executive officer. Are boards doing a good job? A string of brief CEO tenures at some of the best-known corporations – for instance, Douglas Ivester at Coca-Cola, Michael Hawley at Gillette and Rick Thoman at Xerox – suggests ongoing problems. But as current research shows, companies that identify the pitfalls can make succession decisions that will stand the test of time. (See “The Optimum CEO Succession.”)

Passing the baton is a complex process for several reasons. First, the labor market for CEOs bears little resemblance to the labor market for other executives. Both the number of open CEO positions and the number of people capable of running large, complex organizations are few. Second, most candidates already are employed and thus difficult to identify or uninterested in another position. Third, the risks involved in making the wrong choice and having to remove a CEO are enormous. Not only can dismissal cost tens of millions of dollars in severance compensation, but the disruption to the organization can result in lost opportunities.

Finally, the search for a new CEO occurs under a spotlight. A change in leadership affects many stakeholders, including shareholders, employees, customers and suppliers. The board's search for the best



candidate must respond to the interests and scrutiny of many constituencies.

But although such factors complicate the search, they are not the main cause of poor selection outcomes, which are rooted in boards' succession practices -- practices so commonplace and institutionalized they are rarely questioned.

From 1995 to 2000, I conducted research on the process by which boards of large corporations select CEOs. After scores of interviews with directors, executive-search consultants and job candidates – plus careful examination of 100 CEO successions -- I developed a deep understanding of the practices boards use now and the implications for identifying and hiring the most appropriate CEOs.

The Optimum CEO Succession

ONE: ESTABLISH THE GOALS AND OBJECTIVES OF THE SEARCH.

Examine the strategic and market challenges facing the company.
Identify the leadership skills and attributes necessary to meet those challenges.

TWO: CAREFULLY SELECT THE SEARCH COMMITTEE.

Ensure that the search committee has individuals who have a deep knowledge of the company and its challenges.
Ensure that the search committee is diverse in its functional backgrounds or cognizant of its potential biases.

THREE: SEPARATE THE ROLES AND RESPONSIBILITIES OF THE SEARCH FIRM AND THE SEARCH COMMITTEE.

Enlist the entire board in gathering detailed information about candidates through trusted contact.
Allow the executive-search consultant to mediate between the candidate and the company during sensitive compensation negotiations.

FOUR: DEFINE THE CANDIDATE POOL BROADLY.

Encourage less obvious candidates to be considered seriously.
Use the succession to break the cycle of selecting conservatively while hoping for change.
Choose the candidate who can best meet the long-term objectives of the company, not the short-term reactions of Wall Street and the business media.

FIVE: ANALYZE THE MULTIPLE FACTORS AFFECTING COMPANY PERFORMANCE.

Realize that the CEO is an important element of company performance, but not the only one.
Recognize the trade-offs involved in selecting an insider candidate vs. an outsider candidate.

SIX: CHOOSE CANDIDATES ON THE BASIS OF THE GOALS AND OBJECTIVES OF THE SEARCH.

Use the requirements of the position in guiding the selection rather than evaluate candidates against one another.
Avoid political compromises.

The bad news is that seven pitfalls are derailing searches at even some of the best-run organizations. The good news is that there are ways to avoid those pitfalls and trailblazing companies are doing so successfully.

Pitfall One:

Missing the Chance for Organizational Introspection

CEO succession offers boards a chance to assess the company's objectives, evaluate performance and diagnose the source of problems. Unfortunately, most boards don't take advantage of that opportunity. If a CEO position is suddenly vacant, directors feel tremendous pressure to fill

it speedily. They know that a company can pay both financially and in terms of image if leaderless for too long; and they have seen the problems that leadership uncertainty causes for executives, managers and line employees. Wall Street and the business media exert additional pressure. Hence many boards rush to identify candidates before pausing to re-evaluate goals. Some boards appoint a new successor without being sure that the individual's experiences and skills fit the organization. Other boards don't even clarify in their own minds the organization's specific objectives.

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Lack of clarity can lead to a botched succession. Consider what happened at a large U.S. bank. The bank's core strength lay in its highly profitable retail operations. However, at the time of the CEO search, the environment was changing. Industry analysts were saying that only banks with both retail and commercial operations could thrive – and that the next CEO would need to acquire a commercial bank. Lulled by retail's continuing strength, board members did not see the need for significant change or an extensive CEO search. They appointed the outgoing CEO's heir apparent, whose experience was largely in consumer banking. The selection had both immediate and midterm consequences. First, investors and analysts interpreted the decision as a sign that the board was out of touch with the new strategic environment. Second, when the board finally recognized the need to make acquisitions, it found it had the wrong CEO for the challenge. After a handful of high-profile acquisition attempts were derailed by the CEO's poor negotiating skills and limited understanding of commercial banking, he was dismissed. The bank later was acquired at less than favorable terms by a commercial bank.

Usually, search committees begin by defining a wish list of candidate attributes – rather than by defining the demands of the position. Board members spend days debating qualities of the ideal CEO but rarely refer back to the specification sheet after it has been circulated. Instead, they use it like a Rorschach test on which they project hopes, desires, fears, interpretations and solutions. They give little attention to the relative importance of the proposed qualifications. If taken seriously, just the size of the list would deter many candidates.

In the study, the organizations that initiated a search without an explicit strategic purpose ended up comparing candidates in terms of personalities rather than the position's requirements and the company's future needs.

Fortunately, it is possible to avoid a rush to judgment. For example, the board of a major consumer-products company, recognizing the need to appoint a new CEO as quickly as possible, chose a respected board member as an interim CEO and explicitly stated to investors and the media that the individual would not be

considered for the permanent position. The directors then proceeded to examine the company's problems systematically. They met with internal executives, analysts and customers to gain a better understanding of the strategic challenges the incoming CEO would face, and they took time to assess the company's future direction. The result was that they were able to identify several candidates with the experience to guide the company as it made a strategic transition.

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**Pitfall Two:
Choosing the Wrong Search Committee**

Directors of large corporations are competent and busy. Many have had distinguished careers building and running companies, and their advice is solicited by numerous corporations, nonprofits and governments. They are an important resource for companies on whose boards they sit because they complement the skills and networks found internally, but they have significant demands on their attention.

Busy directors do not always focus enough on the composition of a CEO search committee, as two examples attest. In the first, a highly diversified corporation initiated a search for an outside CEO after several years of poor company performance. Committee composition was based largely on which individuals had the most time to devote to it. In the second case, the board of directors engaged in long debates on the size of the committee and jockeyed for a position on it. Both committees ended up with directors who were not knowledgeable about the problems the company was facing. Both companies appointed CEOs who were poor matches with the organizations and were soon dismissed.

It is critical that committee members be deeply familiar with the company and its history, not just with the information they receive in quarterly meetings. They must understand the company's peculiarities and strengths and its future challenges – and be devoted to its long-term

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welfare. And because the future CEO will want some familiarity with the board members he or she will work with, the committee needs individuals who are likely to stay on.

Search committees also need directors from diverse functional areas. In several instances, CEO-succession decisions were biased by directors' narrow backgrounds. Consider the case of a prominent technology company with a strong engineering culture. Although the company's products were considered the most technologically advanced in its market, poor promotion eviscerated its market share. The search committee, largely directors with backgrounds in operations or research and development, recommended a CEO with a strong technical background but little marketing experience. Share continued to erode. It is human nature to gravitate toward people like oneself. The search committees researched were more likely to consider a good range of candidates if members had diverse background.

Search-committee members must be individuals in whose judgments the other board members have confidence. Other board members who question the abilities of committee members will have trouble viewing the committee's selections as appropriate.

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Pitfall Three:

Outsourcing Critical Steps

It is common to hire a search firm when initiating a CEO search. But misconceptions about such consultants' precise role often result in lost time and a poorly executed search. The most common misconception is that, other than the actual choice of the candidate, the search firm will handle everything. But in most of the successful searches studied, the board of directors, not the consultants, produced the list of primary candidates. Search firms may add one or two names, but knowledge of the industry makes directors better at identifying candidates.

Nor do search firms have detailed information about candidates. Their data is accurate but more general than what directors can access through personal networks.

A search firm has information on executives' education, work history and salary, but not fine-grained details about working styles, cultural values or accomplishments. Rich information is more likely to come from the relationships directors develop with other directors through socializing, joining trade groups or serving on additional boards.

In a search at one technology company, the search committee based its choice of candidate largely on the broad brush strokes in the search firm's portrait and on the reputation of the CEO for whom the candidate had worked. Once hired, the candidate has only a two-year tenure, during which he let go two of the most valued insider executives – and nearly bankrupted the company while trying to change it to accommodate his authoritarian style. If the committee members had taken advantage of their connection with directors and executives who had worked with the man, they would have learned that his day-to-day style was diametrically opposed to the team-oriented culture at the core of their own company's competitive advantage.

Most search consultants are not as capable of evaluating CEO talent as board members who have managed large corporations. Consultants do play a critical intermediary role once the committee has serious candidates. As an independent third party, consultants are effective at gauging the interest of a candidate without having to reveal the company's name or detailed information about its problems. Also, the buffer provided by the executive-search firm allows the candidate to explore the possibilities without threatening his or her credibility at the current job.

Skilled executive-search consultants also manage the expectations of candidates and companies. In one case, when a board of directors was forced to raise compensation significantly, a search consultant helped defuse the situation. Several board members were upset about the pay raise. The head of the search committee, realizing that face-to-face negotiations could poison the future working relationship between the board and the CEO, used a search consultant to negotiate salary, stock options and severance contract.

Pitfall Four:

Defining the Candidate Pool Too Narrowly

At first glance, CEO succession appears to offer limitless opportunities to invigorate an organization or to introduce change. A new leader can offer new skills or redefine the organization's culture or strategy. But although many of the boards studied expressed the desire for organizational change, the criteria that determined the CEO-selection process were conservative. No wonder that many search committees expressed frustration with the resulting pool of candidates.

The narrowness of the field is sometimes due to search committees' belief that a potential candidate needs previous experience as a CEO. Certainly, CEO experience provides a track record and may point to an understanding of the job. But insisting on prior CEO experience may reduce the options.

A second factor that narrows the pool of candidates is an excessive preoccupation with what market analysts and the business media might say. Although anticipating outsider reactions has value, it can lead to an unhealthy emphasis on a candidate's prestige. It should not overshadow a sober discussion about ability to lead the company in question. When Gil Amelio was hired as the CEO of Apple, the company stock experienced a short-term bounce, but his poor fit hurt both his reputation and the company's performance.

Pitfall Five:

Equating Candidates With Their Past Companies

Although most academic studies show that the relationship between leaders and their organizations' performance is at best tenuous, cultural, social and psychological predispositions continue to link the two.

Basing the choice of a CEO on the performance of the company he or she is coming from can lead to disaster. For example, Xerox board members looked at Rick Thoman, who had led IBM's PC division, and saw a protégé of IBM CEO Lou Gerstner. They assumed that Thoman would bring IBM's turnaround capability to Xerox, which was facing increased competition in copiers. But according to industry sources, Thoman's operating record had flaws. Too late, consultants revealed that although the PC division under Thoman had developed great products, it had consistently missed both revenue and profit targets.

Directors typically do not try to deconstruct the performance of the candidate's previous organization. The first consequence is that directors may ignore some excellent candidates. In almost every CEO search studied, the performance of candidates' current company was

weighed without regard to the candidate's influence on it. As a result, boards included some mediocre candidates in the pool and excluded other who had performed extraordinarily well under challenging circumstances. The second consequence is disappointment when the new CEO cannot reproduce the magic of the previous company.

Pitfall Six:

Overestimating the Value of Insider or Outsider Status

CEO successions in large corporations have historically been biased toward a company's own internal executive talent. Boards typically have more detailed information on insiders and can compare otherwise similar executives more easily. However, a predilection for the familiar candidate may have negative consequences. The outgoing CEO may exert undue influence, which diminishes the opportunity for strategic change. The selection of an insider also sends a signal to stakeholders to expect the status quo.

In recent years, search committees have leaned toward outsider candidates. Increased investor activism, deregulation, change in board members' attitude, technological development and the shift toward pay-for-performance salaries are some reasons. The number of outsiders hired as CEOs is now almost one-third of all new CEOs in large, publicly held corporations. But there are dangers in that trend, too. First, the appointment of an outsider can mean that important insider executives depart, taking along their deep understanding of the company's problems. Second, investing too much hope in outsider status can signal that a board is avoiding the necessary task of identifying the specific structural issues that have created the company's problems. Neither insider nor outsider status is a guarantee of success.

Pitfall Seven:

Accepting False Assumptions

Search committee members may harbor untested and faulty assumptions – for example, about the company's attractiveness to candidates. Those assumptions tempt committees to pay too much attention to candidates who are happy where they are and to underestimate how much effort is needed to attract candidates.

Even when expectations are more realistic, search committees often rely on two other harmful selection methods: the political compromise and the elimination of promising candidates who lack certain criteria. Compromise often produces a mediocre candidate. The process of elimination produces a survivor who is not necessarily the person best suited of the job's challenges.

Three Keys to Finding the Best CEO

Choosing the right CEO will remain a challenge. The good news is that a board can actively manage the three elements that underlie the CEO-succession pitfalls.

The first is that composition of the search committee. The search committee should feature a diverse group of directors, with complementary skills and experiences relevant to the selection decision. Diversity in age and functional background is important, as is knowledge of the company and its culture.

The second is explicitly recognizing that a CEO cannot be a panacea. When boards see the CEO as the main influence on company performance, a sober discussion about the contributions of other executives – and about how certain skills complement the company's strategic direction – gets short shrift.

The third is adopting outcome-oriented practices. The most important practices are discussing strategic direction explicitly and early; recognizing and defining search participants' roles and responsibilities, with limits on those of the outgoing CEO and the executive-search firm; and evaluating candidates against the requirements of the position, rather than against one another.

If CEO searches start with recognizing the pitfalls, they are more likely to lead to approaches that identify the best person for the job.

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