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 an 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. 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.

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. 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.

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. 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 experi-
ence in evaluating CEO talent. The decision to pro-
mote or reassign a senior executive to a new func-
tional 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 con-
cerned 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 com-
pany requires change. Other CEOs might actually
want their successor to fail—or at least perform
worse than they did—as validation of their impor-
tance 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 be-
lieve 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 selec-
tion 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 estab-
lish 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 nonscient-
fic 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 ob-
viously not based on rigorous methods, they never-
theless 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 suc-
cessors. 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 “fil-
tered” 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 in-
fluence?
3. The companies listed in Exhibit 1 include exam-
ple of both successful and unsuccessful hand-
picked 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 fam-
ily 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 Tay-
an, Corporate Governance Matters: A Closer Look at Organizational
Choices and their Consequences, Chapter 7: Labor Market for Ex-
ecutives and CEO Succession Planning (New York, NY: FT Press,
2011).
2 PricewaterhouseCoopers, “2013 Investor Survey: Through the In-
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).


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

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

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.