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## IN THIS ISSUE



# CEO Selection and Evaluation Today: What Directors Say

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***Interviews with directors reveal positive trends in this important area.***

"The times they are a-changing," as Bob Dylan sang so prophetically in 1964—and again this past August. Corporate greed has always been with us, but this year lapses in ethics and oversight by corporate leaders have reached new heights. Also, many corporate governance rules have changed, with more to come.

Yet governance and management experts agree that you cannot legislate ethics. It is said that you cannot audit a crook—especially a good one. Nor can you legislate leadership, good judgment, and concern for shareholders and employees.

Directors need to be more knowledgeable and involved in selection and evaluation of top management in order to avoid leadership lapses and future scandals.

## Current Perspectives

Some journalists have sadly noted that a chief executive's job is hard, and that "these days the CEO can't even find solace in the inner sanctum" of the boardroom (*Newsweek*, August 5, 2002). Sympathy aside, chief executives should expect their job to be hard and for the board to provide guidance, not solace, especially these days. Meetings are taking longer and "there's a lot more vigilance" as Barbara Franklin, who sits on five boards, noted approvingly in the same *Newsweek* article.

More vigilance is both necessary and appropriate, since boards cannot manage the company but must rely on the chief executive and his/her management team.



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**DIRECTOR'S *Monthly***

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# PRESIDENT'S LETTER

CEO evaluation and compensation, the focus of this issue, are timely topics.

As we go to press, two popular corporate leaders—**Jack Welch**, retired CEO of **General Electric**, and **Dennis Kozlowski**, former CEO of **Tyco**—both driven builders of shareholder wealth in their heydays, are making headlines for receiving compensation that their companies did not disclose. Mr. Welch's situation involved retirement benefits, while Mr. Kozlowski's situation involved $170 million in allegedly unauthorized payments to him and his chief financial officer, and $400 million in gains from the sale of Tyco stock.

These situations differ, of course. The benefits awarded to GE's leader, while they may have violated disclosure rules, do not begin to approach a criminal status, and involve relatively small amounts of money. Also, Mr. Welch was able to rectify the situation by asking the board to rescind most of the benefits. By contrast, the payments to the Tyco executives are subject to criminal sanctions, involve large amounts of money, and may have caused financial harm that would be difficult to reverse.

Yet despite their difference, both cases show how important CEO compensation and evaluation can be. If the GE board had disclosed Mr.Welch's retirement benefits, it could have saved him from embarrassment. If the board of Tyco had evaluated Mr. Kozlowski more thoroughly, it might have saved him from himself. ◗

*Roger W. Raber*
*CEO and President, NACD*

*Note: **Dr. Raber** spoke out recently on "Marketplace," a program of National Public Radio. On September 12, he responded to **Federal Reserve** President **William McDonough**'s call for across-the-board CEO pay cuts. CEO pay should be examined on a case-by-case basis, Dr. Raber said, preserving significant compensation for CEOs who return value. On September 16, he emphasized the importance of full disclosure. For a transcript, visit www.marketplace.org/shows/2002/09/16_mpp.html.

Directors do not typically hire or fire the senior management team; they must rely on the chief executive's view, except when the CEO is in trouble. Accordingly, a bad hire or lax evaluation is very problematic.

## Field Work

For nearly two decades as a partner in the CEO Perspective Group, I have been confidentially assessing chief executives for the boards of corporations, nonprofits, private equity firms, professional associations, and law firms. Our firm's cofounder, Richard Clarke, has been chairman of four corporations and a director of 10 companies over the years.

The recent crisis in corporate ethics and oversight prompted our firm to conduct research regarding executive assessment. Accordingly, we conducted 50 structured interviews in July and August with directors and chief executives of major companies to study the effect of recent events on CEO assessment. We interviewed seasoned directors (half men, half women) of differing ages, backgrounds, and industries; each was on two or more public corporations, and some had served on boards more than 10 years. The chief executives we interviewed differed in demographic characteristics, but all were successful, secure in their jobs, and leading the company a minimum of two years.

Directors and top executives were willing to talk candidly, but not for attribution. When queried, the unanimous reason was fear about highlighting their company or board in the current climate.

The interviews were most revealing. Everyone thought that CEO selection and evaluation practices were improving, but only in some areas. As one director put it, improvements have been "very spotty." Only a few stand-out companies such as General Electric were cited. As a senior director stated "I'm on four boards [and only] one has a good system."

## Trial by Firing

Directors experienced in CEO terminations were significantly more aware and thoughtful about potential leadership problems. As one lead director proclaimed, "If you've had to fire a CEO, you are much more careful the second time around." Similarly, "you're attuned to the issue; you will act more quickly. You know the costs!" The busiest people were willing to talk at length if they had fired a top executive, hoping to spare others the pain.

Retired chief executives and women on boards are typically first to voice concern about a CEO's competence. Retired chief executives have little to lose and thus are apt to be open. Faced with a problem, women directors are generally more direct. As one male director noted, "they haven't learned the rules yet and say what everyone else is thinking." Not surprisingly, directors with a direct personal stake (e.g., private equity firm) or financial stake (e.g., share ownership) were much more involved with CEO selection, spending nearly twice as many hours in the process. Many people noted that directors should focus more on character and ethics.

## The Problem: Bigger Job and Lower Standards

Typically, CEOs receive far less rigorous screening and evaluation than other senior executives. Ironically, the "bigger job" comes with lower standards of scrutiny. There are three reasons for this:

◗ directors often hesitate to ask the tough questions or probe as deeply, since the CEO is often a peer

◗ there is also a justifiable belief that if someone has led a company for years, he or she has already been "checked out"

◗ plus, the demand for good candidates often turns the interviewer into a recruiter.

## Selection Basics: Three Approaches

Boards continue to select chief executives via some combination of the following elements:

*"If you've had to fire a CEO, you are much more careful the second time around."*

◗ internal selection

◗ executive search, and

◗ board referral.

Each method has advantages and limitations.

The primary method is internal selection among candidates within the company. This is changing, with boards turning more often to outside saviors. Reportedly, one out of two leaders are now selected outside at our most prominent companies (*Wall Street Journal*, July 30, 2002). Still, internal selection continues to be the preferred selection method for the majority of corporations and firms.

Over the last few years, succession planning processes have been researched, refined, and implemented in numerous *Fortune* 1,000 companies. While several books have been written on the topic, I recommend the *Report of the NACD Blue Ribbon Commission on CEO Succession*.

### *Internal Selection*

"The average board handles succession planning as well as the average American handles estate planning," commented *Fortune* and *Business 2.0* editor Tom Stewart, author of *Wealth of Knowledge*.

Every company should have a succession plan that includes possible internal candidates, even if these are passed over in favor of external candidates. If a company has no plan, it should install a simple process as soon as possible, followed by a more sophisticated process at a later time.

**DIRECTOR SUMMARY**

CEO selection and evaluation need not be the "same old song." Using a judicious combination of succession planning, headhunting, and referral for selection, and remembering to conduct ongoing evaluation, boards can fulfill their obligation to ensure the best leaders for the firms they serve. ◗

*Directors will not be held hostage by a chief executive if there is a backup.*

Having a backup for the CEO is important. Directors will not be held hostage by a chief executive if there is a backup. One board initially determined three backups for every key position, with "at least one ready now." Two years later, it implemented a more formal plan using key criteria.

Naturally, a significant positive of internal selection is the candidates' knowledge of the company and culture, plus the directors' familiarity with the candidates. On the other hand, internal candidates may not readily embrace change, even if the market conditions dictate the necessity. Also, familiarity may be deceptive, because directors often see the candidates only at social events or formal presentations. Not all internal candidates have been "vetted" noted one director.

Governance expert Tom Horton concurs, adding that "there should be much more development of the internal candidate." Several interviewees suggested directors assist in developing potential successors. Ned Powell, CEO of the USO and former deputy secretary of the mammoth Veterans Affairs, declared, "Directors have a fiduciary responsibility to know the executives, and to know them well."

### *Search Firms*

A second basic selection method is employment of an executive search firm. Search firms can identify and recruit great candidates, and are key when there is a sudden departure or loss, or when confidentiality or special skills are important. Said one director, "we needed that rarity—a dynamic leader with strong financial skills—but had no idea Rick was available."

The problems arise when the board delegates too much authority to the search firm—for example, not providing sufficient information initially, or not rigorously interviewing candidates or requesting intensive reference checks. Indeed, numerous directors interviewed criticized themselves for "abrogating authority" to a prominent search firm. Well-known management consultant Ram Charan cautions directors, "Don't be intimidated by big-name head hunters."

Many directors voiced concern over the trend for search firms to also assess candidates, strongly preferring separate search and assessment firms. Similarly, several directors suggested employing one search firm for selection, with another for reference checking. Many interviewees, notably prominent directors, criticized search firms for going to the "usual suspects," using "computer lists," and "not adding value."

Chief executives complained that search firms and directors do not devote the requisite time to the process. Similarly, a search colleague declared "we nearly lost the best guy (CEO candidate) because two of the directors couldn't find time to meet him." At times CEO candidates were only briefly interviewed; for example, only six hours were spent interviewing the new head of one major retail company. All agreed: CEO search requires time, attention, and thought by all parties.

### *Director Referral*

A third method of CEO selection is director referral—the practice of one or more directors suggesting an individual known to them personally or through the media. The latter might include a top executive who has just turned around a similar company or someone who has been passed over in another company.

While most directors and chief executives did not recommend this practice, it appears to be relatively common. For "objectivity's sake, I will go through a search firm, but it's really a done deal," confided one person. "Make no mistake, the old boy's network is alive and well," declared another director.

However, some interviewees strongly recommended this practice. One female director pointed out that it was both easy and safe: "There are only six degrees of separation, and you can really check someone out." "It's a time-tested method," another added. "Just avoid cronyism." Director referral seems to be most useful when there is a need for an acting chief executive.

## Psychological Testing

Whatever selection method a company uses to identify a candidate, it is increasingly common to use psychological testing (aka "assessment"). Assessments are typically done as the last stage before hiring. They are most commonly used by private equity firms and in Europe.

Directors are frequently worried about "offending" a CEO by suggesting an assessment, but this seems to be lessening as the practice gains popularity. "Most directors aren't very introspective...you can ask about their money or marriage, but not what they believe."

Actually, most candidates do not object if the prospect of assessment is well presented. Indeed, in my two decades of experience with literally hundreds of top and senior executives, only five times have there been questions. Search firms and psychologists add that true leaders are motivated by personal growth and development.

On the other hand, it is important to select a reputable, time-tested tool. Like any field, assessment has its share of "quacks."

Psychometrists (testing specialists) are now more able to objectively and reliably assess personal characteristics such as decision-making, persuasiveness, creativity, and other qualitative criteria. For example, the ability to bring calm to chaos is measurable; so is judgment. There are even sound measures for integrity, but these are validated most easily at middle management and entry levels. Research by the federal government, professional associations, and universities has been significant, but typically has not been translated for practical use. This year, the Conference Board began conducting research, under the direction of Dr. Ann Barrett, on the practice of assessing personal characteristics, including potential for abuse.

The broadening of criteria beyond financial reporting, objective attainment, increasing shareholder value, and other "hard indices" should be done cautiously due to the inherent problems in subjective criteria. But valid testing can provide considerable information on the very traits which are most likely to "bring down" a CEO.

## No Guarantees

History, experience, and interviews continue to reveal advantages and disadvantages with all the selection methods—and with psychological testing. There are no guarantees. No practice ensures that the person selected will be a good chief executive, a good leader, or have good ethics. The key to success for any method is for directors to think, examine, and thoroughly discuss what is needed for leading and managing that company.

General dimensions and requirements should be held up to the light, examined, refined, and operationally defined. Directors should consider quantitative and qualitative criteria, considering less obvious skills and standards.

Skilled consultants can help, but are not mandatory. After one debacle, directors spent one full day and came up with 16 criteria. They rated applicants on a 1-5 scale on each dimension and ultimately selected the CEO who turned the company around. Again, most solutions are simpler than expected.

## Caveat: Check CEO References

Interviewees were nearly unanimous that selection practices could be greatly improved by simple measures. Many cited inadequate reference checking. Boards were often criticized for "over reliance on a name," hiring only executives from well-regarded companies and failing to conduct enough investigation.

One prominent director declared the problems could be prevented "if you conducted thorough reference checks, an hour each." (This same director would automatically reject any candidate requesting excessive upfront compensation.) A private equity fund partner on numerous boards advocated more diligence, specifically that firms should routinely use a search firm, a testing firm, and a financial (private) investigation firm. He declared reference checks were okay, but it was cheaper and easier to employ a private investigator stating, it "saved us a lot of money and headaches ... [and] should be a standard practice."

## Don't Forget Evaluation

Careful selection is the first half of the equation. The second is ongoing on-the-job evaluation. Two prominent directors put it well: "Evaluation done right is really about the company's path," and "Choice of CEO is ultimately a decision about the company's direction."

Evaluation should be routine, a form of monitoring. Periodic reviews are needed to ensure the criteria are still relevant. A more rigorous evaluation is necessary when there are signs of trouble.

The directors and chief executives we interviewed are generally dissatisfied with current monitoring and evaluation practices. Chief executives continue to worry about skeletons in the corporate closets. Many are truly skeptical that directors are not telling the whole truth and "letting me know what's expected."

The old days of protecting the CEO are over. A startlingly high percentage of chief executives have stepped down recently. Booz Allen & Hamilton reported a 53 percent increase in CEO departures in major corporations between 1995 and 2001,* but the rationale for a resignation will vary even amongst the board. Some CEOs are urged to resign, some fired, some retire, and others leave for better positions. The excessive severance packages for former GE CEO Jack Welch and former WorldCom CEO Bernard Ebbers did little to guarantee continued strong leadership—either good or bad.

Most alarming are the number of recent CEO terminations due to fraud and financial irregularities. Frequently executives are lauded only months before they are indicted or led away in handcuffs.

Dr. Judith Klavans of Columbia University studied 10 CEO who quit under adverse circumstances and analyzed media coverage prior to these events. She found that in most cases positive press far outweighed negative remarks until shortly before the resignation. Investigative journalism was uncommon even after initial trouble signs emerged for the 10 CEOs scrutinized.

*Editor's Note: See Leslie Gaines-Ross, "CEO Turnover: A Board Challenge," *DM* August 2002, p. 16.

The interviewees were very consistent in their desire for better communication. The issue is not recognition of a problem, but action.

- "The whole system is full of conflicts."
- "You know there's a problem, but you hope you're wrong."
- "You don't want to be seen as critical, so I'll let it go a few board meetings."
- "Frankly, I wish my board would give me better guidance."
- "Nobody likes report cards, but sometimes it'd be nice."
- "They knew, how could they not know?"
- "They had to approve those pay packages, but nobody did anything."

Recommendations for improving the evaluation process were rare, but two suggestions emerged.

One idea was a simple annual review that includes discussion. In this process, the key competencies or criteria are cleanly defined. After agreeing on these key criteria, the outside directors go around the room discussing the chief executive, with senior directors first, followed by the newer directors.

### SUGGESTED READINGS


"Assessing CEO Performance: It Goes Beyond the Numbers." *Directors & Boards,* Winter 1989.

Clarke, Richard M. "How to Avoid Firing your CEO." *Directors & Boards,* Fall 1999.

Gould, Richard. "CEO Selection: Getting Beneath the Surface." *DM,* April 1999, p. 17.

Lencioni, Patrick. "How to 'Macromanage' the CEO: Helping Leaders Avoid Temptations." *DM,* April 1999, pp. 7-9.

Minow, Nell. "Board Leadership in CEO Performance." *DM,* January 2001, p. 15.

Soder, Dr. Dee A. "Ready, Fire (the CEO), Aim." *Directors & Boards,* Winter 2001.

Truskie, Stanley D. "How America's Leading Companies Evaluate CEO Performance." *DM,* 1996, pp. 9-11.

Yavitz, Boris. "Evaluating CEO Performance." *DM,* October 2001, pp. 11-14.

Another director said his board borrowed an evaluation form used by a comparable firm, spent an hour tailoring it to the company, and then used a 1-5 scale to confidentially rate the CEO on each criteria. The rest of the morning was spent on discussion. Tom Horton summarizes the assessment process well, "the simpler and more frequent the better."

### Appraisals Desired

Whatever the process, directors should not be shy about expectations and appraisals. "We do a disservice to the CEO if we don't say, 'here's what we're going to measure you on.'" Obviously, knowledge of results is integral to improvement. It is noteworthy that chief executives often complain that directors are not engaged or direct with them. "I could fix it if I knew the problem," was a frequent statement. CEOs want and need evaluation before it is too late.

### Signs of Trouble

Indeed, even when there are signs of trouble, directors tend to hope for the best. Typically, one director may notice a "change" in the CEO but wait a few meetings before voicing concern that the CEO seems distracted, always on a trip, non-communicative, or otherwise different. More times than not, little happens except maybe a friendly chat with the CEO. The director who spoke up may be reluctant to assert himself or herself further. Even when several directors are concerned, they have a hard time gaining consensus until major problems appear.

Prompt action can help. The actual fall from power and termination of the CEO can take months and even years; with earlier action, 60 percent of terminations could be avoided.

Five years ago, the CEO Perspective Group conducted intensive research and analysis on these "early warning signs of trouble(c)." We found that nearly 20 percent of CEO failures are readily clear within a few months of appointment. Either CEOs self-identify a wrong fit and depart quickly or directors rapidly resolve the mistake. But the overwhelming majority of cases fail over time, hurting the company, employees, and shareholders unnecessarily. If the issue was identified early, corrective action was neither costly nor difficult. An executive coach, financial review, additional/new staff, or other aid will often save the incumbent. And if a change is required, it can be better planned with more notice. Again, the tragedy is that most of the problems could be remedied if action was taken earlier.

Our research identified 12 definitive "early warning signs of trouble with a CEO(c)." Looking at over 200 reported instances of CEO failures in a two year period, all clearly exhibited two or more of these potential danger signs.

Despite numerous speeches and articles on these warning signs, it is unclear whether boards have heeded the wake-up call or are still hitting the snooze button. Our work did not cover CEOs who are now criminally indicted, but other CEOs fired for fraud and misconduct did display the signs (*e.g.*, excessive trappings of success and unexpected resignation of directors and senior executives).

Apparently signs of trouble were noticeable at Enron, Tyco, WorldCom, Global Crossing, Adelphia, and Imclone, but no action was taken. While those directors seem extremely inattentive and passive in hindsight, one wonders if anyone "smelled a rat" and spoke up.

We should know more in the next few months. Currently, it seems that chief executives are rapidly being terminated, but I continue to wonder, are directors being wiser or just more active? Hopefully, directors will remember the old songs—but have the courage to learn the new tunes as well. ◗

***Dr. Dee Soder** is founder and managing partner of the CEO Perspective Group, an assessment and advisory firm for top executives and boards. The pioneer of executive coaching, she is frequently called in by boards for highly sensitive evaluations to determine the status of chief executives. She has served on several nonprofit boards, including the Women's Campaign Fund. Soder's insights on leadership are often featured in* Fortune, Wall Street Journal, New York Times, *and other national media. She can be reached at dee@ceoperspective.com.*

# CEO-BOARD RELATIONS

## Thoughts from the Bar

Boards have become stronger and tend to insist upon superior performance from the CEO. If this performance is not realized, boards have not hesitated to remove the CEO. Such removals have become more common, even though there is a shortage of marquee CEOs.

Most boards have established a formal process of evaluating CEOs, and this will continue as outside directors deliver on the promise—superior compensation for superior performance and a pink slip for sub-par performance.

◗ ***Succession.*** In my experience, boards still tend to rely on CEOs for management succession. Most boards tend to believe that the performance in this arena needs improvement. In my talks with directors, they report that the performance for succession was either poor or needed substantial improvement.

◗ ***Outside directorships.*** Most boards do not directly limit the number of outside directorships for CEOs. However, I believe they should, and generally do, require their CEOs to have board approval for serving as an outside director.

Most directors believe that the CEO has substantial influence in selecting new directors. Again, I believe boards should play a more active role. ◗

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