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**GROOMING FOR THE TOP POST AND  
ENDING THE CEO SUCCESSION CRISIS**

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**LEARNING FROM RESEARCH**

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# **GROOMING FOR THE TOP POST AND ENDING THE CEO SUCCESSION CRISIS**

## **EXECUTIVE SUMMARY**

We compare three different types of options and related processes of CEO succession: relay succession, non-relay inside succession, and outside succession. We find that relay succession is more likely to occur if a firm is performing well prior to a succession and/or if it has a small number of internal candidates. We also find that relay succession on average leads to better firm performance after succession and this positive performance impact is stronger under challenging succession contexts characterized by poor pre-succession firm performance, and high post-succession strategic and industry instability.

There is no doubt that CEO succession is one of the top priorities for CEOs and boards of directors. However, despite the importance of CEO succession, many companies fail to do a good job in managing this all-important organizational event. It has been noted that the frequency of CEO turnover has been steadily rising over recent years. For example, the average term for a CEO who left office in 2003 in the U.S. was only about 5 years. Rather than being considered a desirable position with honor and glamour, a CEO position often becomes too much to handle for senior executives. A recent survey suggested that 60% of the most senior executives at *Fortune* 1,000 companies have no desire to be promoted to the CEO position. This is probably because a CEO's job has become a high-risk job with greater day-to-day pressure, constant scrutiny and risk of failure than ever before.

All these trends may suggest that something may be seriously wrong in the practice of developing and appointing new CEOs. An obvious question then is: What should boards of directors do in order to end the crisis of CEO succession? Based upon the empirical findings of our research on CEO succession that was published in the *Academy of Management Journal*, we suggest that grooming an heir apparent for the CEO position may represent one effective way to mitigate the problems associated with the CEO succession process and outcomes.

### Types of CEO Succession

There are at least three different options and related processes for selecting a successor CEO. (1) A relay CEO succession refers to a succession in which the successor CEO was an executive of the firm prior to succession and was the heir apparent to the predecessor CEO (i.e., s/he held the title of president or chief operation officer [COO] or both in the firm prior to succession). (2) A non-relay inside succession is one in which the successor CEO was an executive of the firm prior to succession but was not the heir apparent to the predecessor CEO

(The successor CEO was the winner of a “horse race” among multiple internal candidates). (3)

An outside succession is one in which the successor CEO was hired from outside the firm.

Compared to the other two options, relay succession has two major benefits. First, relay successions ease the power transition from the incumbent CEO to the successor CEO and provide enough time to key stakeholder groups to get to know the person who will most likely be the next CEO of the firm. The presence of an heir apparent also provides insurance against a potential vacuum in top leadership should something unexpected happen to the incumbent CEO and thus reduces the potential organizational turbulence associated with leadership change. For example, when McDonald’s CEO, Jim Cantalupo, unexpectedly succumbed to a heart attack in April 2004, the board was able to replace him within hours with the pre-agreed successor, Charlie Bell, a 43-year-old Australian. Bell began working at a McDonald’s in Australia at 15, rising to become that country’s youngest store manager four years later. He earned the company's top job in Asia in 1999 after six years running McDonald's Australia, where he increased the number of stores to 683 from 388. As head of McDonald’s in Europe in 2002, Bell helped revive sales after consumers stayed away from restaurants for fear the beef was infected with mad-cow disease. When Cantalupo took the CEO position in late 2002, he designated Bell as his heir apparent by promoting him to president and COO.

Second, compared to non-heir inside successors and outside successors, an heir apparent has increased opportunity to obtain “on-the-job-training” through having access to the tasks of the CEO even before assuming the position. Hence, the firm’s performance risk resulting from the new CEO’s lack of context-specific skills may also be reduced. For example, in Intel, Paul Otellini, the heir apparent to CEO Craig Barrett, has long been seen as Barrett’s right-hand man. Indeed, Otellini was the architect of the firm’s new strategy – a change of direction called a

“right-hand turn.” The firm is already starting to move in the direction that Otellini has charted before he assumed the CEO position.

In spite of the acknowledged benefits of relay successions, however, a significant proportion of firms do not have any formal succession planning. For example, in a survey of 1,484 firms, the authors found that fewer than 50% had engaged in succession planning. Given the potential benefits of relay succession and the finding that a significant proportion of companies fail to have a relay succession plan, we attempted to investigate three research questions related to relay succession. (1) How do critical internal and external contingencies influence the likelihood of a relay succession? (2) How do relay CEO successions influence post-succession firm performance relative to other types of CEO successions? and, (3) How do these performance effects vary with key internal and external contingencies?

### Research

To examine these questions, we identified 204 events in 184 different companies (20 firms that had two succession events and 164 firms that had one succession event) from a population of more than 750 publicly traded non-diversified manufacturing companies operating in the U.S. during the 1993-1998 time period. We were able to classify these 204 succession events into one of the following three categories: (1) relay successions (75 cases), (2) non-relay inside successions (53 cases), and (3) outside successions (76 cases). Firm performance was measured with a composite index that included return on sales, return on assets, and a ratio of market to book equity value. Complex indices using a variety of objective indicators were constructed to assess pre- and post-succession instability in firm strategies and in industry environments.

Regarding the antecedents of relay succession, our research suggests that in deciding whether or not to use relay CEO successions, firms are guided by several criteria. They consider

the availability of internal candidates for the CEO position and evaluate the competencies of potential alternative candidates (including the heir apparent) in terms of their fit with key organizational contingencies. We found that firms with a larger pool of possible internal candidates (defined as those current senior executives [other than the incumbent CEO] who have the position of executive vice president [EVP] or higher) are less likely to use relay succession. The more the number of internal candidates, the more the firm's options—making it more difficult to identify a clear heir apparent early in the succession process. In addition, we found that firms with a larger pool of possible internal candidates are also less likely to use outside succession. It appears that as firms have a large number of available internal candidates, they are more likely to select their new CEO from within the firm but without designating him or her as the formal heir. In other words, firms are likely to run a “horse race” between multiple internal candidates when more internal candidates are available (i.e., non-relay inside succession).

A well-known example of a “horse race” for choosing a new CEO is the process that was used at GE to pick Jack Welch's successor. Three potential candidates – Robert L. Nardelli, W. James McNerney, and Jeffrey R. Immelt – were identified early in the process (soon after Welch announced his plans to retire), but the identity of the successor was kept secret until Welch announced Immelt as his successor on November 27, 2000.

Second, we found that a firm that is performing well (relative to its industry counterparts) prior to a succession event is more likely to embrace relay succession than non-relay inside succession. In addition, a firm that is performing well prior to a succession event is less likely to use outside succession than non-relay inside succession. In other words, for firms with good prior performance, the perceived desirability of different options for CEO succession ranks as follows: relay succession followed by non-relay inside succession followed by outside

succession. After all, continuity, a potential benefit of relay succession, is more likely to be seen as a “good thing” when performance is strong. Throughout the grooming period, the heir likely continues to be viewed favorably and thus is likely to be promoted to the CEO position when the incumbent CEO leaves office. For example, when it was confirmed in November 2004 that Intel’s new CEO would be Paul Otellini, the firm’s COO and heir apparent for several years, it did not surprise anybody.

In contrast, a firm that is performing poorly (relative to its industry counterparts) prior to succession is more likely to have outside succession, in the hope that an outsider may bring changes that the firm needs. For example, since JC Penney bought Eckerd Drug as a growth engine in 1993, the drugstore chain has fallen on hard times. In 2000, the company brought in turnaround specialist Allen Questrom from outside, who helped Barneys get back on track after it emerged from bankruptcy. It hoped that Questrom would be able to create a synergy between its department store business and the drug business.

And what about the consequences of CEO relay succession? Generally speaking, relay succession improves the post-succession performance of the firm relative to other succession options. There appears to be no significant performance difference between non-relay inside succession and outside succession. This is probably because of the learning benefits provided by relay succession. We divided a completed relay CEO succession process into two phases: the first phase, during which the firm decides whether or not to designate an heir apparent, and the second phase (the “grooming” phase), in which a firm decides whether or not to promote the heir apparent to the CEO position.

Both phases offer significant opportunities for a firm to learn what the key internal and external organizational contexts are and what kind of CEO leadership it needs. More specifically,

in the first phase, the firm assesses the availability and desirability of various candidates for the CEO position. It evaluates the qualifications of these potential candidates in light of key internal and external contingencies in order to decide whether to designate one of them as the heir apparent. At this stage, a firm can also bring in outside talents to enlarge the pool of internal candidates when the time of succession comes. For an example, less than two years after Compaq Computer Corp. dismissed its founder and promoted Eckhard Pfeiffer to CEO in fall 1991, directors started quizzing him about potential heirs. Directors pushed Pfeiffer to bring in more people and strengthen his management team. As a result, between 1993 and 1996, Pfeiffer hired eight more outside executives for his team.

In the second phase, because one of the candidates has been designated as the heir apparent, the firm can now conduct a more focused assessment of this particular candidate's competencies (cognitive and interpersonal) and continuously update its evaluation of whether the candidate's capabilities fit the CEO position. It can then use this evaluation to subsequently decide whether or not to promote the heir apparent. In this sense, the grooming phase is also a probation period for the heir apparent. Indeed, some heirs apparent may not be able to pass this probation period. For example, in November 2003, Boeing had to sack its heir apparent, Mike Sears, when he was found to have offered a job to a person in the procurement department of the Pentagon. For this reason, the risk of mismatch between the new CEO and the firm's CEO position should be reduced in relay successions relative to other types of successions.

The second phase of a relay succession process also provides valuable learning opportunity for heir-apparent successors as they have an opportunity to be exposed to the specialized tasks of the CEO position in a specific context. For example, in McDonald's, as the president/COO, Bell helped CEO Cantalupo improve menu offerings, oversee restaurant closings and stem a two-year

profit and stock slide. Indeed, analysts and franchisees said that Bell deserved as much credit as Cantalupo for Big Mac's comeback in the U.S.

Compared to the successors who enter the CEO position from a narrow functional domain (e.g., finance or marketing), the heir successors are likely to have been exposed to a broader spectrum of issues and functional concerns and thus can learn from their broader span of control and exposure to a wider set of functional domains. In addition, even if a (outside) successor may have held a CEO position at another firm, his or her prior CEO experience may not necessarily be transferable to the new setting because of the idiosyncratic differences between firms. Overall, heir successors are more likely than non-heir successors to acquire knowledge and skills that are specific to the CEO position in this particular firm. In other words, this kind of learning gets started before the actual succession for heir successors, but it gets started after the succession for other successors.

In addition, during the grooming phase, the heir also has opportunities to learn how to manage relationships with both internal and external key stakeholders. Managing internal stakeholders is crucial for building a credible power base and obtaining the support of the top management team, both of which are essential for implementing strategic initiatives in the future. In contrast, infighting and power plays that are not effectively resolved are likely to distract the firm from more important adaptations. An heir successor is likely to have frequent interactions with other senior executives before assuming the CEO position and is hence more likely than other types of successors to gain the support from key internal constituencies that will be valuable assets in the post-succession period. Further, an heir is also well positioned to engage in strategically important interactions with key external stakeholders during the grooming period, either as a participant in CEO-initiated interactions or as a substitute for the CEO when he or she

is unable to participate due to conflicting priorities. These externally oriented interactions (with customers, suppliers, regulatory institutions, etc.) help the heir develop valuable knowledge and insights about external stakeholders and about how they potentially affect firm performance.

Indeed, we found that relay succession led to even stronger firm performance when prior-succession firm performance was poor, and/or post-succession strategic and industry instability was high. These organizational contingencies represent what we called “challenging” succession contexts. Declining firm performance places the new CEO under immediate performance pressure. Strategic instability requires that CEOs both continuously adapt resource allocations in order to better implement strategies and come up with a new strategy for the future. Industry instability requires that CEOs continuously adapt their perceptions of the industry to fit the current reality. Under these “challenging” contexts, cause-effect relationships are also more difficult to evaluate, and knowledge tends to become outdated relatively quickly. These contexts can increase the cognitive demands placed on the new CEO, in that knowledge has to be constantly updated, and these contexts may also increase the likelihood of internal dissension and disagreement on strategic choices.

“Challenging” succession contexts thus often place tremendous cognitive demands upon the new CEOs by increasing the complexity of the learning tasks that confront the new CEO and by demanding superior cognitive and interpersonal capabilities of the new CEO. These cognitive challenges further increase the burden on new CEOs who are trying to acquire the competencies of the CEO position as they are developing an understanding of changing internal and external conditions. Given the costs and risks of managing these internal and external instabilities, links to the prior convergent period can be significant sources of stability for the new CEO. In this sense, it is likely that the learning benefits conferred by the grooming period (i.e., the

opportunity to develop competencies that are specific to the CEO position of this particular firm and relationships with key internal and external key constituencies) are particularly significant and may yield positive dividends particularly under challenging succession circumstances.

Interesting examples are the recent two successions in Xerox. G. Richard Thoman was brought from outside to replace the long time CEO, Paul A. Allaire. Only thirteen months after taking the top position, Thoman was fired in May 2000. When Thoman was fired, Anne M. Mulcahy, a popular 24-year veteran was promoted to president and COO position. She became the CEO in August 2001 and chairman in January 2002. Prior to her assuming the CEO position, Xerox was at the edge of bankruptcy. It had \$17.1 billion in debt and \$154 million in cash. It was about to begin seven straight quarters of losses. The company lost 90% of its market cap in 2000. However, Mulcahy brought the company back from the dead. When the CEO of one of Xerox's biggest lenders said she would have to kill the culture to succeed, Mulcahy shot back, "I am the *culture*. If I can't figure out how to bring the culture with me, I'm the wrong person for the job."

#### Managerial Recommendations

All our research evidence suggests that companies stand to gain when they place a premium on putting CEOs-in-waiting through an extensive grooming process to best prepare them for the challenges of the job. All the time that is often spent monitoring the (sometimes dysfunctional) jockeying among contestants for the CEO position might be better spent on helping an heir apparent develop firm and industry-specific, cognitive and interpersonal skills. In addition, the commonly held belief that outsiders are best positioned to turn things around when a firm faces major challenges may very well be a myth. This is probably because outsiders are relatively unfamiliar with the organization's particular routines, cultures, and competitive advantages. They tend to either ignore or even challenge their firms' competencies. Outside

successors also tend to face frustration and resistance from inside executives. In many cases, when an outsider is brought in, many of a firm's best people will head for the exits or, at the very least, become resistant and uncooperative. For example, it has been reported that several old-timers at Hewlett Packard, disgruntled with outsider Carly Fiorina's approach to decision making and strategic choices, actively complained to HP board members and some of them even left the organization. Indeed, these negative reactions may have played a significant role in her subsequent ouster as HP's CEO. More generally, a high level of senior executive turnover (or resistance) can deprive the outside successors of valuable managerial talents and firm-specific knowledge, including the implementation support that they dearly need, especially during the transition period.

Firms should generally avoid a horse race in CEO succession. This is probably because a non-relay inside successor does not have access to the learning opportunities in the grooming period that an heir successor enjoys. In a non-relay inside succession, the new CEO has likely not yet built a stable power base. Other internal contenders may challenge the new CEO's authority after succession. More important, if a succession is turned into a horse race, the internal candidates who did not get the CEO position will perceive themselves as "losing the contest." As a result, the firm will lose a great deal of talent once the ultimate decision is made. In GE's example, only five business days after the announcement that Immelt would succeed Welch, Nardelli left GE to become Home Depot's CEO and McNerney accepted the CEO position at 3M. While competition is probably unavoidable in a firm's CEO succession, a long, publicly visible horse race will be much more painful than it needs to be. These factors may make the post-succession period particularly difficult for a non-relay inside new CEO especially when the CEO is also placed in "challenging" succession contexts.

The implications of our findings are quite significant because they may help us explain why so many new CEOs fail to influence firm performance positively. As Greiner, Cummings and Bhambri recently noted, “given the many pitfalls awaiting new CEOs, as well as their high failure rate, we need to ask ourselves if there is any way to better prepare them for the job. We are not aware of a ‘school for CEOs’ but there should be one.” Our results suggest that the grooming period in a relay succession may offer an opportunity to both the firm and the heir to learn about each other and about key internal and external contingencies, so that there is an increased chance of an appropriate choice at the time of succession and of better firm performance in the post-succession period. Thus, the grooming period may be akin to the “school” within which the new CEO’s education takes place. In contrast, without the grooming period the education is likely to take place after succession and impose higher costs on the firm.

Some companies have a routine of grooming an heir apparent for the top position. For example, in McDonald’s, when James Cantalupo took the CEO position, he designated Charles Bell as his heir apparent. When Cantalupo died unexpectedly of a heart attack, Bell became the CEO sooner than anyone expected. When Bell took the top position, he designated Jim Skinner as his apparent. Hence, when Bell resigned only seven months after taking office to focus on his battle with colon cancer, Skinner took the top position. Although new to the CEO position, Skinner already has his heir apparent, Michael Roberts, who was promoted to COO from his prior position as the U.S. president. In this case, the continuous presence of an heir apparent within the firm has helped McDonald’s avoid the crisis that can otherwise result from its unexpected frequent leadership changes in such a short time period. Another example is Wal-Mart. David Glass joined Wal-Mart in 1984 and was promoted to the president/COO position as Sam Walton’s, the founder, heir apparent in 1984. Glass assumed the CEO position in 1988 and

has lead Wal-Mart through an unprecedented 12-year period of growth and international expansion since then. As Glass stepped down in early 2000, he was replaced by his heir apparent, Lee Scott. Scott joined Wal-Mart 20 years ago and was named COO and vice chairman of Wal-Mart, in preparation for the CEO position. Because Wal-Mart has groomed the next CEO ahead of time, the transition in leadership has been seamless for this retail giant.

Contrary to the traditional wisdom that outside CEOs are better equipped to turn around poor performance, our results suggest that outside successions do not significantly differ from non-relay inside successions in terms of post-succession firm performance, even under conditions of poor pre-succession firm performance and/or high post-succession strategic instability. Outside successors are usually prized for their new skills and perspectives, and their willingness to initiate changes. Relative to inside CEOs, outside CEOs are more likely to initiate strategic changes. However, the fact that outside CEOs are more likely to initiate strategic change does not lead to the conclusion that such change will result in better post-succession firm performance. Indeed, because outside successors are more likely to lack firm-specific knowledge, it is harder for them to formulate and implement appropriate strategic change. In addition, outside CEO successions are often disruptive to firms, and outside successors find it more challenging to get support from other senior executives within the firm. Therefore, it is not surprising that outside successions may not lead to better firm performance in the post-succession era. An example is a series of outside CEO successions that has unfolded in Kmart, L.L.C. In 1995, Kmart's board, under relentless pressure from shareholders, dismissed the CEO, company veteran Joseph Antonini. It brought in an outsider, Floyd Hall who was a former executive at Target and Grand Union, to replace him. The stock market cheered the arrival of Hall; however, the cheering was short-lived. Soon Kmart's stock price began to slip further. In

2000, Hall was replaced by another outsider, Charles Conaway. Less than two years later, the firm filed for bankruptcy.

However, we did find that at higher levels of post-succession industry instability, outside successions were associated with better post-succession performance than non-relay inside successions. Perhaps unstable industry conditions necessitate the introduction of significantly different competencies. In these contexts, the potential benefits of outsiders' novel strategic approaches may outweigh the costs of organizational disruption. An example is Eastman Kodak's succession. Kodak's industry is shifting quickly from silver-halide film to digital technology. The film business, Kodak's core business, will decline by 30% in 2005 in America and by 20% worldwide. Although the departing CEO, Daniel Carp, a 35 years company veteran, had correctly identified the mortal threat from digital technology to the company, he had done so too slow, too late. The successor CEO, Antonio M. Perez, was a former star at Hewlett-Packard Co., where he ran the consumer and digital-imaging businesses. Carp conceded that "We need a digital leader to carry us through this transformation."

In conclusion, we acknowledge some caveats that should be borne in mind while interpreting our findings. First, we focused only on non-diversified manufacturing firms. The extent to which our findings can be generalized to other contexts (e.g., diversified firms) may be an issue. We also suggest that future studies on CEO succession should include surveys instead of relying solely on archival data (i.e., the type of data used by our research) to better identify an heir apparent. Likewise, researchers should focus more on digging deeper into the backgrounds of outside CEO successors (e.g., do outsiders with certain types of backgrounds or experiences perform better than others?) so that we can develop a more fine-grained understanding of those attributes that distinguish successful outsiders from their less effective counterparts. With these

steps, future studies will help us provide even better advice to firms interested in developing an effective CEO succession process.

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