When the CEO isn't UP TO scratch

Boards need to target potential CEO underperformance well before bigger problems emerge. **Tony Featherstone** provides some tips on how to spot a CEO who isn't up to scratch and what to do about it.

If appointing the right CEO is the board's most important task, removing him or her is surely the hardest. Mary Beth Bauer FAICD should know. The former chair of Talent2 International had to appoint a new managing director to Concept Systems International, which later became Talent2, earlier this decade. The investor relations and strategy consultant has been involved in a dozen CEO or chairman resignations during her career, many under acrimonious circumstances.

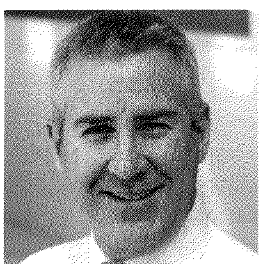
"Boards often act too quickly and have knee-jerk reactions when it comes to removing their CEO, or they wait far too long, sometimes years," says Bauer. "Some boards struggle to find the right balance with this issue and they communicate the CEO's departure poorly to staff and external stakeholders. I've seen huge damage caused by poorly managed CEO changes over the years."

Australian boards have had plenty of practice with CEO resignations lately. The latest Booz & Company's CEO Succession Study of ASX 200 companies found local boards took a much harder line than their global peers with CEO transitions in 2008. Just over 20 per cent of Australian CEOs in the largest listed companies departed then - a record high for the study. Remarkably, CEO departures in the US and Europe fell slightly in 2008.

Boards forced 20 of the 50 local CEO departures, with the financial services and property trust industries hardest hit. Another 22 departures were planned and eight were merger related. Company insiders accounted for 74 per cent of all new CEO appointments in 2008, a trend that has strengthened in recent years as boards have looked within companies for their CEOs.

"It is tempting to conclude that boards globally put a premium on stability at the helm ... as the crisis took hold," said Booz principal Phil Mottram. "But it may also be that Australian boards are less timid, and more willing to change under-performing leaders, even in a turbulent year... Structured succession planning appears not only to be the norm now in Australia but is beginning to bear fruit, as seen by insiders delivering greater returns than outsiders for the first time in 2008."

Internal appointments ease some problems with CEO departures, notably the effect on organisation morale and market uncertainty over external appointments. But core problems, such as knowing when to remove a CEO, remain for boards. Difficult as it was, the global financial crisis in some ways made it easier for boards to remove CEOs as investors demanded blood and as the recession put a blowtorch on corporate strategy and performance.



Further, the crisis starkly identified which CEOs were capable of outstanding

'It may be that Australian boards are less timid, and more willing to change under-performing leaders, even in a turbulent year'

Phil Mottram

Key points

- **Boards often act too quickly or take too long to remove a CEO**
- Australian boards are taking a harder line than their global peers
- **Good boards realise very early on if the CEO is not working out**
- CEO performance is often a grey issue
- **Quick action and a clean break are vital**
- Investors are watching more closely how boards handle CEO resignations

leadership during good and bad times, and those whose past performance was more due to strong economic or favourable industry conditions. Bauer says the challenge for boards is spotting potential CEO underperformance well before bigger problems emerge.

‘In most cases of underperformance, the reasons for the departure are obvious. I doubt that explaining these reasons adds much value’ *Maurice Newman*

"You see the same signs time and again," she says. "One sign is unrest among the senior management team. Good people in the business know when the CEO is not performing, though are often reluctant to speak out against them. Another sign is CEOs who hoard information and filter what gets through to the board, or limit board access to senior executives. These CEOs may also limit board input into organisational culture and staff satisfaction surveys, or make it harder for boards to ask questions and get timely answers regarding company strategy and performance."

Bauer, now CEO of Value Enhancement Management, says the issue of CEO removal ultimately relies on boards having the right systems in place and being in touch with their organisations and stakeholders. "If boards are governing well, it should not come as a surprise when the CEO is asked to leave because the process and performance targets have been transparent. The CEO knows he or she is underperforming and the board has indicated it may have to review the CEO's tenure at the company if performance does not improve."

Bauer's view makes sense, but performance is often a grey issue. Sometimes underperformance can be at the margin for long periods and enough to give the CEO the benefit of the doubt. Or it can result from the board making bad decisions or performing its duties poorly. In other cases, boards ask CEOs to resign because a younger promising executive may leave if denied an opportunity to lead.

Mergers and acquisitions present other challenges for boards to decide on which CEO should lead the combined organisation. Increasingly, institutional investors are having a much greater say on which CEO should lead the merged entity and are pressuring boards.

An example was the Australian Stock Exchange (ASX) and Sydney Futures Exchange (SFE) merger in 2006. The

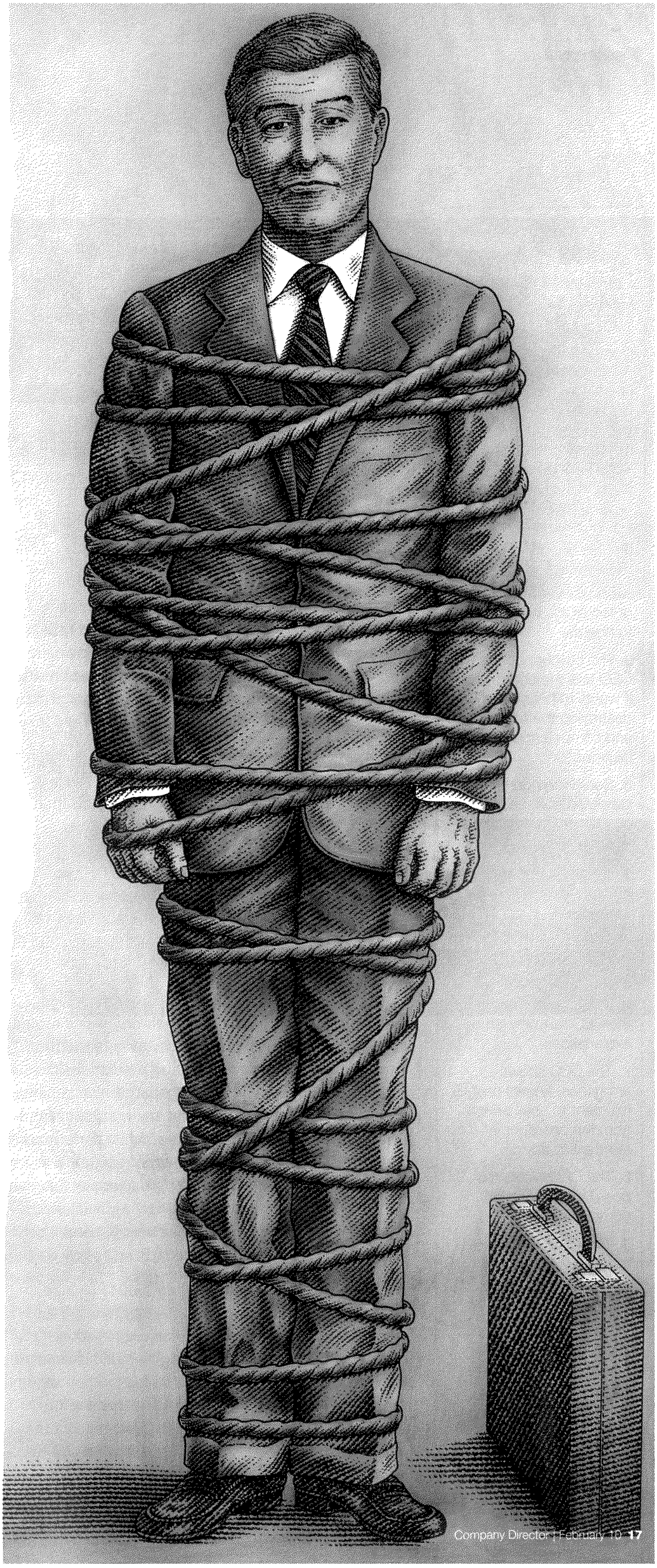


Photo: Photolibrary

10 warning signs of an underperforming CEO

Company Director asked Adolph Hanich FAICD, an adjunct professor at Swinburne University and noted corporate governance expert, to identify early-warning signs that a CEO is underperforming. Hanich, also a registered, practising psychologist, gave these 10 ideas:

1. The CEO gives too little or too much information to boards.
2. The psychopathic CEO tells the board what it wants to hear, while destroying the morale and competence of the organisation.
3. Board members are restricted from easy contact with people at all levels of the organisation.
4. The CEO plays "divide and rule" with directors.
5. The CEO opposes a sensible whistleblower policy.
6. Key talent leaves the organisation and the CEO has only lame explanations.
7. The CEO shows arrogance, knows best, is reluctant to seek advice from the board, or is resistant to advice.
8. The CEO wants the board to play only a compliance role.
9. The CEO appears out of touch with industry developments and is no longer respected by others in the industry.
10. The CEO is no longer fully committed to the company (or has too many outside distractions), or is too focused on internal issues and neglects external developments.

combined organisation had two strong CEO candidates - ASX boss Tony D'Aloisio and SFE chief Robert Elstone. Pressure from SFE shareholders for Elstone to lead the merged entity led to his appointment as CEO and the departure of D'Aloisio, who was appointed Australian Securities and Investments Commission (ASIC) chairman in May 2007.

It was a difficult decision for the ASX board and its then chairman, Maurice Newman AC FAICD. The Australian Broadcasting Corporation chairman has overseen three CEO transitions during a distinguished career in the private and government sectors. "People often get threatened by mergers, so appointing a new CEO can be a delicate process," says Newman. "The ASX/SFE merger brought different points of view from key investors and from within the board about who should lead the merged business. It was challenging at the time, but in hindsight the change worked very well, with ASX continuing to perform strongly and D'Aloisio going on to lead ASIC in what is a very important role."

Newman says unanimous agreement among directors is vital when removing a CEO. "This is not a decision any chairman makes unilaterally. Such decisions, if handled poorly, can greatly disrupt the organisation and fracture board unity. That said, good boards are usually not dealing with extreme situations when the CEO resigns. More likely is the CEO has underperformed at the margin for some time, is aware of it through performance reviews and realises it is time to move on. He or she works with the company to ensure a smooth transition."

When it comes to changing the CEO, boards should have a strong "antenna" within their organisations and pay as much attention to soft issues as hard metrics. "No director should ever assume all wisdom resides with the board," says Newman. "Smart directors have a way of sensing the mood within an organisation and how external stakeholders are viewing its performance. Sometimes this comes from something as simple as talking to staff in a lift or attending a company function. Or it may come from more formal settings such as meetings with key investors. Good boards know when the CEO is not working out very early on."

Newman says once a board has decided to change CEOs, it should move quickly and communicate the change to stakeholders to preserve organisation continuity. "At this point, the board should also ensure the CEO leaves the organisation with his or her dignity intact," he says. "I understand calls from investors to provide more detail on why a CEO is leaving, but in most cases of underperformance, the reasons for the departure are obvious. I doubt that explaining these reasons adds much value."

'No amount of due diligence can overcome the fact that some people simply don't make it as CEOs' *Paul Kerin*

Newman believes directors should also ensure a clean break between the company and its CEO and not allow the departing CEO to join the board. "There can be a temptation to put outgoing CEOs on the board because they have great organisation knowledge and industry contracts and are well known to directors. But such appointments invariably make it harder for the new CEO, given the former CEO may still have direct lines into the organisation and be aligned with other executives. In any event, CEOs usually need time away to recharge."

Clearly, there are many reasons for decisive change of underperforming CEOs. Yet, boards, on average, persevere too long with CEOs as organisational performance wanes, says Paul Kerin, professorial fellow of strategy at Melbourne Business School.

"Academic research shows boards err on the side of taking too long to change CEOs. In some cases, underperforming CEOs remain at companies for years before change is made and only leave after a crisis," he says.

"I suspect many boards hope things will turn around, so they don't take action early enough with underperforming CEOs. Or they may be too close to the CEO - a problem less pronounced in Australia than in the US. And, there is the human element: most people don't like sacking others. Some boards may also be fearful that their own performance will be scrutinised if the CEO resigns suddenly and directors are seen to have 'screwed up'. After all, choosing and monitoring the CEO is their biggest job."

Kerin says such perceptions can be unfounded. "No amount of due diligence can overcome the fact that some people simply don't make it as CEOs. Much shorter CEO tenures have also brought the issue of CEO resignations - and how boards handle them - into focus. Boards should accept that sometimes the CEO does not work out, have a sound succession plan in place for such events and be more open about why the CEO left, especially on matters of strategy."

The executive pay debate has also compounded the issue of CEO resignations for boards. Large termination payments for seemingly underperforming executives have incensed investors in recent years and led to a torrent of bad publicity. Martin Lawrence, an analyst at proxy adviser RiskMetrics, says it is infuriating when companies issue bland statements about CEOs leaving "for personal reasons" and then pay them as though they have been terminated.

"At best, these statements are misleading and in many cases, blatantly untrue," says Lawrence. "Companies and their boards need to be honest with investors about why the CEO resigned. Some boards do everything to protect the CEO's ego when their job should be to protect shareholder interests by explaining the reasons and circumstance for unexpected CEO departures. The reality is many boards are far closer to their CEO than to unsighted end-shareholders. Right or wrong, it reinforces the perception that some boards are cosy clubs that look after their own at the expense of shareholders."

RiskMetrics' submission to the Productivity Commission's inquiry into executive pay said: "It is notable that executives of listed companies are routinely described in audited reports to shareholders and in announcements to the ASX under continuous disclosure requirements to have resigned or retired. The public description of the circumstances of their departure does not, however, appear to bear any relation to the types of payments they receive on departure."

RiskMetrics' review of 25 CEO departures at ASX 200 companies over the period 2000 to 2009 found, as at May 2009, no companies said their CEO was terminated. BHP Billiton came the closest when it said former CEO Brian Gilbertson's departure in 2003 was due to "irreconcilable differences" with the board. Eleven of the 25 departing CEOs received a termination payout even though they supposedly resigned or retired.

"It appears that companies either voluntarily make payments to departing executives which they have no contractual obligation to make or routinely mislead the market on the reasons for the CEO's departure," RiskMetrics said. "The absence of information makes it difficult in many cases for shareholders to assess the reasonableness of payments on departure. In some cases, the reason behind a CEO's departure - such as disagreement with the board over strategy - is likely to be considered material information by the shareholders."

Lawrence believes companies should be forced to disclose the contractual provisions under which the payment was made to a departing CEO (for example, payment in lieu of notice, a redundancy payment or termination payment). Such information could potentially give shareholders a better understanding of why the CEO left, without the board having to spell out the reasons and damage his or her reputation and expose the company to litigation.

One thing is clear: big investors are paying more attention to how boards handle CEO resignations. "When boards axe a CEO, it is very important they communicate quickly and clearly with key institutions," says George Clapham MAICD, managing partner at fund manager Fortis Investment Partners. "The chairman should explain the rationale for CEO change, how it affects the business and its strategy and the plans going forward. Boards need to get on the front foot and not leave key institutions wondering about the change."

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Clapham says institutional investors are paying more attention to board quality when choosing stocks to buy and sell. "We look for boards with strong industry experience," says Clapham. "We are concerned if the board has too many generalists, career company directors or ex-lawyers. We like to see deep industry experience on the board because it shows directors can better gauge CEO performance and weed out underperformers earlier on.

‘Changing the CEO early on was a very difficult issue, but directors are paid to make tough decisions and see them through’ *Mary Beth Bauer*

"Warning signs Fortis looks for with CEO underperformance include too many acquisitions, too much reliance on investment bankers for deals or on consultants when making key decisions. CEOs or directors who can't think for themselves and continually overuse highly paid external consultants or deal doers also send a poor message to the market in my view," says Clapham. "Other signs of CEO underperformance are more 'strategic reviews', margin deterioration or key staff joining competitors. Boards should monitor these early-warning signs closely."

For all the advice, there is no magic board formula for changing CEOs. Bauer chaired Talent2 as it grew from a \$20 million to a \$200 million company and was surrounded by human resource experts. "Changing the CEO early on was a very difficult issue, but directors are paid to make tough decisions and see them through," she says. "Preserving the status quo because it is the easy way out ultimately destroys shareholder value and reputations."