From Board Seat to C-suite

Some companies buck convention by looking to the boardroom for the company's next CEO. But is this a sign of strategic thinking or lackluster governance practices?

By Carrie Pryor and Ted Pryor

It's generally understood that there is a dividing line between the boardroom and the C-suite—a line that's only permeated when the CEO or another high-ranking executive is named to serve as a director. Yet little is said about the reverse: directors being elevated to the CEO role. It's a corporate practice that is more common than many people realize.

Conventional wisdom says that naming a director as CEO for anything other than an interim period is a failure of the board to conduct a proper search or to have a viable succession plan. However, together with our colleagues at Greenwich Harbor Partners, we sought the opinions of knowledgeable executives and found not only that perspectives range widely, but that there are multiple situations where a board member might logically move into the CEO role permanently. Furthermore, there is a record of board members successfully adding value to companies as the new CEO.

To explore the question of when and why making such a C-suite appointment makes good business sense—at least at the outset—we conducted interviews with more than 25 senior executives from a variety of organizations and positions, including CEOs, directors, venture capitalists, and private equity (PE) professionals. While there have been some successes, as well as situations where this might be the most viable—if not desirable—option, there is no clear-cut answer as to whether this should rank as a dubious governance practice.

A Failure of Good Governance?

Several interviewees were adamant that having a director become CEO is indicative of a very flawed CEO succession plan. "When you put a director in as CEO, it is a missed execution in succession planning," says Betsy Atkins, who sits on multiple boards including Wynn, Cognizant, and Volvo. "The directors are responsible if there are no internal or external candidates. Recently at Wynn, we had the surprise resignation of the iconic founder-CEO [Steve Wynn] in early 2018, and we had a good succession plan with the president of four years becoming CEO. The company didn't miss a beat."

Larry S. Kramer was chair of TheStreet.com when CEO Elisabeth DeMarse exited the company in February 2016. He was asked to be CEO and declined, opting instead to be the interim CEO and help lead the search process for a permanent chief executive. Meanwhile, there was an activist investor who was beginning to disrupt the company. Kramer led the board through this situation and, in his words, ultimately "killed the dividend and positioned the company for growth by shifting investment to profitable divisions. The company cleaned up the accounting, and ultimately was able to buy out the preferred shareholder at about 50 percent on the dollar. The company promised investors it would take one year to make the changes, and was able to deliver on that promise."

Kramer sees both sides of the coin when considering this type of succession plan. "The chair is familiar with the strategy and has a stake in what the company is trying to accomplish," he says. The biggest negative, he explains, is "the potential conflict between what the board wants and what the CEO thinks about strategy. That tension point gets to what is the most important aspect of being a board member: boards are representing the shareholders and the company, and its officers are representing employees, other stakeholders, and the customers." From Kramer's perspective, directors often have little knowledge of a company's officers and day-to-day activities because "the CEO has filtered their knowledge."

Jack W. Scott, operating partner of FFL, highlighted a potential problem as the board conducts a search for the next CEO. "You have to be vigilant that there is not a director who is lying in the weeds, torpedoing candidates, only to pop up at the end of process volunteering to be CEO," he says. "I ask the board if any of them want to be the CEO before the search starts and then, if the answer is yes, I exclude them from the search committee so they can be considered on a level playing field with the outside candidates." The potential conflicts associated with a director who wants to be CEO include torpedoing other qualified candidates and politicizing the board by campaigning for the job.

Scot W. Melland, former CEO of Dice Holdings and an active board director, offers a counterpoint. "It is not a very good succession planning tool to bring on a director as a CEO-in-waiting," he says. "However, in a PE environment, I think it can make a lot of sense for an operating partner with CEO experience to act as the non-executive chair to help the company. That role is a very natural transition to CEO, if needed, because the non-executive chair

is very close to the C-suite, operations, and strategy, and well-attuned to the PE objective of growing the enterprise value."

When It Works

The majority of interviewees said that identifying a director who could step in as CEO is a sensible succession planning tool. Many of them said that they liked the idea of having one or more strong operating executives from the relevant industry on the board as an insurance policy for a non-performing CEO, as this person would ensure a continuity of operations and strategy. A subset of interviewees pointed out that the best director in this scenario is the chair, as she or he most likely has had the greatest interaction with the company's senior executives and is the most familiar with its operations and strategy.

Many stated that CEOs often resist having a strong, operationally focused executive on the board who could challenge executive decisions and may be perceived as too aggressive in confronting the CEO with their own thoughts. Furthermore, an active director who wants the top job can both undermine the current CEO as well as potential replacement candidates.

In looking at several recent examples, these appointments are usually made when

- the company is in a crisis situation, such as an unplanned CEO departure or a scandal surrounding the outgoing CEO;
- poor company performance reaches a critical situation, such as breach of loan covenants or major accounting issues; or
- there is a change in ownership or the threat of an activist investor demanding board seats.

Take, Daniel F. Akerson, for example. Akerson was a successful CEO of several privately held companies: General Instrument Corp., Nextel Communications, and XO Holdings. Between 1995 and 1999, he grew Nextel's revenues from $171.7 million to $3.3 billion and brought XO (then known as Nextel Communications) back from the brink of bankruptcy, increasing the stock value from $8 per share to more than $50 per share in the process. He was also a seasoned director, having served on the boards of Nextel Communications, America Online, and Time Warner.

In July 2009, Akerson, then a partner at Carlyle Group, where he ran its U.S. buyout fund, was named to the General Motors Co. (GM) board to represent the U.S. Treasury, which held a 61 percent stake in the company after government bailout funds saved the automaker from bankruptcy. A year later, Akerson became CEO, and he was named chair in January 2011. Under his leadership, GM had a successful initial public offering and saw profits every quarter he was CEO. What's more, the Treasury sold its stock for $39 billion and the stock price rose from $34 in November 2010 to $40 in mid-January 2014.

Ford Motor Co. also placed a director in the CEO role in May 2017, when it elevated James P. Hackett, the recently retired CEO of Steelcase, from both director and leader of its Ford Smart Mobility unit. Hackett was chosen because of the perceived need to accelerate innovation at the company. While it is too early to judge his impact on the company's performance, the stub year of 2017 showed significant improvement over 2016 with strong earnings. Top-line revenue was at $156 billion—more than 3 percent better than in 2016, with revenue increasing in both automotive and financial services. However, Ford said in January that it expects to report 2017 earnings that are below anticipated estimates and will be hit by higher commodity costs while Hackett initiates cost-cutting efforts.

Then there is Jeff A. Leddy and Global Eagle Entertainment. Leddy had served as CEO at SkyTerra Communications and Hughes Communications before joining the Global Eagle board

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in 2013 as an industry expert. In February 2017, however, the company was in crisis. The CEO and chief financial officer had resigned and the company's stock went into a tailspin, declining over 30 percent all in the same day. Leddy was immediately named the new CEO.

As CEO, Leddy has dealt with underlying operational problems, stabilized the accounting and financial functions, and developed a strategy that is focused on creating value for investors. "A director will learn more about their company in the first few days as CEO than they can learn in a year of board meetings," Leddy says. "While it is a steep learning curve, even if the director has been heavily involved, the 'fresh look' can be very helpful to the company and to the board, whether it is an interim arrangement or long term."

Sometimes directors are placed on the board and groomed to be the next CEO by new owners or activist investors. These investors often believe that management is spending too much on future growth, and they are more interested in streamlining operations, reducing costs, and preparing the company for a merger or sale. They want a new CEO who is similarly focused on these goals.

Daniel R. Hesse was the CEO of Sprint Nextel when the majority of the company was sold to SoftBank in 2013 and the company was renamed Sprint Corp. Hesse says he "stayed in place during the heavy-lifting phase over the next year of upgrading and unifying the incompatible networks of the company's three main entities, Sprint, Nextel, and Clearwire."

SoftBank in January 2014 placed Marcelo Claure, founder and CEO of Brightstar Capital Partners, on the Sprint board as a part of the merger agreement. Although an imminent CEO succession was not being discussed, Claure was being groomed as a potential candidate, and he regularly attended Sprint's monthly operational reviews with Softbank. After spending seven months reviewing Sprint's strategy and operations, there was a very orderly transition with Claure stepping into the CEO position. Most observers would say that this was a well-thought-out succession plan developed in partnership between the acquiring company, the incumbent CEO, and the independent directors. In April 2018, Sprint and T-Mobile announced plans to merge.

Another subset of this issue is the CEO cycling out of the role, staying on the board, and then returning as CEO. This individual is often the founder and a major shareholder. One example is Howard D. Schultz. Schultz was CEO of Starbucks Corp. from 1987 to 2000, after which he became, in his own words, "a non-involved board member." Although stock prices hit an all-time high of $19.82 in 2006, a management team that was ill-equipped to navigate the company through the following economic recession saw stock prices tumble to $9 and hundreds of underperforming stores.

Schultz returned to the CEO role in January 2008, and over the next seven years he closed poorly performing stores, expanded the Starbucks footprint into high-potential areas, invested in its customer experience in terms of both products and services, and became a market leader in related technology. At Schultz's second retirement in April 2017, Starbucks' stock price was up to $58 and revenues had more than doubled from $10.4 billion in 2008 to $21.3 billion in 2016. Schultz announced in June that he was stepping back even further and resigning as executive chair to become chair emeritus.

And then there's Jack Dorsey, whose experience as of this writing doesn't offer a definitive argument for or against board seat to C-suite appointments. A co-founder and the first CEO of Twitter, Dorsey was serving on Twitter's board when CEO Dick Costolo resigned in 2015. The board initiated a full executive search but ultimately elected Dorsey as CEO. Dorsey, however, was (and still is) also the CEO of Square. Twitter's financial results were underwhelming for years: its stock price dropped from $36 in July 2015 to $31 in October 2015. This year has been tumultuous, with prices down to $22 in February, up to $32 on May 1, and reached a three-year high of $43.49 on June 12.

Some analysts have attributed this uptick to a renewed focus on and improvements to its core business and newfound profitability. It's too soon to say if this success, which hinges in part on attracting new monthly users and advertising dollars, can be sustained.

The Advantage for Private Companies

While activity at venture capital- (VC) and PE-backed portfolio companies is much harder to track,

interviews with more than 20 executives affiliated with these companies reveal a clear picture. In these environments, directors who move into CEO roles are not unusual. Here are the primary situations where this might occur:

- A director, or a director who is also an operating partner for a PE firm, has industry expertise.
- The company's former CEO or founder stays on as a director but steps back into the chief executive role.
- A director who is part of the CEO succession planning process is ultimately named to the role.
- The current CEO might be seen as unable to take the next step after a material change in the company, such as an initial public offering or sale.

"It is a pretty common occurrence and we have done it two or three times," says Bruce Eatroff, founding partner of Halyard Capital. "A growing business can outpace the capabilities of the original entrepreneurs. Management should be surrounded by board members with the skills to help, and by definition there will be CEO candidates at the table. The directors understand the business and may be the best solution in a crisis. However, pulling from the board should be a backup strategy, not a bench of potential candidates."

Andrew P. Lipsher, chief strategy and revenue officer of Volta Industries, a privately held electric vehicle charging station company, concurs. "Ideally, you should have a succession plan and have an internal candidate, or have the time to canvas the market for a new CEO, but that is not always possible," he says. "A good operating executive who is on its board and working closely with the company will know the personalities and the strategy and have a good feel for its operations. They will also be in alignment with the goals of the board and investors, which can be different from the goals of the original entrepreneurs."

Gregory F. Back, managing member at Free Sky Capital, cautions about the potential to send undesirable signals. "I think you want to be very careful not to send the message to the operating team that the board is there as a CEO insurance policy," he says. "Management needs to know that they are in charge right up until the moment that the board decides that a change needs to be made."

There is a fine line between having operating partners who are assisting the incumbent CEO and operating partners who are second guessing or even undermining the CEO, he adds. Successful boards and CEOs learn how to rein in those kinds of behaviors.

According to George K. Kollitides, managing director of Alvarez & Marsal Capital Partners, if a board is intent on making a director the new CEO, having a strong, operationally focused chief operating officer is critical. "You must be acutely aware of his or her strengths and make sure the senior management team has the skills to balance the director's. There is a good chance that the director's skills are around strategy, management, governance, and capital markets, and maybe somewhat removed from operations or specific knowledge of clients, services and products," he explains.

Several PE partners said that operating partners are sometimes more valuable to their funds when they work on the boards of multiple portfolio companies rather than becoming the CEO of one company. Furthermore, they said they preferred that operating partners be named interim CEOs, the implication being that they would go back to adding value to several companies.

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"Operating partner is a tough job with a lot of travel," says Steven C. Yager, senior managing director of The Gores Group. "For lifestyle and other reasons, operating partners will sometimes want to transition to one portfolio company as CEO, and we let them do it because we'd rather retain them than lose them completely. Every situation is unique, but when we are consolidating multiple businesses, it can become too complex for the incumbent and we have asked the operating partner to step off the board. That may or may not be interim."

While there are situations when it may be logical to elevate a director to the CEO role, there is no clear consensus on this course of action. Across a spectrum of company sizes, levels of maturity, and industries, the appointments that are most successful are when a director who is both an industry expert and a proven CEO takes the helm. The private-equity sphere, with its industry expert operating partners, appears to have a long tradition of putting a director in the top job either in a crisis or when the director is simply the best candidate. Ultimately, the board must decide based on the company's situation and select the best person for the job. D

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