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Views from Governance and Boardroom Experts

EXECUTIVE COMPENSATION

Simple Incentives to Improve CEO Succession

Board members have an obligation to protect the company from gaps in executive talent by ensuring leadership continuity, particularly during times of CEO succession. While we find numerous commentaries addressing best practices surrounding the planning for succession, we believe incentives should be considered that focus on the succession result.

Most boards recognize that they must rely on the CEO for much of the insight into potential internal and external successors and risks. Unfortunately, the CEO is perhaps the only individual who typically has no financial interest in the actual success of the succession effort.

Through our work with boards of directors, we have identified three types of obstacles to a CEO effectively planning for his or her own succession:

> socially, it may be difficult to discuss succession with a CEO who perceives that a ready and able successor diminishes the CEO's relative power with the board;

> culturally, there may be a history within the organization whereby the CEO has controlled the pace and timing of succession based on the CEO's own plans for retirement; and,

> economically, there may be incentive programs and employment terms that clearly exclude the CEO from accountability for the succession result.

While we do not believe these obstacles prohibit effective succession management, we do recommend boards and committees responsible for succession consider the impact these factors may have on their efforts to mitigate business risk related to CEO succession.

Board Advisory LLC reviewed 50 recently filed CEO employment agreements to identify current practices with respect to CEO succession. We were looking to identify contractual employment terms that support successful succession of the CEO role. What we found was that CEOs typically have little, if any, financial stake in the ongoing success of the company during the 12-18 month period immediately following their termination of employment. In almost all situations, executives were allowed to fully liquidate their ownership in the company upon leaving. Moreover, CEOs often negotiated accelerated vesting of time-based, and sometimes even performance-based, equity incentives in the event of terminations without cause or for good reason (i.e., a "good leaver").

In evaluating contemporary pay practices in light of CEO succession, we have identified several interesting arrangements that can align interests between the outgoing CEO and the ongoing organization through the most critical portion of the succession process. The concepts may be far easier to implement when recruiting a new CEO than when renegotiating with a current CEO, but we believe they are worth discussing in both situations.

1. Establish at the beginning of the relationship that the CEO is the leader of the organization and thus is obligated to ensure continuity in leadership under all circumstances. Whether as a result of voluntary or involuntary termination, the CEO is expected to have plans in place to protect the organization—and will be held accountable to some extent for the success or failure of these plans.

2. Recognize the CEO's obligation to the organization extends beyond the last day worked. We find that over 90% of CEOs already have post-employment covenants such as non-compete/non-solicit arrangements, but only one CEO in 50 had a stock ownership obligation that extended beyond the last day worked. Requiring CEOs to retain their target ownership for 12-24 months beyond the termination of employment helps maintain a real interest in leadership continuity and success.

3. Do not accelerate equity vesting upon "good leaver" terminations. Construct 409A-qualified arrangements whereby shares continue to vest over time and are retained by the former CEO through the succession period, adding to the former CEO's financial alignment with continued organization success.

We propose that compensation committees consider requiring CEOs to have "skin in the game" for a brief post-employment period to shift the focus from the process of succession planning to the actual succession result. After all, a principal responsibility of the board is to manage the succession risk, not the succession plan.

"Compensation committees should consider that linking CEO pay to post-employment succession effectiveness may be as critical as linking pay to performance during the CEO's career."

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