



Compensation Design for Succession Planning

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WHEN A CHIEF EXECUTIVE OFFICER (CEO) LEAVES A COMPANY, THE DEPARTURE IS JUST AS LIKELY TO OCCUR AS A

result of performance concerns, strategic misalignment with the Board, or a merger as it is a result of retirement. Regardless of the proximate cause, whether planned well in advance (retirement), or not (poor performance), most companies are not, by their own estimation, adequately prepared. Increasingly, as governance standards have risen, and CEOs have been given shorter time horizons to perform, Boards are turning their attention to the issue of succession planning. In the process, they are grappling with a variety of complex issues, most of which are sensitive and full of risk.

Among these issues is the fundamental approach to replacing a CEO, and whether to fill the role from within or outside the company's executive talent pool. Given that performance expectations and market reactions will differ depending on where the incoming CEO is sourced, Boards must operate on the premise that the compensation programs they choose must facilitate the transition.

How We Got Here and What's At Stake

Turnover amongst CEOs is high; moreover, the rate of turnover has increased steadily since the end of the last century. Between 1995 and 2006, the rate of CEOs leaving large global organizations rose from nine percent to 14.3 percent, according to a 2007 study by Booz Allen Hamilton. A similar study conducted by Booz Allen in 2006 showed that CEO tenure has dropped by almost half. Performance standards, if not the standards for shareholder forbearance, have changed dramatically, a reality that's borne out in the fact that when CEOs fail, 40 percent have been at their post for 18 months or less.¹

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In addition to holding sway over the future strategic direction of the company, CEO moves have a direct impact on the market, which if mishandled, can create a snowball effect of instability within the company, taking out other key executives, employees and shareholder value in its path. Conversely, a well-planned and executed transition can immediately improve shareholder value and energize employees. However, companies often do not focus on succession – a three- to five-year process – until succession is eminent, forcing Boards and incumbent management into reactive, and possibly compromised, positions at a time when they are trying to secure the future leadership of the company.

Within this environment, it is, at least on the surface, surprising that 80 percent of companies say they do not have an adequate number of quality candidates identified to fill the post through internal or external channels.² However, there are signs that despite the packed agendas and limited experience of Board members collaborating on this issue, more Boards are shifting from their former reactive, event-driven orientation toward forward-looking succession planning. Of those companies with succession plans, 60 percent have implemented those plans in the past two years. However, many of those plans have not been fully developed, or updated to reflect changes in the company's profile or strategy.

While many of the forces that discourage companies from planning leadership changes show no signs of changing – for example, packed management and Board agendas, internal politics, and hair-trigger reactions of markets to unexpected news – the task of creating and implementing succession plans has fallen on Boards already struggling to keep up with all the new accounting, compensation, risk management and company performance standards and regulations. However, it is a balancing act that Boards are recognizing the importance of maintaining. Institutional shareholder groups, such as Risk Metrics/ISS or Glass Lewis, use succession planning as criteria for examining a company's corporate governance program.

Leadership transition is seldom without turmoil. In addition to the increased strain on the remaining management team (and the potential costs the company will incur for retaining these executives during an "uncertain" transition), the strain of an unplanned-for change of leadership extends to the employee population and precipitates market reaction that can take months, if not years, to repair. General market research suggests that a company's stock will typically lose about 10 percent of its value immediately in the wake of a CEO death. Between 10 percent and 15 percent of the stock's value will disappear if an "heir-apparent" leaves the company. If a

departing CEO remains on as the company's Chairman, the stock will likely drop about five percent.³

Types of Succession and Process Overview

The 2007 Booz Allen study defined three types of succession: Normal, Performance-Related and Merger-related. Normal succession was defined as unrelated to CEO performance, typically occurring at retirement. In 2006, approximately 46 percent of departing CEOs left under normal circumstances. Performance-related succession is self-evident; it pertains to a CEO's departure linked to either unacceptable company performance and/or divergence from the Board. About 32 percent of CEOs that departed in 2006 left under this scenario. Finally, about 22 percent of CEOs that left their posts in 2006 did so as a result of mergers

Irrespective of the specific causes for the CEO's departure, Boards should be prepared with a process that is defined, implemented and reviewed/revise *before* it is needed. (See "A Process for Succession" at end of document.)

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Facilitating Succession Via Compensation Design

With a succession process defined, the Board and incumbent CEO have a mutual understanding about the objectives and goals associated with ensuring the company's leadership continuity. At this point, several philosophical decisions must be made to determine the appropriate compensation structure used to facilitate succession. The guiding tenets of this decision-making process are:

- How will successful succession be defined? (i.e., the succession itself, or some level of post-succession performance)
- At what point will success be determined? (at, or after the current CEO steps down)
- What is the desired succession time horizon? (e.g., 2-3 years)
- Will the exiting CEO provide post-termination services to the company? (i.e., will the CEO stay on as Chairman or consultant?)
- What forms of succession should be dissuaded? (i.e., selling the company below a threshold value)

Establishing the transition plan for the current CEO is an important initial step in the process to determine whether the company is best served by the CEO transitioning to the Chairman role; remaining solely as a Board member; providing consulting services in some capacity; or leaving the business altogether. All of these decisions set the framework for hiring a new CEO, but also provide a framework for determining how best to structure compensation to motivate the CEO to work with the Board to complete a successful transition for the company.

Within this philosophical context, there are several additional questions to address, such as whether the CEO has indicated a preference for one compensation vehicle over another, such that succession payments can be tailored to provide additional motivation to successfully complete the transition. Additionally, Boards should understand the consequences of taking a "carrot" vs. a "stick" approach. To the extent that rewards are paid on the backend, the Board has more ongoing control over the process. The downside of this may be that the total cost of succession is increased particularly if equity-based programs (such as performance shares) are used to provide an incentive to meet succession milestones over a period of time. Finally,

Boards need to understand when shareholder value will be better served by selling the company rather than passing the torch to the next generation of CEO.

Driving specific behaviors is achieved through a variety of levers. First, the incentive strategy must determine whether rewards will be granted at the successful completion of the succession or based on milestones; whether there will be a penalty for unsuccessful completion (beyond foregone opportunity); and whether there will be some combination of rewards and penalties, taking into consideration an understanding of when an incentive becomes a disincentive. The strategy will determine the emphasis of the program, that is, whether the focus will be on the completion of succession, or short- or long-term milestones.

Once these questions are answered, the choice of vehicle (cash, equity, deferred compensation) and the size and frequency of the awards can be determined. Considerations in this process can take into account the types of vehicle that will provide the greatest motivational value to the CEO, creating a tailor-made program. For example, if a particular CEO would be better motivated by deferred compensation, and is willing to forego longer-term incentives, the program design can take this into account by creating a deferred retirement benefit based on the success of the transition.

Ultimately, the best approach for any given company depends on that company's situation. The following design examples illustrate how the various approaches work to drive specific behaviors and outcomes.

There are various factors to consider when deciding between looking inside vs. outside the company for a CEO

Example: Former CEO Transitioning Into Other Roles With The Company

This example addresses the compensation philosophy pertaining to CEOs who remain with the company as Executive Chairman, Non-Executive Chairman, Director and/or consultant to the company.

If the departing CEO transitions to an Executive Chairman role, the succession plan should also address how best to compensate the short-term and long-term contribution of that role. Executive Chairman roles are typically compensated via cash, as a reflection of the time commitment – as high as 50 percent of the full-time CEO – necessary for the role. At issue also is whether, and to what extent, Executive Chairman will participate in equity or other long-term incentive awards. Incentive bonus opportunities are atypical in this scenario.

The succession plan will also need to address whether the former CEO will be allowed additional vesting time for the equity he or she held at the close of his/her tenure as chief executive. Companies sometimes grant additional vesting time to reflect the longer-term impact of the value created while the executive was CEO.

Should the one-time CEO transition from Executive to Non-Executive Chair, compensation is typically based on current Board Compensation. Cash compensation for the Non-Executive Chair typically ranges from 1.5x to 2.0x of Director cash compensation, and equity compensation. When the former CEO transitions to a consultant role with the company, compensation is most frequently in the form of cash, and is reflective of the required time commitment.

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Example: Retirement Performance Share Grant

Under this example, an award is made “Day 1” with the opportunity to receive more or fewer shares based upon timing of the succession event. This approach maintains the focus on protecting and growing shareholder value – the targeted award is determined in number of shares – so increases in the value of the award (through number of shares and share price improvement) will directly align the current CEO with increases in shareholder value. Additionally, in order to motivate the current CEO to identify and find a replacement on a predictable schedule, the reward opportunity ramps according to the CEO's performance in achieving the time-based objectives. For example, the CEO receives 150 percent of the target award if the succession is completed within 30 months; 100 percent of target if completed between 30 and 35 months (the targeted time horizon); 75 percent of target if completed between 36 and 47 months; and zero percent of target if succession is not completed within 48 months. The program would require unanimous Board agreement on the identified successor.

Further, to motivate the CEO to find the best possible replacement, the shares could be distributed 12-18 months after succession occurs, which results in the outgoing CEO having a financial stake in the success of his/her replacement. Finally, to ensure against a “fire sale,” the shares would not vest under a change-in-control where the deal size is under a target amount.

Example: Company Sale

This award would be triggered by a sale of the company with a deal size in excess of a pre-determined amount, and the CEO would receive a percentage of all incremental shareholder value created above that baseline value. This approach achieves the dual aim of protecting against a below-market sale price and motivating the CEO to focus on executing the operational excellence required to attract suitable deal partners.

The award is structured either as a flat percentage or on a sliding scale percentage, based on the final deal price. For example, assuming a threshold company value of \$400 million, and the CEO receiving five percent of every \$1 million of the deal price above \$400 million, the CEO would receive \$5 million with a deal price of \$500 million. Alternatively, the percent could increase at milestone value buckets. In either case, payment would occur once the terms of the deal are agreed to by the Board and the deal is consummated.

Example: Link Variable Compensation to Succession Milestones

This approach involves carving out all or a portion of the CEO's incentive bonus and attaching payment of that incentive based on the completion of successor developmental milestones. Under this approach, the CEO is responsible for setting aggressive, Board-approved, developmental milestones for internal candidates and ensuring that they are achieved. Ideally, the CEO will work with an external firm to assess the successor candidates' strengths and weaknesses, which will guide the creation of specific, measurable objectives to ensure that the successor is positioned for a successful transition.

The CEO's performance is evaluated by the Board at the end of the performance period; at that time awards are determined based on the successor's performance relative to the pre-determined goals and candidate readiness.

Example: Exercise Negative Board Discretion

Many executive compensation programs generally incorporate the flexibility of Board discretion, which can impact bonus funding, non-qualified deferred compensation matches, and other compensation elements. To the extent that the CEO succession process significantly deviates from the desired roadmap or timeline, the Board could exercise negative discretion by using succession as a basis for determining award amounts. For example, the Board can tie executive management team incentive awards, or non-qualified deferred compensation matches to the team’s success in supporting the process, as a way of ensuring that ownership for succession is shared across the management team.

In cases where the company achieves its operating goals, but does not meet succession planning goals, excess dollars can be distributed back to shareholders or invested back into the company.

Different design approaches work to drive specific behaviors and outcomes

A Process for Succession

The following outlines common steps in the creation and maintenance of a successful succession process:⁴

- Involve the full Board: While most Boards leave the “heavy lifting” to search/nominating committees, the process (and its outcomes) will benefit from diverse perspectives. This practice will also help facilitate the decision-making process and ensure that final decisions can be made with a unified voice. Regular reports to the full Board that incorporate their feedback will also build consensus support for the final candidate.
- Translate the company strategy into operational terms and create a succession “roadmap”. Understanding how the company creates value is a fundamental requirement for ensuring succession is successful. While this might seem self-evident, studies have demonstrated that about 40 percent of directors do not have sufficient understanding of the firm’s value creation process. This fact could help explain why the CEO has often had responsibility for creating the roadmap and candidate profiles; however, this part of the process most appropriately belongs with the Board.
- Based on the operational requirements for driving value, identify the specific skills/experience/requirements of the successor. This is both the skill sets needed now, and those required for future company growth. The greater the degree of specificity, the better; avoid general characteristics (e.g., “strong leadership background”).

Ensuring a smooth transition of company leadership is a risk-laden undertaking

- Stay abreast at all times of talent within and outside the company that can fit into, and lead, the business:
 - Internal candidates: Identify the rising stars in the organization and record their accomplishments to-date. Based on this foundation, understand where these potential heirs need development, and how they will obtain that development opportunity well before succession is required. These development plans should be included in a formal succession plan.
 - External candidates: Educate external search firms with a detailed profile of the strategic theme, measures, targets, projected initiatives and expected results of the organization. Questions that need to be answered include:
 - How has the candidate managed and led at the Board and shareholder relations level?
 - How is the candidate viewed from the external world as a leader?
 - Has the candidate performed activities and set and achieved goals comparable to those outlined in the firm's strategy?
 - What kinds of results has the candidate had?
 - Will the candidate's skills transfer well to the firm?
 - Did the candidate engage and inspire other managers by actively participating in the implementation of key activities and initiatives?
 - Did the candidate set realistic goals, overcoming hurdles along the way?
 - What are the potential risks that the candidate will not achieve success in the new firm, even though he or she was successful at the former company?
 - How are the cultures the candidate has worked in before similar to, or different from ours?
- Test and choose from short-list candidates: Provide hypothetical (or real) cases to determine how the candidate might approach the situation using a highly interactive format. As a follow-up, ensure there is a thoughtful process in place for making decisions about candidates. Avoid the temptation of comparing candidates to each other rather than to the operational and strategic objectives in front of the company.

Pros/Cons of Insiders vs. Outsiders

Booz Allen reported in its 2007 study that while outsiders were selected to replace 30 percent of CEOs in 2003 (a high point for that practice), about 18 percent of new CEOs were outsiders in 2006. There are numerous factors to consider when deciding between looking inside vs. outside the company for a CEO replacement. In general terms, outsiders are selected most often when the Board has identified the need to “shake up” a company through a change of strategic direction, higher performance standards or reduced costs. Conversely, insiders most often will continue on a path of profitable growth and will focus on stimulating further expansion of the company’s success by leveraging the core infrastructure in place for grooming CEO candidates.

Conclusion

Investor expectations of company performance have changed; time tables for performance delivery have shortened; and CEO turnover has risen in the wake of this change. As a result, succession planning has become a critical concern for Boards. Ensuring a smooth transition of company leadership – one that does not jeopardize remaining employees and company stock performance – is a risk-laden undertaking, and Boards are responding by instituting succession plans and implementing sound compensation strategies that facilitate the succession process, preserve continuity of leadership and grow company value.

Footnotes

¹ “Ending the Succession Crisis,” Harvard Business Review, Feb 2005

² “National Association of Corporate Directors Survey on Succession Planning,” Directors & Boards Supplement, Spring 2005: 15-20

³ “Ending the Succession Crisis,” Harvard Business Review, Feb 2005

⁴ “How to Succeed at CEO Succession Planning,” Directorship, May 2003

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Ted Buyniski has more than 25 years of tax, legal and human resources experience. He is a leading practitioner in the areas of executive compensation, equity, and corporate governance. For more than a decade, his practice has focused on serving national and global clients in the high technology and life science communities, particularly software, semiconductor, and medical device companies.

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