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CEO Exit Packages and Other Considerations for Departing Executives

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Committees spend a great deal of time ensuring that the executive compensation program delivers a competitive pay opportunity, which facilitates effective recruitment and motivation of the executive team. They typically spend less time on how the program works when there is the separation of an executive under various circumstances. Twenty years ago, tally sheets came into vogue as a way for compensation committees to monitor, manage, and prepare for external communications about exit pay for CEOs. But over time, it seems that this analysis has fallen by the wayside.

However, proxy advisors have put the spotlight back on exit pay, and not just for CEOs, but for all proxy-named executive officers (NEOs). Both ISS and Glass Lewis have refined and sharpened their positions, with increased negative consequences for poor practices. In fact, in the most recent annual review of "Against" say-on-pay vote recommendations by ISS, poor exit pay practices are second in frequency only to poor pay-for-performance alignment. Clearly, it's time to put exit pay back on committees' radar.

Essentially, there are two practices that companies should seek to avoid. First, avoid ex-post separation arrangements, where a departing executive receives materially richer treatment than they are contractually entitled to. For example, a company may determine that it is time for an executive to move on but finds that formal severance arrangements are either too thin, or non-existent. To ensure a smooth transition, the committee approves liberal treatment of unvested equity despite a plan provision that calls for forfeiture. If the value of the ex-post provisions is rich enough, and the company is receiving nothing of value from the executive in exchange, the proxy advisors are increasingly likely to issue an "Against" vote recommendation.

The second practice to avoid is paying severance for a "voluntary" termination. Proxy advisors are acutely opposed to severance pay associated with an apparent retirement, or a "mutual agreement" to separate. For example, a company may determine that it is time to upgrade their CFO, but the outgoing CFO is long-tenured and well-liked by the CEO and the board. Further, the CFO is concerned about the stigma of an involuntary termination, but nevertheless, expects "a package" to leave. The company pays severance but discloses the separation as a mutual agreement as opposed to a termination. As far as the proxy advisors are concerned, the days of gratuitous cordiality are over. Such a disclosure is very likely to garner an "Against" vote recommendation.

To eliminate, or at least reduce, the need to resort to such practices, companies should do a few things well in advance of any separation.

1. **Review and update the formal treatment of cash incentive and equity grants upon all classes of separation.**

   Ensure that the exit pay is appropriate to real-world situations for your executive team.

This goes for voluntary terminations, involuntary terminations (both for-cause and not-for-cause), death, disability, and retirements. Pay particularly close attention to the involuntary not-for-cause case, including the formal severance pay component. Model the provisions to understand how each member of the executive team would be treated to ensure all seems fair, so that exceptions can become extremely rare.

2. **Carefully consider and plan the disclosure of named executive separations.**

   For any NEO departure, the proxy advisors will carefully scrutinize the narrative disclosure as well as the specific pay provisions. Stick to the plans and get comfortable with clearly disclosing terminations as such when severance pay and provisions are utilized.

3. **Use retention agreements to set ex-ante special arrangements.**

   It may seem odd to suggest "retention," since the proxy advisors also don't like special retention awards. But there are occasions when a company can anticipate a key executive separation in the next few years and wants to ensure service through a particular date. For example, a company might give retirement treatment to that executive's equity even though they won't be retirement-eligible, provided they serve through that date. It is far better to bake that special treatment into new equity grants and disclose those terms ex-ante than to deliver them as a "golden handshake," and modify existing grants.

If exceptions must be made, consider if some continued service through a transition period can legitimately be incorporated into the separation agreement, such as a consulting arrangement or service in a special executive role. Such an arrangement will garner further scrutiny by ISS and Glass Lewis but they will provide at least some cover for exceptional treatments.

About the Author

Matt Turner is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. He specializes in advising company boards and senior management on executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives.

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