REEXAMINING RETIREMENT PROVISIONS

Implementing or refining measures on treatment of equity awards at retirement can smooth executive departures.

DESPITE SHAKESPEARE'S MUSINGS, parting ways isn't always such sweet sorrow. In the case of an exiting executive, it can become downright unpleasant without proper planning. Take the case of a longtime chief executive who surprises his or her board with imminent plans to leave, sparking a succession-planning frenzy. Or the equally disruptive reverse—a leader who derails a carefully planned transition with a sudden, compensation-motivated change of heart. And then there's the faltering company whose board decides to make a leadership change, only to discover the move will result in its CEO collecting both cash severance and all outstanding equity.

In other cases, the situation may be less extreme but still far less than ideal. Board members may face pressure from a retiring executive to risk shareholder ire by making a discretionary change so he or she can collect performance compensation. There's also always the risk that a poorly designed program may allow for accelerated vesting of LTI awards on departure, incentivizing a departing leader to prioritize short-term performance to boost the grant award value.

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All of these are real-world scenarios that have significant ramifications, says Eric Winikoff, managing director at FW Cook. "There are real talent pipeline implications tied to retirement treatment. If companies aren't smart about this, they can end up causing senior talent retention or succession-planning pipeline issues, triggering say-on-pay ramifications or simply paying out too much."

The good news? Implementing or refining provisions for the treatment of equity awards on retirement can help companies guard against these outcomes while providing meaningful company benefits.

CREATING CRITERIA

In designing such provisions, boards should begin with basic blocking-and-tackling measures that ensure the plan functions as intended in various scenarios. For example, many companies have retirement provisions on RSU and PSU grants that link eligibility to age and years of service criteria. "However, it's also important to define retirement as voluntary to ensure that executives are eligible for either cash severance or retirement treatment of equity, not both," says Winikoff. "Otherwise, a CEO getting forced out who meets the criteria will be entitled to get the award on top of any severance package."

Conditioning retirement provisions on providing the company with a designated amount of notice about a CEO or executive's intentions to retire is another safety measure companies should consider. While there is additional complexity, "the company gets the benefit of time to plan and ensure a smooth transition and, in the case of an early-fiscal year transition, can size any future LTI awards based on the portion of the year that will be served," explains Winikoff.

Flexibility should be built into the provision to allow for situations when a longer lead time is unwarranted, such as when the board is pressing for a change in leadership, adds Eva Gencheva, a principal at FW Cook. "The advance-notice requirement should also include a provision that it can be waived by the company," she says.

Alternatively, a company might require that employees stay at the company for a designated amount of time after a grant date in order to be eligible

Retirement Provisions Rationale

ADVANTAGES OF IMPLEMENTING ENHANCED RETIREMENT EQUITY AWARD PROVISIONS INCLUDE:

- **Motivating** long-term business decision-making through the retirement date
- **Ensuring** advance notice of retirements for smoother succession planning
- **Avoiding** requests for individual incentive program modifications by employees approaching retirement age
- **Enabling** consistency in treatment across all LTI recipients
- **Allowing** for restrictive covenants that include important shareholder protections
- **Enhancing** the competitiveness of the equity program in tight labor markets
- **Guarding** against the need for award modifications that may create say-on-pay pressure

for retirement treatment. "This avoids executives receiving a full-year LTI grant when only a small portion of the year will be served," says Winikoff. "Requiring advance notice of retirement or requiring a length of service following a grant both help prevent that."

INSTILLING ACCOUNTABILITY

Retirement provisions should also be structured in such a way that outgoing executives have incentive to foster a smooth transition and lay the groundwork for long-term performance goals. "For example, we recommend providing for continued vesting rather than accelerating vesting upon retirement," says Winikoff. "Philosophically, you don't want to treat retirees better than you're treating active employees, and you want your retiring executives to be invested in bringing other people up to speed, making sure that the transitions of responsibility are happening smoothly and making decisions that position the company for long-term success."

Restrictive covenants that prevent retired executives from hiring their former colleagues, sharing trade secrets, working for competitors and soliciting employees are additional protective measures that should also be in place to protect shareholders and strike a cost-benefit balance when providing enhanced equity treatment in connection with retirement.

RETENTION AND RECRUITMENT

Provisions that enable retiring executives to be eligible to receive a percentage of their long-term incentive pay can also serve as a talent differentiator for companies during today's tight talent market. Provisions may also help companies avoid a situation where individual executives nearing retirement request modified award programs. Modifying outstanding awards for proxy-disclosed executives in termination scenarios creates meaningful say-on-pay risk that can be avoided by having a balanced approach considered and implemented at the time of the grant. "Companies that don't have retirement provisions may have executives nearing retirement raise concerns about being awarded equity grants that they won't earn. They may request a different arrangement in their final years, such as heavier emphasis on cash over equity or on awards that vest annually rather than over several years," says Winikoff.

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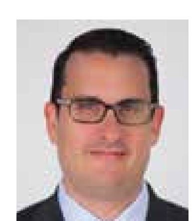
While considering such one-off arrangements might seem reasonable in the case of a long-term employee, they can be time-consuming, expensive and distracting. "They require compensation committee approval, which takes a lot of time," explains Winikoff. Modifying awards on an individual basis can also create a precedent that fuels future requests or internal equity issues among other employees, especially when made for proxy-disclosed executives, where such actions are visible to both current and future executives. In the case of discretionary, after-the-fact adjustments, it also has the potential to create governance issues. "Committee discretion award modifications result in proxy disclosure obligations for named executive officers, which has negative say-on-pay implications in the current governance environment," says Gencheva.

"The governance issue comes in when you try to do something different from what's written in the award agreement," explains Winikoff. "But if the award agreement covers retirement provisions up front, that's not a problem."

A policy that ensures consistent treatment of LTI awards for departing executives also helps boards avoid one-off treatments that create a precedent or internal equity issues, adds Winikoff, who sees formalizing provisions for the treatment of equity awards as a win-win if done correctly. "Transitioning out senior executives, especially CEOs and CFOs who have been with the company for a while, can be difficult. Ultimately, defining retirement and implementing formal provisions for the treatment of LTI awards on retirement protects both the company and its departing executives."



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