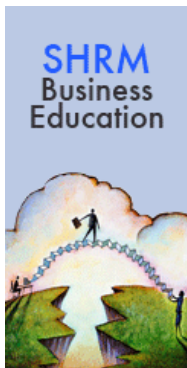




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Succession Planning

Published September 2008

CEO Succession Compensation Design

Ted Buyniski, Edward J. Speidel and Robert Surdel

When a company's chief executive officer (CEO) steps down and the departure is unplanned, the company is overly exposed to numerous risks associated with unanticipated leadership transition. CEOs are leaving more frequently than at any time in the past decade, with the rate of CEO exits from large global organizations between 1995 and 2006 rising from 9 to 14.3 percent, according to Booz Allen Hamilton data.

Moreover, performance standards — if not the standards for shareholder forbearance — have tightened dramatically, resulting in ever-shorter CEO tenures. When CEOs exit in the wake of performance-related issues, 40 percent have been at their posts for 18 months or less, the Center for Creative Leadership reports.

Within this environment it is surprising — at least on the surface — that 80 percent of companies are not adequately prepared for their CEOs' departure, as documented in a 2004 Corporate Leadership Council study. However, despite packed board agendas and directors' limited experience with succession, more boards are shifting from reactive, event-driven postures toward forward-looking succession planning and the compensation designs that will best position the company to successfully manage a transition.

Facilitating Succession via Compensation Design

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 help determine how best to structure compensation that motivates the CEO to work with the board to complete a successful transition.

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

- How will successful succession or levels of post-succession performance be defined?
- At what point will success be determined: during tenure or after the current CEO steps down?
- What is the desired succession time horizon?
- Will the exiting CEO provide post-termination services to the company, such as staying on as chairman or consultant?
- What forms of succession should not be supported? For example, is it acceptable to sell the company below a threshold value to achieve an exit and avoid the succession question completely?

Driving specific behaviors through the transition process 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 and whether there will be some combination of rewards and penalties. 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.

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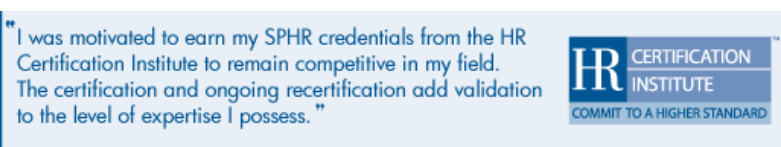
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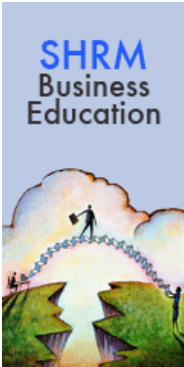
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Once these questions are answered, the choice of vehicle — such as cash, equity or deferred compensation — and the size and frequency of the awards can be determined. Ultimately, the best approach for any given company depends on that company's — and at times, the CEO's — situation. The following five examples illustrate how various design approaches drive specific behaviors and outcomes.

Example 1 - Former CEO transitions into other roles with the company: If the departing CEO transitions to an executive chairman role, the succession plan also should address how best to compensate the short- and long-term contribution of that role. Executive chairman roles typically are compensated via cash as a reflection of the time commitment — as high as 50 percent of the full-time CEO — necessary for the role. Also at issue is whether and to what extent, the executive chairman will participate in equity or other long-term incentive awards. Incentive bonus opportunities are atypical in this scenario.

Should the one-time CEO transition from executive to non-executive chair, compensation typically is based on current board compensation. Cash compensation for the non-executive chair typically ranges from 1.5 to 2 times of director cash and equity compensation.

Example 2 - 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 will directly align the current CEO with increases in shareholder value.

Additionally, to motivate the 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 0 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, tying the CEO's interests to the success of his or her replacement.

Example 3 - Company sale: This award would be triggered by a sale of the company with a deal size in excess of a predetermined 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 execute 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. Alternatively, the percent could increase at milestone value buckets.

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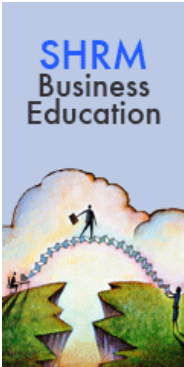
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Example 4 - Link variable compensation to succession milestones: This approach involves carving out all or a portion of the CEO's current or multiple years' incentive bonus and attaching payment of that incentive based on completion of successor developmental milestones.

Under this approach, the CEO is responsible for setting aggressive, board-approved, developmental milestones for internal candidates and ensuring they are achieved. Ideally, the CEO will work with an external firm to assess the successor candidates' strengths and weaknesses, which will guide creation of specific, measurable objectives to ensure the successor is positioned for a successful transition.

Example 5 - Exercise negative board discretion: Many executive compensation programs incorporate the flexibility of board discretion, which can impact bonus funding, nonqualified deferred compensation matches and other compensation elements. To the extent the CEO succession process significantly deviates from the desired road map or timeline, the board could exercise negative discretion by using succession as a basis for determining award amounts and actual payment. For example, the board can tie executive management team incentive awards — or nonqualified deferred compensation matches — to the team's success in supporting the process.

CEO turnover has been on the rise during the past decade, highlighting the importance of succession planning 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 with sound compensation strategies that facilitate the succession process, preserve continuity of leadership and support the growth of company value. **TM**

Ted Buyniski is senior vice president, Edward J. Speidel is senior vice president, and Robert Surdel is assistant vice president at Radford Surveys + Consulting.

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