Designing CEO Compensation Plans From Hire to Retire

CEO compensation is a sensitive topic that generates a lot of energy and emotion among shareholders, employees and external audiences. It is critical that boards and compensation committees use a thorough and objective process to arrive at both reasonable and fair compensation decisions. It is also a highly nuanced topic—there are many avenues through which a new CEO can attain that position, and they all have implications for how compensation packages are, and should be, designed. There are even more factors to consider as the CEO grows in the role, makes progress toward business objectives, and resigns or retires from the position. Roles and steps in the process as well as relevant data also influence outcomes.

Setting the Stage

The process for establishing CEO compensation includes a variety of stakeholders beyond the CEO. Within the organization, key figures include other members of management and senior leadership, the Board of Directors, and the compensation committee. Institutional shareholders and proxy advisors also look closely at external messaging, optics, and disclosures. From a data perspective, compensation committees must evaluate what types of information are most critical, where that data can be found, and how to conduct the proper analyses to extract the most impactful information. Non-financial or qualitative data is also important to the process. The key theme that unites all these inputs is a commitment to honest, open communication as a means to an effective and efficient process. Each stakeholder must have a clear understanding of their role and every step in the process.

Establishing Compensation for Internally Promoted CEOs

The starting point for this process depends on how the new CEO came into the role. Internal promotions are the most common path. Spencer Stuart, a global executive search and leadership consulting firm, tracks CEO transitions at S&P 500 companies. During Q1 of 2021, 22 companies reported the appointment of a new CEO. Of those 22, 17 were promoted from within, and 14 of those were elevated as part of a planned succession.

Boards tend to prefer appointing internal candidates to the CEO position. It is a powerful signal that the company has an effective succession management development process in place with

a solid bench of talent. It's also the less expensive option. In general, pay packages for internally promoted candidates are less than their predecessor and below the market median. There are several reasons for this. First, a newly appointed CEO is moving into a large and critical role within the organization, but they have not yet developed their skill set relative to existing experienced CEOs.

A common approach is for boards to earmark the 25th percentile as a starting point, anticipating a two or three-year progression toward the median as they grow and develop their skills in the role while driving company performance. Meridian's consultants are often asked to craft models of what a salary and performance progression might look like. For example, models might show what a progression toward increased long-term incentive opportunities might look like, or the implications of increasing cash compensation sooner rather than later.

Of course, there are almost always unique scenarios. Special circumstances may warrant a compensation package that is closer to that of the exiting CEO, such as an individual who has been waiting in the wings for several years. There are also limited situations where a company or board may see fit to make a special grant of equity to the incoming CEO on top of establishing the annual salary, target bonus, and annual and long-term incentive plans. This might occur when the transition takes place off-cycle. The special grant would serve as a one-time bridge award to help get the new CEO toward their targeted annual run rate of long-term incentives. Other times, the board might make a special grant to send a strong message around alignment to share price, or to bolster the incumbent's unvested equity stake. It all depends on the specific facts and circumstances.

Establishing Compensation for External Hires

In general, there are two types of external hires—those who have prior CEO experience and those who are hired into the role from other non-CEO positions. For an external hire without prior CEO experience, compensation tends to resemble that of an internally promoted CEO. Total compensation will likely be more conservative relative to market or that of the outgoing CEO. Again, this is to acknowledge that the new CEO has not yet developed into a fully experienced CEO and to establish expectations for a reasonable progression to that median. There are always exceptions, depending on the company's context and situation.

If a company wants to hire an experienced CEO from another organization, they are looking at a more expensive proposition. When an executive leaves a company, that executive potentially forfeits a significant amount of compensation, like unvested equity and other incentive compensation that would otherwise be payable. Compensation committees must have a full understanding of the new CEO's current situation, and a detailed analysis can help the board decide whether it makes sense to replace some or all of that unvested compensation.

In contrast, if experienced CEOs are moving to a similar-sized company in a similar or related industry, they are better equipped to "hit the ground running." If they are being recruited, they have likely already proven their ability to meet performance objectives and generate value. Potential compensation packages at a new company must be competitive enough to reflect the significance of this experience. It is, however, a balancing act—compensation committees must sometimes be prepared to stretch to find the right talent and get them excited about the opportunity, while remaining conscious of how a larger compensation package may be perceived by external stakeholders. When these factors do not align, organizations risk a negative impact on Say-on-Pay vote outcomes.

One significant consideration is the balance between the expectations of the candidate regarding what they are leaving behind and what they stand to gain by taking a risk and joining a new organization. The candidate might expect there to be more time-vested components to the compensation package, especially if they have earned much of that compensation with their prior employer and it is about to be payable. Shareholder expectations also play a key role—investors usually prefer replacement awards to be reasonably sized and heavily performance-based with longer-term vesting. This is one of the biggest areas of nuance in CEO compensation, and certainly the biggest area of thoughtful negotiations between the candidate and the potential employer.

One of Meridian's roles in this process is to assist with market data and financial analysis. Evaluating an executive's unvested equity is an easier exercise when the CEO was a named executive officer of a publicly-traded company. Their pay history is public, allowing us to get a clearer understanding of what the CEO will leave behind if they take a new role. We also look at the company's performance and try to make reasonable assessments as to how some of the performance incentive compensation initiatives might be tracking. Our goal is to illuminate for the board what kinds of time-based and performance-based rewards and longer-term equity vesting the CEO will potentially lose. These analyses are intended for boards and compensation committees to review and use to make more informed decisions.

Evaluating Compensation for Current CEOs

In general, most companies are not frequently transitioning CEOs in and out of the organization. There are usually at least a few years where CEO compensation is evaluated and adjusted annually. Even for established CEOs, however, it is important to establish and define key roles and steps in the process. The first step is to reflect on any written board governance charters or documentation. These documents help define who is responsible for deciding CEO pay and how the organization should go about completing the work. In most cases, the established process calls for the compensation committee to independently review a variety of factors and make a recommendation to the full board of independent directors for their approval. The timing and cadence of the CEO's annual performance review must align with the CEO compensation design process.

Neither of these processes is simple, so everyone must have a clear understanding of the process steps and roles. Newer CEOs will likely have questions around governance or timing, and part of ensuring an effective and efficient compensation process requires the CEO's full understanding of how decisions are made and reasonable expectations. There should be no surprises.

Who is involved?

The compensation committee chair typically takes the lead in executing the process and facilitating discussions with the committee on an independent and objective evaluation of CEO pay. Often, another member of management or board member (not the CEO) will coordinate with the committee chair and provide perspectives on what the compensation package should look like. These two roles are usually in alignment.

The CHRO's role in the process is to provide data for evaluation by the committee. This data might include historical compensation information, details of outstanding equity holdings, equity sales transactions, and a variety of other internal details. The CHRO provides information but is typically not involved in the board's ongoing discussions regarding pay decisions.

Independent compensation consultants like Meridian assist the committee chair and the full committee by providing external market context and insights. This context might include market data and analysis, pay and performance assessments, projections of realized and realizable pay, unvested equity holdings, and a variety of other information. They also inform the committee on prevailing standards and policies of proxy advisors like ISS and Glass Lewis, and provide insight into the expectations of large institutional shareholders.

Other than participating in the CEO evaluation process and being the recipient of approved compensation, CEOs are typically not heavily involved in the plan design process. In fact, CEOs are rarely involved in any conversations or deliberations by the independent board members on compensation matters.

Data Considerations

CEO compensation should ideally be evaluated against both internal and external data. The process for setting or adjusting compensation levels usually begins with a thoughtful peer group review. Most companies should have a reliable, up-to-date group of peer companies to establish baseline market data. From there, a company's unique context will affect what types and sources of data will make sense to inform the decision. This market information is the starting point for further dialogue with the committee or the entire board.

Companies are maturing quickly in their use of data to inform business decisions, from sales and marketing to talent acquisition and succession planning. Compensation committees are likewise growing more sophisticated in their expectations regarding data analysis. They want more real-time data from more diverse sources. Sometimes they are primarily concerned with financials and other quantitative data, but qualitative measures can also add insight.

Trends in Adjusting CEO Compensation

Committees and boards have multiple levers they can pull when adjusting CEO compensation in any scenario, from onboard to exit. In general, Meridian's consultants are seeing less movement on the cash compensation element in annual evaluations. Rather, the focus is increasingly on adjusting long-term incentive compensation.

For experienced CEOs, there is a strong chance that their cash compensation is already strongly aligned with market norms. Compensation adjustments occur largely within equity compensation packages to drive long-term performance and focus on long-term shareholder return. Over time, CEO compensation adjustments often shift towards more performance-based rewards.

Outgoing CEOs: Compensating the Transition

Just like there are several paths by which a CEO might enter the role, there are also different ways a CEO can exit an organization. There are two prevalent types of CEO exits. One is a simple, one-step approach—the CEO goes right into retirement. They step away from all roles within the organization and end their employment based on a qualifying retirement termination event. An equally common but more complicated transition occurs in phases. A CEO may resign from the CEO role but stay involved for a short time as the board chair before ultimately moving on to retirement.

Direct-to-Retirement Transitions

When a CEO's retirement is planned and stakeholders are in agreement as to how the transition will proceed, few compensation changes will usually be made. There is rarely any additional cash severance or bonus equity granted upon departure. The board's primary focus at this stage is the treatment of unvested equity. This has usually been addressed ahead of time—there is a process in place and definitions and provisions have been clearly outlined in public disclosures and award agreements.

However, the board often requires a "refresher course" on what the actual outcomes will be. They will want to know how different equity vehicles will be treated and what the actual outlay of dollars will be. In many cases, they look to the compensation consultant to illuminate these outcomes at a high level; provide detailed, nuanced summaries of the outcomes; and answer questions regarding tax implications, accounting treatments, and other considerations.

Phased Transitions: Executive Chair of the Board

The Executive Chair role is one that a CEO may move into for six to twelve months after stepping down from their position as CEO. There are many reasons for moving a company through a CEO transition more slowly. Sometimes it is as simple as having the former CEO available to help the new CEO get up to speed and ensure a thoughtful, thorough transition, especially if the former CEO held that position for many years. In other cases, it allows companies to mitigate the appearance of risk or instability that could affect relationships with large investors and other key stakeholders like customers or suppliers.

Without question, the Executive Chair role is designed to be transitional and temporary, though its purpose varies widely depending on the context and circumstances of the company. As such, compensation for the role is highly variable across companies and industries. The Executive Chair is, however, still an executive officer of the company so the compensation package is still comparable to that of other executives with salary, bonus, and long-term incentive options. Beyond those basics, every situation is very different.

It is customary to maintain a salary. Executive chairs often participate in the bonus plan, but not always. They may or may not participate in further equity grants, but if they do, they are usually fully time-based. It is not uncommon for the total compensation package for an executive chair to be about half that of a new incoming CEO. When the retirement date finally approaches, the board will again require a full summary of what the departing CEO's compensation will be and a full understanding of any other contractual obligations that may be due, on behalf of the company but also on behalf of the CEO in terms of restrictive covenants, non-compete agreements, confidentiality clauses, etc.

Conclusion

As with all compensation arrangements, establishing CEO compensation is a complicated and nuanced process. There are many paths to becoming CEO, many metrics for determining a CEO's success, and even multiple ways to retire from the CEO role. This article represents the most widely used approaches and high-level processes, but all matters are subject to each organization's unique facts and circumstances.