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Pay Negotiations for Top CEO Talent Heat Up

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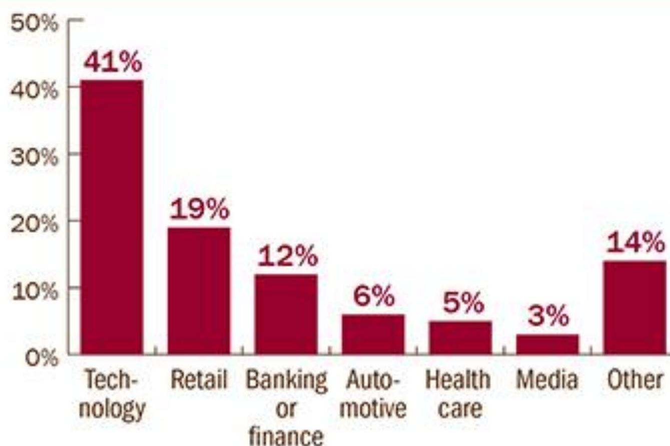
Directors believe that the qualified pool of CEO talent capable of running the largest U.S. public companies is "incredibly small," according to a new research report by **Stanford** Graduate School of Business and the Rock Center for Corporate Governance.

This shortage of talent is changing the pay negotiations between the board and CEO, say experts. Compensation committees are more open to offering retention awards, including make-whole payments, to land top CEO talent. When awarding these types of payments, experts advise boards to evaluate how they could impact the company's overall compensation philosophy and then properly disclose the pay scheme to shareholders.

"Almost across the board, directors of the largest publicly traded U.S. companies believe that the available pool of qualified CEO talent in their industry is small, the issue of 'fit' difficult to get right, and the downside risk of making the wrong choice high," says professor **David F. Larcker** of Stanford Graduate School of Business, who co-authored the study.

According to the study, on average, Fortune 250 company directors estimate that fewer than four executives have the ability to move into a CEO role today and run their company at least as well as their current top executive. Furthermore, these directors estimate that only six executives could perform as well as the CEO of their largest competitor, and no more than nine would be able to engineer a corporate turnaround under poor industry conditions.



Corporate boards appear to prefer experienced CEOs, given that there seems to be a big experience gap among the current available candidates.

A Tight Market for CEOs

"These findings have profound implications for talent development and CEO compensation," says Larcker. How you groom senior executives and structure CEO pay really hinges on how available replacement talent is, he says.

Indeed, research shows that among CEOs, compensation is highly sensitive to tightening labor markets. "In fact, companies may significantly raise their incumbent CEO's pay (or be willing to offer a substantially more generous pay package to an incoming CEO) when the demand for top leadership talent in the industry intensifies, and even more so, if they experienced situations where some of their executive talent left to join industry peers," says **Matteo Tonello**, managing director of corporate leadership at **The Conference Board.**

In these cases, companies may be willing to forgo benchmarking considerations or existing compensation policies to avoid the risk that one or more isolated instances may trigger reputation damage and a talent drain, a risk that, if it materializes, may have disastrous consequences for an organization, he explains.

The tight market for talent has also given experienced CEOs more leverage in pay negotiations, according to experts.

"The reality is that a good cross section of boards feel that replacing the CEO would be very difficult, and that will shape their behavior," says **Alan Johnson**, managing director and founder of compensation consulting boutique **Johnson Associates**.

"Given the scarcity of outstanding CEO talent among large corporations, it is unlikely that the labor market for CEOs functions efficiently," says **Brian Tayan**, researcher at Stanford and co-author of the study. With an inefficient labor market, management faces less pressure to perform and distortions can arise in the balance of power between the CEO and the board, and in compensation.

Some experts say that in this tight market for CEOs, private equity firms have played a role in escalating salaries. One director cited in the study suggested that there are better private equity opportunities for experienced CEOs.

James Bender, a director at **Two Harbors Investment Corp**., says private equity firms are a lot more active in looking for talent and have bigger treasure chests to spend, which allows CEO candidates to "look at the upside of getting a piece of the action and working in a private setting."

Retention and 'Make-Whole' Awards

According to Tonello, retention risk mostly affects the equity-based component of a compensation package, since it's the component over which compensation committees have the most flexibility in the design phase. In particular, retention risk could impact the number of awarded shares or reduce the share retention period to which the CEO is subject, he says.

Some boards are offering retention awards to executives in highly competitive industries.

"In the highly competitive technology sector, where attracting, retaining, and motivating employees is a continuous effort, some companies may have elected to increase the grant value of restricted stock and decrease option grants," according to comments by **Etrade Corporate Services** that were cited in **Equilar**'s 2017 Equity Compensation Trends report.

In some cases, boards are also offering "make-whole" awards to attract a CEO from another company. These payments reimburse executives for certain payments that they would forgo when moving to a new company.

For example, the board of **CSX Corp.** assumed the obligation to pay $84 million related to compensation that current CEO **E. Hunter Harrison** forfeited when he was lured away from his prior employer, **Canadian Pacific Railway**. These obligations were assumed from activist hedge fund **Mantle Ridge**.

Mondelez International agreed to a $38 million make-whole award for its CEO, **Dirk Van de Put**. This payment included $18 million in deferred stock units.

When it comes to recruiting a new CEO, companies may go beyond the normal incentives to entice an executive to leave their existing job, says **Eric Gonzaga**, partner and practice leader for the Human Capital Services group at **Grant Thornton**.

"I wouldn't call it mega grants, but to get people to come aboard, you'll see, more often than not, a larger-than-normal grant of restricted stock, or stock options, at maybe twice the typical levels," he says

According to the Stanford study, on a scale of 1 to 10, the median rating was 6 when directors were asked whether top executives in their industry have so much unvested equity that it is hard to recruit them to another company. Therefore, these make-whole awards are seen as a necessity, even though they might be scrutinized, according to some experts. "No rational executive is going to leave a large amount of unvested equity on the table to start fresh at a new firm with the 'promise' to eventually earn more over time," says Tayan.

When examining make-whole awards, one area that **ISS** looks at is how the awards are treated if the executive in question should suddenly leave the company, says **Sydney Carlock**, senior compensation analyst at ISS. "So, if it doesn't work out with this executive, are they going to leave carrying a large equity award, with shareholders left paying for it?" he says.

ISS also looks at vesting. "We ... look at the vesting period — if it's going to be earned over a long period of time or will they get it in just a year or two," Carlock says. "If it's just a year or two, then that raises some questions as to whether it will actually retain the executive."

Vesting periods should have a time frame that is consistent with the award that is being made whole, says Johnson. "If they were going to get that $10 million for sure over the next three years, then I think you would want to do your $10 million over the next three years," he says.

However, Johnson advises that make-whole awards should not vest based on performance. "Usually, the makeup is going to be a time-vest kind of thing because [the executive] doesn't know the new company [and] it would take too long to negotiate what those performance goals would be," he explains.

ISS does look to see if there are any performance conditions on the award. "Performance awards have become more of the norm, so shareholders expect to see at least a part of the award, if not the whole award, conditioned upon some sort of performance hurdle," Carlock says.

Some companies could seek to put time-based vesting conditions on the make-whole award and balance this with performance conditions on other new equity awards, says Johnson.

In the case of Mondelez, the make-whole payment was composed of $10 million in performance share units and $10 million in cash, in addition to the deferred stock units.

Disclosure to Shareholders

While some see make-whole payments as necessary, it's generally accepted that shareholders are opposed to these awards, according to experts. Therefore, they agree that shareholder disclosure is important when these payments are involved. After the board disclosed that "[i]n his last two undertakings … [Hunter Harrison] delivered 321% and 350%

total shareholder return respectively" in an 8-K filing, more than 93% of CSX shareholders voted in favor of Harrison's retention payments at the company's annual meeting in July.

The compensation committee should articulate very clearly to shareholders the rationale for selecting a CEO for which a substantial "make-whole" payment is required, says Tonello.

"A comp committee concluding that such payments are in the shareholders' best interest should describe the operating environment, articulate the considerations made in the selection of the candidate in light of the business strategy as well as other available candidates, and describe the circumstances that led the committee to the conclusion that the payment is necessary," he says.

Besides this, the compensation committee should explain to what extent the grant will or will not affect future compensation practices and why it will not distort the company's overall compensation policy. "The compensation committee has a responsibility to avoid the situation where adjustments made to a CEO compensation package to respond to exceptional market circumstances and temporary talent retention needs become an ordinary feature of the company's compensation policy, therefore leading to generalized and inordinate increases in compensation for other senior executives or future CEOs. Such changes in the compensation culture of the organization (i.e. turning the exceptional into the normal) would clearly impair shareholder value," Tonello writes.