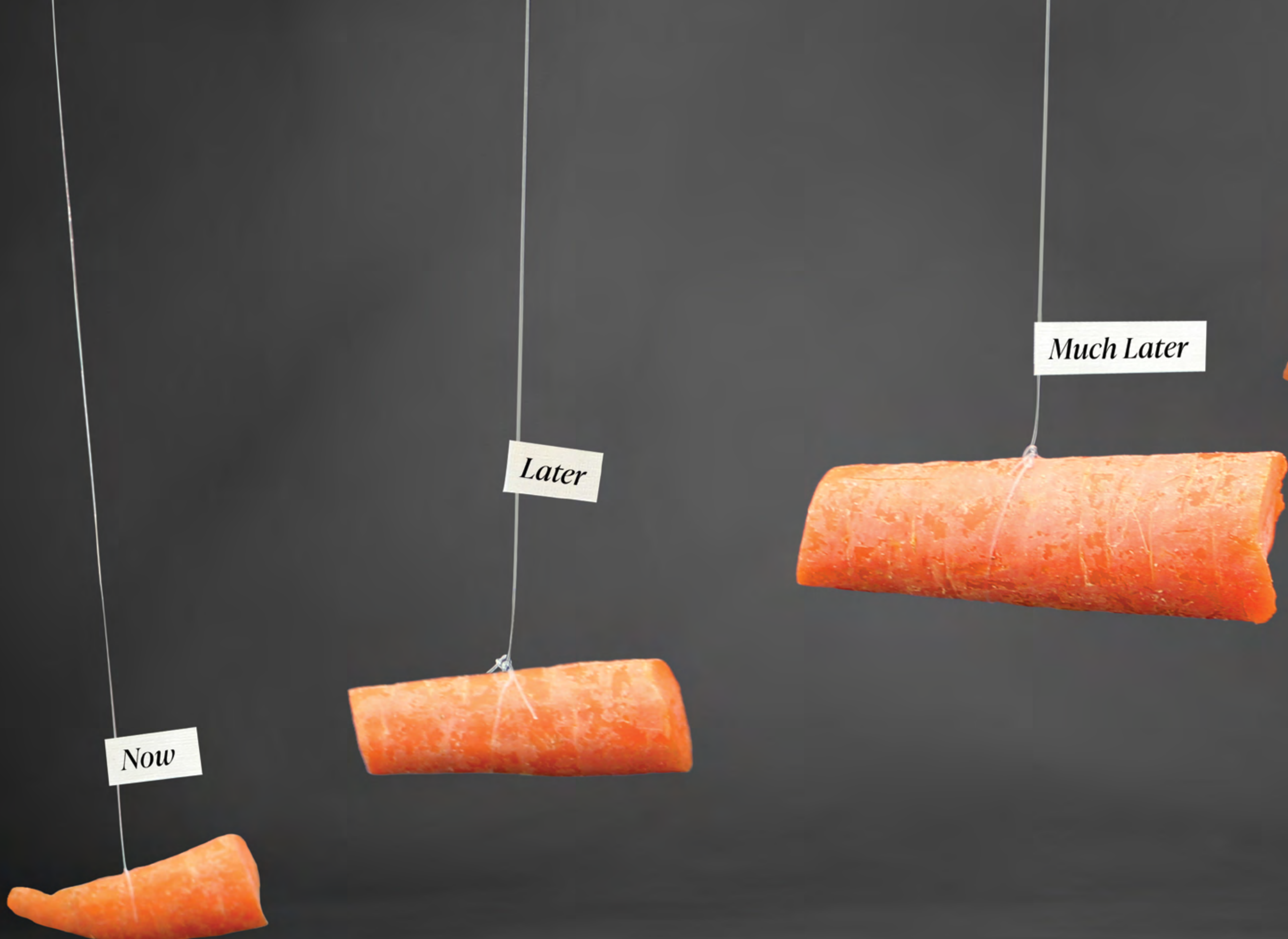
Educating and Inspiring the World at Work
2ND QUARTER 2023
WORKSPAN



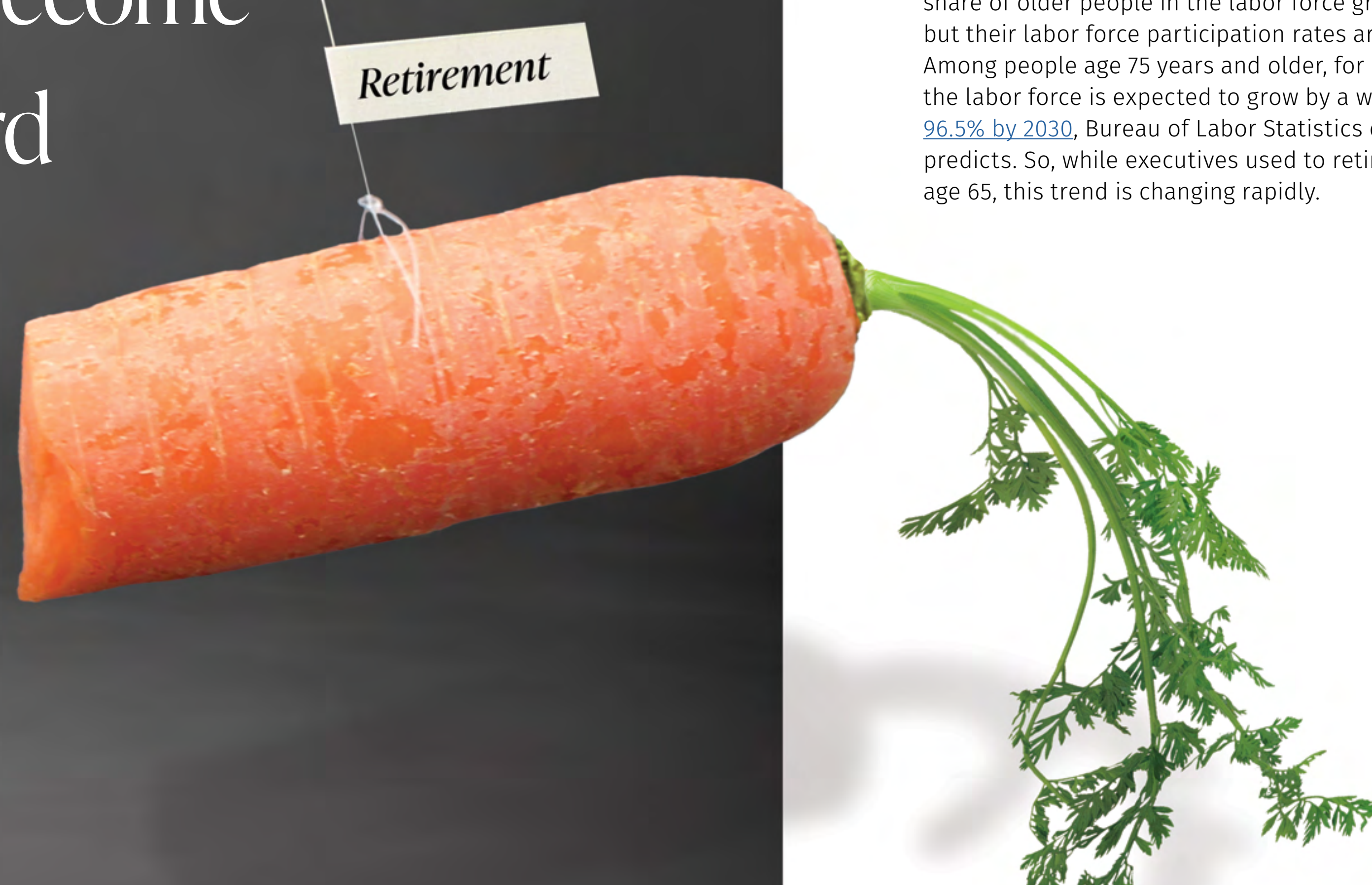
Solving the Challenge of

Executive Retiree Incentive Compensation

EASE INCREASINGLY TENSE BOARDROOM DEBATES WITH SENSIBLE GUIDELINES

BY CHRIS CRAWFORD, CCP, CECP, MBA, AND IAN KEAS

What used to be golden handshakes for retiring executives — along with the retirement parties and going-away gifts — have increasingly become executive and board wrestling matches.



Compensating retiring executives, in fact, has become a tense challenge in boardrooms across the country. From macro labor force trends to current political debates and legislative protection gaps to individual considerations, corporate boards and management are spending significantly more time determining how to pay retiring executives on their way out.

Here are the competing complexities in the current climate, and a set of guiding principles that can help navigate the delicate balance of compensating retiring executives.

Macro Challenge: The Rising Retirement Age

Shifting norms about employees and executives working well past traditional retirement age dominate boardrooms, newsrooms and election debates. Whether out of necessity due to inflation, investment volatility or as a choice to help support health and wealth, older employees are much more likely to continue working past age 65 than the prior generation, according to a Pew Research Center analysis.

Compounding this issue is the sheer size of the Baby Boomer population who are either working or looking for work today (41 million). Not only is the share of older people in the labor force growing, but their labor force participation rates are rising. Among people age 75 years and older, for example, the labor force is expected to grow by a whopping 96.5% by 2030, Bureau of Labor Statistics data predicts. So, while executives used to retire near age 65, this trend is changing rapidly.

This shift creates new friction between employers and their incumbents, who have generally spent considerable years loyal to the enterprise, developing institutional knowledge, generating value and nurturing the next generation. In particular, the Age Discrimination Employment Act (ADEA) protects workers over age 40 but stops at age 65 for a "bona fide executive." In short, most of the leverage shifts to the employer after age 65, and for a variety of reasons that we'll explore next, many more executives are working past that age.

Micro Challenges: Productivity, Succession and Management Change

In addition to the macro workplace challenges, company boards and management also face a myriad of micro concerns that shape compensation decisions for retiring executives. Here are just some of the current pulls in the retiree compensation tug of war.

Diminished Work Beyond Retirement Age

Some of the executives wanting to work beyond a typical retirement age may not deliver the same value. Personal health or family issues can diminish productivity and effectiveness, forcing a company into an awkward performance management discussion or decision.

Lack of Savings

Depending upon the executives' savings rate, personal finances, stock market volatility, company performance or any other number of financial influences on the retirement nest egg, executives may delay retirement.

Lack of Succession Plan

Executives may want to retire, but a company either doesn't have a solid succession plan or lacks qualified successors, leaving the organization exposed and at risk. In many of these cases, companies continually ask for "just one more year" and try to compensate the time beyond typical retirement.

Move Out or Move Over

In other scenarios, a company may be ready for successors to step in or risk losing valuable younger talent who may not perceive a path of promotion. In these situations, a company must assess whether they want to encourage retirement for executives who may not be ready to leave.

New Executive Team

Whether prompted by a new CEO or board members encouraged by shareholders, companies are frequently forced to make difficult changes to senior leadership. When these changes are company-triggered events, they often include executives who are near or past retirement age. Not surprisingly, such scenarios can create challenging executive retirement decisions, especially for long-tenured employees who weren't ready to retire.

Guiding Principles for Compensating Executive Retirees

Due to a myriad of company and executive circumstances, boards frequently don't have formal policies or even guiding principles for compensating executive retirees. Consequently, they find themselves ineffectively spending excess time and money in the following areas:

- High-value board member time in areas that are not shareholder accretive.
- Excessive expenditure of emotional capital resulting from the negotiated process that often ensues.
- More compensation paid to the retiring executive(s) than might be necessary to execute the succession plan.
- Legal challenges for disparate treatment.

To help companies effectively navigate the growing complexities of retiring executives, here are several guiding principles boards and management can consider to create healthy executive retirements that serve the interests of all parties.

1. **Develop a retiree eligibility window**
   Companies that adopt formal retirement policies often use a combination of age and years of service that add up to 65 to 80 depending on the company and industry. However, due to multiple executive and company dynamics that create a fluid state of decision making for the right retirement age, companies are often reluctant to adopt a rigid formula. To help ease retirement-age tension, companies can consider a guiding formula of age and years of service, such as 72, with a minimum age of 60, to begin the retirement discussion.

2. **Establish a 'good leaver' policy**
   Succession planning is important and not an overnight process. When executives retire unexpectedly, it can put the company in a bind. Companies that require sufficient retirement notice can provide something back to the executive in exchange for the good leave. Best practices suggest at least six months of executive retirement notice as adequate timing for succession planning.

3. **Maintain reasonable non-solicitation and non-compete agreements**
   While non-compete (NC) agreement regulations vary by state, and are currently under review for enforceability nationwide, non-solicitation (NS) agreements, which limit employees' rights to pursue clients or employees after leaving a job, are a good practice and legally enforceable.
   Companies often have concerns that retiring executives may leave and then work for a competitor or startup in a similar market. One-to-two-year NS and even NC agreements ensure the executive is truly retiring. These agreements then create an opportunity for the company to provide friendly payout terms for unpaid short-term incentives (STI) and unvested long-term incentive (LTI) payments.

4. **Create prorated, pay-all or pay-nothing guidelines for in-flight, STI payouts**
   When an executive leaves midyear there is often tension around how much of the bonus is paid out. Companies with good-leaver policies (notice of six months) are well positioned to provide prorated or even pay all STI payouts.

5. **Develop LTI award guidelines for executives who provide retirement notice**
   Companies that use a minimum six-month retirement notice are in a strong position to make more informed decisions about new LTI awards to a retiring executive. Note: If a company has a one-year retirement-notice requirement, this decision is nearly eliminated for companies who make annual LTI awards.

6. **Implement LTI award guidelines for unvested or unpaid LTI payouts**
   Companies use LTI awards not only to retain executives but to incentivize long-term decision making and performance. Upon retirement, executives often contemplate this very principle: the possible forfeiture of unvested LTI awards and the future performance of the company. Additionally, for most companies that have a discretionary decision-making policy for compensation at retirement, unvested LTIs often become the most contested discussion.

"Companies can't plan for every macro and micro permutation to adequately compensate each retiring executive perfectly, but they can create a baseline of solid guiding principles."

What If the Company Triggers an Executive's Early Retirement?

When company boards and management decide to prompt an executive's early retirement in a retirement-age window, they may need to provide additional consideration.

Say an executive isn't ready to retire but is over age 65 (beyond the protected ADEA age window). Then the company should consider providing up to one year of base salary and bonus to offset the executive's unplanned retirement. This guiding principle provides a smooth, orderly succession and preserves the integrity of the tenured executive.

Key takeaway: When companies artificially force an executive's retirement without any consideration, the potential legal, financial, time and reputation costs to the company can significantly outweigh the one-year payout.

Determining how to treat unvested LTIs becomes a much easier decision if a company has developed guidelines for a retirement-age window, sufficient retirement notice, NS and NC agreements, STI payout treatment and LTI award grants. In particular, if an executive is a good leaver, meeting the first three guidelines of retirement-age window, sufficient notice and signing an NS agreement, then providing continued or accelerated vesting for LTI awards[1] is viewed as fair and favorable by both the company and the executive retiree.

Planning for a More Principled Outcome

Companies can't plan for every macro and micro permutation to adequately compensate each retiring executive perfectly, but they can create a baseline of solid guiding principles. These principles can help boards and CEOs spend compensation dollars more efficiently and ensure alignment with market practices as opposed to getting caught up in subjective and emotional decision making. Once the principles are established, company decision makers such as the board or CEO can be more objective and effective in determining a retiree's final compensation.

Finally, when long-term executives and employees leave on good terms, they're more likely to be good ambassadors to the remaining company employees, customers, shareholders, partners and community at large. And that's a value well beyond the dollars spent. **WS**

Chris Crawford, CCP, CECP, MBA, is founder and CEO, and **Ian Keas** is co-founder and managing partner of Zayla Partners, an executive compensation and corporate governance consulting company with offices in Houston, Dallas and Denver. Crawford can be reached at chris.crawford@zayla.com; Keas can be reached at ian.keas@zayla.com.

[1] If a company adopts a policy or consistent practice of continuing vesting or accelerating vesting of stock-based compensation upon reaching a certain age/time of service, the company may lose the ability to amortize the stock expense.