Compensation Committee Leadership Network

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CCLN

VIEWPOINTS

Managing executive transitions and the effects of digitalization

Effective management transitions are critical to a company's long-term success. The desire to create more opportunities for high-potential managers requires Compensation Committee Leadership Network (CCLN) members and their committees to consider how best to handle retirements and other departures. In addition, as companies rely more heavily on technology to automate business processes, CCLN members seek to better evaluate the benefits and challenges that these developments present for the workforce.

On March 18–19, CCLN members met in Washington, DC, to discuss these topics. They were joined for portions of the meeting by Steven Chabinsky, partner and chair of White & Case's global data, privacy, and cybersecurity practice, and Max Yankelevich, founder and chief strategy officer at WorkFusion. This *ViewPoints* synthesizes members' conversations in conjunction with the meeting.[1]

Executive transitions

Fifty-five S&P 500 companies installed new CEOs in 2018, down just slightly from 2017's 10-year high of 59.[2] CCLN members observed that executive departures across management ranks have become more common and less predictable. A board faces important considerations when a senior executive leaves its company. CCLN members discussed the benefits of having a defined set of criteria for retirement eligibility, a detailed transition plan for departing executives, and a consistent policy for handling severance payments in the case of an unplanned termination. Members also considered the governance implications of a CEO transition, including the merits and challenges of having a retiring CEO remain with the company as board chair.

Compensation implications

CCLN members acknowledged that while they do not want to create compensation programs that provide departing executives with a handout, there are compelling reasons to consider programs that incentivize executives to focus on the long-term health of the firm as they approach retirement.

Defining retirement

A substantial portion of most payouts includes equity in the company, much of which does not vest immediately; typically, employees only receive the compensation if they remain employed by the company when the grants vest. Such a system has many benefits but can create a challenge when an employee approaches retirement (and thus will not be an employee of the company when certain grants would vest). In many cases, companies attempt to solve this problem by allowing for accelerated vesting or other favorable treatment for retirees, so long as they meet an agreed-upon definition of retirement.

According to Equilar, "For an executive to receive special equity treatment upon retirement, they need to qualify as retirement eligible under the company's incentive plan or the accompanying award agreements. The definitions of retirement eligibility are often intricate, but typically include two components: (1) one or more age thresholds and (2) a length of service threshold linked to each age threshold. Typically, the older an executive is, the fewer years of service he or she is required to have in order to be retirement eligible."[3]

CCLN members shared the retirement eligibility requirements at their companies. The policies vary, but most include some combination of age and years of service and offer favorable treatment to employees who fall into this category. One member said, *"Our retirement eligibility is age 55, with 10 years of service at the company."* Another said, *"Our formula for retirement is either reaching age 70 or a combination of age 55, plus 10 years of service. At that point, you can retire and performance shares and stock options vest. It's a very reasonable and positive retirement program."*

Obligations and benefits of an executive retirement

Executive compensation plans are not designed for retirements, as one member pointed out: *"We create a program to keep people inside the company, not encourage them to leave."* Members discussed their perspectives on how to address this challenge.

When an executive reaches retirement eligibility, equity payments can be forfeited, accelerated, or allowed to continue to vest on the original schedule.[4] Members said it was important to create a plan that minimizes the forfeiture of incentives that have been earned. Several said they favor allowing shares to continue to vest. One said, *"Our committee discussed using accelerated versus continued vesting, and we are convinced that continued vesting is in the best interest of our set objectives. It ensures the departing executive has a vested interest in the successful performance of the company during their transition period. It aligns the incentives of executives with shareholders' interests."* Another shared the details of an accelerated vesting plan: *"For a retirement of a senior executive, any restricted stock vests upon retirement. The performance shares, which represent the bulk of the long-term incentive plan, are prorated upon retirement. They do not continue to vest after retirement."* One member said their company has three-year vesting periods that overlap, with a new plan starting every year, *"so you are always in the middle of a three-year plan."*

Members also considered the appropriate period for continuing to allow retired executives to exercise stock options. One described a recent committee discussion: *"We have a stock option plan for senior executives. The options vests upon retirement and must be exercised* *within five years. We debated extending this to 10 years but ultimately decided as a committee that 10 years post-retirement was just too long."*

Boards may sweeten the retirement offer in certain cases, either to nudge an executive to leave the company or to encourage an executive to help his or her successor with the transition. One member said, *"There were a number of executives that we wanted to encourage to move on because we had great bench strength. We created a policy to help encourage that transition."* Another said, *"We had a situation where multiple executives were retiring at once, and if we incorrectly managed any of these transitions, the damage to the business could be significant. We didn't want to be too stingy, so we modified our plan to have hooks to incentivize them to stay and help. We determined specific roles for the outgoing executive to support their successor as they transitioned from the company. We told shareholders about the change in plan and the reasoning for it and we received no pushback."*

Severance for unexpected retirements

Sixty-nine percent of CEO transitions at S&P 500 companies in 2018 were attributed to the outgoing CEO's decision to retire or step down; however, 22% resigned under pressure, up from 15% in 2017.[5] It is more common for executives below the CEO to be asked to leave, whether for performance reasons or to refresh the management team. Members described the severance policies and practices at their companies.

Parting ways with an executive absent cause, retirement, or a change in control can be challenging. A recent study by Meridian Compensation Partners found that in 2017, 65% of companies studied reported severance arrangements that provided cash benefits for named executive officers.[6] At the meeting, Meridian's Annette Leckie told members that many severance payments are negotiated on a case-by-case basis: *"No contracts and no guaranteed severance is increasingly common, so it ends up being a negotiation."*

Members favored eliminating severance agreements with executives when possible. One member described an effort to align executive and employee benefits: *"We have a severance policy but do not have individual contracts with severance agreements. It is better to treat everyone equally."*

Severance policies and practices can vary dramatically from company to company. A member shared one company's approach, which leaned conservative: *"If someone is a good soldier but we are changing directions, we may allow their performance shares to vest, but we don't provide a big payout."* Others described policies that provide substantial compensation, using a fixed multiple of pay. Meridian's study states, "For CEOs, 61% of companies determine cash severance based on a 2× multiple. For other [named executive officers], 42% of companies determine cash severance based on a 2× multiple and 40% determine cash severance based on a 1× multiple."[7]

Members also discussed the importance of receiving agreements from a departing employee as consideration for severance payments. In particular, they seek to ensure that the company receives a release and waiver of claims as well as restrictive covenants such as noncompete, nonsolicitation, and nondisclosure provisions.[8]

Governance considerations

Many US-based companies combine the role of CEO and board chair. In some cases, an outgoing CEO remains in the role as board chair for a transition period after a new CEO takes office.[9] Members said that while there are benefits to having a departing CEO continue to chair the board after a new CEO is in place, the challenges often outweigh them.

Benefits and challenges of retaining the departing CEO as board chair

Of the 55 S&P 500 companies that had executive transitions in 2018, 35% had the outgoing CEO stay on to serve as board chair for some period, a significant decline from 51% in 2017.[10] Members shared concerns about a retired CEO playing an outsized role in the boardroom. One said it creates ambiguity about who is in charge: *"I am adamantly against it. It suggests that you failed in managing the transition. I have lived this—my predecessor always supported me, but anytime I wanted to make a significant change, the board would look to the former CEO for validation. It was not his fault, but it bothered me."* Another said, *"Sometimes the board keeps the old CEO on as a safety net—it's more comfortable for them that way. But in my experience, once the departing CEO turns over the keys, they aren't as involved in the day-to-day and their support is not very helpful."*

Other members, however, said that the practice can be helpful in unique circumstances. One said, *"We had an activist come in, and the old CEO stayed on as executive chair to handle that situation. It allowed the new CEO to focus on running the company."* Another member advocated against a blanket policy in this area: *"I think this is such a critical decision that you can't just say it should be either/or. It's situational; it depends on so many variables and it's up to the incumbent and the board to have serious discussions to determine the best course of action for the business."*

If the outgoing CEO does stay on as chair, members said it works best for a limited period of time, ideally not more than six months, with a clearly defined and agreed-upon set of responsibilities. *"The model can work well if there are clear definitions of roles. The chair should handle external issues, such as investors, and should not get in the operational way of the new CEO,"* one member said.

How to compensate the transitioning CEO

A study of 18 S&P 500 CEOs who transitioned to an executive chair role found three key trends regarding compensation: (1) overall compensation fell as a result of these transitions; (2) cash compensation remained relatively stable; and (3) equity represented the majority of the overall decline.[11] The study found that median total equity compensation declined 72.5% when a CEO became an executive chair.[12] The study also noted that 38% of boards disclosed using market data or a consultant to help set pay for the former CEO's new role.[13]

One member said that their company's policy is to *"cut the transitioning CEO's pay to 60% of what it was previously."* Meridian's Ms. Leckie said, *"Sixty percent is about average, but the market pay range is so wide that it makes a median or average meaningless. I've seen situations where the outgoing executive chair makes more than the current CEO. To determine the appropriate pay, you need to ask, what is the role that the executive chair will be playing during this transition period? Will they be involved in strategy? Acquisitions? Special projects? What is the right pay for this person? Do they need/want to be on the benefits plan?"*

Board oversight of cybersecurity

Emerging technologies are increasing the potential for cyberattacks and for the damage they cause. Mr. Chabinsky emphasized that cybersecurity is an issue for boards and senior management, not just information technology: *"It is a risk-based problem that needs management decisions, not just technical ones."* Members discussed data protection, indicators of good management practices, and board governance of cybersecurity.

Data protection

A 2019 World Economic Forum global risk threat assessment found cyberattacks to be the fourth greatest overall risk—having the combined highest likelihood and greatest impact, behind natural disasters, failure of climate-change mitigation, and extreme weather events.[14] In terms of anticipated impact, it was the highest-ranked man-made risk on the list, ahead of man-made environmental disasters, interstate conflict, and data fraud and theft.[15]

While data privacy issues are currently garnering significant attention, situations where attackers target a company's products or systems, rather than just stealing consumer information, can cause even more significant damage. Mr. Chabinsky offered a few examples:

- **Global systems are vulnerable to attack.** Shipping conglomerate Maersk was one of many victims of a 2017 attack called NotPetya.[16] Mr. Chabinsky explained that NotPetya was similar to an earlier ransomware attack—Petya—but that in this case, the attackers did not seek a ransom: *"Its goal was simply to be destructive."* The event disrupted the company's container related businesses, causing their data and applications to be unavailable. The financial impact, mostly stemming from lost business during the incident and extraordinary costs in IT and operations, was approximately $300 million.[17]
- **Security may come at the expense of convenience.** Another example that Mr. Chabinsky shared illustrated the need to consider trade-offs. He asked members, *"Think of the automotive industry. There are over 50 electronic control units in your vehicle that control brakes, the radio, etcetera. Two companies found vulnerabilities, but each had a different approach to fixing the problem. One company beamed down the update to all cars via*

satellite and the other company required customers to come into the service office to have the update made. Which car would you want to own?" The company that could beam down the update is the more convenient option, but if the company's system were hacked, the bad actor could beam down destructive malware. Meanwhile, the company that requires in-person appointments and support results not only adds inconvenience but places many vulnerable cars on the road at any given time.

- **Third parties may be secure, but your interface could create vulnerabilities.** Members shared concerns about their reliance on third-party vendors and the risks associated with outsourcing services, for example, to cloud providers. Mr. Chabinsky, pointing to good vendor management risk practices, said, *"Companies must assess third party security. Even then, many companies tend to accept that if a vendor is compliant with some standard, it means that by using that vendor, the company is also compliant, but that isn't always the case. You need to consider how your company's access is controlling the risk of outsiders getting into your systems first and using that access to steal the credentials to get into the cloud. Make sure that your ability to process data by a particular cloud provider has also been reviewed for any contractual or regulatory constraints."*

Good management practices and board oversight

For boards, it is more important to look to a company's activities than to be satisfied by the particular standards it adopts. While companies should align their cybersecurity program against a standard, like the National Institute of Standards and Technology framework, Mr. Chabinsky said, *"There are plenty of risk-based standards that look good on paper. Problems come when companies don't adequately implement the one they adopt."*

Cybersecurity controls also need to be updated regularly, as good practices and risk considerations often change over time. Mr. Chabinsky suggested grouping controls into three categories: *"Think about physical controls: For example, what sensitive documents and servers do the night-shift cleaning crew have access to? Consider administrative controls: What policies are in place? Mandatory password changes, which no longer are considered a best practice? Compliance with GDPR [Europe's General Data Protection Regulation]? And finally, technical controls: Do you have encryption and endpoint protection on all computers?"* He suggested board members ask technical professionals some basic questions that can yield useful information, such as, *"If you were a hacker, how would you attack us? Why would you attack us?"*

Despite the massive efforts to improve cybersecurity at their companies, members said that it can be difficult to test their adequacy. Mr. Chabinsky agreed and cautioned against relying too heavily on benchmarking: *"If your company would fail because of a cyberattack and so would all of its peers, would you accept that, or would you do more? This is an opportunity to differentiate; it's not just about avoiding liability."* He emphasized the importance of measuring the efficacy of a company's defenses: *"You align with a standard and implement it, then you measure your progress by doing vulnerability assessments and penetration tests."*

One member asked about red team exercises and whether companies should employ full-time staff to run these drills. Mr. Chabinsky responded, *"I've seen incredible internal talent used for red teams, but I would not solely rely on them. There is a natural bias against attacking your teammates or the efforts of the testers themselves. In addition, an external party brings in a view of current events and observations of good practices at other companies that your internal team simply does not possess."*

Members wanted to know how they could test whether management is doing enough protection and prevention. One asked, *"If management is telling the board that our company has never been breached, are they telling the truth?"* Mr. Chabinsky said that while it could be true that a company has not been breached, every company of size has been subject to intrusion attempts, many of which are automated and not specifically targeted. He told members, *"The key to a good cyber program is detection, containment, response, and remediation. If you hear no one is trying to break in, that is when you should be concerned."*

Intelligent automation and machine learning

Technologies such as robotic process automation, intelligent automation, and machine learning are transforming the workforce. Mr. Yankelevich told members, *"Machine learning, where machines learn tasks from human subject matter experts, focuses on streamlining mundane tasks. This is the primary technology that will drive economic change as far as AI [artificial intelligence] is concerned."*

Technology replicates predictable human tasks

According to a McKinsey study, about half of all time spent in current work activities is technically automatable, and six out of 10 current occupations have more than 30% of activities that could be performed by machines.[18] Mr. Yankelevich explained that right now machine learning targets lower- to mid-level support-function tasks, such as predictable physical labor, data management, and data manipulation. *"Companies are looking to automate tasks that robots can learn first-hand by watching humans, without needing to be programmed. It takes time, but the machines learn to become more and more autonomous,"* he said.

While companies are focused on automation as a source of cost reduction, Mr. Yankelevich said there are growth opportunities for businesses as well: *"Once the robots are in place, you can easily identify bottlenecks and make changes to correct these very quickly. Companies become much nimbler, quicker to respond, and gain the ability to process more tasks more efficiently and without additional costs."*

Automation has implications for the future of the workforce

Very few occupations—fewer than 5%—consist of activities that can be fully automated.[19] So, while Mr. Yankelevich predicted that 70% or more of human tasks are subject to intelligent automation, robots are not being designed to replace people entirely. Instead, companies are implementing a robot-human hybrid model. *"Discrete pieces of machine learning can automate things, but we aren't going to see sci-fi or artificial general intelligence. Robots are not replacing humans' empathy or creativity,"* he said.

Members were concerned that for a company to recognize cost savings from an investment in automation, it would have to significantly reduce the size of its workforce. One member discussed a company that faced this dilemma: *"We took the initiative to retrain, but it was not one to one. We reduced head count in some of our outsourced areas, but then you get down to your core people. We are in a tight labor market now, but there has been all this dialogue around upskilling and retraining or partnering with educators to be sure the future workforce can handle this new environment. What will happen to all of these people?"* Another member pointed out the reputational consequences of extreme reductions to the workforce: *"We can't lay off 20,000 people; it's just not socially acceptable. So the board and management need to think through how to reskill employees. Some can be reskilled and some can't, but we will need to go through group by group to figure that out and determine the resources needed to make it happen."*

Mr. Yankelevich said that the technology is moving faster than organizations expected: *"Every new technology introduction is messy. Education is still far behind, but it will catch up when the necessity is there. Educators aren't pushing the envelope right now, but as momentum picks up, we will see online programs become more nimble."* He pointed to the internet boom of the 1990s: *"It was a chaotic transition, but we got through it. We are seeing similar patterns now, but instead of offshoring jobs, we are automating them. There will be some layoffs, but the employees that are upskilled are moving into higher-profitability positions."*

The journey to successful implementation requires patience

Members were interested in the timeframe needed to implement this technology at their companies. Mr. Yankelevich said that leading adopters are still in the early stages of a multiyear automation journey. Most firms expect these projects to take five to seven years. He suggested companies begin by identifying their best use cases for automation, with the understanding that things will change over time.

One member asked, *"What are the key obstacles to transitioning to this technology?"* Mr. Yankelevich said that implementation is smoothest when a company's infrastructure is *"Software 2.0"* ready. He noted, however, that automation is viewed by some as a Band-Aid of sorts, to avoid investing in more fundamental core systems upgrades. Mr. Yankelevich advocated, however, for an *"automate first, optimize later"* approach: *"At this point, you can automate without throwing out the legacy systems. You can decide how to optimize based on* *the data you get from the robots. They generate new insights and create commercial opportunities as a result."* He added, *"They operate using 'white box' algorithms, so you can go back and see how the decisions were made."*

Companies benefit the most from automation when management is committed and transformation is led from the top. Mr. Yankelevich stressed the value of building a strong team to oversee implementation: *"Establishing a center of excellence that is empowered to drive change in the organization is very important. Enable this team to focus on identifying opportunities for machine learning where there is significant return on investment. Also, do not neglect to address the human resources implications of this process. Failure to do so could hinder your success."*

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The context in which boards must make decisions about risk and reward is constantly changing. Executive transitions are becoming more frequent and less predictable, requiring compensation committees and boards to plan in advance to ensure that compensation plans appropriately incentivize management over the long term. They also have to balance the desire to retain strong performers with the need to provide opportunities for rising executives. As companies increasingly digitalize processes and customer interactions, vulnerabilities to cyberattacks are evolving, requiring diligent board oversight and frequent evaluations of internal controls and procedures. Technological innovation is also driving increasing automation, which could have a transformative impact on the workforce. CCLN members emphasized the need for a strong culture of trust between the board and management that trickles down through the organization in order to effectively navigate the risks and opportunities inherent in a rapidly changing business environment.

About this document

The Compensation Committee Leadership Network (CCLN) brings together compensation committee leaders from North America's most prominent companies for private discussions about improving the performance of their corporations and earning the trust of their shareholders. *ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions.

Meeting participants

- Erroll Davis, Union Pacific
- Colleen Goggins, TD Bank Group
- Marianne Harris, Sun Life Financial
- Bill Kerr, IPG
- Annette Leckie, Meridian Compensation Partners
- Karen Maidment, TD Bank Group
- Joyce Roche, AT&T
- Virginia Ruesterholz, The Hartford and Frontier Communications
- Samme Thompson, American Tower
- Marc Ullman, Meridian Compensation Partners

The following directors took part in discussions before or after the meetings:

- Beth Cobert, CBRE
- Jim Kennedy, United Continental
- Steve Reinemund, Marriott International

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

[2] Spencer Stuart, *CEO Transitions* (Spencer Stuart, 2018), 2.

[3] "Equity Treatment Upon Retirement in the Financial Sector," *Equilar Blog*, October 21, 2016.

[4] "Equity Treatment Upon Retirement in the Financial Sector."

[5] Spencer Stuart, *CEO Transitions*, 3.

[6] Meridian Compensation Partners, *2018 Study of Executive Severance Arrangements Not Related to a Change in Control* (Lake Forest, IL: Meridian Compensation Partners, 2018), 7.

[7] Meridian Compensation Partners, *2018 Study of Executive Severance Arrangements Not Related to a Change in Control*, 7.

[8] Meridian Compensation Partners, *2018 Study of Executive Severance Arrangements Not Related to a Change in Control*, 6.

[9] Melissa Burek, "Considerations for Compensation of Separate Board Chairman," Compensation Advisory Partners, May 25, 2016.

[10] Spencer Stuart, *CEO Transitions*, 7.

[11] Xiao Bi, "Key Compensation Trends for CEO to Executive Chairman Transitions," Equilar, March 4, 2015.

[12] Bi, "Key Compensation Trends for CEO to Executive Chairman Transitions."

[13] Bi, "Key Compensation Trends for CEO to Executive Chairman Transitions."

[14] Aengus Collins et al., *The Global Risks Report 2019* (Geneva: World Economic Forum, 2019), 5.

[15] Collins, *The Global Risks Report 2019*, 5.

[16] Andy Greenberg, "The Untold Story of NotPetya, the Most Devastating Cyberattack in History," *Wired*, August 22, 2018.

[17] Greenberg, "The Untold Story of NotPetya, the Most Devastating Cyberattack in History."

[18] James Manyika et al., *Jobs Lost, Jobs Gained: Workforce Transitions in a Time of Automation* (McKinsey and Company, December 2017), 27.

[19] Manyika, *Jobs Lost, Jobs Gained: Workforce Transitions in a Time of Automation,* 27.