

Why Severance Pay? Why not Retention Pay?

Dear *LogiStyle* Colleague:

Food for Thought is our way of sharing interesting concepts on corporate leadership and management with others who might find it useful. The thoughts offered are intended to be controversial and thought provoking. They always follow our motto of helping develop logical leadership.

Severance pay, a customary clause in executives' employment contracts, was probably designed to ensure financial security for the executives. However, in the case of public company CEOs, most of whom need little in the way of additional financial security, severance pay commitments are mostly for the purpose of being market competitive. A board would have difficulty recruiting a high quality CEO without a severance pay arrangement.

We propose an alternative to severance pay, called retention pay, which provides comparable market competitiveness in the pay package, but is more shareholder friendly. As the name suggests, retention pay pays to retain the executive for another year in lieu of severance payment upon termination.

Here is how retention pay might work. Let's say that traditional, market competitive, severance pay would equal twice the annual salary. Let's also assume that the average tenure of a CEO is four years. Under these assumptions, the proposed retention pay arrangement would guarantee the CEO a retention pay of one half the annual salary for each year that the board retains the CEO in that capacity. The board would have to overtly discuss and decide on an annual basis, whether they wish to ask the CEO to continue to serve in that role for an additional year. Should they choose to retain the CEO they are obligated to make the retention payment, in addition to all other customary compensation items. The retention payment might be paid in four quarterly installments to ensure that the CEO serves through the year to collect the amount. However, if the

board chooses not to retain the CEO for another year, they may terminate the CEO, without cause and without any severance obligations.

If the tenure of the CEO, as determined through the annual decisions of the board, is exactly four years (the assumed average for CEOs, in general) then the CEO would receive four retention payments, the sum of which is comparable to the severance pay that the CEO would have otherwise received. If the tenure is longer, the CEO comes out ahead - as it should be; if the tenure is shorter, the CEO comes out behind - as it should be; providing a better alignment with shareholder interests.

At first sight this might seem like an egregious payment to CEOs who are already being paid handsomely in cash and equity compensation. But observe that there is no new money involved in this proposal. We are simply paying the expected value of severance payments in the form of retention payments – using the same money to reward performance that you want repeated rather than paying for performance that you found unacceptable.

There are a number of other advantages to this approach. The board has to overtly decide every year to make a substantial payment for retaining the executive. The board is less likely to be tolerant of living through another year with an under-performing CEO, when it has to “pay to keep,” but is “free to let go.” In CEO recruitment, retention pay - as a substitute to severance pay - is likely to be more appealing to self-confident CEOs who believe that they will outlast the average tenure. Additionally, the accounting becomes cleaner and represents the true compensation costs. Instead of having a large “one-time, non-recurring” severance cost every four years or so, retention pay can be accounted for on an ongoing basis, every quarter, reflecting the true cost of doing business.

There are a number of other related items to be addressed: What about equity considerations in severance? Why should a voluntarily departing CEO get a windfall of the retention pay already paid? Is retention pay paid the very first year of appointment? How does retention pay impact change of control arrangements? Can retention pay be held by the company as deferred pay until termination? If so, is it then identical to severance pay? For the sake of brevity we will not elaborate on these and other related questions. Suffice it say, thinking through this provocative approach might itself be beneficial for a board that is in the process of recruiting a new CEO.

If you would like more information on the questions raised above, or how this process might be effectively implemented, or on other such progressive governance ideas, please call or write to us. We have received many responses to our Food for Thought mailings, asking if you can freely share and forward these thoughts. Indeed you can. All we ask is that a clear attribution to LogiStyle and our contact information are included.

As always, we welcome your comments. We hope your business is doing well. If we can be of any assistance please feel free to call – even, if just to chat.

Best Regards,

Balaji