

CEO Sign-On Practices, Risks

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One of the most important decisions a board makes is identifying and hiring the company's CEO. Given the critical nature of this decision, boards often make major investments in signing packages for new CEOs. These signing packages serve multiple purposes: helping secure new talent to run the company, providing "staking" grants to align the new CEO with shareholders, and, in some cases, buying out existing equity packages.

Given the significant investment these packages represent, compensation committees often have four concerns:

1. How are these signing packages typically structured?
2. How do the size of these signing packages affect company stock price? In particular, do very large packages have a negative effect on stock price?
3. What effect do sign-on packages have on subsequent say-on-pay votes? Will a special sign-on package (especially if it is out-sized) negatively influence the say-on-pay vote?
4. How should signing packages be structured and explained?

To help address these questions, we analyzed the pay packages for 18 CEOs hired externally at the 300 largest S&P 500 companies between 2010 and 2012.

Typical Structures

A well-designed pay package is important to ensure the CEO is properly focused and incentivized and that the package both meets corporate governance requirements and avoids negative shareholder reaction that may spill over into the say-on-pay vote. The right design will vary by company, and take into account its economics, business strategy, and compensation philosophy. However, competitive

practice can give a committee some comfort that the pay package being proposed is reasonable.

Among the companies in the sample, there was a range of practices for new CEO sign-on packages.

Purpose: In the vast majority of cases (16 of the 18) sign-on pay was intended to serve either as an inducement to join the company or to stake the new CEO (average of 60% of the package). Disclosure of “make-whole” grants was less common, with only six companies disclosing that a portion of the grant was intended to replace forfeited value from the new CEO’s previous employer.

Amount: The most common amount was a total sign-on package between \$10 million and \$15 million, including sign-on amounts and ongoing incentives. This compares to a median ongoing long-term incentive (LTI) level of \$8–10 million for CEOs among similarly sized companies. The highest levels generally reflected the buying out of unvested awards from the previous company or the providing of staging grants in the hiring company.

Compared with the departing CEO’s package, the incoming CEOs received between 1x and 6x of the departing CEO’s ongoing long-term incentive, with a median value of 2.44x.

LTI mix: Generally, we observed a high use of restricted stock units (RSUs) — more than 50 percent of the companies use RSUs as the predominant vehicle — perhaps reflecting a buyout of value from the previous employer or a desire on the part of companies to ensure that the CEO has a baseline value even if the stock price declines.

Additionally, the prevalence of performance-based grants was low in the sample, with less than 50 percent of the

package granted as performance-based equity. The low prevalence was likely driven by challenges in aligning the timing of the new CEO’s performance goals with the rest of management (especially if hired mid-year) and the difficulty of making a new CEO accountable for goals that he/she did not help set. The prevalence of options was also low — five percent of the package on average.

How does the size of these signing packages affect company stock price? In particular, do very large packages have a negative effect on stock price?

Although our research indicates that the announcement of a new CEO’s hire had a statistically meaningful impact on the company’s stock price 35 percent of the time, the subsequent disclosure of the CEO’s pay package only had a statistically significant effect on the stock price 12 percent of the time. Moreover, the pay packages in the two instances that were statistically meaningful were relatively small and were not likely the cause of the stock price change. The absolute size of the pay package also does not seem to have a statistically significant effect on stock price.

What effect do sign-on packages have on subsequent say-on-pay votes? Will a special sign-on package negatively influence the say-on-pay vote?

In the year following the CEO sign-on package, say-on-pay votes for the companies in our sample were somewhat lower than the average result across all companies. However, it is difficult to isolate the effect of the CEO sign-on package from other factors that impact say-on-pay votes, including in some cases poor company performance that led to the new CEO hire in the first place. It should be noted that in cases where the new CEO received a package that was a high multiple of pay relative to the former CEO, the company’s say-on-pay vote was markedly lower. (Note: Data was only available for 13 of the 18 companies.)

How should sign-on packages be best structured and explained?

Although competitive practice is a useful guide for structuring sign-on packages, we believe companies are best served when they:

- Fully understand the preferences of their shareholders and proxy advisors —this will help ensure that they do not unintentionally run afoul of their guidelines and receive an “against” say-on-pay recommendation/vote.
- Use the following principles to help ensure a sign-on package that is compelling to both the new CEO and shareholders.
 - Carefully think through and clearly disclose the rationale for the size of a sign-on award, making clear the amounts that are intended to make up for forfeited awards
 - Strive for maximum alignment with shareholders and company performance, while addressing the risks and uncertainty faced by a CEO moving to a new company
 - Minimize the company’s exposure in the event the CEO is not successful, while still providing a package that is attractive enough to secure the new CEO’s service

Balancing Interests

An appropriate design is important to ensure the CEO is aligned with company performance and shareholders. A committee can be comforted that the sign-on package for a new CEO is not likely to have a negative effect on company stock price and, if appropriately sized and structured, will likely not lead to a low say-on-pay vote the following year.

Competitive practice can be an important guide to a well-designed program. However, the principles outlined above will likely lead to the most effective design, while balancing the interests of the incoming CEO and the company.

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