CEO Contracts and Succession
Optimal CEO Tenure, Termination Payments and Succession Planning: Issues for Australian Superannuation Funds as Equity Investors

Research Report prepared by

ISS PROXY AUSTRALIA

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ISS Proxy Australia ................................................................. 4
1 Executive Summary ................................................................. 5
2 The Research Brief ................................................................. 7
3 Introduction ........................................................................... 7
4 The Agency Problem and CEO Remuneration ......................... 7
  4.1 Why Shouldn’t Executive Pay Be Entirely Performance-Based? .. 8
  4.2 How Do You Really Know if an Executive is Performing Well? ... 8
  4.3 How Can Incentive Pay Be Counter-Productive? ....................... 9
  4.4 Is Performance-Related Pay the Major Driver of Value? .......... 9
  4.5 Why Shouldn’t These Issues be Examined in Isolation? .......... 9
5 Organisational Architecture: Structure, Incentives and Culture .... 9
  5.1 What is Organisational Architecture? .................................. 9
  5.2 What Does the ‘Knowledge Economy’ Mean for Organisational Structure? .......................................................... 10
     5.2.1 Flatter Structures ...................................................... 10
     5.2.2 Implications for Executive Remuneration ...................... 10
     5.2.3 The Link Between Firm-Specific Investment and Promotion .. 11
     5.2.4 Implications of Long-Term CEO Contracts .................. 11
  5.3 Is Organisational Structure Taken into Account? ................... 13
6 Incomplete Contracts and CEO Tenure .................................... 15
  6.1 Retention Payments ......................................................... 15
  6.2 Sign-on Bonuses ............................................................. 15
  6.3 Termination Payments and Lengthy Contracts ...................... 15
7 Conclusions ......................................................................... 20
8 References ........................................................................... 21
ISS Proxy Australia

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1 Executive Summary

The relevance of human capital in the ‘knowledge economy’ has several important implications for organisational architecture, and corporate governance:

- If value creation involves not merely deploying physical resources in some well-defined production process, but also utilising human capital to adapt to changes in the business environment, then having a centrally ‘planned’ firm is not tenable.

- Moreover, the relative importance of those at the helm of the organisation is also diminished, as much of the value-creation story is no longer about CEO and senior management acumen.

- Once the importance of all layers of the organisation is recognised, there are implications for CEO remuneration. In the ‘old economy’, the differential between CEO and worker compensation packages might have been more easily justified by their relative impact on firm performance. But when company performance is far more closely tied to the human capital throughout the firm, then the differentials in compensation between different layers of the organisation are far less justifiable.

- When a board is setting a compensation contract, one driver is likely to be how best to structure the package to minimise the agency problems between the CEO and the shareholders. But, now, boards should also be considering the organisational implications of those contracts. When developing remuneration packages and succession plans, boards should take account of the nature of the company, and the extent to which it relies on human capital.

Long-term contracts, and rolling contracts, are sometimes used to try to ensure that CEO decision-making is not constrained by short-term considerations. But there are implications for all other layers of management within the organisation:

- In particular, while guaranteeing tenure (for some time) relieves the short-term decision-making of the CEO, it is likely also to impact on the decision-making process through the rest of the company. Those senior managers aspiring to the top role, are being given incentives (albeit unintended) to seek alternative opportunities because extending the tenure of the CEO by definition limits the prospects of others.

- Succession planning in the shadow of a long-term CEO contract is confounded not just by the prospect of losing some of the best possible candidates, but also by reaffirming the importance of the CEO in choosing a successor. It may not be the case that the incumbent CEO’s choice of successor is the best internal candidate.

Data on contract length among Australian CEOs is difficult to assemble, because not all companies disclose the contract term in their annual report. Among those Top 100 companies that do disclose contract length, there is considerable variety in practice: Lengthy contracts can be found — the Chief Executives of AGL, AMP, Boral, Investa Property Group, Lend Lease, Mayne, St George Bank and Suncorp Metway are all on 5-year contracts.

This paper suggests that CEO contract terms need to be considered in their entirety. This is particularly true because of the complementarities in different contract terms and the changing nature of many companies. The importance of human capital and its implications for organisational structure suggest that considering CEO contract terms without regard to the impact on organisational effectiveness (e.g. thwarting effective succession planning and harming employee morale), may be very costly.
Two key ‘take aways’ from this paper are:

- The available evidence does not suggest an across-the-board answer to the question ‘What is the optimal length of a CEO contract?’

- On the other hand, a case can be made for companies to disclose how CEO contract terms take into account organisational effectiveness as a whole. In particular:
  - When determining the quantum and structure of incentive pay for the CEO (and other senior executives), is regard had to the organisational structure of the company?
  - When determining the length of the CEO’s contract (and the contracts of other key executives), is regard had to the impact on succession planning?
2 The Research Brief

This Research Report was commissioned by the Australian Council of Superannuation Investors (ACSI). The research brief was to prepare a report addressing these issues:

- Consideration of incentives and contracts for senior management with review of academic and business literature on optimal contract terms.
- Summary and analysis of duration of contract length and its implications for managerial decision-making and succession planning.
- Summary and analysis of the relationship between termination payment structure, contract duration, CEO appointments and the implications of ‘pay for failure’ type contracts in Australia.

Several of these issues fall within the field of economics. ISS Proxy Australia therefore retained Dr Vivek Chaudhri, an Associate Professor in Economics at Monash University’s Department of Management, to work with its analysts in preparing this paper.

3 Introduction

In recent years there has been extensive coverage in the media and the academic literature on the level and efficacy of executive compensation.1 There is growing disquiet amongst investors and the general public at the perceived excesses of senior executives around the world. The change in CEO and senior executive compensation as a multiple of average worker compensation has been dramatic over the last few decades. The general unrest has swelled to towering proportions when a large compensation package coincides with spectacularly poor performance on the part of the company concerned. The media has highlighted large bonus and exit packages to CEOs at the helm of otherwise disintegrating organisations forced to cut staff and worker compensation. Much of the discussion, though, has been around the virtues, or otherwise, of so-called incentive-related pay schemes. The fact that these sometimes pay out in both good times and bad indicates that the ‘at risk’ components of executive compensation packages are not always at risk.

Analysis of optimal contract length, termination payments and the implications for a range of organisational performance measures (including the effectiveness of succession planning), should be considered in the broader context of the underlying agency problem between the managers and owners of a company.

4 The Agency Problem and CEO Remuneration

Berle and Means [1932] argued that, because dispersed shareholders have little incentive to closely monitor the managers of a corporation, managers who lack material shareholdings are able to direct firms towards ends other than profit seeking. Since then, there has been much discussion on how to align managers’ objectives with those of shareholders. Appropriately designed incentive contracts have been seen as part of the solution.

The foundations of incentive-based executive remuneration lie in the inherent agency relation between different players in the firm. An agency relationship refers to a situation where one party, the principal, engages another party, the agent, to perform some tasks for them.

In relation to a company, an economist would say that there is an agency relationship between shareholders and senior executives. In a variety of settings the objectives and incentives of the two parties are not going to be perfectly aligned. Cleverly designed compensation schemes are one way of aligning the divergent incentives of the principal and agent.2
4.1 Why Shouldn’t Executive Pay Be Entirely Performance-Based?

An economist would warn against designing an executive’s compensation package *solely* with a view to reducing the divergence of interests between the executive and the shareholders. Another important consideration should be taken into account — shareholders can diversify their risk through holding a portfolio of shares, while executives have their human capital tied to the company and are therefore less able to diversify away their risk. It is therefore argued that gains from trade can be derived through risk-sharing between shareholders and executives. This risk-sharing entails:

- Shareholders (the company) paying executives a significant *fixed* salary (and other not-at-risk compensation), and
- In exchange, shareholders enjoy the residual return from the executives’ hard work. What this means in practice is: holders of ordinary shares receive a share of the company’s profits each year through dividend payments (where the company is profitable).

However, fixed salaries reduce the executives’ incentives to seek to maximise shareholder value. Hence, there exists a trade-off between optimal risk-sharing and optimal incentives. A typical executive remuneration package therefore tends to include both:

- A fixed component (e.g. base salary, superannuation and use of motor vehicle, etc).
- An at-risk component (e.g. share options). Executive stock options are a way of trying to reinforce the incentives without necessarily losing the gains from risk-sharing between shareholders and executives.

4.2 How Do You Really Know if an Executive is Performing Well?

The actions of executives are not perfectly observable. Also, outcomes (e.g. increases in profit) are often driven partly by executives’ efforts and partly by external factors. Performance measurement systems need to accommodate the relative weightings of agent actions and exogenous factors that may affect outcomes.

The design of performance measures is further complicated by the difficulty in attributing performance across individuals and teams within organisations, and the relative risk profiles of the agents and the principals.

In designing appropriate performance measures, recourse to the ‘informativeness principle’3 is appropriate. Essentially, the use of performance metrics should be limited to those that improve information about the actual performance of the executive. Bonuses that are based on performance metrics that cannot be tied back to management effort are not appropriate.

The cost of monitoring, and of including all the indicators that would measure the performance of an executive, has led to a preference for *relative* performance measures in many settings.4

In the extreme, ‘tournaments’, which are winner-takes-all relative performance measures, are often used to explain career ladders. Ascension up a corporate ladder can be considered ‘winning’ each round of a tournament. Rewards at different stages of the tournament get commensurately higher, with CEO remuneration being the big pay packet (just as the winner of the US Open tennis tournament gets much more than the runner up). Unfortunately, the analogy with sporting tournaments breaks down when you consider that value creation within a company, particularly in light of the importance of human capital throughout the organisational structure, involves decision-making by many other layers of the organisation than just the CEO. Unlike in tennis, the loser of a round of the tournament is still critical to the subsequent success of the organisation. In short, tournament theories fail to recognise the importance of many individuals in delivering value.
Many firms base individual incentive compensation around both individual performance targets and group or company performance (such as increases in earnings per share, or in share price). However, the larger the gap between an executive’s actions and their impact on the company’s performance, the less effective the ‘company performance’ component of the compensation package.

4.3 How Can Incentive Pay Be Counter-Productive?

Several of the corporate collapses in recent years, both in Australia and the United States, have indicated that badly thought-out performance metrics (such as achieving a market capitalisation target: One-Tel) can yield bad corporate outcomes. CEO compensation that is tied to either short-term gains in market-share, or even stock market performance, if not properly thought through, may result in CEOs destroying shareholder value across time.5

4.4 Is Performance-Related Pay the Major Driver of Value?

While incentive compensation is in principle aimed at aligning principal (shareholder) and agent (executive) objectives, there is considerable controversy around the relative merits of financial and non-financial benefits within organisations. Culture, transparency and an openness of exchange of information and ideas across an organisation may well have much more to do with maximising value across time than performance-linked executive compensation schemes.

4.5 Why Shouldn’t These Issues be Examined in Isolation?

Companies use many levers to affect the agency problem inherent in the relationship between owners and the CEO. The complementarities between some of these levers has, however, received little attention. The nature of executive compensation packages, base pay and bonuses, termination payments, tenure, retention payments, perks, etc need to be considered in total, not isolation. Moreover, in addressing the agency relationship between the CEO and the shareholders sufficient thought needs to be given to its subsequent implications for all the other agency relations in the firm and organisational effectiveness more generally.

5 Organisational Architecture: Structure, Incentives and Culture

5.1 What is Organisational Architecture?

Organisational architecture (or structure) deals with the general patterns by which companies organise tasks, people for tasks and information flows. Ensuring that a company’s strategy formulation has satisfied the value creation and sustainable competitive advantage frameworks does not ensure profit creation. Effective implementation of strategy necessitates an understanding of the company’s strategy and its operational details by individuals within the company. Hence a company’s organisational structure also reflects the ways in which it deals with information and coordination on a regular basis.

Large companies rely on complex hierarchies that involve multiple groups and levels. These companies need to deal with the issues of departmentalisation (i.e. the formal groupings within an organisation) and coordination of activities. Coordination requires the flow of information to facilitate each group or sub-unit decision such that they are consistent with each other and the company’s overall objectives.
The design of organisations to ensure that information flows appropriately and that there are neither efficiency nor agency losses is a difficult and often neglected task. The information revolution, while facilitating communication and information flows across an organisation, makes the task of appropriate firm design no easier. Rather, an appropriate set of incentives and contracts that aligns decision-making at every level of the firm with overall corporate objectives also has to overlay the appropriate operational design for information flows and communication systems.

5.2 What Does the ‘Knowledge Economy’ Mean for Organisational Structure?

If the costs of organising within the company are sufficiently high, new kinds of market-specialist firms are likely to evolve to fill this space. Thus, a reliance on human capital and knowledge generation in the ‘new’ business landscape may result in a number of activities that traditionally occurred within the firm, being outsourced.

We are moving from a world in which companies gained and sustained competitive advantage through sourcing manufacturing and resource-processing capabilities to one in which the key for many companies is information processing. This observation has rendered a paradigm shift in business strategy. The relevance of human capital in this new ‘knowledge economy’ has several important implications for organisational architecture, and corporate governance.

5.2.1 Flatter Structures

For a variety of reasons many companies are moving towards flatter organisational structures. The reliance on information-processing capabilities has been accompanied by a commensurate increase in the role of human capital in most businesses. The relative importance of human capital has weakened the command and control system inherent in the vertically integrated firm.

If value creation involves not merely deploying physical resources in some well-defined production process, but also utilising human capital to adapt to changes in the business environment, then having a centrally ‘planned’ firm is not tenable. Moreover, the relative importance of those at the helm of the organisation is also diminished, as much of the value-creation story is no longer about CEO and senior management acumen. This further threatens the ‘tournament’ view of CEO appointments, where the presumption is largely that shareholder wealth creation is almost entirely contingent on CEO ability.

5.2.2 Implications for Executive Remuneration

The importance of human capital in the knowledge economy has implications for both the nature of CEO remuneration and (as discussed in 5.2.4) the efficacy of succession planning, and as such the viability of the firm itself.

Once the importance of all layers of the organisation is recognised, there are implications of continuing to treat CEO remuneration as a stand-alone issue of agency between the shareholders and the senior manager. In a world where the residual bearers of the financial risk, the shareholders, found that it was the ownership and utilisation of the physical means of production that created value, it made sense to reward CEOs and senior executives with appropriately designed incentive compensation schemes. In a sense, the differential between the CEO and worker compensation packages was justified on their relative impact on firm performance (at least in theory!). But when company performance is far more closely tied to the relevance of human capital, particularly as that is where the
information-processing capabilities are at least partly embedded, then the differentials in compensation between different layers of the organisation are far less justifiable.

Indeed, it is unlikely the current ‘star’ status afforded many CEOs, both in terms of reputation and associated remuneration, is tenable in the organisations of the ‘new economy’.

The extent to which large Australian companies are in the ‘new economy’ varies. Companies in parts of the manufacturing sector (e.g. steel production) are still heavily reliant on physical capital, compared to human capital. In contrast, companies in the media and financial services sectors are increasingly reliant on human capital.

When a board is setting a compensation contract, one driver is likely to be how best to structure the package to minimise the agency problems between the CEO and the shareholders. But, now, boards should also be considering the organisational implications of those contracts. When developing remuneration packages and succession plans, boards should take account of the nature of the company, and the extent to which it relies on human capital.

5.2.3 The Link Between Firm-Specific Investment and Promotion

In theories of the firm, it is often observed that power comes from the control of valuable resources. When a company’s most valuable resources are its human capital, rather than physical capital, then firm-specific investments become increasingly important. (One example of a ‘firm-specific investment’ is the investment of time and effort, and possibly expense, by an employee to learn how to perform a function that is useful for the current employer but not valuable to other potential employers.)

Companies need to encourage employees to make firm-specific investments, particularly where the alternative — acquiring skills and training of value to a wide range of potential employers — is readily available. In many companies, the organisational structure and potential internal labour markets (i.e. promotion), is regarded as one way to reward employees for their human capital and to try to encourage them to make firm-specific investments.

As the next section explains, if CEO contracts are too lengthy, this can have a negative effect on the promotion prospects of the next layer of management. The result can be less firm-specific investments by the affected executives, as they lack the promotion stimulus.

5.2.4 Implications of Long-Term CEO Contracts

Long-term contracts, and rolling contracts, are sometimes used to try to ensure that CEO decision-making is not constrained by short-term considerations. A possible implication of these contracts is a large termination pay-out. This could potentially be as much as the salary for the entire remaining term of the contract, less any amount allowed for ‘mitigation’ — unless the contract contains specific clauses specifying what termination benefits will be paid in which circumstances (known as liquidated damages clauses). A potentially much bigger cost, mostly overlooked, is the implication for all other layers of management within the organisation.

In particular, while guaranteeing tenure (for some time) relieves the short-term decision-making of the CEO, it is likely also to impact on the decision-making process through the rest of the company. Those senior managers aspiring to the top role, are being given incentives (albeit unintended) to seek alternative opportunities because extending the tenure of the CEO by definition limits the prospects of others. There is no shortage of anecdotal evidence — for example:
The CBA’s board has, over time, extended Murray’s stay at the top for 13 years, which has led to the departure of ambitious executives Michael Ullmer, Gail Kelly and John Mulcahy, all of whom had been pegged as successors. ... ANZ and Westpac could suffer similar problems in the loss of talented executives as CBA if McFarlane and Morgan, with their boards’ acquiescence, decide to stay past their contracted terms.4

As well as anecdotal evidence, there is also some rigorous empirical evidence supporting the value of CEO succession planning. One U.S. study, which covered the period 1984 to 2002, found that amongst companies whose CEO died unexpectedly, stock returns over the one-day, three-day and five-day window after the death were higher for those companies that had a succession plan in place compared to those that did not.9 As the authors explained:

Management changes may cause more instability in companies with no heir apparent than in those companies with a formal succession planning process; thus, market participants ... react more adversely to those firms with no apparent succession planning.10

As articulated by Kesner and Sebora (1994):

Over time ... firms require more than one CEO. Consequently, what a firm becomes can be significantly influenced by how and to whom this power and authority are passed ... This makes CEO succession a defining event for virtually every organization.’

Succession planning in the shadow of a long-term CEO contract is confounded not just by the prospect of losing some of the best possible candidates, but also by reaffirming the importance of the CEO in choosing a successor. There is a danger of an ‘adverse selection’ type result, where the company is left with internal candidates who failed to secure external opportunities; and of those, the ones who are in the mould of the incumbent CEO are supported for the top job. It may not be the case that the incumbent CEO’s choice of successor is the best internal candidate.

In those companies where human capital is key, the cost of lengthy tenure does not stop at the most senior level. There will be similar flow-on effects at each executive and employee level. There may also be a loss of confidence in the senior management, and diminished morale, as the best employees leave for other jobs. Quantifying these costs is, of course, difficult.

Data on contract length among Australian CEOs is difficult to assemble, because not all companies disclose the contract term in their annual report. Some companies disclose only the date of expiry, while others provide details of notice periods and termination benefits without disclosing the contract length.

Among those Top 100 companies that do disclose contract length, there is considerable variety in practice:

- Several companies employ their CEO on a contract with no fixed term (but with specific terms dealing with notice periods and / or termination benefits).
  - For example: Ansell, BHP Billiton, Billabong, Brambles, GPT, QBE, Sims Group and West Australian Newspapers.
- Three years is a common contract length:
  - For example: Alinta, Aristocrat Leisure, ASX, Cochlear, Qantas and UniTAB.
- Five years is also common:
  - For example: AGL, AMP, Boral, Investa Property Group, Lend Lease, Mayne, St George Bank and Suncorp Metway.
5.3 Is Organisational Structure Taken into Account?

Do boards even have these considerations on the radar screen when deliberating over CEO contract terms?

Almost always, CEO contracts are justified on the basis of trying to recruit the best possible talent and ensuring that their incentives are aligned with shareholders’ objectives. Unfortunately, such a narrow view cannot ensure that shareholder value will be delivered because the CEO contract terms need to be considered in light of their effect on organisational efficacy as a whole, not just CEO decision-making.

Several of the issues raised in Sections 4 and 5 are summarised in Figures 1 and 2 on the next page.
FIGURE 1 - CEO CONTRACT TERMS & ORGANISATIONAL PERFORMANCE

OLD WORLD - ONE DIMENSIONAL

GET BEST CANDIDATE TO TOP JOB AND MITIGATE AGENCY PROBLEMS VIA CEO CONTRACT

NEW WORLD – MULTI DIMENSIONAL

MUST CONSIDER HOW CEO CONTRACT TERMS IMPACTS ON ENTIRE ORGANISATION

SHAREHOLDERS

X LIMITED TALENT POOL

HEEDING & INCREASING CEO REMUNERATION

SHOULDN'T CONSIDER CEO CONTRACT IN ISOLATION

INEFFECTIVE GOVERNANCE

SUBOPTIMAL ORGANISATIONAL PERFORMANCE

• SUCCESSION PLANNING
• INCENTIVES
• CORPORATE CULTURE
• MORALE
• AGENCY COSTS
• DECISION MAKING AT OTHER LEVELS

CEO CONTRACT TERMS

FIRM PERFORMANCE

BALANCING ACT!

RECRUITMENT CONSULTANTS SEARCH FOR CEO

NEED ‘WEIGHTS’ TO ATTRACT BEST CANDIDATE

OLD WORLD - ONE DIMENSIONAL

NEW WORLD – MULTI DIMENSIONAL

GET BEST CANDIDATE TO TOP JOB AND MITIGATE AGENCY PROBLEMS VIA CEO CONTRACT

MUST CONSIDER HOW CEO CONTRACT TERMS IMPACTS ON ENTIRE ORGANISATION

LIMITED TALENT POOL

HEEDING & INCREASING CEO REMUNERATION

SHOULDN'T CONSIDER CEO CONTRACT IN ISOLATION

SUCCESSION PLANNING
• INCENTIVES
• CORPORATE CULTURE
• MORALE
• AGENCY COSTS
• DECISION MAKING AT OTHER LEVELS

FIGURE 2 - TOURNAMENTS, CORPORATE LADDERS & ORGANISATIONAL STRUCTURE

TALL HIERARCHICAL STRUCTURE

BEST CANDIDATE REACHES TOP

INCREASING IMPACT ON FIRM PERFORMANCE

PAY & RESPONSIBILITIES INCREASE AS CANDIDATES WIN EACH ROUND OF THE TOURNAMENT

FLAT STRUCTURES

HUMAN CAPITAL OF GREATER IMPORTANCE & VALUE IS CREATED ALONG ALL LAYERS OF THE ORGANISATION

SMALLER RELATIVE IMPACT ON FIRM PERFORMANCE AT HIGHER LEVEL

PAY DIFFERENTIALS HARDER TO JUSTIFY

CANDIDATES FROM INSIDE & OUTSIDE THE ORGANISATION COMPETE TO MOVE UP THE LADDER

LOSERS IN THE TOURNAMENT STILL VERY IMPORTANT

HUMAN CAPITAL OF GREATER IMPORTANCE & VALUE IS CREATED ALONG ALL LAYERS OF THE ORGANISATION

SMALLER RELATIVE IMPACT ON FIRM PERFORMANCE AT HIGHER LEVEL

PAY DIFFERENTIALS HARDER TO JUSTIFY
6 Incomplete Contracts and CEO Tenure

In an uncertain world it is tautologically true that the terms and conditions in CEOs’ executive service contracts are incomplete. It is impossible to contract over all possible future states of the world. As such, in devising contracts ex-ante (in advance), the goal is to incorporate all the appropriate information about incentives and decision-making processes, while being fully aware that some ex-post (after-the-event) renegotiation is inevitable.

6.1 Retention Payments

One example of an ex-post renegotiation is a ‘retention payment’. These are typically used to try to stop, at least for some period of time, the leakage of valuable firm expertise and information through poaching of employees.

AMP made retention payments to many senior managers at the time the UK businesses were demerged. When many of these executives signed their original executive service contracts, the spin-off of the UK businesses would not have been known. Thus, a retention payment is an example of an ex-post renegotiation of the terms of employment.

6.2 Sign-on Bonuses

The term ‘golden hello’ is now becoming common parlance for very lucrative sign-on bonuses. There is no element of ex-post renegotiation here, because these are agreed at the time of hiring.

The justification for golden hellos is that they are compensating an executive for changing organisations (e.g. Ahmed Fahour at National Australia Bank). For example, if the executive leaves his or her current company, valuable share options that have not yet vested may be forfeited.

6.3 Termination Payments and Lengthy Contracts

Termination-payment clauses, and long-term contracts that facilitate a large pay-out if the executive is removed in the early years of his or her appointment, are very different to retention payments. This is because termination payments (and lengthy contract terms) are negotiated ex-ante (at the time an executive first joins the company, and then whenever the executive service agreement is renewed), whereas retention payments are negotiated ex-post when a particular event or state of affairs unfolds. Most termination payments are entitlements that are not contingent on performance. With the exception of dismissal for some very specific — and narrow — reasons (such as fraud or gross misconduct), the termination payout is guaranteed to an incoming CEO even if he or she is fired (or pushed out of the job) for failing to meet performance targets.

Similarly to ‘golden hellos’, a common justification for the quantum of termination entitlements is that it is what it takes to attract the best talent. This appears to be a somewhat vacuous argument, for these reasons:

- Presumably the best talent would be identified as such by most organisations, and therefore would have career opportunities in a number of different companies.
- A lengthy contract term, or a large payout in the event of exit, appear to be about mitigating the risk to that CEO of failing to be appropriately employed after their time at that company.
Those executives who are deemed to be the best seem to be in a position not only to renegotiate their contracts with existing employers (through retention payments), but also to command sign-on bonuses with new employers.

Much of the discussion around termination payments originally surfaced in the United States where ‘golden handshakes’ were implemented to try to ensure that incumbent CEOs would not thwart value-creating merger or acquisition deals that threatened their own jobs. The evidence on such deals is mixed but suggests that in many cases there are some quite perverse effects.11

Termination payments that are negotiated *ex-ante* with an incoming CEO are also troubling because they are dealing with entitlements that are about transferring risk of under-performance from the individual to the company (and therefore its shareholders).

Termination payments, like rolling contracts (that guarantee tenure for some period), are sometimes justified on the grounds that by mitigating short-term risk for the CEO they will encourage a long-term decision-making view that will allow difficult decisions to be made even where these may be risky for the individual but are in the interest of the company. Such contractual terms are likely to throw up some quite perverse incentives. For example, the guarantee of financial security, independent of performance, may lead to bad decision-making as an accentuation of the agency problem.

Several of the contract features discussed in Section 6 are explained in Table 1 on the next page.
<table>
<thead>
<tr>
<th>Contract term</th>
<th>Definition</th>
<th>Pros (or ‘Potential arguments in favour”)</th>
<th>Cons (or ‘Potential arguments against’)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Golden hello</td>
<td>One-off payment made at the start of the contract period.</td>
<td>• Used to lure potential recruit away from current job.</td>
<td>• Typically unrelated to any performance requirements.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Is compensation for forgone entitlements at existing employer.</td>
<td>• May just be increasing the quantum of CEO remuneration without being sought.</td>
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<tr>
<td></td>
<td></td>
<td>• Signals the company’s strong support of candidate.</td>
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<tr>
<td>Tenure</td>
<td>Length and nature of contract- fixed term, rolling etc.</td>
<td>• Longer tenure is often associated with mitigating short-term decision-making on the part of the CEO.</td>
<td>• May in fact compound the agency problem as decision-making is somewhat decoupled from outcomes.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Aimed at reducing the agency problem between the CEO and shareholders.</td>
<td>• Adverse impact on efficacy of succession planning, as lengthy CEO tenure limits opportunities for others in the organisation.</td>
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<td></td>
<td></td>
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<td>• May result in loss of good senior managers and impact corporate culture and morale.</td>
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<tr>
<td>Base salary</td>
<td>Guaranteed component of remuneration package.</td>
<td>• There exist gains from trade by allowing some degree of risk-sharing between the CEO and the shareholders (i.e. not all of the remuneration package should be at risk).</td>
<td>• The relativities of at-risk versus guaranteed pay are an important consideration in addressing the agency problem.</td>
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<td></td>
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<td>• Easy to report and compare across different companies.</td>
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<td>Short-term incentive</td>
<td>Part of the “at-risk” component of remuneration package. Usually an annual cash bonus. Performance hurdles not normally related to share price.</td>
<td>• Designed to align managerial decision-making with corporate objectives.</td>
<td>• Efficacy is subject to the ‘quality’ of the performance metrics. Quality includes:</td>
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<td>o Type of metrics chosen – e.g. quantitative (like EPS) versus qualitative assessments (like customer satisfaction levels).</td>
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**TABLE 1**
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<th>Contract term</th>
<th>Definition</th>
<th>Pros (or 'Potential arguments in favour')</th>
<th>Cons (or 'Potential arguments against')</th>
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| Long-term incentive | Also “at-risk” component of remuneration package. Usually options or shares. Performance hurdles often related to share price or total shareholder return (i.e. share price appreciation plus dividends). Performance hurdles may be ‘absolute’ or ‘relative’. | • Designed to align managerial incentives with the longer-term shareholder value maximisation objective.  
• Mitigates the risk of short-term decision making.  

|                                                                                                                                         |                                                                                                                                                                                                 | • Hard to ensure that short-term and long-term incentives are not in conflict.  
• The larger the gap between an executive’s actions and their impact on the company’s share price, the less effective the long-term incentive component of any compensation package.  
• Efficacy is subject to the ‘quality’ of the performance metrics. Quality includes:  
  o Type of metrics chosen – e.g. financial-statement measures of performance (like EPS) versus shareholder-return measures (like TSR).  
  o Rigour of particular metrics – e.g. can hurdle be re-tested if not satisfied at vesting date?  
  o Scrutiny of testing – e.g. does independent party verify that performance metrics have been satisfied? |
| Termination entitlement | Guaranteed payment in the event that the contract is terminated. | • Mitigates the risk to the CEO of taking difficult decisions in the company’s interest.  
• Helps attract the best possible candidates by guaranteeing a considerable remuneration package in all contingencies. | • No link between performance and termination entitlement.  
• Given that most contract terms can be renegotiated, may be a problem of adverse-selection in candidates who seek termination payment guarantees.  
• Raises the quantum of CEO remuneration, and further distorts the relativities between guaranteed and ‘at-risk’ entitlements. |
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<td>Retention Payment</td>
<td>Renegotiated payment to induce current senior management to stay with the firm for a short period of time (often following a merger).</td>
<td>• Limits the risk of poaching of key personnel (and information) in the short-term.</td>
<td>• Raises the level of executive remuneration even further.</td>
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</table>
7 Conclusions

Ascertaining the ‘optimal’ length of a CEO’s contract, termination payments and their implications for succession planning is part of a bigger question on optimal contract terms for CEOs. Much of the academic and practitioner literature to date has focused on the quantum of CEO remuneration and the mix between guaranteed pay and ‘at-risk’ remuneration (with the interest in the latter driven by shareholder concern about the agency problem). Relatively little attention has been given to the issue of CEO tenure and termination.

This paper suggests that contract terms need to be considered in their entirety. This is particularly true because of the complementarities in different contract terms and the changing nature of many companies. The importance of human capital and its implications for organisational structure suggest that considering CEO contract terms without regard to the impact on organisational effectiveness (e.g. thwarting effective succession planning and harming employee morale), may be very costly.

Two key ‘take aways’ from this paper are:

- The available evidence does not suggest an across-the-board answer to the question ‘What is the optimal length of a CEO contract?’
- On the other hand, a case can be made for companies to disclose how CEO contract terms take into account organisational effectiveness as a whole. In particular:
  - When determining the quantum and structure of incentive pay for the CEO (and other senior executives), is regard had to the organisational structure of the company?
  - When determining the length of the CEO’s contract (and the contracts of other key executives), is regard had to the impact on succession planning?
8 References


1 See, for example, Gomez-Mejia and Balkin (1992), Jensen and Murphy (1990), Kroll, Toombs and Leavell (1997) and Tosi, Katz and Gomez-Mejia (1997) for a variety of different theoretical perspectives. The empirical literature has tended to suggest a strong link between executive compensation and firm size, but limited support for a relationship between changes in pay and changes in performance (for more details, see Barkema and Gomez-Mejia (1998), Finckelstein and Hambrick (1996) and Lambert, Larcker and Weigelt (1993).

2 See for example, Milgrom and Roberts (1992), Baker, Jensen and Murphy (1988) and McMillan (1992). Complexity in the standard principal-agent models arises from a number of factors. At its broadest cut, most of these fall under the categories of imperfect and asymmetric information problems. If actions were costlessly observable, and state-contingent contracts could be completely written, the alignment of incentives between principal and agent would be relatively easy. However, there is uncertainty about the relationship between the actions of the agents and the associated outcomes. The basic theory of agency assumes that enforceable contracts can be written on the observable performance measures, even though the actual desired behaviour is not able to be specified entirely in a contract.

3 Holmstrom (1979).

4 Gibbons and Murphy (1990).

5 That is alignment of incentives, between principals and agents, needs to occur in an inter-temporal fashion.

6 If an executive has an X-year rolling contract, on any particular day there are always X years to run on the contract. So, termination by the company would typically lead to a pay-out of up to X years’ remuneration. The larger X is, the bigger the pay-out.

7 Mitigation refers to the legal obligation of the terminated executive to try to minimise her or his loss — by trying to find another job.

8 Hyland and Hooper (2005).

9 Behn, Riley and Yang (2005).

10 Behn, Riley and Yang (2005).