The Design of Compensation Programs for the C Suite and Senior Management

Created: 14 October 2013
Revised: 6 December 2014

The Design of Compensation Programs
for the
C Suite and Senior Management

JEFFREY L MINCH

Published by:

WISDOM OF THE CAMPFIRE

Austin, Texas
December 2014

Introduction

There is no more important relationship than that of a company and its Chief Executive Officer and by extension all the occupants of the C suite and senior management.

Very few small companies or startups do a good job of designing C level compensation programs. The Exxons do a good job but not the small companies and startups.

The identification, attraction, hiring, inspiring, motivating, retaining, appraising of talent is the secret sauce of successful small and startup business. It is the jockey riding the horse. Bad jockey and the outcome is inevitable.

Designing a program of compensation that is attractive to the best talent is the job of a Board and when done well can make things smooth and sweet and productive. Done poorly and it can lead to costly chaos in the C suite. No company ever failed because it had done too good a job attracting talent.

Here is the big secret: **IT IS EASY TO DO WELL** and this document will provide a road map for doing it well. It is written by someone with thirty three years of experience of doing just that. In thirty three years you learn a few things. [Bad news? You never really stop learning.]

I will share this information like we were sitting around a campfire and chatting about the folk lore, the legend of your company, the Wisdom of the Campfire.

If you have any questions, you can reach me at:

jminch2011@gmail.com
512-656-1383 cell phone

Want to learn more? Read www.themusingsofthebigredcar.com for other tips. This will be fun.

Jeffrey L Minch
Austin, Texas
December 2014

The Design of Compensation Programs for the C Suite and Senior Management

Created: 13 October 2013
Revised: 6 December 2014

The purpose of this document is to provide a road map for small and medium sized companies to develop effective compensation programs for their C suite occupants and senior management. Done well, it will attract and retain superior talent while providing excellent continuity—all things that are critical to the health of small and medium size business.

Done well, it will also prevent the expenditure of substantial recruiting costs to replace C suite occupants and senior managers who have departed over inattention to their compensation expectations and market forces.

Who is the audience?

The design of compensation programs for the C suite and senior management is critical to the parties on both sides of such an arrangement—C suite occupants, senior managers and Boards of Directors (sometimes acting through a "compensation" committee of the Board).

These interests are sometimes adverse to each other—only in the nominal way that any parties to a contract have a different interest than the other party—but the design of such programs serves both of their needs. The issue can be approached in a collaborative manner and like all business agreements; one does not get what one "deserves," one gets what one "negotiates."

You do not get what you deserve, you get what you negotiate.

A successful negotiation leaves both parties energized to execute the duties agreed to by the agreement. A well negotiated program of compensation is a force multiplier.

The C suite may include a Chief Executive Officer, a Chief Operating Officer, a Chief Financial Officer, a Chief Technical Officer, a Chiet…well, you get the idea. This is the top line of leadership and their subordinates, the senior management of a company. [In writing further, I will refer to the "CEO" but know I also mean all the C's and the senior management.]

Why?

The parties have obvious interests and motivations which while seemingly obvious are often totally overlooked in small and medium sized companies. Too late, the departing CEO is suddenly valued and the Board wishes it had created a stable, long term relationship. This document will prevent you from experiencing that regret.

The CEO has an interest in obtaining the best possible compensation possible. This interest is a personal interest. When evaluating for whom to engage his talents, compensation is often the paramount consideration and a measure of how the Board values the CEO's talent. A misstep here can have disastrous consequences later and expose the company to an expensive search process to find a replacement.

Done well upfront, these costs can be avoided.

The Board has a duty to retain management to run the corporation. This duty flows from the shareholders who have elected the Board to undertake and discharge that duty, perhaps their single most important duty.

As part of the Board's duty there is also the corollary duty to, having attracted good management for the enterprise, retain it for the long run and to inspire and motivate the CEO to do the best job possible. Energy consumed between a Board and its CEO is not available to run the company.

Who designs the program?

In many instances, an experienced CEO will be the original architect of the compensation program in the context of arriving at an Employment Agreement.

In other instances a savvy Boardmember will understand the requirement and act upon that understanding. This may be undertaken by the Compensation Committee of a Board of Directors.

In public companies, it may be an attorney who suggests that an Employment Agreement is necessary for the Board to adequately discharge their duty to the shareholder.

The program can also benefit from the retention of a compensation consultant though that may be overkill if you read and understand this simple document. An employment lawyer may do the same thing.

It really does not make a lot of difference who initially designs the program as long as the process gets started. It is a process.

That's enough preliminary information, let's get into the essence of the subject.

What are the elements of a sound compensation program?

There are five elements to a well-designed compensation program:

1. Salary;
2. Benefits;
3. Short term incentive compensation;
4. Long term incentive compensation; and,
5. Something special.

Take a second and reflect on this—you already knew something about all of these elements and, likely, you have already dealt with some of them and perhaps intimately. What the design of a sound compensation program requires is to deal with all of them at the same time and with the same philosophical approach.

Let's dig into each of the elements in some more detail.

Salary

Salary is often the only element that is negotiated in a compensation discussion. This one dimensional approach is unfortunate as it denies both parties the ability to weave a powerful tapestry that will meet their needs over a long period of time. It is a single thread which can be cut very easily while that tapestry will be a much more difficult challenge to sever.

If salary is your only consideration then the only impediment to someone stealing your CEO is going to be that one number. This is not a very high hurdle.

When salary is not the only element negotiated in a compensation discussion, the other elements can provide supporting strength to reduce the emphasis on salary. Many other things in this discussion will ultimately be evaluated by being reduced to costs—often with importance attributed to "before tax" v "after tax" implications.

The CEO is going to require a market rate of salary, whatever that might be. Who really knows what market is? The advice I always give to Boards is to endeavor to pay your CEO at least 125% of "market" because market is such a nebulous and inexact term. If you pay your CEO more than the average pay for a comparable position, it will be difficult to find fault with that.

Market compensation is an average number built of the worst of the best and the best of the worst. It is so inexact that you can never really know what the right number is but the philosophical benefit of your CEO understanding that you intend to err on the side of generosity is real. Very real.

Later we will discuss "deferred compensation" so you have not heard the last word on the subject of salary. Keep some powder dry until we discuss that notion.

Benefits

Any company should have a clear, coherent and well-designed program of benefits. Lots of companies have good benefits; they just don't write them down and use them as an inducement to create the behavior they want. They fail to use them in the hiring process, as an example.

A company should have every imaginable benefit and should exercise discretion by funding something less than the entire cost of the benefit. Years and years ago, I used to provide healthy care, dental, vision and wellness programs for my employees. I used to justify that because they were tax deductible to the company and they were before tax expenditures for the employees.

I used to worry that the employees really didn't understand or appreciate the benefits I was providing. Then I stumbled on the notion of their having a bit of "skin in the game" whereby

I didn't pay for the entire benefit. I might pay for, say, eighty five percent of the health insurance cost. Suddenly, the employees had some skin in the game and took a much bigger interest in the program.

To digress for a second, I then formed an employee committee to oversee the bidding, analysis, selection of the health care insurance and the employees completely owned the issue. I would agree to invest a finite amount each year and they would try to negotiate a deal that would make that annual contribution as large a percentage of the total cost as possible thereby limiting their out of pocket cost. Some years, the company's contribution paid for the entire program.

In working with your CEO, adopt the same approach. Figure out what she wants and then provide it but don't pay for the entire thing or somehow limit the cost contribution by the company.

Offer very comprehensive benefits and engage on this issue.

Short term incentive compensation

Short term incentive compensation is intended to take propel the attainment of tactical objectives, critical tactical objectives, on an annual basis. Think about Vision, Mission, Strategy, Tactics, Objectives, Values and Culture but focus on Tactics and Objectives to find those specific tactical objectives which you intend to prioritize by making part of the compensation be based on the attainment of these specific objectives.

This will require some hard thinking by the Board or the Compensation Committee. What is critical to accomplish this year?

This compensation can be thought of as a "performance bonus" and is most effective when given as cash. Take a second to consider how this cash bonus taken with the salary component puts the CEO in a position of being able to control his own fate with his own efforts. This is garden variety motivation.

Long term incentive compensation

Long term incentive compensation is where such issues as equity and the Golden Handcuffs come into play. A CEO is going to want to own some of the stock of the company she is leading—why not?

Providing long term incentive compensation based on stock options—or any synthetic derivative of stock options, equity—is going to align the interests of the shareholders (share price essentially) and the CEO. Aligning the interests of the management and the shareholders is a critical duty of the Board and one that a good Board should tirelessly consider and act upon.

This is neither enlightened nor revolutionary; it is however good common sense. The total option pool for a well-run small company would total ten to fifteen percent of the total company. The CEO should share in this pool.

A good approach is to identify the number of shares and then initially allocate up to half to the C suite and senior management with an eye toward allocating the balance as the company continues to grow and the CEO's Employment Agreement is renewed.

Care must be taken to ensure that these options—or other synthetic securities—are in compliance with ERISA and are subject to a written Option Plan ratified by the Board and, in some instances, the shareholders. Seek legal counsel to ensure compliance.

As to Golden Handcuffs, remember that the vesting period for options is the carrot that can create long term stability, continuity and longevity. Use it wisely but make sure to use it. If a CEO is going to lose something of great value should she untimely depart, make it a very significant loss. Tighten up those Golden Handcuffs.

Something special

In the care and feeding of CEOs, it is imperative that they receive "bespoke" treatment and that their compensation be carefully designed. That is the reason you have read this far because you have a genuine interest in developing the most effective relationship that you can between a CEO and the company.

Now is the time to put some special sauce on the relationship. Here are some topics that can do just that.

Deferred compensation. Deferred compensation is an opportunity for the CEO to build meaningful wealth by deferring a portion of annual compensation and placing it in an investment account to be owned by the company until distributed in accordance with the rules established to administer the account.

For the CEO, it grows tax free until distributed. It is however a company asset and in the unfortunate eventuality of a bankruptcy, it is a company asset.

The distribution of deferred compensation will be taxed as ordinary income but remember it was ordinary income when it went into the account.

Word of warning: deferred compensation is a complicated tax issue so get advice before establishing the account. It can be done and the easiest and least complicated approach is always the best.

Remote working. A good CEO is not going to require much in the way of motivation but it is always useful to clarify that the CEO can work remotely from home, a ski house, a lake house or other remote real estate. A CEO's work space is really his keyboard and his phone and Skype is a wonderful invention. Clarify the policy and make it generous.

Computer gear. Most CEOs are gadget freaks. Liberally spice her existence with the latest efficiency building gadgets—smartphone, tablet, laptop, desktop and software. This is like giving a carpenter a nail gun rather than a wooden handled hammer.

Annual review, performance appraisal. There is nothing more important than an annual performance appraisal—both for the CEO and the Board. This is where you take the temperature of the relationship and plot small course corrections.

Force yourselves to answer the big questions—considering firing the CEO, CEO considering leaving? Get it on the table and then deal with the annual compensation review.

Do not let this linger. Every day it lingers the glue between a CEO and his Board weakens until the CEO is telling you where to forward his mail.

Boards typically do a very poor job on this because they often just don't pay attention or they don't have the cojones to do it. Do it.

Special expense reimbursement. If your CEO is a pilot and uses his plane to fly from location to location on business, reimburse him for the applicable costs. Find every expense the CEO incurs on behalf of the company and make damn sure to reimburse it with before tax dollars. Smoke these expenses out quickly and deal with them.

Professional development. A good CEO is constantly learning and the Board should push her in the direction by providing expense reimbursement as well as setting specific objectives for professional development—peer group membership like YPO (Young President's Organization), Vistage, the Alternative Board; seminar attendance; industry group membership; professional reading on leadership, business and management.

Administrative assistant. Many CEOs require the assistance of an assistant to discharge their duties. Make certain that this is provided for by your agreement with the CEO. Empower the CEO to use her administrative assistant to discharge personal duties which would otherwise consume her time such as paying bills, handling personal correspondence and any other activity that will rob the CEO of time she could otherwise be spending on the company. Do not be small minded on this subject.

Social activity. The CEO will engage with customers in both the marketplace and in society. Make it easy for the CEO to conduct social activity. We touched on this a little when we discussed peer group membership. CEOs may need a little encouragement to be active in other social activities which will pay long term dividends such as engagement with an industry group or the Chamber of Commerce.

If the CEO has an annual Christmas party at her home for customers, employees and others support this endeavor with the company's checkbook as the company will reap the benefit.

Review the thrust of this "something special" discussion and find other bespoke considerations which can make the CEO relationship special and hand crafted.

The Devil is in the details?

In approaching this subject philosophically consider the following questions:

What would it cost to replace the CEO?

What would the financial cost and the operating cost be?

How is the replacement of a CEO best done?

These three questions suggest that it will be very expensive to replace a CEO financially and perhaps more so from a continuity perspective. There has to be a reason to replace a CEO.

Don't be afraid to replace a CEO. CEOs get replaced all the time. Do it under control and in accordance with an initiative that protects the company and ensures the Board discharges its duty to recruit, hire, inspire, motivate and appraise management.

Know exactly why you have decided to replace a CEO—for cause, not for cause, because of a change of control, for the convenience of the CEO (she resigns). Each of these reasons has a different implication as to style, timing and cost.

The agreement between a CEO and the company has to be documented. This short document contains decision points that must be considered and committed to writing. An

Employment Agreement is essential to ensure the agreement is truly a meeting of the minds and to set the legal framework which will govern the relationship. The Employment Agreement should have the joinder of both parties and be review by counsel for each side. It should be formally approved by the Board and it isn't a bad idea to celebrate its existence.

Know this—failing to commit this agreement to writing will always result in disagreement, misunderstanding and confusion and that is if both parties are operating in good faith. Throw in a little angst and it has the makings of a real donnybrook.

The purpose of this document is limited to designing the compensation program but care must be taken to ensure the Employment Agreement actually says what the parties have agreed to in the design.

In closing, it is necessary to say that most—yes, MOST—small companies and startups make a shambles of the design of C suite compensation. Less than ten percent attack the challenge in a professional manner and usually when they do it is because they have a very savvy CEO who insists on protecting his interests. Having said that, it is very easy to do well and when done well will set the tone for the entire relationship. Consider doing it well.

You have been warned.

Do not be afraid to contact:

Jeffrey L Minch
512-656-1383 cell
jminch2011@gmail.com

to discuss further.