Jeff Kirk

The retirement conundrum

There are times when paying severance to a retiring senior executive is warranted. But as a standard practice it raises questions and scrutiny. The good news: boards have options to help avoid the problem

By Ken Hugessen with Guillaume Poulin and Parvathi Subramanyam

Severance payments are typically provided to executives in the event of a termination without cause. However, some companies also make severance payments to senior executives upon what looks to be a retirement. These situations often raise questions regarding the rationale for providing a severance package if the employee is retiring.

Boards typically want executives to retire at an agreed time referencing the succession plan. Yet, from an executive's point of view, in some situations it can be lucrative to wait to be "pushed out" and receive a severance, rather than to formally retire. This is what we refer to as the "retirement conundrum."

Payment of severance to a retiring executive occurs mainly in companies that treat the vesting of their equity the same way upon a true retirement as upon a termination without cause. This gives the executive the choice of either, a) retiring on his/her own, receiving no severance while receiving pro rata vesting of his/her equity holding and his/her pension; or, b) waiting to be pushed, receiving a severance and receiving pro rata vesting of his/her equity holding and his/her pension. In effect, the plan incents the executive to seek termination without cause.

One way to eliminate this incentive is to allow for more favourable vesting of the equity on an approved retirement than on a termination without cause. Although this may not always fully compensate the lack of a severance payment, more generous equity treatment will make retiring without a severance more enticing from the executive's perspective. And, in fact, this is the majority practice among the TSX 60 issuers. The typical approach, with respect to long-term incentive plan treatment upon a CEO retirement, is to provide some form of continued vesting for stock options and restricted share units.

That said there are still companies with identical equity vesting in both retirement and termination without cause scenarios. For them, moving to a more generous equity vesting treatment at retirement could be an alternative worth considering. If so, the following factors should be weighed:

- The more generous vesting of equity on retirement should be conditional on not receiving a severance payment and signing a waiver of the right to a severance;
- The executive should give reasonable notice (e.g. six to twelve months for the CEO) as agreed with the board and should carry out responsibilities related to their transition;
- The executive should agree to and comply with restrictive covenants (non-compete, non-solicit) during the continued vesting period, otherwise all equity would be forfeited.

Some companies are also beginning to implement a "good leaver" policy. For these companies, the treatment of equity vesting remains the same under a retirement and a termination without cause, but the board, upon recommendation from the CEO, can provide for full, continued vesting at retirement if the executive is deemed to be a good leaver. In these situations, a good leaver definition would be determined, and would include the conditions mentioned in the bullet points above.

We understand that each company has its own reasoning behind its equity treatment; however, companies that treat equity vesting upon retirement and termination without cause equally may want to re-evaluate its potential effects. If adjustments are deemed appropriate, it would be important to conduct detailed financial modeling to prevent any unintended consequences before finalizing the adjustments.

> Some equity vesting plans incentivize executives to hold out for termination. One way to eliminate this is to allow for more favourable vesting of the equity on an approved retirement than on a termination without cause.

Even if equity fully vests upon retirement, the termination without cause scenario may still result in a higher payout for the executive (because of the severance payment). However, the reduced gap between the two scenarios could diminish the risk of executives waiting around for the board to act.

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