

# A Call to Action: Reviewing Severance Policies and Change-in-Control

Shorter CEO tenures, organizational shuffling and the quest for greater globalization. These are just a few of the characteristics defining today's corporate America. A byproduct of such activity is heightened awareness of executive pay. In fact, hardly a day goes by without the business press covering a story on severance pay or change-in-control packages.

This article outlines several emerging trends which have exacerbated this situation, and explores what companies are doing to handle these changes by comparing responses from a 2004

WorldatWork/Aon Consulting severance and change-in-control survey to responses from the updated survey in late 2005.

## Cause for Change

Why is there a need for severance and change-in-control policies? The number of CEOs being asked to step down by their boards has increased at a significant rate during the past two years, especially at public companies. According to one study, more than 14 percent of CEOs left their corner offices in 2004. This represents a 300-percent increase since 1995. The average tenure of a CEO is now five years, down from 10 years in the 1990s.

In addition, the number of companies merging or acquiring other companies has grown significantly during the past two years. Initial Public Offerings (IPOs), one measure of business activity, have quadrupled since 2002.

Finally, the economy has not improved in a number of sectors and, in fact, has

### QUICK LOOK

- ➔ Three out of four organizations do not review their severance plans on a scheduled basis.
- ➔ The definition of the severance multiplier often includes base salary plus actual or target bonus.
- ➔ Compensation committees should conduct a thorough review of companies' severance and change-in-control policies on an ongoing basis.

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turned downward for several industries. For example, in the 2005 survey on severance and change-in-control policies, 63 percent said their organizations had experienced a reduction in force within the past 24 months, compared to 76 percent in 2003. While showing signs of improvement, this number is still staggering.

### Survey Findings

The purpose of the survey was to update the analysis and review carried out in 2004, and observe new trends in severance and change-in-control policies.

Main highlights of the survey include the following:

- The vast majority of employers (85 percent) use years of service to determine severance pay for most nonexecutive employees.
- In severance plans covering the largest number of employees, about 44 percent of organizations pay a minimum amount of two weeks' salary, and 45 percent pay a maximum between six months' and one year's salary.
- About one in three organizations creates separate severance plans for the CEO, officers/executives and all other employees.
- Three out of four organizations do not review the top executive's severance plan on a scheduled basis.
- One in three organizations has not reviewed the change-in-control policy since it was established, and 20 percent have not reviewed it in two years or more.
- The last time the change-in-control policy was reviewed at responding organizations, 63 percent made no change.
- The trend to offer outplacement benefits seems to have continued since 2003. In the current study, 42 percent of typical, nonexecutive severance plans provide for outplacement benefits to

all covered employees, and 35 percent provide them on a case-by-case basis.

### Emerging Trends

One interesting trend to emerge, which has received national media attention as of late, is the use of severance as an enforcement tool for a covenant not to compete. If an executive receives a large severance award and then leaves a company to join a competitor as one of the top executives, it is a de facto breach of the noncompete clause, so argue many employers.

In addition, a number of new developments have emerged in the awards themselves. For example, the definition of the severance multiplier often includes base salary plus actual or target bonus. This concept was not used nearly as much five or 10 years ago.

### What Should Compensation Committees Be Doing?

First, compensation committees should establish a regular and thorough review of the companies' severance and change-in-control policies. Making it an agenda item is an easy way to embed the review in the governance process. In the top executive arena, the amounts come under too much scrutiny not to be carefully monitored on a periodic basis, and things also change so rapidly that employers need to be updated on these situations.

Why is this governance best practice particularly important now and for the immediate future? Several reasons stand out today more than ever, including the following:

- The size of the awards is greater than ever.
- The board's governance process can be called into question and examined by courts today if it does not follow the proper methodology.
- Board members turn over (and turn down appointments) at a much higher rate than in previous years, due in

part to greater scrutiny by the media, shareholders and regulators.

In short, compensation committees should pay attention to the *details* surrounding these plans, especially for top executives.

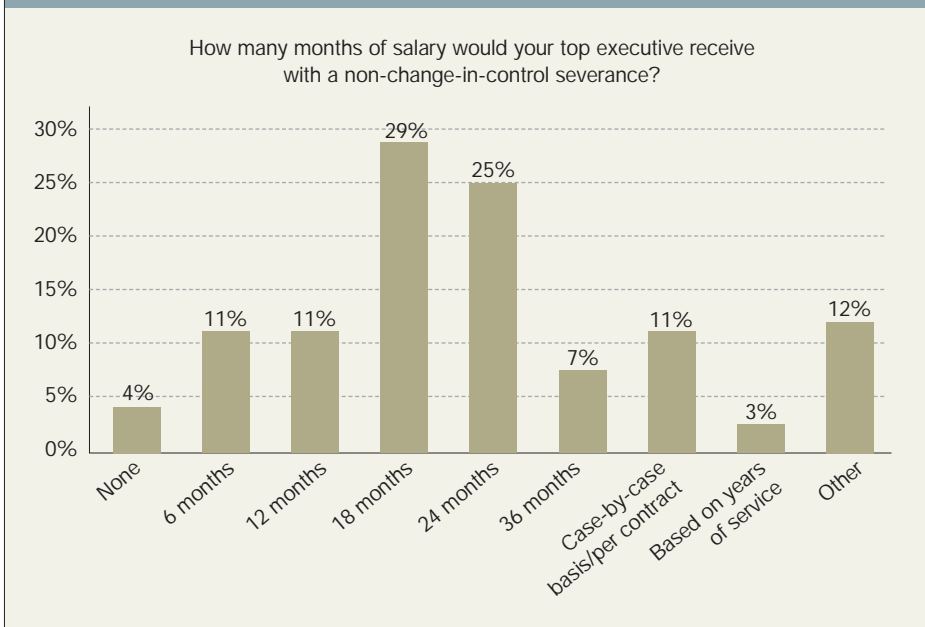
Committee members should ask themselves several questions, including how severance and change-in-control plans fit in with other important benefits provisions. Those include retirement plans, supplemental executive retirement plans (SERPs), nonqualified deferred compensation (NQDC), stock options and other long-term incentives, annual incentives, executive benefits and tax code changes added by Section 409A of the American Jobs Creation Act of 2004. These changed the operation and taxation of nonqualified deferred compensation plans for amounts that are deferred or are vested on or after Jan. 1, 2005. Severance can now be defined as deferred compensation under these rules, under certain circumstances.

How long should the company fund health and welfare benefits in its severance policy, either on a COBRA, or non-COBRA basis? If it does so on a non-COBRA basis, has the company considered whether FAS 106 (post-retirement medical) provisions apply? And if the benefit is self-insured, does it affect certain nondiscrimination requirements?

Has the company considered outplacement for the executive or group of executives? How should the severance be paid? Should it be paid as a lump sum or as periodic payments enabling the employer to monitor compliance with the many covenants that exist?

How many months of salary should the top executive receive? This is often a "standard-setter" for the next level of executives and direct reports, and certainly affects the level provided to other management employees. See Figure 1 on page 69.

FIGURE 1: MONTHS OF SALARY



Finally, how is the multiplier defined? There is, of course, a distinction as to whether the multiplier is base salary or base salary and targeted bonus. Obviously, this makes a significant difference to the executive and company, especially in an environment where more companies are adding pay-for-performance target-bonus plans to their arsenal.

### A Call to Action

It is more important than ever for compensation committees to heed this call to action. Due to the greater sense of urgency today, the rapid pace of events, the compression of time in most industries, the new rules (including Section 409A) that can affect severance and change-in-control awards and the potential size of the awards, compensation committees cannot be too well-prepared for any eventuality. The alternative to careful due diligence is potential delay, poor decision making, or at worst, exposure to costly and lengthy shareholder litigation, as well as potential unexpected Internal Revenue Service taxation and penalties. Severance and change-in-control agreements should

assume greater importance on a periodic basis with compensation committees and HR liaisons from the companies they serve. [WS](#)

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- Type in this key word string on the search line: Severance agreements.

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- C6A: Advanced Concepts in Executive Compensation.
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