The realities behind corporate executives' golden parachutes

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If you lost your job today, how much would your former employer pay you? As much as you are worth? What if you lost your job because you failed to perform your job adequately - how much would you be worth then?

Just recently, Hewlett-Packard came under fire for sacking its former chief executive, Leo Apotheker, after seven months in the top job - but that's not why the company's board was criticized. The fuss came after HP also reported that it would pay Apotheker severance including a $7.2 million payment - or a million dollars per month as a so-called "failed" CEO.

You don't have to be an Occupy Wall Street protester to wonder why boards of directors dole out such generosity, when the perception is that these executives have - by the company's own admission - not performed adequately for shareholders. So why do these executives supposedly deserve such largess when lower-level employees receive no such treatment?

Let me try to explain.

For starters, the view taken by many in the media, in the blogosphere and everywhere else ignores the fact that the causes for lagging corporate performance in our globalized, interconnected economy often come from distant forces over which top executives have no control - and of which they have no warning.

It is for these reasons that directors are not, and should not be, expected to be guarantors of success - only prudent in exercising their collective business judgment in the selection of top executives. Typically, the directors will hire sophisticated headhunter organizations to help in the search to fill these positions, and will also solicit suggestions and recommendations from trusted advisers such as attorneys, accountants and investment bankers.

Bottom line: relationships and reputation matter greatly in these decisions.

When it occurs, the "failure" of the executive selection process can, many times, be traced to the reality that a recognized set of talents, and past successes, do not necessarily transfer from one company to another. You can hire an executive with an impeccable pedigree, but what boards of directors are actually banking on (whether they know it or not) is the executive's ability to adapt to his new surroundings. That is tough to predict under the best of circumstances.

Notwithstanding this uncertainty, because of market and other factors, a board of directors that wants to compete for a certain executive must commit, up front, to a compensation and exit package that: (1) will

be binding regardless of the results of the executive's efforts ; and (2) will inevitably be critiqued if the company's value suffers. And here, market forces affect these decisions.

The U.S. supply of top executives is surprisingly small, while the demand is high. In addition, potential hires (and pay packages) are evaluated primarily on the potential upside benefits that the executive can produce. After his rehiring in the late 1990s, for example, Steve Jobs took Apple from the brink of failure to, recently at least, the most highly valued corporation in the world. Just think of the hundreds of millions of employees, stock and mutual fund holders, and customers who benefited along the way.

In the public company markets, then, the upside for executive success can be huge, and as a result executive compensation mirrors this best-case scenario.

When hiring top executives, however, few if any in the process dwell on the downside - but that is starting to change.

More companies are embracing a "hedge" of sorts that divides the executive's pay package into two parts: (1) a base plan, and (2) an equity incentive plan, along with a time factor embedded in each component. For example, the company can offer base pay that is equal to, or better than, what the prospective new executive is leaving, guarantee it for one or two years, and supplement it with annual bonuses that are tied to a sliding scale of targeted earnings for the company. Since the typical "value multiple" tied to increases in public company earnings far exceeds the corresponding bonus, the company can afford to be generous with these bonuses. Bonuses would be fully earned even for a partial year's work.

These equity-based incentives represent predetermined annual awards of fully vested stock equivalents that would, by their nature, lock the executive into a share of the future success of the company whether he is around or not. The longer he or she is there, the more stock they receive. This plan fairly compensates the unsuccessful employee, avoids the short tenure/big reward morass, and gives the longer -tenured executive a reasonable parachute should he or she be summarily dismissed.

In short, market forces drive how board directors view these hiring opportunities where commitments must be made - and how the prospective candidates exercise their leverage. Of course, the hiring busts get a lot more media attention than the successes, but at the end of the day it helps to remember timing is sometimes as relevant to executive performance as skill and ability - and as with horseshoes and hand grenades, sometimes it is better just to be lucky.

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