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CRI News *Insights on Executive Compensation*



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THE FUTURE OF EXECUTIVE COMPENSATION

One of the most often asked questions given the impact of the financial industry meltdown and concerns with runaway Executive Compensation is: How will Executive Compensation be impacted?

In order to begin to make any reasonable forecast as to what Executive Compensation will look like both in the near-term and further into the future, it is important to first understand how it became the hotly contested issue that it is today. How did Executive Compensation become the poster child for greed and everything wrong with Corporate America? A lot of people put the blame totally on "greed", saying that it is strictly caused by executives who want more and by Boards who acquiesce and approve pay plans that has caused the problem. This is of course a gross oversimplification.

Greed has certainly been a significant factor, particularly in those instances in which certain executives have pushed the envelope of reasonableness and received much more than is warranted or deserved. Carried to an extreme are situations in which the desire to get more compensation is accomplished through illegal or unethical means. Back-dating of stock grants, falsifying company financials, tax fraud, and cheating on expense accounts have, unfortunately, become all too common examples of greed in Corporate America. These examples have attracted tremendous media attention, resulting in considerable public indignation, and ultimately in regulatory action.



The starting point in trying to understand the factors driving Executive Compensation should be to look at the overall objectives of the pay program and what companies are trying to achieve. The most commonly stated goals espoused by many companies in their supporting documentation are: (1) the need to **attract** highly qualified and experienced executives, (2) the desire to **retain** members of their management team, and (3) the ability to **reward** them for achieving the financial goals of the company, often measured as increased "shareholder value". There is a fourth key objective that should be included in any Executive Compensation program, that being to provide the necessary **focus** that will enable the executives to stay on track and work towards the company's goals, not ones that can be construed as self-serving. Focus enables a company to have the compensation drive specific performance measures that are consistent with its business plan and strategy. The simple acronym, "FARM", can be used to identify these four (4) key objectives of pay programs: **F**ocus, **A**tract, **R**etain, and **M**otivate.

Even though it is important that the plan be designed with a specific goal in mind, unfortunately, plan designers often fixate too narrowly on those objectives and do not adequately consider the potential consequences of the plan. Without a doubt, the most important goals of any incentive plan are to provide the financial motivation and focus that will help to achieve the company's specific financial and/or operational goals. However, without appropriate checks and balances, or limitations built into the plans, there is a good chance that the results will be achieved at the expense of quality, ethics, or long-range results. As an example, the incentives for loan officers in investment banks and mortgage companies have been cited as contributing factors in the current financial meltdown. Highly leveraged incentives, without adequate checks and balances, can often lead to disaster. A design feature that would have equalized the number and volume of loans with a longer-term measurement of their quality could have dramatically changed the picture.

When considering the design of Executive Compensation plans, it is important to consider the



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impact of five (5) factors, which we refer to as the “**GRATE**” factors because they often annoy those involved with Executive Compensation. The G stands for **Greed**, which we believe only impacts a minority of executives; however, the label tends to have tainted many Executive Compensation programs and thus has a negative connotation to outsiders such as stakeholders and the media.

Unpleasant as the name implies, the **RAT** portion of “GRATE” includes Government **R**egulations, **A**ccounting Rules, and **T**ax Implications. Government regulations affect compensation at different levels, generally at the extremes, such as minimum wages at the lower levels and various restrictions affecting Executive Compensation at the upper levels. One of the most important regulations impacting Executive Compensation is IRC 162(m), which eliminates the tax deductibility of non-performance-based pay in excess of \$1 million. Initially, this had a significant impact on the design of such pay programs, and actually contributed to a huge increase in the use and amount of other incentives. In the late 1990s we witnessed an increase in incentives for “C” suite executives, growing from approximately 25% to 100% or more of base salary in many instances. Since stock options are considered to be performance-based, and therefore not subject to the 162(m) limitations, there was a corresponding dramatic increase in the use and amount of stock options granted during that period, leading up to the award of “mega option grants”. Following the burst of the dot.com bubble in 2001, FAS 123R was adopted in December 2004 that required stock options to be expensed as compensation. This resulted in an almost immediate reduction in the granting of options and resurgence in the use of restricted stock. Since restricted stock is typically time-based, companies were faced with either granting a smaller number of restricted shares with much less value than the options previously granted or switching them to performance-based restricted stock. The last few years of proxy reports have indicated that companies have done both: providing smaller option grants and larger grants of both time-based and performance-based restricted stock. While the “RAT” was designed to, among other things, protect shareholders and provide favorable tax and accounting treatment to both companies and executives, recent and historic abuses of Executive Compensation have caused many to dread the oversight requirements imposed by regulators. However, properly structured Executive Compensation packages can provide an overall win/win situation to executives, Boards, shareholders, media, and regulators.

When considering the design of the Executive Compensation plans, it is important to consider the “GRATE” factors.

Lastly, it is **Ego** that becomes a factor in the design of many Executive Compensation programs. The desire to provide programs or total values of those programs that emulate the compensation paid by peers is a major factor in designing plans. The desire (or need) to have the same total value of compensation as a company’s identified peers is inherent in “setting the bar” for most compensation programs. This factor is probably more subtle, since it tends to be consistent with the Compensation Philosophy of most companies that identifies market positioning. By itself, it is appropriate to provide a competitive compensation package in order to be able to attract qualified executives and to retain proven talent. However, the purpose goes askew when the company’s performance is below that of the peers it has used for market comparison. RiskMetrics Group (RMG), formerly ISS, has indicated its intention to focus on companies where increases in Executive Compensation are inconsistent with company performance, relative to total shareholder return of the peer group, over one and three year timeframes. This focus can be expanded to examine the level of severance and other compensation elements when they are not justified by performance. In other words, if the shareholders are losing value, why should the executives be reaping large rewards? Ultimately, should executives among a group of peer companies be paid similarly if they don’t exhibit similar levels of performance? Ego aside, pay programs should be structured so that they provide the benefit to both the company and the individual, without compromising the goals and objectives of either one.

Properly structured Executive Compensation packages can provide an overall win/win situation to executives, Boards, shareholders, media, and regulators.

Although the designers of the various Executive Compensation programs may not admit it, a significant consideration in plan design is to maximize the value of the benefit to the executives, while minimizing the negative impact to the company. Many companies looked to achieve this by providing some type of “gross up” to the executive whereby the company increased the executive’s pay so as to cover the taxes associated with that compensation. However, because that increased pay is also subject to tax, this practice can become an almost never-ending upward spiral. This type of gross up will ultimately cost the company approximately double the amount of the initial tax payment. It is fair to say that the recent public disclosure of the use of gross ups appears to have hit a “raw nerve” with shareholders, regulators, the media, and the public in general.

With all of this as a backdrop, what do we foresee as the future of Executive Compensation? We see the future of Executive Compensation evolving to include the following:

- There will be a series of well-intended, but ambiguous rules enacted by Congress. It will take some time for all of the new rules and regulations to take effect, but within three (3) years, we

believe that Executive Compensation, as we currently know it, will be very different. The financial industry bailout is the first look at Executive Compensation's changing future.

- Performance will continue to be the most significant factor in determining levels of compensation; however, we envision that both the government and Boards will establish upper limits or caps on potential earnings. More importantly, these will be tied to achieving real performance once circuit breakers are met, and that performance will be measured by increased value to shareholders, socially and morally positive standards (whatever that means), and comparison with the performance of peers.
- Equity will still be an important element of the total pay package; however, we do not expect to see a return of the "mega grants" that were so popular in the late 1990s and early part of this decade. Options will have shorter vesting periods (5 to 7 years), thus lowering their grant-date value and corresponding expense, while restricted stock will vest over 3 to 5 year periods. We also believe that both options and restricted stock will increasingly contain performance requirements that must be met before the award can be realized.
- In the past we have seen options being granted as a substitute for cash incentives that were not earned because of lackluster performance. We strongly feel this is inappropriate and sends a very mixed message. The anticipated regulations may make it much more difficult for Compensation Committees to grant these rewards,



especially when they are not merited.

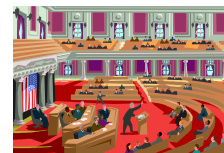
- In the not-for-profit arena, there currently are very distinct regulations covering both the amount of and procedures for determining Executive Compensation. These regulations also carry a number of extremely rigid requirements and punitive fines. We anticipate that some of these rules will find their way to the for-profit sector, especially within publicly-traded companies. It is even conceivable that some of these rules may be written so as to impact privately-owned companies.
- We believe that some costly perks will be eliminated. For example, there is a little known provision which prohibits companies from funding a Supplemental Executive Retirement Plan (SERP) if its contribution to a Defined Benefit retirement plan falls below a certain level. There is a good chance that this regulation could be expanded to make it much more difficult to create and fund a SERP, particularly when the company has eliminated its regular retirement plan for other employees, or abolished 401(k) matches, as many companies are currently doing.

Executive Compensation is an evolutionary process, and will continue to change and adapt as conditions allow. We are not sure of all the changes that will occur, but we are positive that it will be an interesting next few years and, ultimately, Executive Compensation of the future will look much different than it does today.

Commentary on Current Governmental Intervention on Executive Compensation

As consultants, we are often asked what our position is relative to President Obama's limits on executive compensation for those executives whose companies take TARP money. While many applaud these limits, executive compensation is an exceedingly complex issue and does not lend itself to any simple or "one size fits all" solution. Consideration needs to be given to the following items in order to determine if executive compensation limits are justifiable:

1. There are a multitude of legal issues that will have to be resolved in order to implement the changes that have been proposed. Much of the compensation is set forth in Employment Agreements, Change of Control Agreements, and documented in Compensation Plans (Yes, the courts have long held that they are contracts, regardless of what some companies may say to the contrary). These would need to be mutually agreed to or could potentially evoke breach of contract suits.
2. One of the hard-won battles for transparency and shareholder rights is that all stock-based compensation plans require shareholder approval. These require a specified time for vesting stock grants, as well as for the life of the option. If the rules are now changed so that the options or restricted stock cannot be sold until the TARP bailout monies have been paid back, this could be in direct conflict with the limitations set by Sarbanes Oxley that require shareholders' approval.
3. The tax laws and rules, plus the accounting standards (GAAP and IAAP) may have to be re-written to cover these changes.
4. The announcement only said "executives". Some of the large companies have hundreds of highly-paid executives. Where will the line be drawn? Does that mean that the top officers will only be able to make \$500,000 per year, while their subordinates (lots of them) can make more? It is not unusual for CEOs to accept the fact that their best sales people (or producers) make more than them, but not on such a wide scale.
5. We have already seen that some companies will refrain from accepting the government's bailout so that it does not have to come under these rules. What about the companies that will go private so they don't have to abide by them either? A recent example is the large number of companies that went private so that they didn't have to adhere to Sarbanes Oxley.
6. Lastly, wage freezes have been attempted a few times in our history. In each instance, they had unfavorable consequences. Like Prohibition, it didn't stop people from drinking, but only made people cheat and find illegal ways around the rules.



EXECUTIVE COMPENSATION – WHAT’S NEXT?

The Executive Compensation fire keeps burning, with new fuel being poured on it, seemingly every day. The recent controversy with AIG bonus payments, which many viewed as wrong, unwarranted, and ill-timed, have continued to stoke the demand for radical changes on how Executive Compensation decisions are made. Both sides of the aisle in Congress have voiced their opinions on the issue, and have thrown their support behind legislation that will place restrictions on Executive Compensation arrangements. With over 2.6 million jobs lost in the last four months, and AIG having received over \$180 billion of TARP money, we can be assured that the attention focused on compensation excesses will cause more restrictive legislation to be approved, in addition to the threatened imposition of a special excise tax.

Although it is not possible to know the details until new compensation regulations are written and promulgated, we believe that some of the more flagrant excesses will be targeted:

- Elimination of gross ups and indemnification on compensation issues (e.g., Golden Parachutes, severance packages, etc.).
- Addition of claw back provisions for incentives, bonus awards, and equity grants. These would require repayment (known as “disgorgement”) by the individual of paid awards under certain conditions (e.g., financial problems including bankruptcy, ethics issues, etc.).
- Addition of circuit breaker provisions to incentive, bonus, and equity programs. These provisions will preclude any payment being made to participants in the event that specified financial and/or operational performance measures are not met.
- Reduction and additional restrictions on Supplemental Executive Retirement Plans (SERPs) to limit the level of income replacement provided, potentially tying the SERPs to achievement of measurable performance, and/or funding restrictions under certain situations.
- Tightening the Golden Parachute (IRC §280G) rules to require double triggers, shorten the time after change of control in which an executive can “pull the ripcord”, and possibly eliminate any payments over 2.99 times.
- Moving the goal post for performance measures further out, so that the size of short-term awards (12 month or under) will be substantially reduced, and the emphasis shifts to long-term incentive plans (LTIPs).



Another possible impact of any new legislation resulting from AIG’s actions would be the enactment of punitive fines for Executive Compensation excesses, not dissimilar to those already in place in not-for-profit, exempt organizations.

Executive Compensation continues to be a hotly contested topic during the current economic crisis, but provides the opportunity for Compensation Committees and compensation professionals to examine programs within their own companies to ensure that they address proper governance and best practices relative to performance-based pay.

FOOD FOR THOUGHT

Board Compensation: Should They or Shouldn’t They

Board pay has been targeted recently in the wake of salary freezes/reductions, layoffs, and eliminations of executive bonuses. The challenge many Boards face is to be able to act in the best interest of stakeholders, while being able to retain key talent that will help drive recovery and eventual growth. However, Boards are an integral part of the company and as such should not be excluded from pay actions that impact the general employee population. Any actions that Boards take which affect their compensation should be in line with actions taken throughout the company, as well as what is being done by their peers. Good governance requires that Boards play a significant role in the design and execution of Executive compensation programs, with rewards commensurate with the level of performance attained during the performance period. If Boards reduce or eliminate bonuses for their top executives due to below-target performance, it may be the time for them to examine the level of pay they themselves are provided.



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