

Setting 2009 Executive Compensation: A Real-Time Discussion About Annual Bonuses

In a February 27 webcast, Roger Brossy and Blair Jones, Managing Principals of the Semler Brossy Consulting Group joined Latham & Watkins Partners Jim Barrall and Bradd Williamson to address some of the questions clients are asking. This issue of Advancing the Dialogue summarizes their discussion about annual bonuses.

WE are living in tumultuous times when it comes to executive compensation. While this has been building over the years, the demise of the financial markets from September 2008 on has heightened public and congressional scrutiny on all matters related to executive pay. Executive compensation is clearly in the crucible.

Companies facing tough decisions about paying out 2008 bonuses may feel equally flummoxed about the prospects for 2009.

- How does a company structure its annual bonus plan given the market turbulence and lack of visibility?
- Should annual bonuses be based on shorter performance periods or different metrics?
- What's the secret to setting reasonable goals?

At the center of the dilemma: how do companies plan for the short term without creating havoc for the long term?

For many companies, if they don't do things right in the short term, they may not survive and ever get to the long term.

How to Tackle Goal Setting in 2009?

FOR most companies, 2009 is going to be a bad year, and the majority will likely suffer a downturn. For some, it will be down profits; for others it will be to move to a loss. And for others, it will be tripping debt covenants in a world in which rolling over financing is in question, and therefore, viability and bankruptcy are two ends of the seesaw. More than anything though, visibility is incredibly weak, making goal setting a very traumatic experience.

A company with a discretionary pool and no targets and no compensation structure can have an easier time of this. But for companies that have a structure and target bonus amounts, those amounts are not that meaningful. Furthermore, they don't hook up well with the goals. If we're moving from \$100 of profit to \$10 of profit, achieving that may take heroic effort but it may not be affordable to pay bonuses at the full rate.

What Can Be Learned from 2008?

IT'S an understatement to say that 2008 is a year that companies are glad to leave behind. Companies face the quandary of retaining employees and preserving morale while remaining fair to shareholders.

For 2008, most companies are paying out according to their formulas. The rules were set ahead, and if people played by the rules, they are following the formula payouts.

Yet some companies face harder choices. Perhaps their year started well but then deteriorated, and finally ended poorly. With stock prices down, they may need to lay off employees or face tax constraints. Yet the bonus plan stands at 70 to 80 percent of goal based on solid performance at the start of the year. What do they do in this situation?

Most have decided to still pay out according to their formula—and provide a good explanation in their proxy's Compensation Discussion & Analysis (CD&A). Companies that face cash constraints, or have received government funding, however, are eliminating bonuses at the top and sometimes more broadly. Some are taking a more targeted approach toward the employees they need to retain and giving special restricted stock awards to a select few stars in the wake of no bonuses. Yet others paid bonuses in restricted stock rather than in cash. In the latter case, executives must agree voluntarily as they are giving up the opportunity for cash and putting their pay at risk. One company in this position had been through layoffs. It has maintained a bonus plan, but now the payout is at risk based on the continued, sustained performance of the company. Vesting is restricted for another two years and is based on turning the corner.

What if the formula did not fund the plan and a company faces real concerns about the retention of key employees? The constraints of the million-dollar cap (i.e., regulation 162(m)) make it costly to pay discretionary bonuses to top executives. (The purpose of that legislation was to eliminate non-performance-based pay.) In most cases, companies have not paid bonuses to the senior executives, and some have funded a high-performance pool for the non-senior officers—perhaps equal to 25 percent of a target bonus pool—and distributed the pool based on individual contributions.

How to Tackle Goal Setting in 2009? (continued)

So what can companies do to the annual incentive plan?

■ **Suspend the targets and introduce reduced targets for 2009.** Should a company then return to the old targets in 2010 or 2011? That's up in the air, so it's wise not to address that yet.

■ **Adjust the payout curves and apply broader and more gentle leverage.** If plan thresholds seem within reach, a company may worry that as the outlook improves, performance could exceed target. So it's important to temper or flatten the curve beyond target and extend the payout curves over bigger increments of up or down performance. In a world with low certainty over goals, a company does not want to get stuck with either high bonuses or very low bonuses, punishing or rewarding for small increments of change. Note that even if gentler leverage is applied to accommodate the broader possibility of performance outcomes, a company should recognize and communicate the threshold below which it is not willing to pay.

■ **Reset goals on a regular basis throughout the year.** Some companies are shifting to a structure where they bank quarterly against quarterly goals, reset the goals every quarter or six months, and pay out annually.

Does Discretion Have a Place in Annual Plans?

SINCE 2009 introduces a whole new playing field, it may be appropriate to take some novel action with respect to annual bonuses: Allow companies to apply subjective judgement to bonus decisions without relying on pure algebra. Even for an annual plan, companies may want to introduce relative operating and financial metrics, strategic progress, or goals associated with how well the company positions itself for the upturn.

Should they use discretion when they do that? Discretion historically has tended to forgive weak results. Yet, companies can make discretion work better and be viable and fair to both shareholders and the participants. For starters, identify up front the events that may be part of the discretion discussion and determine how they are going to treat them. (See Rationale for Mid-Cycle Goal Changes exhibit below.) For example, an

accounting change may receive total forgiveness, while losing a key customer merits no relief.

It's important to talk about the events that might impact results in 2009 and whether they should be considered in bounds or out-of-bounds for discretion. Agree on the soft weights: if relative performance is being considered, how big a weight does it merit? One-third? One-quarter? It's necessary to put a stake in the ground, track it throughout the year, and have discussions with the Compensation Committee. This way, discretion is not something that occurs at year end, but is a recurring narrative all year long that is tracked and discussed and understood. Companies also can develop a scorecard to inform the discretion, i.e., "structured discretion" based on objective criteria.

Rationale for Mid-Cycle Goal Changes

Identify events or conditions that would warrant a mid-cycle adjustment to incentive goals, e.g.:	Will Adjust	Consider Adjustment	Will Not Adjust
Accounting rule change (e.g., FASB 106)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Unanticipated regulatory change	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Capital or business restructuring	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Strategic decision to increase research, advertising, etc. beyond planned levels	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Legal action against the company affecting operating income by >5%	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Natural disasters	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Recession	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Interest rate shifts	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Planning errors	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Competitor actions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Poor publicity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Strikes	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Legal action against the company affecting operating income by <5%	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

And If All Else Fails?

THE objective of an annual incentive is to keep executives focused on those short-term value drivers that will lead to long-term success. Perhaps this is the year to forgo 162(m) compliance and the tax deduction in order to recognize contributions and aid retention. If a company finds itself out of the money by mid-year, it may wish to consider a much reduced discretionary bonus that rewards executives for doing the right things to preserve value. This is not meant to imply forgiveness or open ended discretion, but structured discretion with input from a scorecard of metrics. If any bonuses are extended to NEOs (the highest paid named executive officers in the proxy), be prepared to make a strong defense in the CD&A.

Along this line, if performance warrants, companies may want to provide a special mid-year bonus for non-executives based on overall aggregate performance, or targeted by function. To avoid losing additional ground and/or to shore up value, some companies have found this approach particularly successful to focus non-executives on the key drivers within their control.

Finally, consider a change in metrics. Bonus metrics are changing in this environment—with greater focus on cash flow and balance sheet measures as companies struggle to attain the financial soundness to live to fight another day.

Participants in this issue of *Advancing the Dialogue*

At Semler Brossy Consulting Group (SBCG), we understand that effective executive compensation programs are both highly complex and critical to a business' success. As one of the largest independent executive compensation consulting firms in the United States, we believe it only makes sense to take a holistic view of executive pay—one that takes into account your strategy, business and market characteristics, talent requirements, culture, management style, and rewards strategy. That's our approach. Visit us on the Web at <http://www.semlebrossy.com>



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