advancing the dialogue

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Setting 2009 Executive Compensation: A Real-Time Discussion About Long-Term Incentive Plans

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 long-term incentives.*

IN a time of limited visibility, no one can predict the economic outlook for this week let alone tomorrow, so how do companies plan a three-year long-term incentive plan (LTIP)?

Across the globe, equity values have taken a beating. Stock markets are down 50 percent worldwide. What should be done about the massive amounts of underwater options that don't provide any retention value? How can companies provide executives with a meaningful stake that both rewards and retains if there aren't enough shares in the pool?

Two words sum up the state of equity grants and LTIPs: arrested development. While viable approaches do exist, companies making decisions about 2009 are advised to proceed with caution.

How to Approach Equity Awards?

CLEARLY, it's an extremely challenging time for equity awards. Share prices are lower, so it takes more shares to deliver the same value to employees, putting pressure on share pools. Shareholders must approve plans and authorize any increases in the number of shares available. Such approvals may be difficult to obtain in this environment. As a further complication, if grants are made now when stock price is low, will this

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create the opportunity for an unfair windfall in the future when the stock rebounds? And what if the price drops further after the grant date?

Approaches range from using a pre-determined percentage of shares outstanding to using an average share price over a long-period of time (e.g., one year). Some companies plan to safeguard against windfalls by attaching performance restrictions whereby a portion of the award only vests if results beat peers.

When considering action, first and foremost, beware of survey data: Although it may be met with resistance, this may be the year to give up on the pay structures that have been developed by looking in the rear-view mirror at survey data. That data simply is not reliable now; it is not meaningful. It may again be relevant at some future point, or we may emerge in a year or two with new levels and new mixes and new ways of paying people. All those fair values used for options probably never meant that much any way, and at this

point, they are problematic and can largely be discarded. This includes the obligation to issue 30 percent Black-Scholes value options and even extends to the notion of annual bonuses.

How to Set Goals in a Volatile World?

WHILE the world of executive compensation is moving towards an ever greater connection to performance, the challenge of setting goals makes this transition all the more daunting. Some potential solutions exist, but it's best to be cautionary. For example:

■ **Setting a one- or two-year performance period with multi-year vesting based on service** might be a workable way to go. It reflects the reality that goal setting is difficult in this environment and companies may be unable to forecast three or more years ahead. It also keeps the emphasis on performance and handcuffs participants for a few years. This approach is being seen particularly in the high-tech sector where high-cycle volatility makes it tough to look ahead further than even one year. Companies that want a longer-term hold on their people can set one-year performance goals with rewards vesting after two, three, and four years of service. It also makes sense in companies where "the future is now," and achieving this year's goals is an imperative for survival.

■ **Measuring performance in annual cycles, "banking" incentive amounts according to annual progress, and adjusting payouts based on results at the end of the measurement period.** This approach acts as a multi-year governor. If performance falters after two-to-three years, compensation would be reduced. This is new, and different from a clawback. It involves holding compensation in escrow and then adjusting it downward depending on results. One company is using a negative adjustment in connection with its return-on-capital goal. It must hit annual return-on-capital targets and also achieve a longer-term return on capital. After the third year, if the average of the annual goals is higher than the overall goal, any payout will receive a haircut of about 25 percent. Many portfolio plans in banks employ a delay or holdback—expect much more of that going forward.

What About Cash?

COMPANIES with dilution issues (e.g., no stock is left, the overhang is huge, Risk Metrics Group will not approve additional shares, cannot do an exchange and get the shares back in the pool for the underwater options) may want to consider cash. A company can use a cash plan in two ways:

1. Use cash similarly to an annual plan, but with a longer term performance period, or
2. Make the cash value a unit value that rises with the stock price.

One company in that situation had only a few RSUs left and could provide only about 10 percent of what used to be a regular target opportunity with its remaining equity. This opportunity is far short of anything that might incent long-term performance or retain key talent. The company is cash-rich so it has introduced a performance cash plan focused on the critical actions needed to preserve the value of the company.

One of the difficulties in using a cash-based plan is that it requires variable (or liability) accounting. When cash plans are structured as stock units settled in cash, the potential liability can be open-ended. Such plans may employ caps to limit liability, such that the award can't increase more than double or triple the value of the stock.

Measuring relative performance. Given the difficulty of setting absolute goals for LTIPs, some companies are considering relative performance. Relative measures can work in industries that are highly cyclical such as retail, where performance vs. peers in this environment has some meaning. It may not drive performance, but it may keep rewards in check with relative performance.

However, when considering relative performance, be careful. Many plans use total return to shareholders (TRS) relative to peers as the default measure. Such a choice can be problematic for three reasons: 1) performance at the start and end of the performance cycles may vary significantly resulting in odd outcomes, 2) participants often feel that the TRS portion of their compensation is beyond their control, and 3) the sudden improvement of a poor performer emerging from a trough can throw off relative results. Consequently, TRS may not be effective in focusing or driving performance. Companies may explore financial or operating metrics that may offer a valid peer group comparison. Again, proceed with caution, as there are many issues around adjusting and interpreting financial performance.

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Employing discretion. The big problem with discretion in LTIPs is the continuity of compensation committees if they are the users or adjudicators of that discretion. Compensation committees experience a lot of churn, and too often discretionary decisions are not fully captured and recorded. Employing discretion requires a very careful process for how it will be used—when, why, and under what circumstances. In addition, if the LTIP is equity based (vs. cash based), the use of discretion can jeopardize fixed accounting.

Retention Concerns — Real or Imagined?

WITH the rate of job contraction, why worry about retention in this market? Is mobility at such a level that retention pay in 2009 is warranted?

True, many employees have fewer options and those who might be recruited may hesitate to make a change in such an uncertain market. That said, there are two things to think about:

- **The best employees are always mobile.** Troubled companies with their futures at stake are eager to lure very talented executives and will pay what it takes to get them. Companies need to consider the impact of such possible losses as they review their talent pool.

- **Never assume all employees will stay around forever—that can be a dangerous place to play.** It's important to be proactive and make sure those key employees know they are valued. This is a time to use retention awards as they were intended, which is in a rifle shot fashion rather than as an annual entitlement.

Ultimately, there is no single right answer. Companies must consider what is best for their situation in the long term. It's also important to be aware of the external environment and have a good rationale for any retention awards that are granted, particularly to senior executives. Such payments may be an 8-K event (requiring announcement to shareholders) if made outside of the plan. They must be explained that in the Compensation Discussion & Analysis (CD&A) in the proxy. There will be instances when retention awards are appropriate—just be sure the rationale makes for a compelling story.

> **"Any decision about pay must take into account a company's unique business situation, its talent needs, and its pay philosophy."**

What to Do About Underwater Options?

THE economic downtown and steep declines in share prices over the last year or so have had an adverse impact on stock plans. A lot of options are severely underwater, and many stock awards have lost a significant amount of value.

What are companies doing to address these challenges? Several approaches merit discussion:

- **Reprice options or offer exchanges.** While talked about frequently, option repricing and exchanges are not often utilized—just 50 or so occurred last year, mainly in the Silicon Valley/technology area. Repricing and exchanges are not easy processes. In most cases, they require shareholder approval under the New York Stock Exchange or Nasdaq rules. They often require a tender offer—a long, complex, and costly process. If stock prices continue to decline or flat-line, more companies may move in this direction, but so far, it's mostly talk.

  Short of a repricing or option exchange, several other avenues are open, but the tax consequences must be carefully considered:

- **Extend the term of options.** If a company is facing reductions in its workforce, including individuals whose options are underwater, consider extending the post-termination exercise period. Such a decision gives some sort of lifeline to option holders, who otherwise will lose any potential opportunity if they only have 90 days to exercise. Most companies with underwater options will not see the stock price increase above the strike price in just 90 days, so an extension is only fair.
- **Accelerate vesting.** Even though options will still be under water, they'll be vested and not subject to further service requirements. This approach also has the advantage of accelerating the accounting charge into a period that might not be such a good one.
- **Cancel options without offering to reprice or give new options.** Most option agreements provide that a company cannot adversely affect the option value without the optionee's consent. It's becoming more common for senior executives to agree to cancel underwater options or performance-based options where it's not realistic that performance goals will be met. Yet, this is tricky territory, even if the inquiries about cancellation are altruistic. Companies must be careful when dealing with changes to stock option plans. Under the exchange rules, an action may be considered a repricing under the gap rules, FAS123R. It is paramount that any company considering such changes work closely with its accountants to understand the ramifications.

Is It Time to Take a Few Steps Back?

GIVEN this environment and the outlook for the next two-to-three years, companies are stepping back and revisiting their compensation philosophy regarding long-term vehicles to see which make the best sense for the times. The result may be a wholesale change from one vehicle to another. For instance, a company that has used options and performance shares in the past has decided to focus only on performance shares for the new term to preserve current value. Other companies seeking to stabilize their population may favor time-vested restricted stock for a portion of the opportunity.

As a final cautionary note, this is not the time to simply follow trends. Any decision about pay must take into account a company's unique business situation, its talent needs, and its pay philosophy. It is not time to follow the leader, but rather to lead with a design rooted in your company's strategy and your shareholder's best interests—and have a rationale ready for the CD&A.

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.semlerbrossy.com

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