

Executive Compensation in a Troubled Economy: Different Thinking for Different Times

The economic crisis brought about by the meltdown of the U.S. financial sector has spread throughout the global economy. The crisis, which has not stopped at financial firms but has extended to most industries, has had clear effects on executive compensation plans, corporate-wide bonus plans, and long-term incentive plans. Executive compensation has been under intense scrutiny from investors, the media, the government, and shareholder advocacy groups and the popular perception is that executive compensation is both “out of control” and not linked to company performance.

Given this current market and environment, this white paper will address how Board Compensation Committees and CEOs should be thinking about their executive compensation plans during these troubled times. We will briefly look at the magnitude of the current crisis, how long it is projected to last, and what the impact has been and will likely continue to be on executive compensation programs. We will then offer strategies for Directors to address the issues and design executive compensation for the current market.

How Bad is the Crisis and How Long Will it Last?

The economy is in a massive and likely prolonged crisis. The Dow has fallen nearly 6,000 points from its 2007 high of 14,078, down 40% to 8,378, and the NASDAQ has fallen 46%, from 2,859 to 1,552. The total loss in wealth from declining market capitalization is over \$5 trillion dollars. Layoffs continue to escalate, foreclosures continue to rise, banks continue to withhold credit, and consumer spending has plummeted. These are the most challenging times this country has faced since the Great Depression, and it is not forecasted to recover any time in the near future. Leading economists, financial sector experts, and venture capital and private equity firm partners predict that it will likely be 12 to 18 months before we see any clear signs of an upturn. Corporate America must face the crisis head-on, as the spotlight on corporate activity intensifies. Already, executive compensation has been thrust under a microscope, resulting from some of the pay packages that were disclosed in the financial sector. Other firms not connected to the financial industry will see their executive compensation packages more closely examined in the face of mediocre or weak performance.



What Have Been the Impacts on Executive Compensation?

There have been several significant impacts on executive compensation resulting from the financial sector meltdown and resultant economic crisis. The most significant are:

1. There is a renewed and intense focus on executive compensation from the media, the legislature, the public and the Presidential candidates. All are looking to Compensation Committees to ensure they are practicing strong governance and implementing programs that balance both executive and shareholder interests.
2. Annual incentive plan payouts are either zero because thresholds were not achieved or are below target because the financial targets were missed.
3. Stock options are significantly underwater and restricted shares are worth far less than before, significantly reducing “retention value”.
4. Annual long-term incentive (LTI) grants need to be rethought because:
 - a. Traditional valuation methodologies are yielding unacceptable levels of dilution.
 - b. Companies do not want to ask shareholders for more shares at this time.
 - c. Current LTI portfolio mixes may no longer be appropriate.
5. Performance-based LTI plans are not paying out because targets cannot be achieved or are unlikely to be met in the near future.
6. Annual incentive plan financial targets for 2009 are very difficult to predict because of the lack of visibility into the economy and overall market. Thresholds and stretch targets are also difficult to set.

These issues have the ability to negatively impact executive retention and motivation. As a result, Board Compensation Committees need to consider if and how they will address these issues.

Should Boards Respond?

There are several primary questions that Boards need to discuss when deciding whether to make changes to executive compensation programs to address the impacts of the financial crisis:

1. Was the company’s current situation caused by the company/management and was it something that they should have anticipated, or was it caused by overall market and economic factors?
2. If the Board does not respond to the current conditions, what are the retention and motivation risks for the company?
3. If the Board does respond to current conditions, what are the investor and employee relations issues that the company may encounter?



Increased Scrutiny on Executive Compensation

The increased awareness, negative press, and public reactions regarding executive compensation put Compensation Committees under intense scrutiny. While most companies have plans that are designed well and link pay to performance, a few companies continue practices that give the rest a bad name. In order to practice good governance to help restore public faith in companies, Compensation Committees should:

- Work with a truly independent executive compensation consultant. During periods of economic downturn, cross-selling conflicts of interest will draw increased criticism and disclosure.
- Employ and regularly review scenario-based tally sheets that consider multiple performance situations and timeframes.
- Ensure that a balanced downside risk accompanies upside potential.
- Govern as if your executive compensation plans will end up in the news. If they do, how will it look?
- Schedule quarterly half-day meetings to give adequate time to committee discussions and decisions. This is not an environment of “business as usual.”
- Plan a half or full-day offsite meeting annually to review trends and best practices in executive compensation.
- Hold executive sessions every scheduled meeting and have your independent consultant included in those sessions.

2008 Bonus Plans

2008 bonus plan metrics were set back in Q4 of 2007 without any visibility into the current economic crisis. In most firms, these plans are projected to pay out below target or even may result in zero payout. In many cases, this has occurred because of the general economic downturn, and not from anything within the company’s control. How should Compensation Committees address this situation?

This question needs to be addressed on a case-by-case basis, because each company’s situation is unique. The factors that must be considered are as follows:

- Was the company’s performance below plan or did the company miss the threshold because of circumstances completely beyond the executives’ control?



- If the company missed its targets due to reasons other than market conditions, the Committee should do nothing. If the company's performance was primarily due to market conditions, then the following additional questions need to be considered.
 - Does the current financial situation of the company warrant the payment of any bonuses?
 - Are there any retention risks if bonuses are not paid? If yes, can these be addressed in another way (e.g., stock)?
 - How will investors and employees react if any bonuses are paid?
 - Any bonus payouts would be at the discretion of the Board, and as a result would be disclosed in the proxy as a discretionary "bonus" instead of a non-equity incentive. Executive and employee bonus plans should be treated similarly.

Underwater Stock Options

With stock prices on average down 45% since last October, and many firms' stock prices down as much as 80%, underwater stock options are rampant. Many firms have options that were granted in the last three to four years that are now significantly underwater. Again, every company's situation is unique and must be considered in its own light – there are no cookie cutter answers. The following questions will help Committees in their discussions of whether to address underwater options:

- Is the company's stock price decline primarily due to outside forces?
- Have stock options been underwater by more than 40% for at least 60 days?
- Could stock market speculation or a general short-term rise in the market eliminate the underwater stock option conditions?
- Did performance-based equity grants produce results expected by their design?
- Do executives have competitive levels of equity participation?
- Are there adequate shares available in the equity incentive plan without seeking shareholder approval for more shares?
- Does the equity incentive plan allow for *value-for-value exchanges*, which allows an optionee to choose to cancel their underwater options for a new grant of equal or less value? If so, will a Form TO-1 (Tender Offer) be required?
- Do the CEO and CFO hold a substantial percentage of all underwater stock options?
- How would a *value-for-value exchange* or *special grant* integrate with last year's proxy statement CD&A disclosures?
- How will a *value-for-value exchange* or *special grant* integrate with this coming year's proxy statement CD&A disclosures?



- Is the Board of Directors certain that shareholders would benefit from correcting the underwater stock option situation?
- Would correcting the underwater situation be perceived as “one more” incident in a series of negative events?

Annual LTI Grants

Because of the massively depressed stock prices of most firms, upcoming annual LTI grants could be problematic. Using the traditional Black-Scholes or Binomial approach off the current share price yields burn rates (the number of shares that are required to fund the LTI grants annually) that are unacceptable. For example, if a firm granted 2.5% of shares outstanding last year and its stock price is down 50% this year, it would require a burn rate of 5.0% to deliver the same value to executives and employees.

To add further complexity to the situation, firms do not want to ask shareholders for additional shares during such troubled economic times, so they need to conserve the remaining shares they have available for grant. The question all firms are asking is: How do we approach this problem?

Because most companies these days have share prices that are dramatically lower than they were at this point last year (with the average Dow stock down 44% and the average NASDAQ stock down 46%), using a standard Black-Scholes or Binomial model approach to calculate the number of options to grant, or using the current share price to determine how many restricted shares to grant, will simply not work. There are two primary reasons for this:

1. Using Black-Scholes or a Binomial model when the share price is half to a third of what it was at this point last year will result in using two to three times the same number of shares this year to deliver equivalent value. This will result in burn rates that are simply unmanageable.
2. By using competitive long-term incentive proxy data from 2007 or 2008 before the crash, for most companies the values that were delivered previously will be simply unattainable this year. We firmly expect LTI grant values to drop significantly this year, but this will not show up until the 2009 proxies. Companies cannot wait that long to plan competitive LTI grants.

As a result, a new approach is necessary. We believe that competitive market value transfer is the best approach for these times. This approach takes the Black-Scholes value of the option grants in each Peer Group company plus the face value of restricted share grants and divides this by the



company's market capitalization. Assume that for the CEO, the annual grant values at the median last year were \$3M and the median market capitalization was \$1B. This is a market value transfer of 0.3%. If the company's market capitalization, which was \$1B last year is now \$500M, the grant to the CEO would be $0.3\% \times \$500M = \$1.5M$. The same methodology works for equity grants in total – if 2.5% of the market value were transferred last year, the same would be transferred this year. The value of the grants would not be the same, but the ability to capture upside value creation would be. Therefore, executives have the same opportunity to participate in the company's share price growth as they did last year even though share prices and value have changed.

Performance-Based LTI Plans

Many firms have migrated to the use of cash or stock performance-based LTI plans over the last few years. These plans align executives with shareholder interests and, when they are stock-based, often significantly reduce share dilution by providing the same value as options but with less shares. However, with the recent decline in the market, many of these plans are unlikely to pay out, or will pay out significantly below target. The same questions that we presented relative to both the 2008 bonus plan and underwater stock options need to be considered with respect to these plans. There are a few additional wrinkles that need to be factored into the equation:

- With these plans, it is possible to extend the timeframe for achievement. If it were originally designed as a three-year plan, the timeframe could be extended, such as for another year or two. There are two issues here: 1) it is virtually impossible to determine how long this economic downturn is going to last, so an extension may not fix the problem; and 2) the change in the timeframe results in an additional and potentially considerable expense to the company.
- Companies can keep these performance-based awards active, even though the probability of achievement is minimal. If awards are not achieved, companies may also reverse the expense (with the exception of market-based measures). Given the small probability of the grant ever paying out, most firms would issue another grant; however, if the economy were to recover significantly, there is the possibility of “double dipping,” as both grants could pay out.

If a new award is granted during this period, setting the right performance targets, thresholds, and maximums is extremely problematic. We counsel considering overlapping two or three-year grants during this time, given the uncertainty of market conditions and the inability for companies to



accurately predict financial targets. In the short run, firms may also want to consider using key strategic objectives instead of financials as the primary metrics for the plans.

2009 Bonus Plans

Firms are struggling with their 2009 bonus plan designs, as there is little or no visibility into where the economy or their firm financials are going to be over the next six to twelve months. As a result, the same problems with performance plans exist as with bonus plans – how do companies set appropriate targets, thresholds, and maximums, and what metrics do they use?

We believe that companies need to consider two fundamental shifts in their thinking relative to bonus plans:

- Consider using two six-month plans or even quarterly plans instead of an annual plan. This shortened window provides both increased visibility and the ability to reforecast and reset targets.
- Consider a lessened focus on financial metrics and more emphasis on the achievement of key non-financial objectives that will improve the health and competitive positioning of the firm. With financial visibility nearly unknown, this is a way to provide a focus on necessary strategic accomplishments in order to be well-positioned when economic recovery happens.

Since both of these approaches reduce the risk of not achieving the plan, upside potential should be reduced, and downside risk should be significant.

If you would like to discuss this white paper and how it relates to your firm, please contact Jack Dolmat-Connell at jackdc@dolmatconnell.com or (781) 392-3600.

