

## Using SERPs to Create a Balanced Executive Compensation Program

*by Peter Lupo and Bruce Brownell*

Well-balanced risk and rewards are one of the foundations of an effective compensation program. Over the past two decades, stock-based incentives have been the primary means used by companies to motivate and retain their most valued executives. However, the economic downturn has highlighted the extent to which the design flaws of some equity programs may have encouraged executives to take excessive risks contrary to the company's and shareholders' long-term financial interests. Moreover, it is increasingly clear that stock price alone does not always correlate with either executive performance or sustainable long-term shareholder value.

In many situations, introducing a supplemental executive retirement program, or SERP, can help in promoting a more diversified, "portfolio" approach to executive rewards. Such a portfolio approach helps companies avoid the potential for excess leverage in pay programs incorporating primarily stock-based incentives, thereby better balancing the overall risk/reward equation. Other benefits include:

- Helping executives maintain meaningful equity ownership within a balanced investment portfolio
- Retaining top talent in challenging business circumstances through extended vesting of a portion of total pay
- Facilitating clawbacks of payouts based on discredited financial statements

### SERPs Then and Now

Until recently, most traditional SERPs were in the form of defined benefit plans that were intended primarily to recognize pay above Internal Revenue Code compensation limits and, in some cases, to provide benefits based on enhanced benefit formulas. In recent years, such designs have been criticized as "stealth pay" that operates beneath shareholders' radar and is not tied to business performance. The term became popular several years ago in reference to the difficulty, under older disclosure requirements, of understanding the value of the benefits provided by such plans.

While there are exceptions, the promise of a guaranteed lifetime pension for an executive is now generally considered to be inconsistent with shareholder expectations and interests. As a result, companies have begun offering SERP designs that, similar to the trend of other forms of executive pay, are more often based on performance than tenure and are intended to better align pay programs with best practices.

### The Problem with Long-Term Incentives Based Only on Equity

The combination of the growing use of performance-based equity incentives and heightened ownership requirements has had an unintended consequence: over time, many executives have

accumulated an inordinate amount of their net worth in company stock. At the same time, the market has tended to view negatively any major equity sale by corporate leaders. As a result, senior-level executives needing additional liquidity for a home purchase, tuition, retirement or other major financial event often have found themselves constrained by the combination of ownership requirements and market perceptions. Such a situation may drive the executive to consider other employment opportunities to escape the onus of equity requirements.

In response, more companies are considering the use of a defined contribution SERP to mitigate those risks while maintaining the alignment of executive and shareholder interests. With a defined contribution SERP, the company credits a contribution to an account maintained on behalf of an executive. That contribution can be defined in a number of ways, including discretionary contributions, formula-based contributions, or contributions that are tied to company performance. The account balance (or notional balance, since these programs are typically not funded) is typically invested in a choice of investment vehicles established under the program, similar to a Section 401(k) plan. Company stock can also be offered as an investment alternative. Additionally, the defined contribution SERP can be designed to increase total pay value if the company believes the executive compensation program is not competitive, or if it would enhance the company's ability to attract and retain executives. Alternatively, to avoid increasing the value of total pay, the company can reduce incentive compensation opportunities to offset the value of the SERP contribution.


Using these approaches, a company implementing a defined contribution SERP can better balance its overall executive compensation program. From the executive's viewpoint, the compensation package is made more stable, more diversified, and less risky, since the design can be less focused on incentive compensation.

## Consider Your Typical CFO

As part of a recent assignment, we gathered benchmark pay data for the CFO of a \$1 billion general industry company. This executive had a target long-term incentive of \$380,000 at median pay practices, or about 110% of his \$345,000 salary. In lieu of continuing his annual equity grant of \$380,000, the company could reduce the grant in exchange for an equivalent SERP contribution. The executive would then be given a choice of low- to high-risk investments for the SERP, possibly but not necessarily including company stock.

Coupling a smaller equity grant with a SERP contribution can promote the goals outlined at the beginning of this article by:

- *Better balancing fixed and incentive-based pay:* By adopting a defined contribution SERP, a company can reduce incentive compensation, which is typically the largest component of total pay.
- *Keeping total pay opportunities attractive to executives, even in a difficult business and economic climate.* When stock prices decline, a SERP account need not be invested in company stock or broader-based equity funds.
- *Extending vesting of some portion of total pay.* In contrast to traditional equity grants that typically have three-to four-year vesting, SERPs can have longer or age-specific vesting – for example, to age 60. The latter approach can be particularly effective in retaining senior executives in a down market.
- *Maintaining meaningful and reasonable stock ownership requirements, without overexposing the executive to company stock.* If company stock is offered as an investment alternative, the SERP can help the executive meet minimum stock



ownership guidelines. By including a clawback, the company can recoup SERP contributions in cases of fraud or for contributions based on inaccurate financial statements.

### **Illustrative Example**

Our CFO is expecting an annual equity grant of \$380,000. Lowering the value by 25%, or \$95,000, would leave an annual grant of \$285,000, or 80% of salary. The executive gains the opportunity to build significant deferred value in a SERP account, reducing his or her at-risk pay for deferred compensation that is not related to company performance. In this example, trimming the \$95,000 potential SERP contribution by 25% (to account for the SERP being less risky) would leave an annual contribution of about \$71,000 per year. If the SERP earned 7% annually, the executive would end up with a \$1 million SERP benefit over ten years, roughly equivalent to a \$90,000 lifetime annual pension benefit starting at age 65.

This example shows how reducing long-term incentive grants and substituting a defined contribution SERP can promote a more balanced executive compensation program, without materially changing the overall program design. SERPs can be modeled to weight the multiple goals of motivating, incentivizing and retaining an executive over the long term. The company can target total cash income replacement ratios and specific dollar targets, or tailor the plan's vesting schedule to the company's overall goals.

### **Summary**

Until recently, a well-designed, equity-based incentive program could be counted on to deliver wealth to the executive team over the long-run if they delivered strong performance. Today, executives are more keenly aware of the vulnerability of their investment portfolios to market swings and corrections beyond their control, as well as the eventual impact on their retirement cash flow. For companies, executives, and shareholders seeking a balanced executive compensation program that continues to attract executives while reducing incentive compensation risk, adding a thoughtfully designed SERP to the total rewards portfolio may make sense.

*Pete Lupo is Managing Director and head of the New York office of Pearl Meyer & Partners.  
Bruce Brownell is a Partner at Fulcrum Partners.*



[www.pearlmeyer.com](http://www.pearlmeyer.com)

**NEW YORK**

570 Lexington Avenue  
New York, NY 10022  
(212) 644-2300  
[newyork@pearlmeyer.com](mailto:newyork@pearlmeyer.com)

**ATLANTA**

One Alliance Center  
3500 Lenox Road, Suite 1708  
Atlanta, GA 30326  
(770) 261-4083  
[atlanta@pearlmeyer.com](mailto:atlanta@pearlmeyer.com)

**BOSTON**

132 Turnpike Road, Suite 300  
Southborough, MA 01772  
(508) 460-9600  
[boston@pearlmeyer.com](mailto:boston@pearlmeyer.com)

**CHARLOTTE**

3326 Siskey Parkway, Suite 330  
Matthews, NC 28105  
(704) 844-6626  
[charlotte@pearlmeyer.com](mailto:charlotte@pearlmeyer.com)

**CHICAGO**

123 N. Wacker Drive, Suite 1225  
Chicago, IL 60606  
(312) 242-3050  
[chicago@pearlmeyer.com](mailto:chicago@pearlmeyer.com)

**HOUSTON**

Three Riverway, Suite 1575  
Houston, TX 77056  
(713) 568-2200  
[houston@pearlmeyer.com](mailto:houston@pearlmeyer.com)

**LOS ANGELES**

550 S. Hope Street, Suite 1600  
Los Angeles, CA 90071  
(213) 438-6500  
[losangeles@pearlmeyer.com](mailto:losangeles@pearlmeyer.com)

**SAN JOSE**

2880 Zanker Road, Suite 203  
San Jose, CA 95134  
(408) 954-7399  
[sanjose@pearlmeyer.com](mailto:sanjose@pearlmeyer.com)