

Five Trends Driving Change in Executive Compensation Programs

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Given continuing public controversy over the level and structure of executive compensation, the onus is clearly on Boards – and Compensation Committees in particular – to be knowledgeable and prudent about the mega-dollar deals they approve. A new emphasis on transparency and disclosure requires that Boards understand not just the current price tag for multi-part compensation packages, but also all possible payouts under what have become increasingly complex and contingent arrangements. Additionally, they must accommodate major changes in the accounting, disclosure and tax treatment of executive pay. The result: a compensation environment of heightened governance demands, increased investor expectations and multiple new compliance pitfalls. In the coming year, five trends will be key considerations in how companies approach the design and delivery of compensation for their most senior executives.

1. New Stock Vehicles Become Drivers of Equity Value

FAS 123R, which becomes fully effective in 2006 but has been embraced by hundreds of early adopters, requires that the cost of stock option awards be reflected in corporate income statements. The prospect of having to take a charge for an equity incentive long perceived as “free” has prompted widespread cutbacks in option use, whether through reduced grants, more limited eligibility, or elimination altogether.

At the same time, the new accounting rules have spurred renewed interest in less well-known equity vehicles that are now afforded better accounting treatment. Time-based restricted stock is among the instruments filling the option void, particularly in circumstances when retention is a concern. Companies also are looking more carefully at full-value vehicles that include a performance element. Performance shares link long-term incentive plans to measures of financial performance that are more directly impacted by the executive. Also gaining popularity are hybrid equity instruments such as performance-accelerated restricted stock (or PARS) and performance contingent restricted stock grants, which combine performance characteristics with the time-based vesting characteristics of restricted stock.

Prior to FAS 123R, corporate equity use was often based primarily on accounting considerations. With a broader selection of attractive stock vehicles now available, companies can choose the instrument that best fits with its financial needs and executive pay philosophy. The latter consideration is particularly critical, given that a formal statement of corporate pay principles is among the additional information that must be provided to shareholders under new proxy disclosure requirements.

2. The Veil is Lifted on Proxy Pay Disclosures

“Expanded transparency” is the new battle cry of critics of executive compensation. It represents a shift from previous tactics that were more focused on limiting the level of compensation. That approach was characterized by Congress’s 1993 elimination of the corporate tax deduction for non-performance-based compensation over \$1 million to reported executives. Rather than limiting pay growth, the virtual salary cap is widely seen as having been a factor in driving typical CEO salaries closer to the seven-figure limit.

SEC Chairman Christopher Cox is taking a different approach. The agency is finalizing new rules that will greatly expand the information companies must provide about executive and director compensation in their public company proxy statements and other securities filings. The proposed rules, which also mandate the use of "plain English," have the strong support of institutional investors who own a majority of shares outstanding in many publicly-traded U.S. companies. In the legislative arena, the proposed Protection Against Executive Compensation Abuse Act includes requirements for more detail disclosure of compensation.

Advocates maintain that giving investors more detailed and easily understood information on how corporate leaders are rewarded will encourage Boards to be less generous and make executives more reluctant to make outsized pay demands. Just how enhanced disclosure plays out remains to be seen, but it has numerous ramifications for compensation oversight, design and administration, as discussed below.

3. Executive Contracts Get Ready for Their Close-Ups

New SEC disclosure requirements directly affect executive contracts, particularly agreements related to employment, severance and change-in-control. Among other mandates, companies would need to quantify and explain the rationale behind many of the arrangements entered into with executives. Regulators and stakeholders are particularly sensitive to contract use as a result of various large and well-publicized payouts in change-in-control and severance situations, as well as the extensive post-retirement benefits originally promised to executives such as former GE chief Jack Welch.

As a first step, Boards will be seeking a more solid understanding of existing agreements in their entirety. They are aware that compensation information that is moved from a quarterly filing to the company's annual financial statements must be able to hold up under the glare of public scrutiny. Companies will be looking particularly closely at the financial outcomes of multiple circumstances of executive termination, which can include death, disability, retirement (both normal and early), resignation for "good reason" and cause. The necessity of carefully modeling termination scenarios was driven home by the recent litigation involving the departure of former Disney President Michael Ovitz, which largely focused on whether the Board fully understood the terms of the promised payout.

In addition to disclosure issues, new Section 409A tax rules will directly affect employment contracts and, in many cases, entail rethinking and redefining some commonly used contract language. Aside from compliance issues, there is a practical benefit to companies that pay closer attention to how contracts are written. Precise language reduces the chance of varying interpretations and the he said/she said disagreements that occur when companies and executives differ and, often, resort to the courts to resolve. Potentially problematical issues include the potential cost of tax grossups in change-in-control situations; when an executive has been fired for cause; and the extent to which an executive's attorney fees must be reimbursed following a termination.

Revising executive contracts will not necessarily be a simple process. In such bilateral agreements, both parties – the executive and the company – must agree to any change. In many cases, contractual changes may need to be made over a period of years to allow for contracts to expire and be renegotiated on new terms.

4. Tally Sheets Become Required Reading

Tally sheets, which provide a comprehensive look at the cost of every component of executive pay packages, have quickly evolved from a useful tracking tool to a governance necessity. In the spring of 2005, many companies provided tally sheets to their Boards and a handful even published truncated versions in their proxy statements. Under the current SEC proposal, companies will be required to disclose the equivalent of a tally sheet summation in their annual proxy statement, most likely starting in the 2007 proxy season.

Tally sheets are a highly effective means of giving Boards and committees an in-depth understanding of all components of the executive agreements in place. They also are a key element of a trend toward more formalization and documentation of Board processes and decision making. (see below)

But tally sheets are not an antidote to excessive compensation. On the contrary, having more information on pay publicly available to shareholders also allows executives and their advisors to more easily analyze and compare programs on a dollar-for-dollar basis with their peers at other companies. Moreover, the idea that shareholders will be able to identify a definitive price tag for CEO pay is unrealistic. Practically speaking, the value of an executive's compensation at any given time will depend on performance and other variables, and tally sheets should include those multiple analyses.

5. Board Processes are Formalized

Among the lessons learned from recent compensation controversies is that what Directors don't know – or just don't give significant weight to – can hurt them badly. No Board wants to be perceived as a “rubber stamp” for management or one that fails to exercise due diligence.

Among the responses being taken by Directors are requests for more detailed data, well in advance of meetings, from management and consultants; implementation of more formalized processes for how issues involving compensation programs are vetted, considered and finalized; deliberations of key decisions over the course of multiple meetings; and a new-found appetite for producing meeting minutes which, if needed, can serve as evidence of careful and thoughtful deliberation. Among the criticisms leveled at the Disney Board was that many of the official accounts of its meetings were vague, inaccurate and incomplete.

This is an issue that links back to the SEC's proposals on pay disclosures. The proposals will require the disclosure of dollar amounts, but also will require detailed narrative disclosure of Board decisions on pay programs, including the process by which they were reached and the program's alignment with the company's pay philosophy and objectives. The actual implementation of the proposed pay disclosure regulations will likely mean increased attention to the decision-making process on the part of Boards and their Committees.

The End of Auto-Pilot

The common thread of these trends is rejection of a “one-size-fits-all” approach to compensation planning that is based largely on past practice. The prevailing good governance view recognizes that the most effective and appropriate pay practices are specific to an individual company. Boards that continue to operate on auto-pilot in defiance of intense public scrutiny and increased transparency risk serious repercussions from regulators and shareholders. In many respects, these trends are an outgrowth of the wave of business scandals in the first years of the 21st century. But what began in scandal could end positively, with the return of executive pay from a distraction and a conflict to a genuine driver of corporate value.

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