



October 2008

Executive compensation: What to do after the credit crisis and stock market meltdown

Introduction

The ongoing credit crisis and global stock market meltdown has caused a number of short-term executive compensation issues for many companies and their boards, and in the longer run may even result in a changed world for executive compensation. For many issuers, not just financial institutions, opportunities under equity-based incentive plans have been severely affected – indeed, many opportunities are now beyond any realistic chance of ever being realized – while awards under annual bonus plans based on financial measures are looking increasingly unattainable as the recessionary impacts of the crisis begin to take hold.

This situation raises two critical questions for boards and senior management teams at affected companies: what, if anything, should be done in the face of these events; and, just as important, *when* should it be done? There is, of course, an obvious conundrum to be faced. On the one hand, it is not unreasonable to view incentive plans to be operating as they should: performance goals have not been met and therefore no (or severely reduced) awards will be paid. On the other hand, these plans are also intended to retain and motivate people with a view to protecting and growing value for shareholders, so consideration must be given to the questions of whether they will continue to do so in the current environment, and what if they do not?

What to do? A checklist for the board

Executive compensation after the recent meltdown is an issue which boards and senior management, like it or not, need to consider immediately, irrespective of whether a decision is made to act in the short term. Boards and senior management will need to develop a view as soon as possible on what (if any) action is in fact required in the short term, and what longer-term changes should also be considered.

The fallout from the credit meltdown has and will continue to have widespread effects – not just economic and financial effects, but also personal and motivational. While a handful of very highly paid executives in the financial services industry have come to be

viewed as perpetrators, the vast majority of public company executives, whether on or off Wall Street, feel more like victims. Most feel blind-sided by what has happened, and realize that, rather than receiving “pay for performance” they’ll instead be receiving non-pay for somebody else’s poor performance – obviously a frustrating and possibly distracting situation for all.

We present below a number of ideas for consideration by boards and senior management facing such circumstances. In all cases, careful deliberation should be supported by detailed analysis of the facts at hand, accompanied by analyses of longer-term historic compensation and “mark-to-market” wealth transfers in order to get the clearest possible picture of a company’s true exposures.

Instead of “pay for performance”, execs will now receive non-pay for someone else’s poor performance

Short Term

As soon as possible, directors will want to assess whether their company has vulnerabilities with respect to its most highly valued executives:

- How much retention risk is there? In answering this question, the board will want to consider, among other things, how well the executive team has performed and whether there is sufficient talent to fill essential roles. Remember to consider the retention question in light of the relevant job markets, which may or may not be healthy.
- Are executives sufficiently and correctly motivated? This question is distinct from whether an executive feels grateful for having a job – rather, it asks whether existing incentive plans are still causing the executive to work hard on the initiatives that create the most value for the company.

A board will need a well-founded rationale for why any action should be taken, even in the face of retention or motivational vulnerabilities. In most cases, there will likely be no need for immediate action. However, there may be situations where the board’s assessment of the flight risk of critical talent is such that they feel it would be irresponsible not to act. In such cases, boards should be highly selective in determining who participates, focusing on individual executives who meet two criteria: first, they must be absolutely essential to the immediate survival and success of the business, and second they must be considered irreplaceable, even recognizing that labor markets are likely to be very soft for the foreseeable future. Very few executives are likely to meet both these tests.

Particular caution is advised when boards are considering retention payments with respect to the most highly compensated officers. There is huge sensitivity on the part of shareholders and the public to the notion of “bailing out” highly paid executives. Even in industries whose senior executives played no role in the credit crisis, any payment of special considerations will need to be carefully and credibly explained, or risk a rough reception from shareholders, the public, and the media.

Mid Term

Over the next 3 to 6 months, boards will need to consider the following:

1. Should discretionary cash awards be considered for calendar 2008 in those situations where annual bonus awards would otherwise almost certainly be zero?

Resetting performance targets in the fourth quarter of the year could look disingenuous no matter how well intentioned – better to apply discretion in the spring of 2009, and disclose it for what it is. Nevertheless, boards will have to be convinced of compelling reasons to transfer value from shareholders to management by exercising such discretion. Consider the degree to which the poor performance is unique to the company, or reflective of the performance of the sector or broader market. What are the unique circumstances that dictate such action? What benefit will shareholders get as a result? Will it unduly insulate executives from the experience shareholders are themselves feeling?

2. In certain cases, consider resetting performance goals in mid-term and long-term performance plans (i.e. those with maturity dates in 2010 and later). This need not be dealt with immediately, but could be considered at a later stage if the plans no longer are serving as effective incentives.
3. In some situations, where a company's prior equity awards have been and continue to be deeply underwater and where the decline in stock price is more than a cyclical slump, more radical action may be called for – albeit only after careful deliberation by the board:
 - (a) In those circumstances where employee retention and motivation have become critical, consider moving up the annual grant of equity (e.g. from early 2009 to late 2008). We caution, however, that given the magnitude of the recent drop in stock prices, such action should only be considered after the market stabilizes so as to avoid the action being interpreted as “timing” the grant.
 - (b) Only consider the repurchase and cancellation of stock options where they are deeply underwater and where a decision has been made to move away from options. The best way to minimize the perception of repricing is to forego the future use of options.

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Long Term

Looking to the future, the board will want to consider what steps could be taken to insulate the company as far as possible from similar difficulties in the future, by making fundamental changes to their executive compensation policy and programs. Possible changes include:

1. The introduction of risk calculations into performance measures and incentive award determination. Perhaps the most troubling feature of the recent high profile financial services events is that management incentives of all forms seemed at best insensitive to risk and at worst may have actually encouraged excessive risk-taking.
2. The adoption of better risk assessment and risk audit processes for the board, since risk measures can only work with ongoing oversight. Such processes should also make sure that the risk and compensation committees work together to monitor enterprise risk (including financial risk).
3. Reducing or in some cases eliminating the use of high-volatility equity plans, particularly option-based plans.

4. Increasing the deferral requirements on granted equity, in conjunction with more stringent clawback provisions that would entail repayment for losses and write-downs and not just for financial restatements. However, clawbacks and longer hold periods for vested equity, while perhaps necessary, are obviously not sufficient. As noted in a recent issue of *The Economist*, “even firms with compensation systems that encouraged their managers to lend carefully got into trouble. In both Bear Stearns and Lehman Brothers, for instance, employees owned a large part of the firms’ shares.” (*The Economist*, October 11, 2008)
5. For key risk management jobs, replacing bonus plans based on financial results with plans based on the achievement of risk measurement and assessment goals set and monitored by the board’s risk and compensation committees.
6. Particularly for senior officers, renewing efforts to ensure that incentive pay is justified by sustainable business performance.
7. Ensuring an actionable succession plan is in place; if an incumbent CEO or other top officer does not want to stay for whatever reason (or should not stay), the board should have real and immediate alternatives.

Some of these ideas will not be welcomed by everyone – witness the oft-made argument that the issuer must always pay up or risk losing the talent. However, given the recent events, it would appear that the rules of the game may be changing and the pressure on boards to manage pay in a more performance-sensitive and shareholder-friendly manner will inevitably increase. Boards will want to keep a close watch on developments as they deal with the inevitable executive compensation issues that will arise.

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