Counsel for
BOARDS AND EXECUTIVES
August 2000 Vol. I, No. 9
A Bricker & Eckler Initiative
Acredula

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Views of Institutional Investors Affect Executive Compensation

This month's Acredula is the second in a series of issues focusing on executive compensation. July's feature article highlighted the greater flexibility of non-qualified stock options over incentive stock options.

This issue focuses on some general principles and, more importantly, "red flags" identified by institutional investors that executives and their board should be aware of before proposing or adopting executive compensation programs. This month's feature article concentrates on the policies of TIAA-CREF, and how they apply to the development of executive compensation programs.

The September will issue continue our executive compensation series, offering useful tips for designing and administering executive compensation programs that allow for flexibility while avoiding red flags.

Editor's Note

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Investors' Red Flags Play an Integral Role in Determining Executive Compensation

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Introduction

Before proposing and adopting any substantial program of executive compensation, executives and their boards must first understand the view of investors on executive compensation. In general, institutional investors have been more outspoken about their views on subjects like executive compensation than other investors. In fact, the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF) has probably been the most candid, articulating many of its opinions in its Policy Statement on Corporate Governance as revised in March 2000. The TIAA-CREF Policy not only expresses some general views, but also addresses some "red flag" issues that it will vote against. The TIAA-CREF Policy is

instructional because it conveys views that are probably similar to the unspoken views of other investors, including venture capitalists, angels, and market-makers.

In its policy, TIAA-CREF reports that it closely scrutinizes executive compensation of its portfolio companies, especially compensation in the form of stock options, stock purchases, stock appreciation rights, savings, pensions, bonus and management incentive awards.

Institutional investors look favorably upon stock options and restricted stock in employer stock, at least as used traditionally, and urge that they "should be integrated with other elements of compensation to formulate a competitive package."

"While some elements of a company's compensation policies may not require shareholder approval," the TIAA-CREF Policy states, "TIAA-CREF analyzes all available information in order to determine its vote on the proxy matters before it. We may, for example, vote against a stock option plan if the company's bonus plans or retirement arrangements for senior executives, taken together with the option plan at issue, make the total package appear unreasonable."[1]

Another reason for TIAA-CREF's close scrutiny is that forms of compensation determined by formula, especially when combined with a deferral of that determination, may impose "a liability on the company for many years after an executive's retirement," the policy states.

In its policy, TIAA-CREF stresses that a company's need to "attract, motivate and reward" employees must be balanced against shareholders' concerns, including dilution of shareholder stock values, promotion of self interest over the corporate interest, and compensation not based upon performance of the employee.

General Principles

There are some general compensation principles that are supported by all forms of investors, including TIAA-CREF:

- ***Set from the Top.*** The board and its compensation committee should set the compensation of the chief executive officer and the compensation program for all executives. Although most institutional investors believe that the CEO should have the authority to not only hire and fire, but also set the compensation of, all other executives other than the board chair, most of these investors believe that the board should assume responsibility for setting the tone and establishing the underlying principles of all executives' compensation.
- ***Obtain Independent Directors' Approval.*** Independent directors should approve the CEO's compensation and the program of compensation for other executives. For larger companies, a separate compensation committee composed of independent directors should handle all compensation issues. For companies lacking a separate compensation committee, compensation issues should be determined by vote of a majority of the independent directors. For this purpose, independence is defined in the same manner as determining membership of audit committees. Therefore, an independent director is a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.
- ***Include Both Salary and Performance Components.*** Any compensation program should consist of both salary and performance components. Overall, the program should favor "pay for performance" in order "to ensure equitable treatment between the shareholders and corporate management."[2] Most investors recognize that all companies have stakeholders other than investors, and that salary or compensation not based on performance favoring investors remains an important component.
- ***Have Industry Comparability.*** According to the TIAA-CREF Policy, the salary component of any compensation program should be comparable with salaries in industry peer groups. The performance component "should relate to key characteristics accepted within the particular industry … measured over time periods adequate to assess and link actual performance with responsibilities."[3] This position is carefully stated by TIAA-CREF so as not to preclude a company from being on the leading edge of executive compensation, at least with respect to the performance component, as long as the performance being awarded relates to characteristics accepted within the particular industry.
- ***Favor Stock Options and Restricted Stock Awards.*** Most institutional investors like TIAA-CREF still look favorably upon stock options and restricted stock in employer stock, at least as used traditionally, and urge that they "should be integrated with other elements of compensa-

tion to formulate a competitive package."[4] However, TIAA-CREF has identified a number of "red flag" issues with respect to stock options and restricted stock which are discussed below.

Starting with the CEO

With almost every institutional investor, review of a company's compensation package starts with the compensation of the CEO. A general principle of the Council of Institutional Investors is that "the CEO's compensation, including any bonus, severance, equity-based and/or extraordinary payment" be approved annually by the board or compensation committee.[5]

TIAA-CREF urges in its policy that there be a "clear understanding between the board and the CEO regarding the corporation's expected performance and how that performance will be measured," with the compensation committee or board establishing "a specific set of performance objectives for the CEO annually." Given the "top-down" philosophy, most institutional investors like TIAA-CREF believe that the same understanding of established performance objectives should exist between the CEO and the rest of the company's executives.

Although the Council for Institutional Investors believes that chief executive officers should have no more than one form of equity-based compensation,[6] most institutional investors do not object to inclusion of the executives in a broad-based employee plan, such as an incentive stock option plan or another personal plan awarding either stock options or restricted stock to a particular executive if certain criteria are met. TIAA-CREF words it differently, stating that the redundancy of equity-based plans is a red flag, unless the redundancy is on a sequential basis with no more than two years of overlap.[7]

Red Flags

In addition to the general principles expressed in its policy, TIAA-CREF has identified "red flag" issues. At a minimum, these "red flag" issues described in the Policy's appendix call for further research on a particular portfolio company and could result in a negative vote of TIAA-CREF's portfolio shares. TIAA-CREF has recognized the following as red flags:

- ***SERPS.*** SERPS, or supplemental retirement compensation for an executive, are determined by a formula based upon future factors. Determining compensation by using a formula based upon future factors raises the red flag because it "may impose a liability on the company for many years after an executive's retirement."[8] Current compensation paid during an executive's career is favored by institutions.
- ***Repricing Underwater Options.*** Underwater options are options with an exercise price that is higher than the market price of the securities. A general principal of the Council of Institutional Investors is that "[u]nless submitted to shareholders for approval, no 'underwater' options should be repriced or replaced, and no discount options should be awarded."[9] TIAA-CREF will generally vote against such proposals because "[r]epricing options after a decline in the stock price undermines the rationale for establishing an option plan in the first place [and] gives management a benefit unavailable to shareholders and thereby reduces the alignment of interests between shareholders and management." However, institutions may not object to repricing if it is "tied to a significant reduction in the total number of outstanding options."[10]
- ***Excessive Dilution from Equity-Based Plans.*** Excessive dilution is defined by TIAA-CREF with respect to most companies as total potential dilution from existing and proposed compensation plans (apart from restricted stock which is treated separately) that exceeds 15 percent over duration of plans or 1.5 percent per year. TIAA-CREF is more tolerant of small-capitalization companies (meaning those with market equity capitalizations under $100 million) and "high technology" companies, raising the red flag for a total dilution of 20 percent and 25 percent, respectively.[11]
- ***Discount Options.*** Discount options are options that are granted with an exercise price less than the market price. A general principle of the Council of Institutional Investors is that any program offering discount options should be submitted for vote of shareholders.[12] TIAA-CREF will generally vote against option proposals in which the exercise price is below 85 percent of fair market value on the date of the grant.[13] The argument in favor of discount options is that they, unlike out of money options, do not encourage a

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"bet the bank" psychology that is not in the best interests of shareholders. For this reason, TIAA-CREF as well as other institutional investors may permit balancing underwater options with discount options as long as the total discount from all plans is not greater than 2.25 percent (or 3.00 percent for small-capitalization companies or 3.75 percent for high technology companies) of the total market capitalization of the company.

- ***Reload Options.*** Reload options are options that, as they are exercised or expire, are automatically replaced with comparable options. There is no reason for an executive to exercise a traditional option with a fixed exercise price before the end of the term. An argument in favor of reload options is that they encourage an executive to purchase shares throughout the term. The argument against them is that they allow an executive to take advantage of all increases in stock price that occur over the duration of the option with no attendant risk. Because this is at odds with the payout structure of common stock, TIAA-CREF believes that reload options can create a divergence between the interests of outside shareholders and the option recipient.[14]

Conclusion

Before proposing and adopting programs of executive compensation, executives and their boards should review any policies of the company's major investors, especially those of institutions if they are significant stakeholders. If those investors do not have articulated policies, the TIAA-CREF Policy is a good starting point. Both executives and boards should be aware of those elements that have been identified as red flags when determining executive compensation programs. By avoiding these red flags and complying with the general principles supported by all investors, executives and their boards can establish successful compensation programs.

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[1] *See "Introduction" of the Appendix to the TIAA-CREF Policy (March 2000)*

[2] *See "Executive Compensation" of the TIAA-CREF Policy (March 2000)*

[3] *See "Executive Compensation" of the TIAA-CREF Policy (March 2000)*

[4] *See "Executive Compensation" of the TIAA-CREF Policy (March 2000)*

[5] *See "General Principles for Director and Management Compensation" of the Counsel of Institutional Investors Core Policies (May 1999)*

[6] *See "General Principles for Director and Management Compensation" of the Counsel of Institutional Investors Core Policies (May 1999)*

[7] *See "Voting Guidelines – Omnibus Plans/Redundancy" of the Appendix to the TIAA-CREF Policy (March 2000)*

[8] *See "Executive Compensation" of the TIAA-CREF Policy (March 2000)*

[9] *See "General Principles for Director and Management Compensation" of the Counsel of Institutional Investors Core Policies (May 1999)*

[10] *See "Voting Guidelines - Repricing Options" of the Appendix to the TIAA-CREF Policy (March 2000)*

[11] *See "Voting Guidelines - Dilution from Stock-Based Plans" of the Appendix to the TIAA-CREF Policy (March 2000)*

[12] *See "General Principles for Director and Management Compensation" of the Counsel of Institutional Investors Core Policies (May 1999)*

[13] *See "Voting Guidelines - Option Pricing" of the Appendix to the TIAA-CREF Policy (March 2000)*

[14] *See "Voting Guidelines - Reload Options" of the Appendix to the TIAA-CREF Policy (March 2000)*

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