

Acredula

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Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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

Surveys Provide Insight into Executive Compensation

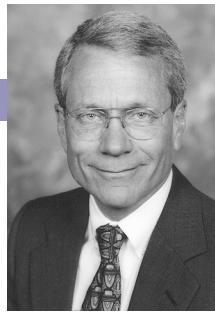
This month's issue of *Acredula* continues our focus on executive compensation. Our feature article offers useful guidelines for designing executive compensation programs that avoid investors' red flags.

For this issue, *Counsel for Boards and Executives* conducted two surveys:

- A survey of randomly selected executives on their views of the importance of various components of executive compensation; and
- A survey of empirical data on executive compensation available from public sources such as definitive proxy materials of randomly selected organizations.

Editor's Note

We would like to continue both surveys as an annual part of *Acredula*. In an effort to increase the geographic representation of executives and organizations located in Ohio and its neighboring states, we are looking for volunteers. Participating executives and organizations will receive the survey results, and their identities will remain anonymous. To volunteer, please write us at our Bricker & Eckler address or e-mail us at jbeavers@bricker.com.



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Following These Guidelines May Avoid Red Flags in Designing Executive Compensation

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From commercial banks to angel investors to institutional managers, most providers of capital have identified "red flags" with respect to executive compensation packages. These red flags will result in declining investment opportunities in the employer's organization. When

developing executive compensation programs, boards of directors and management have a difficult time identifying investors' red flags because they are not usually publicized. One exception is the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), which has

identified red flags in its March 2000 Policy Statement on Corporate Governance (See the August issue of Acredula). Organizations can design executive compensation programs around investors' red flags by not deviating significantly

from the programs of organizations that receive substantial capital from these investors. Recent surveys conducted by Counsel for Boards and Executives¹ provide useful guidelines for avoiding these red flags.

Background

Objectives. Employer organizations need to design executive compensation around the three primary objectives that are most important to providers of outside capital:

- Attracting executives for hiring by the organization;
- Retaining executives after they are hired; and
- Motivating executives by providing incentives while they are employed.

Employer organizations also need to be aware of capital providers' secondary objectives:

- Minimizing the after-tax cost to the employer organization (i.e., is the compensation deductible); and
- Minimizing any accounting charge to earnings.

Components. In designing any element of an executive compensation program, employer organizations need to keep in mind all of the components usually present in organizations with substantial outside capital, including:

- Salary;
- Annual bonus;
- Long-term incentives;
- Retirement and severance benefits; and
- Other benefits and prerequisites.

Defining the Roles of the Board and Management

A preliminary step in designing a successful executive compensation program is defining the roles of the board or

its compensation committee and management. Most providers of capital believe that the role of a board or its compensation committee is to determine:

- The terms of employment, including compensation, of the chief executive officer (CEO);
- The overall direction and objectives of the compensation system for management; and
- A maximum limit on the aggregate compensation of all executives, other than the chief executive officer, as a group.

In most cases, providers of capital prefer that the CEO, rather than the board, have the authority to hire, fire, and compensate the rest of the executives, other than the chairman of the board, subject to any direction and limits set by the board. However, many providers of capital favor the board's assuming some oversight by setting the maximum limit on the aggregate compensation of all executives as a group. Often this determination is assumed as part of approval of the organization's operating budget for the ensuing year, but most providers of capital prefer that at least the aggregate compensation of executives be considered separately from the rest of the budget.

Typically, when a board determines the terms of the CEO's employment, it indirectly sets the limits on the terms of the rest of the executives' employment. Most CEOs are not inclined to give a term of employment to a subordinate that they did not receive from the board themselves.

Today, most providers of capital favor an annual evaluation of the CEO's performance by either the board or its compensation committee as part of the compensation process. To many, the most important part of the compensation process is the feedback and mentoring that the board or its compensation committee can give to the CEO regarding his or her future performance.

Finally, management's role is to perform due diligence for the board or its compensation committee by researching executive compensation of industry peers, surveying its executives as to what incentives they would like, and reporting any comments from shareholders, investors, and other providers of capital. Management can also suggest compensation packages that it believes are appropriate for consideration by the board or its committee.

Determining the Components and their Objectives

Another preliminary step is determining the components of the overall executive compensation system and the objective of each component. Although the components of different

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classes of executives will likely vary, the objectives of those components are often consistent from one class of executive to another. Typical components and their objectives include:

- **Salary:** To provide the base or minimum compensation for attracting and retaining executives.
- **Annual bonus:** To provide short-term incentive based upon annual performance of the individual or of a business unit or segment of which the individual is a part within the organization.
- **Long-term incentives:** To provide incentive based upon the performance of the organization over a period of time typically ranging up to three to five years.
- **Retirement and severance benefits:** To provide post-employment compensation for retaining executives until retirement or through a change in control.
- **Other benefits and perquisites:** To relieve executives of matters such as expenses for health care that may divert their attention from focusing on their responsibilities for the organization and to provide executives with perks that will allow them to compete with executives of comparable positions.

Most providers of capital are familiar with compensation surveys where executives rank the various components of compensation for attracting, retaining, and motivating them. Below are the results of a recent survey² where executives ranked each component on a scale of one to five, with one being of little importance and five being of great importance.

	Attraction	Retention	Incentive
Salary	4	3	1
Annual bonus	3	4	5
Long-term incentives	4	5	5
Retirement and severance benefits	2	3	1
Other benefits and perks	1	1	1

Based upon these and other surveys, *salary* is a major factor in attraction, except for new economy companies where it may only be a secondary factor. Salary is less of a factor in retention if there is incentive compensation, and does little for incentive. An *annual bonus* is slightly less of a factor than salary in attraction and is a major factor for both retention and incentive. *Long-term incentives* are becoming major factors in attraction, especially with new economy organizations. Traditionally major factors in retention, long-term incentives are becoming *the* major factors for incentive.

Retirement and severance benefits are, at best, only secondary factors in retention. *Other benefits and perks* do not hold much influence, except in the non-profit world where they remain secondary factors for retention.

Integrating the Components among Various Classes of Executives

Capital providers typically expect integration of the compensation components according to some consistent pattern among the various classes of executives. Our experience is that capital providers request and review information on the following three classes of executives:

- **CEOs;**
- **NEOs,** or the five highest-paid executive officers as a group. This is typically information that publicly traded companies are required to report in proxy and public offering materials; and
- **Top hat group,** which is a select group of management and highest-paid employees for which the organizations provide compensation and benefits not subject to the participation, vesting and funding provisions of ERISA.

Capital providers expect that the components will vary in amount and proportion among the different classes with some consistent pattern. For example, the table below details the components, expressed as a percentage of total compensation, of each of these three classes for our client, a traditional economy organization in which there is significant institutional investment.

	CEO	NEOs	Top Hat Group
Salary	28%	35%	45%
Annual bonus	28%	25%	20%
Long-term incentives	30%	25%	15%
Retirement and severance benefits	12%	12%	15%
Other benefits and perks	2%	3%	5%
Total	100%	100%	100%

Comparing Industry Peers

In designing executive compensation, the components and total compensation of each class of executive should be compared with those of industry peers. Capital providers typically make these comparisons by measuring the total compensation of executives as a percentage of the

organization's revenues and total compensation of all employees, which are easily available from annual reports as well as from sources such as the Almanac of Business and Industrial Financial Ratios, by Leo Troy and RMA Annual Statement Studies, by Robert Morris Associates.

Both of these percentages vary greatly by industry. The table below sets forth the percentage of executive compensation that consists of an organization's revenues and its total compensation of all employees for organizations in various industry peer groups.

Industry Peer Group	As a % of revenues	As a % of total compensation of all employees
General constructions	2.4%	40.0%
Rubber	1.1%	10.4%
Motor vehicle manufacturing	0.4%	4.2%
Telecommunications	0.3%	2.4%
Electric utilities	0.3%	4.8%
Retail apparel	1.5%	9.9%
Retail food	2.8%	12.7%
Banks	2.5 %	23.4%
Life insurance	0.2%	5.7%
Hospitals	0.4%	0.8%
Nursing facilities	1.2%	2.7%

Announcing Bonus Criteria and Standards in Advance

Because of the importance executives' attach to annual bonus programs for both retention and incentive, boards or their compensation committees should announce in advance the criteria and standards that will be used to determine bonuses for the ensuing year. A recent survey³ showed that about 80 percent of new economy companies and 75 percent of traditional economy companies announce their annual bonus criteria and standards in advance. As a percentage of total compensation, the annual bonuses of these programs range from 30 percent for a non-profit CEO to 50 percent for a traditional economy CEO to 70 percent for a new economy CEO.

Unless there is behavior that the organization needs to encourage or discourage, the more successful programs base the annual bonus on the performance of a business segment or unit. The segment or unit must be something that is affected by the executives' efforts, and it must be empirically measurable. Examples of these segments include:

- For CEOs, the segment is usually the entire enterprise, and the most common measure is growth in earnings per shares or in return on equity;
- For the rest of the NEOs, the segment is often the entire enterprise or, for operating officers of a division or subsidiary, it is the division or subsidiary. The most common measure is growth in earnings before taxes or, to the extent that these executives do not control depreciable or amortizable assets, earnings before taxes, depreciation and amortization; and
- For the rest of the top hat group, it is frequently the financial factors of the business segment or unit they affect, such as sales growth, especially for new economy companies stressing growth, or growth in operating income or profit for more established companies.

Surveys of customer or employee satisfaction can also serve as measures of performance. Non-financial measures could include the completion of a project, such as closing a stock offering, listing on NASDAQ, reorganization of segments or units, or identifying a successor CEO.

The more successful annual bonus programs have standards for three levels of payout, more or less on a bell curve, based upon the expected likelihood that the financial measure can be achieved:

- **Minimum Payout Level.** At this level of payment, there is at least a 75 percent, but less than 50 percent, likelihood of achieving this measure (nothing is paid for performance falling below the 75 percent level).
- **Target Payout Level.** At this level of payment, there is a 50 percent, but less than 75 percent, likelihood of achieving this measure.
- **Maximum Payout Level.** At this level of payment, there is a 25 percent or less likelihood of achieving this measure.

For example, a CEO may receive a multiple of 0.5 times his or her target bonus if the organization has at least a 10 percent, but less than 15 percent increase, in earnings per share. A CEO may collect a multiple of 1.0 times his or her target bonus if the organization has at least a 15 percent, but less than 20 percent, increase in earnings per share. Finally, a CEO may receive a multiple of 1.5 time his or her target bonus if the organization has a 20 percent or more increase in earnings per share for the performance period.

Considering Options and Other Forms of Equity for Long-Term Incentives

A recent survey⁴ revealed that the forms of long-term incentive most frequently used by for-profit companies are:

- **Non-qualified stock options**, used by over 75 percent of the surveyed companies;
- **Restricted stock options**, employed by about 35 percent of the surveyed companies;
- **Incentive stock options**, used by about 30 percent of the surveyed companies;
- **Phantom stock options**, used by about 15 percent of the surveyed companies;
- **Stock appreciation rights**, employed by about 5 percent of the surveyed companies; and
- **Cash plans** (other than phantom stock and stock appreciation rights), used by about 20 percent of the surveyed companies.

Stock options are a popular form of long-term incentive because they:

- Do not involve a cash expenditure or an accounting charge to earnings for the employer and, with respect to a non-qualified stock options, entitle the employer to a tax deduction upon the exercise of the option; and
- Allow each executive to determine when he or she is taxed by exercising the option, if non-qualified, or selling the underlying stock, if incentive; and allow the executive to share in capital equity growth, which has been growing at a faster rate than other forms of wages and salaries since the 1990s.

Staying within Some Dilution, Burn and Overhang Limits

Share Dilution. Although options are a cash-free form of compensation to the employer, excessive use of options can create so much potential dilution in voting rights or earnings per share that they diminish the market value of the employer's stock. Although options represented 8 to 10 percent of an organization's outstanding shares on a fully diluted bases prior to the 1990s, a recent survey shows that options today represent, on a fully diluted basis, about:

- 20 percent of a new economy company's outstanding shares; and
- 14 percent of a traditional economy company's outstanding shares.

Increase in Share Dilution. Based upon a recent survey, options are increasing as a percentage of companies' total outstanding shares at a rate of 2.0 percent annually. This is often referred to as the "burn rate."

Price Discount. Most capital providers disapprove of price discounts greater than 25 percent. That is, they believe the

exercise price of options should be at least 75 percent of the market price. However, the price discount taken by itself is rather meaningless. A better measure is an overhang factor or value transfer.

Value Transfer. TIAA-CREF suggests an overhang limit on value transfer of 2.25 percent for most organizations. TIAA-CREF calculates the value transfer by multiplying the average share dilution (expressed as a percentage of outstanding shares on a fully diluted basis) by the average price discount of all stock options, restricted stock, and other equity-based compensation programs of the organization. The 2.25 percent limit is determined by multiplying a 15 percent share dilution, which is the maximum share dilution tolerated by TIAA-CREF without a red flag, by a 15 percent price discount, which is the maximum price discount tolerated by TIAA-CREF without a red flag. The limit on value transfer for small capitalization companies is 3.00 percent, which is a 20 percent share dilution maximum tolerated for high technology companies multiplied by the 15 percent price discount maximum. The limit on value transfer for high technology companies is 3.75 percent, which is a 25 percent share dilution maximum tolerated for high technology companies multiplied by the 15 percent price discount maximum.

Considering Floating Price and Use-Them-or-Lose-Them Options

Capital providers argue against traditional fixed-price options for two reasons:

- They are "riskless" to the executive because there is no incentive to exercise until the option is about to expire; and
- In times of rising market prices, they contribute to dilution in per share earning and eventually market value.

As a result, it is becoming more common for non-qualified options to have an exercise price that "floats" with the market price of the underlying security. Typically, these are discount options having an exercise price that is a percentage of the market price of the underlying security at the time. The typical discount is 15 to 25 percent, so that the exercise price is 75 to 85 percent of the market price.

Capital providers argue against traditional fixed-term options because there is little incentive to exercise the option until they are about to expire. Some organizations have tried "reload" options to encourage their exercise. A reload option automatically renews itself if it is exercised during a certain window, typically tied to a vesting schedule where the option would renew itself for the number of shares purchased within, for

example, a three-month period of the option's vesting with respect to those shares. However, providers of capital are objecting to these "reload" options because they believe they contribute to greater dilution than traditional options. As a result, it is becoming more common for both non-qualified and incentive stock options to include a tiered "use-them-or-lose-them" feature. In lieu of a vesting schedule on the exercise of the option, the option provides that if less than a percentage of the total shares subject to the option are purchased during any period, the shares that are not purchased are forfeited. For example:

- If less than 20 percent of the total number of shares subject to the option are purchased prior to the second anniversary of the date of grant, the optionee forfeits a number of shares up to 20 percent of the total;
- If less than 40 percent of the total number of shares subject to the option are purchased prior to the fourth anniversary of the date of grant, the optionee forfeits a number of shares up to 40 percent of the total;
- If less than 60 percent of the total number of shares subject to the option are purchased prior to the sixth anniversary of the date of grant, the optionee forfeits a number of shares up to 60 percent of the total; and
- If less than 80 percent of the total number of shares subject to the option are purchased prior to the eighth anniversary of the date of grant, the optionee forfeits a number of shares up to 80 percent of the total.

All remaining shares that have not been purchased will be forfeited upon the 10th anniversary of the date of grant.

Conclusion

The two areas of governance for which independent shareholders and other providers of capital demand the most oversight are accuracy of the organization's financial statements and compensation of the organization's executives. One is accomplished by requiring internal accounting controls and an audit of the resulting financial statements. The other is accomplished by some oversight of the compensation process. By following these guidelines, your organization can avoid the red flags that shareholders and other providers of capital may raise regarding executive compensation. Designing executive compensation programs around investors' red flags will help your organization establish more successful relationships with providers of capital.

¹ Counsel for Boards and Executives has conducted two surveys. One is a survey of CEOs and NEOs of randomly selected new and traditional economy companies conducted in August 2000. The other is a survey of proxy statements and annual reports of randomly selected new economy companies and traditional economy companies publicly available during the 12-month period ending June 30, 2000.

² Survey by Counsel for Boards and Executives of CEOs and NEOs of randomly selected new and traditional economy companies in August 2000.

³ Survey by Counsel for Boards and Executives of proxy statements and annual reports of randomly selected new economy companies and traditional economy companies publicly available during the 12-month period ending June 30, 2000.

⁴ Survey by Counsel for Boards and Executives of proxy statements and annual reports of randomly selected new economy companies and traditional economy companies publicly available during the 12-month period ending June 30, 2000.

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