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A Compensation Committee's Most Difficult Task— Finding the Right Path to Connect Pay With Performance

BY MARSHALL T. SCOTT AND LAURA G. THATCHER

Introduction

Loud and clear from investors, both chambers of Congress, and the folks on the street: ''job number one'' for compensation committees is finding a way to better correlate executive pay with company performance. No message could be more compelling or straightforward. But finding the right way to do that is not simple. In this article, the authors will discuss some of the many nuances and suggest practical tips for:

- aligning performance goals with company business objectives,
- setting incentive plan targets,
- using the compensation philosophy to help with target setting,
- avoiding incentive arrangements that encourage excessive risk-taking,
- explaining the incentive plan to shareholders, and
- preserving the company's tax deduction where possible and advisable.

Aligning Performance Goals With Company Business Objectives

Incentive compensation is but one element of an executive's total direct compensation. In addition to base salary—which guarantees a predicable income stream regardless of performance outcomes—most compensation committees also use short-term incentives (annual bonus) and long-term incentives (typically equity awards and multiple-year performance awards) to encourage specific behaviors that the committee believes will enhance the company's short and longer-term business objectives. Incentives plans have a highly direct impact on specific behaviors. For that reason, a fundamental understanding of the company's business objectives over the short and long-term is critical to the committee's ability to identify the operational and financial drivers that will best enhance achievement of those objectives. Designing a compensation system that incentivizes the wrong behaviors can be far more costly to the company than providing no incentives at all.

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There is no single ''right way'' of choosing effective performance metrics. The selection can vary based on the company's size, where the company stands in its development cycle, the company's business sector (manufacturing, technology, healthcare, real estate), the company's appetite for leverage and tolerance for business risk, and the geographic footprint of the company's business and workforce, to name a few variables.

For example, an annual bonus plan that rewards return on assets may be perfectly appropriate for a manufacturing company, but could be less effective for a company in a service sector. Likewise, a long-term incentive plan that employs a combination of five financial metrics, three operational metrics, and individual performance modifiers may be fine for one company, but too complex and therefore counterproductive for a different company.

Also, a compensation committee may find that different metrics should be employed to drive short-term objectives for the annual bonus plan (such as year-over-

year improvement in sales) from those used to measure performance over a three- to five-year performance period (such a total shareholder return as measured against an identified peer group).

In short, selecting the most effective performance drivers for a particular company, the right balance of short- and long-term incentives, and the right mix of cash and equity is much more of an art than a science. Compensation committees and their advisers must fully appreciate the company's business strategy in order to devise incentives that enhance rather than detract from it. Ideally, they should design a nimble program that can be effective in a highly changeable economic environment and adjustable to account for the effect of post-performance period reversals (such as financial restatements).

Setting the Incentive Plan Target

Once the compensation committee has identified appropriate performance drivers that foster its business objectives, the next challenge for the committee is setting the incentive plan target (whether for the annual incentive or the long-term incentive plan). The incentive plan target is an understanding between the compensation committee and senior management as to the company's expected performance for a set period; if the target performance is achieved, there will be additional compensation paid or earned by management for achieving that performance result.

Target setting helps to communicate, reinforce, and manage expectations for success. If target performance can be achieved too easily, the incentive plan may not motivate the executives to achieve the optimal performance outcome for the company. Similarly, if the target's achievement is too difficult, it may not motivate an optimal performance outcome, and, in fact, it may motivate risk taking beyond the profile or appetite of the company. Accurate target setting is also relevant in determining whether the amount of compensation is appropriate relative to performance.

Compensation committees typically strive to set a target that reflects what the business is capable of, provided management develops a good strategy and executes it effectively. Problems can arise, however, because compensation plans tend to measure performance and deliver pay on a pre-set, periodic basis (e.g., one-year or three-year basis), which may not coincide naturally with the achievement of business results (i.e., a timing disconnect). Another common problem is that the performance metric(s) used in compensation plans are often based on accounting measures under generally accepted accounting principles (GAAP) or some modification[1] thereof, which may be an imperfect indicator of the company's successful pursuit of its business strategy.

It is also difficult to predict what the business strategy and its execution will produce, even if timing and reporting differences can be controlled. Externalities—those events that are external to the business—such as war, terrorist attacks, banking system failures, etc., may disrupt the business outcomes and expectations of the best strategy and its execution.

Using the Compensation Philosophy to Help With Target Setting

There are processes and information that a compensation committee can use to help set the incentive plan target. First, the committee should establish a compensation philosophy that articulates for the committee, as well as for management, the company's perspective on this point. The compensation philosophy should address certain key questions:

—What is the appropriate starting point for determining the incentive target?

Most companies build a budget or operating plan for the fiscal year. The broader purpose of an operating plan, as its name implies, is to help managers operate the company for the fiscal year. Through the operating plan, those parts of the business responsible for driving revenue, those parts responsible for containing costs, and those parts responsible for managing the capital obtain a perspective on what is expected of them and each other. The hope is that by arriving at the planned results, the business will appropriately deploy its capital, achieve the desired or needed profitability, and either pay dividends, or retain earnings to fund growth or expansion.

Based on Towers Watson's recent[2] research, we believe that more than half of all businesses use the operating plan or budget as the starting point or primary basis for setting the annual incentive plan target. But, the use of the operating plan is not universal and there are other approaches—based on the compensation philosophy—for setting an incentive target.

The second most prevalent approach to setting the target—used by almost one-third of companies[3]—is to set the target based on year-over-year improvement. A company may expect growth because the markets for its products and services are expanding, or the organization is continually investing in the business. This may lead the compensation committee to adopt an incentive plan philosophy in which the target must reflect continuing year-over-year growth.

Year-over-year growth would seem challenging in the economic environment following the 2009 economic recession. Towers Watson's research,[4] however, shows that the percentage of companies who report using this approach (about 30 percent) has remained steady both before and after the events of 2009.

Other starting points for setting the incentive target—used by a minority of companies—are based on external factors. These include relative performance (15 percent of companies reported using this approach), shareholder expectations (10 percent), and the company's cost of capital (4 percent). These external or market-based approaches to target setting can provide a helpful perspective to compensation committees, and it is somewhat surprising that they are not used more widely.

Towers Watson's experience tells us that relative performance is often viewed favorably in theory, but when

[1] Common adjustments include such items as changes to accounting rules, regulatory standards, income tax rate changes, or other legal modifications; the impact of acquisitions or dispositions; and restructuring charges.

[2] See Table 1.
[3] See Table 1.
[4] See Table 1.

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a compensation committee tries to apply the concept, it is often difficult to find a peer group that is credible to both management and the committee. Companies in the same sector or industry can be at different points in their life cycles and the development and execution of a strategy, so that a performance comparison may not be as reasonable in practice as in theory.

Table 1

	2010 Survey	**Pre-2010 Survey**
Determined by management / board based on business conditions	58%	25%
Based on budgeted performance	49%	37%
Year-to-year growth or improvement	30%	27%
Peer group performance or some other external standard	15%	1%
Achievement of strategic milestones	11%	1%
Based on expectations of investors	10%	3%
Timeless / absolute standard	5%	1%
Company's cost of capital	4%	-

Source: Towers Watson 2010 Annual Incentive Plan Survey

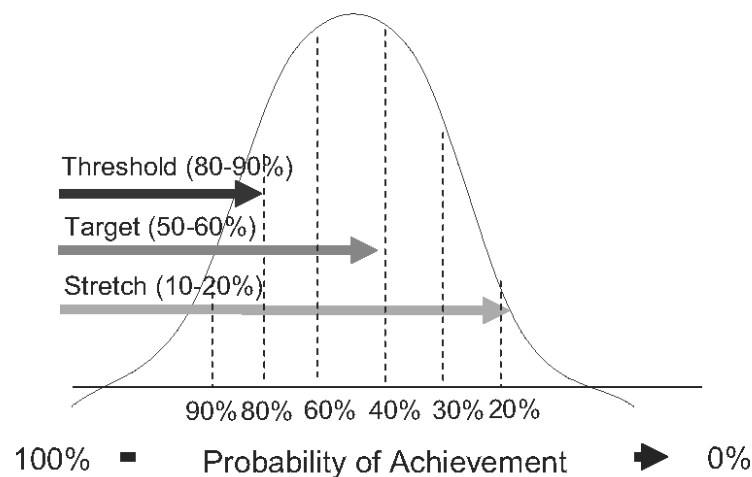
For companies that deploy a significant amount of capital in the business and also have rigorous standards for determining its cost, a cost-of-capital approach can be very helpful. Usually this approach helps a company factor in the risk embedded in its cost of capital, and thus help it set incentive targets that adequately compensate for risk. One of the reasons this approach is not used more often is that it requires extra effort in defining the capital base and returns that require adjustments to GAAP. Many companies and their compensation committees are reluctant to engage in an extended process to that effect.

—What is the appropriate degree of difficulty or ''stretch'' that should be reflected in the target?

A compensation committee philosophy should express the degree of difficulty associated with the target performance.

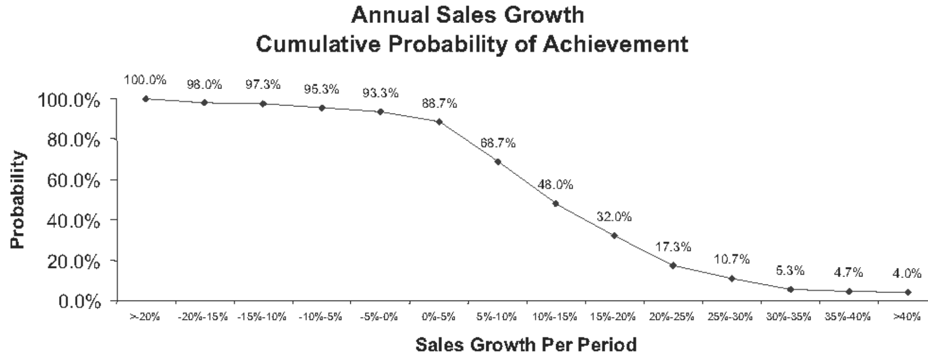
Compensation committees generally want the incentive target to be ''challenging but attainable.'' Stated as a probability, most committees want the probability of a target attainment to be approximately even or slightly better (i.e., 50 percent to 60 percent), so that executives perceive there to be a real chance to reach the target but requiring sustained attention and effort.

The chart below shows a normal distribution with typical threshold, target and stretch performance probabilities:



The threshold goal (or better) would be achieved eight or nine times out of 10 (and there would be no payment one or two times out of 10); target performance (or better) would be achieved five or six times out of 10 (i.e., providing probability of somewhat better than even odds) and outstanding performance would be achieved one or two times in 10.

Past performance may be a gauge of the probability of attaining the incentive target. The following illustration depicts the probability of achieving certain amounts of sales growth for a certain period. This could be the historic sales growth for a specific company or a group of peer companies or an entire sector. The time period could be annual or multiple periods, and thus, could apply to either an annual or long-term incentive plan.



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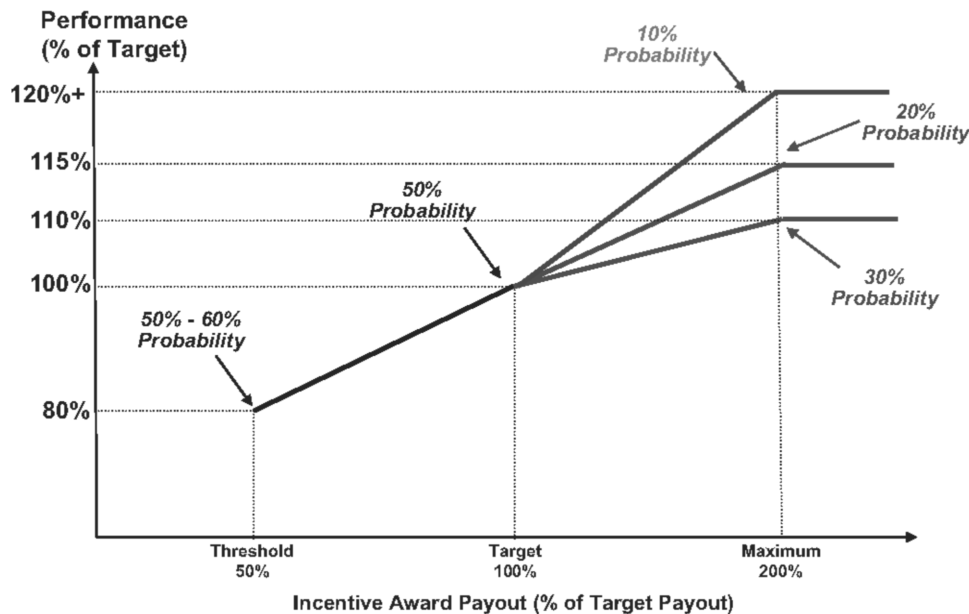
A 10-year historical analysis of sales growth reveals:

- ~80 percent probability of 3 percent growth: *Threshold?*
- ~60 percent probability of 10 percent growth: *Target?*
- ~20 percent probability of 20 percent growth: *Maximum?*

These probabilities can convert into a performance curve where the probabilities of performance are aligned with different payout amounts. The following curve illustrates how the maximum payout (of 200 percent of target) may be aligned with different probabilities of performance (i.e., 10 percent to 30 percent).

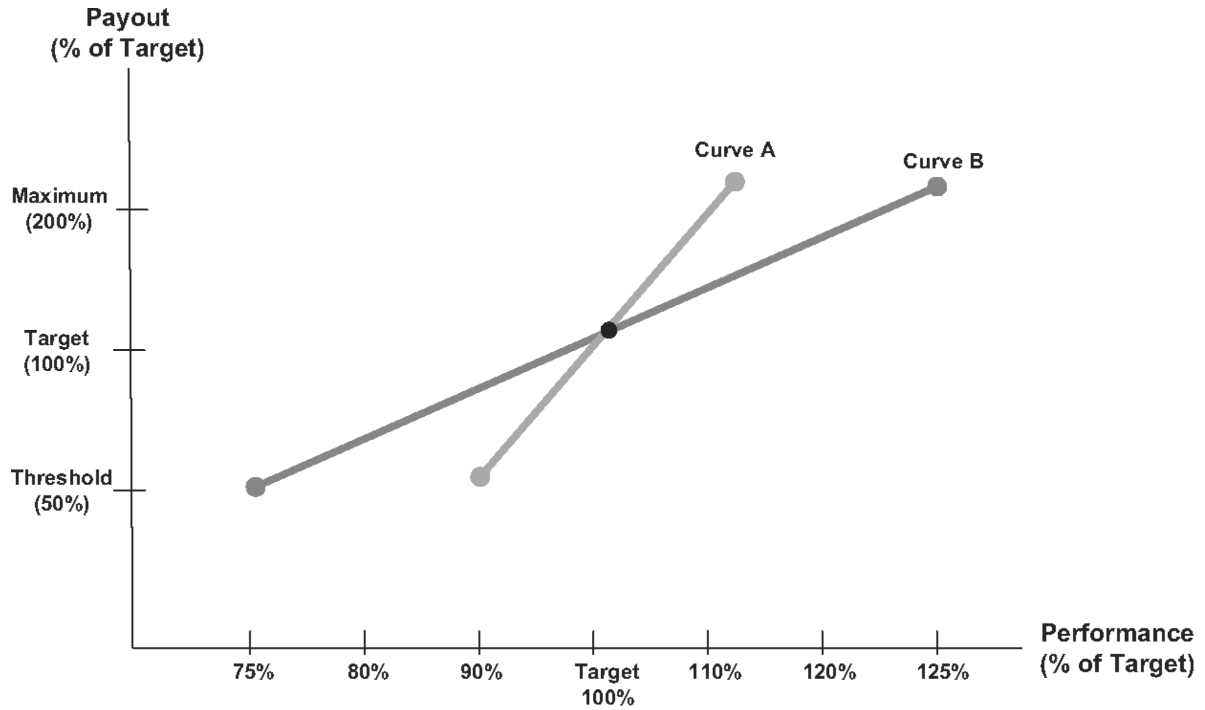


—How should the incentive targets reconcile operating conditions, including volatility and cyclicality that result from those conditions?

A compensation philosophy should articulate how the incentive targets will deal with volatility (i.e., the variability in performance due to input or supply price variability) and cyclicality (i.e., the degree performance may be effected by the demand for goods and services).

One approach to volatility or cyclicality is to use a fairly wide performance range, with lower ''leverage.''

The following illustration compares two performance curves: Curve A is a ''normal curve,'' representing a company that experiences a lesser amount of volatility or cyclicality; Curve B represents a company that experiences a higher degree of either volatility or cyclicality, or both. Curve B, the curve for use by the cyclical company is wider, which may reflect the probability of performance varying more greatly. It is typical for a cyclical company to have or use less leverage in the performance/payout curve (i.e., the curve is ''flatter''), thus making precision in selecting the target less critical.



	Curve A – Normal			Curve B – Cyclical		
	(a) Payout (% of target)	(b) Performance (% of target)	(c) Leverage (change in payout / change in performance)	(d) Payout (% of target)	(e) Performance (% of target)	(f) Leverage (change in payout / change in performance
Threshold	50%	90%		50%	75%	
Target	100%	100%	> 5 : 1	100%	100%	> 2 : 1
Maximum	200%	111%	> 20 : 1	200%	12%	> 4 : 1

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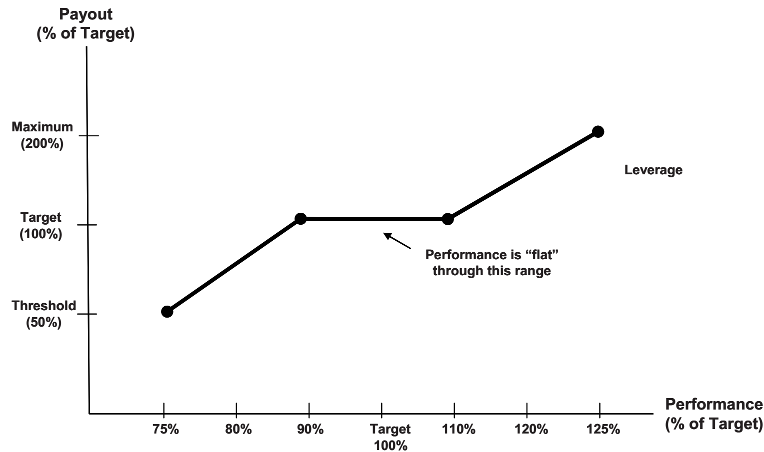
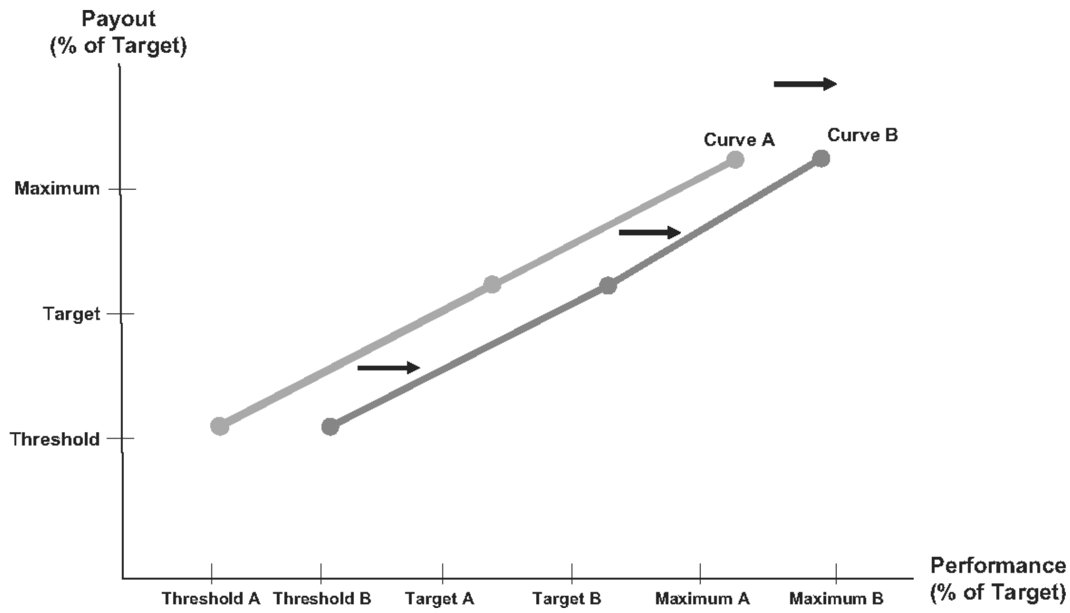
In the following illustration, the target is a range (i.e., the flat part of the curve), and illustrates another way a cyclical or volatile performance company may deal with variability and target setting.



	Performance (% of target)	Payment (% of target)	Leverage (change in payout / change in performance)
Threshold	75%	50%	> 3:33:1
Target	90%	100%	
Target	100%	100%	> -
Target	110%	100%	
Maximum	125%	200%	> 13:3:1

The width of the performance range allows for a greater number of results to be within the curve, and the ''flatter'' slope of the range through the center or heart of the range keeps a payout amount more reasonable.

Another way to address volatility or cyclicality is to adjust the performance/payout curve after-the-fact (i.e., after the committee has an opportunity to see how performance was actually achieved). As an illustration, suppose the operating conditions that can impact performance are identifiable by referencing some external condition or conditions, such as the price of oil or general interest rates. A company may set its performance payout curve based on the budget at the beginning of the financial year. This budget and performance payout curve is based on certain assumptions. After the year is over, the facts actually show that because of external reasons, such as the price of a key commodity input (such as oil), the budget and performance payout curve should have been set differently, i.e., the performance curve should have been Curve B. Once the price of the commodity (such as oil) is known, the compensation committee can determine whether performance is good or bad. Consider the following performance payout curves where the target is the expected performance before year begins and Target B is performance after the year ends, when the operating conditions are perfectly known. If operating conditions can be objectively characterized, an adjustment to create an appropriate curve after the fact may be a possible solution.



Another way to address the uncertainty of operating conditions is through compensation committee discretion, particularly negative or downward discretion. Here, the committee sets a minimal degree of performance which is likely to be attained, then the committee determines after the fact, whether to reduce the award or leave it stand. Usually, it is reduced if the amount of the award would appear large given the actual outcome, or if the award would not be affordable given actual performance.

— *What is the sharing ratio implied by the performance target? How much can the organization afford?*

The incentive target should consider the affordability or sharing relationship between executives and shareholders. Most companies either use a profitability measure as one of the metrics in the incentive plan, or profitability of a certain minimum amount that must be achieved (a so-called ''circuit breaker'') before any incentive payout is made. Usually, this allows the compensation committee to test the sharing relationship between executives and shareholders.

As the company's performance increases through the performance range, more incentive compensation is paid to participants in the incentive plan.

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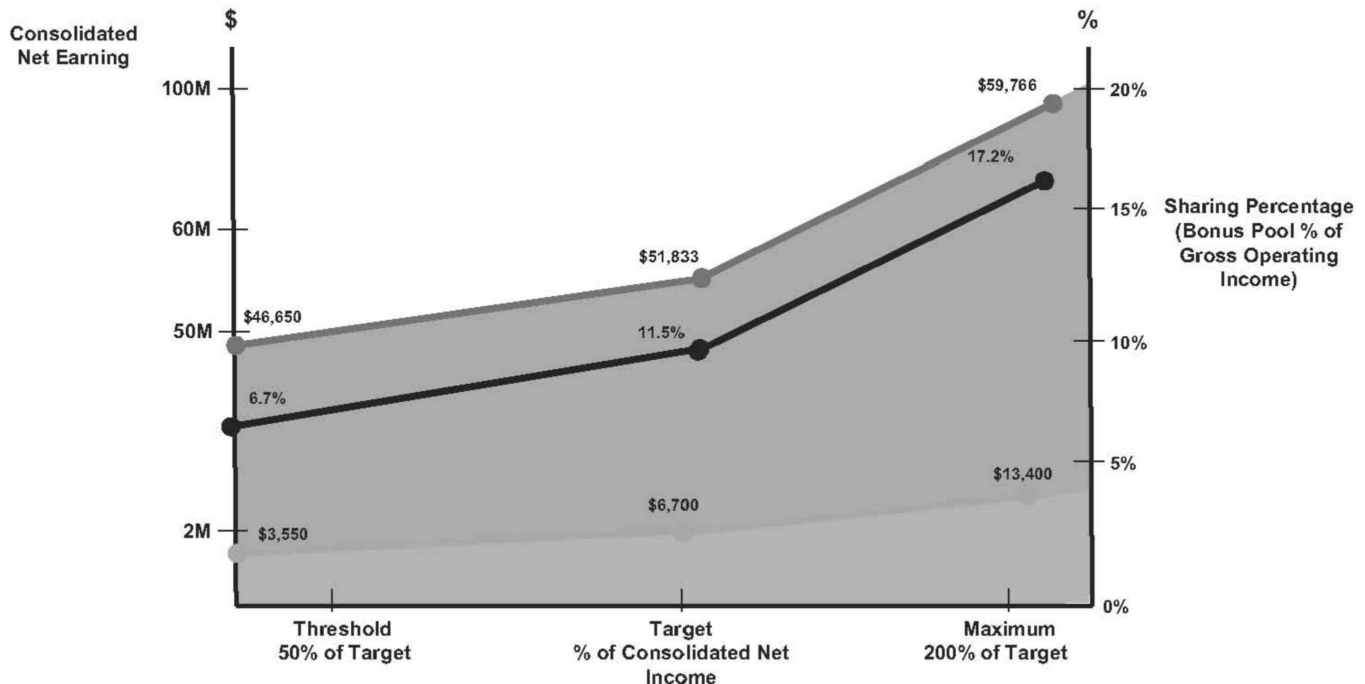
Illustration

Performance / Payout Curve	Threshold	Target	Max
Performance Curve	90%	100%	125%
Payout Curve	50%	100%	200%
Consolidated Net Earnings (a)	$46,650	$51,833	$59,766
Pool Funding (net of taxes) (b)	$3,350	$6,700	$13,400
Gross Net Earnings (a) + b = (c)	$50,000	$58,533	$73,166
Share Percentage (b) ÷ (c)	6.7%	11.5%	17.2%



Avoiding the Use of Metrics and Targets That Encourage Excessive Risk-Taking

Beginning in summer 2009, the Obama Administration, Congress and a number of federal agencies, including the Securities and Exchange Commission and the Federal Reserve Board, have produced waves of proposed legislation and rulemakings that could effect important changes in the corporate governance and executive compensation practices of both U.S. financial services companies and the rest of corporate America. A recurring theme in all of these proposals is that compensation practices were among the significant causes of the recent financial upheaval.

In June 2009, the Secretary of the Treasury announced executive compensation principles and proposals for all U.S. public companies, including financial institutions.[5] The Treasury Secretary laid out a number of broad-based principles that are expected to evolve over time with the help of industry and expert advice—in order to ''develop standards that reward innovation and prudent risk-taking without creating misaligned incentives.'' The following three principles, together with Secretary Geithner's explanatory remarks, focus on the interplay of compensation design and excessive risk-taking.

First, compensation plans should properly measure and reward performance. Compensation should be tied to performance in order to link the incentives of executives and other employees with long-term value creation. Incentive-based pay can be undermined by compensation practices that set the performance bar too low, or that rely on benchmarks that trigger bonuses even when a firm's performance is subpar relative to its peers. To align with long-term value creation, performance based-pay should be conditioned on a wide range of internal and external metrics, not just stock price. Various measurements can be used to distinguish a firm's results relative to its peers, while taking into account the performance of an individual, a particular business unit and the firm at large.

Second, compensation should be structured to account for the time horizon of risks. Some of the deci-

[5] See *Statement by Treasury Secretary Tim Geithner on Compensation*, available at http://www.treas.gov/press/releases/tg163.htm.

sions that contributed to [the current financial] crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders. Financial firms, in particular, developed and sold complex financial instruments that yielded large gains in the short-term, but still presented the risk of major losses. Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm. Asking executives to hold stock for a longer period of time may be the most effective means of doing this, but directors and experts should have the flexibility to determine how best to align incentives in different settings and industries. Compensation conditioned on longer-term performance will automatically lose value if positive results one year are followed by poor performance in another, obviating the need for explicit clawbacks. In addition, firms should carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments.

Third, compensation practices should be aligned with sound risk management. At many firms, compensation design unintentionally encouraged excessive risk-taking, providing incentives that ultimately put the health of the company in danger. Meanwhile, risk managers too often lacked the stature or the authority necessary to impose a check on these activities. Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. At the same time, firms should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking.

Consistent with these guiding principles, the SEC adopted enhancements to its compensation disclosure rules in December 2009.[6] Public reporting companies are now required to assess whether and how the company's overall compensation policies for *employees generally* (not just ''named executive officers'') create incentives that can affect the company's risk and management of that risk. Disclosure is required only if it is determined that risks arising from such compensation policies or practices are reasonably likely to have a material adverse effect on the company. The revised rule gives examples of compensation policies and practices that might trigger a discussion, in particular those relating to:

- a business unit of a company that carries a significant portion of the company's risk profile;
- a business unit with compensation structured in a significantly different manner than other units;
- a business unit that is significantly more profitable than others in the company;
- a business unit where compensation expense is a significant percentage of a unit's revenues; or
- compensation that varies significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

[6] Securities Act Release No. 33-9089 (Dec. 16, 2009).

While many companies likely will conclude that their overall compensation programs are not reasonably likely to result in a material adverse effect on the company, this disclosure requirement will compel companies to engage in a more formalized risk analysis than they may have done in the past in order to reach that conclusion. If the company concludes that its compensation policies and practices *do not* create risks that are reasonably likely to have a material adverse effect on the company, it is not required to affirmatively state that or describe the review process. However, the SEC has indicated that if a company is silent or simply sounds the ''all clear'' in its 2010 proxy statement, the SEC Staff will ask for a description of the risk assessment process that was followed. The trend so far in 2010 proxy filings is to include a brief description of the assessment process and the factors that led to a conclusion the program does not encourage excessive risk-taking.

In making the overall risk assessment, the company is allowed to consider the cumulative effects of risk mitigation features of the program. These might include some or all of the following:

- diversification of incentive-related risk by employing a variety of performance measures;
- a balanced weighting of the various performance measures, to avoid excessive attention on achievement of one measure over another;
- fixed maximum award levels for performance-based awards;
- an assortment of vehicles for delivering compensation, including cash and equity-based incentives with different time horizons, to focus executives on specific objectives that help the company achieve its business plan and create an alignment with long-term shareholder interests;
- guidelines designed to assure the independence of compensation consultants who advise the compensation committee;
- a compensation recoupment policy; and
- stock ownership and retention guidelines applicable to executive officers.

Articulating the Incentive Plan to Shareholders

Since 2007, U.S public companies have been required to include in their annual proxy statements a Compensation Discussion and Analysis (CD&A) which is a ''plain English'' narrative description and analysis of the company's compensation objectives, policies, and pay decisions with respect to its top five executive officers. Among the many topics required to be addressed are the company's incentive compensation arrangements, including the reasons for the selection of specific performance metrics (such as, return on equity, sales, or earnings per share), specific *targets* with respect to each metric (such as an EPS target of $2.23), and the resulting performance outcomes.

In the first few proxy seasons of CD&A disclosure, most companies have done a pretty good job of telling shareholders how their incentive programs operate and how and why they chose particular performance measures. However, a great many companies have strongly resisted spelling out their actual performance targets for short and long-terms incentives. Almost half of re-

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porting companies in 2007 did not disclose performance targets, presumably on the assertion that disclosure was either not material or would result in competitive harm. In 2008, the incidents of nondisclosure decreased somewhat but still remained surprisingly high. The failure to disclose performance targets was met head-on by the SEC Staff, being the most prevalent issue raised in the Staff comment letters in 2007, 2008, and 2009.

In order to dispel any lingering confusion about what is required and expected, in July 2008 the SEC Staff published a detailed interpretation of the rule (CD&I Question 118.04),[7] in which it reiterated that:

■ The competitive harm standard is the *only* basis for omitting performance targets if they are a material element of the registrant's executive compensation policies or decisions.

■ A company should begin its analysis of whether it is required to disclose performance targets by addressing the threshold question of *materiality* in the context of the company's executive compensation policies or decisions. If performance targets are not material in this context, the company is not required to disclose the performance targets. Whether performance targets are material is a facts and circumstances issue, which a company must evaluate in good faith.

■ A company may distinguish between *qualitative/subjective* individual performance goals (e.g., effective leadership and communication) and *quantitative/objective* performance goals (e.g., specific revenue or earnings targets). There is no requirement that a company provide quantitative targets for what are inherently subjective or qualitative assessments—for example, how effectively the CEO demonstrated leadership.

■ When performance targets are a material element of a company's executive compensation policies or decisions, the company may omit targets involving confidential trade secrets or confidential commercial or financial information *only if* their disclosure would result in competitive harm. The standard for the omission of information on the basis of competitive harm is the same as would apply when requesting confidential treatment of information in a registration statement or periodic report, except that there is no requirement to submit a written request for confidential treatment in this context.

■ To reach a conclusion that disclosure would result in competitive harm, a company must undertake a competitive harm analysis taking into account its specific facts and circumstances and the nature of the performance targets. In the context of the company's industry and competitive environment, the company must analyze whether a competitor or contractual counterparty could extract from the targets information regarding the company's business or business strategy that the competitor or counterparty could use to the company's detriment. A company must have a reasoned basis for concluding, after consideration of its specific facts and circumstances, that the disclosure of the targets would cause it competitive harm.

Through three years of comments under the new proxy disclosure rules, the SEC Staff has been very skeptical of competitive harm arguments in the context of CD&A disclosure of performance targets, and it remains steadfast in that view. However, based on the comment letters to date, competitive harm arguments tend to be more successful where the targets relate to operational goals (such as specific business unit goals) as opposed to companywide financial metrics. Also, the Staff appears to be somewhat more receptive to nondisclosure of targets for future periods (in the case of multi-year performance periods) as opposed to targets for periods that have already concluded (such as annual bonus plans). Finally, the rules are clear that to the extent that a performance target level or other factor or criteria otherwise has been disclosed publicly, a company cannot rely on a competitive harm position to withhold the information.

Why do companies resist disclosing targets?

One reason that companies resist disclosing financial targets is a concern that the information could be viewed constituting (or conflicting with) earnings advice to investors. As a precaution, it has become increasingly common to see a disclaimer in the CD&A along the lines of the following: ''Financial target levels set for our executive compensation program are used for that limited purpose and should not be understood to be statements of management's expectations of our future results or other guidance. Investors should not apply these targets in any other context.''

For companies that remain resolute against disclosing financial targets, some have moved to a purely subjective measure for determining annual bonuses and, to a lesser extent, long-term incentives. While this method is arguably less effective at driving specific behaviors to enhance achievement of the company's business objectives, it works best in an environment in which executives already are well attuned to the company's business strategy and have a strong sense of what to do to achieve positive results.

Another concern relates to the disclosure of specific goals for individual officers' performance, which tend to be qualitative and subjective. While the SEC Staff has indicated that there is no need to show quantitative targets for what are inherently subjective or qualitative assessments—for example, how effectively the CEO demonstrated leadership—the fact remains that *quantitative* individual goals are subject to the same disclosures rules as quantitative financial or operational goals. This may steer companies away from setting quantitative individual goals.

What if targets are not disclosed?

In those cases that disclosure of targets is omitted on the basis of competitive harm, the CD&A must discuss the significance of the undisclosed target, so that an investor could understand, for example, the relative degree of difficulty in achieving the target. This is much more difficult than it would seem. The SEC Staff is looking for something more than a simple statement that the plan uses ''stretch'' goals. Some of the better proxy statement ''degree of difficulty'' descriptions include such information as how the current incentive plan goals relate to the company's operating plan targets, how the current targets relate to historical performance, how often the threshold, target, and maximum performance levels for similar performance goals have been attained in the past, and how the targets can be affected by individual performance.

[7] See Compliance & Disclosure Interpretations for Regulation S-K, available at http://sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.

Finally, even though the ''degree of difficulty'' disclosure is required only when the actual targets are not disclosed, a growing best practice is to provide that type of analysis in every event, in order to put the disclosed targets into context.

It is widely anticipated that by the 2011 proxy season, all companies will be required to submit their executive compensation to a nonbinding shareholder vote—often referred to as ''say-on-pay'' resolutions. It will be more important than ever to draft the CD&A with the view that it is the primary ''prospectus'' for soliciting shareholder approval of the company's compensation philosophy and implementation. Companies will be wise to use the CD&A to their advantage by being forthcoming about incentive plan targets so that investors can readily track the correlation between executive pay and company performance.

Preserving the Company's Tax Deduction Where Possible and Advisable.

Section 162(m) of the Internal Revenue Code imposes a limit of $1 million on the amount of compensation that a public company may deduct in any one calendar year with respect to compensation paid to its top five executive officers, other than the chief financial officer.[8] However, compensation that meets the regulatory definition of (and strict requirements for) ''performance-based compensation'' is not subject to the $1 million deduction limit. The most typical form of ''performance-based'' compensation is a time-vesting stock option (or stock appreciation right) having an exercise price of not less than the fair market value of the underlying stock as of the date of grant. Other types of equity-based or cash incentive awards may qualify as performance-based if the award meets certain strict criteria.

Design Approaches to Section 162(m) Plans.

There are numerous ways to formulate the business criteria, performance goals, and payout metrics when drafting an incentive plan that is exempt from Section 162(m).

■ Under the plan design of a typical incentive program, the compensation committee, within 90 days after the beginning of the performance period, does two things:

1. Establishes a *target* payout for each participant (the committee may also set a *threshold* and *maximum* payout level); and
2. Establishes *objectively-determinable* performance goals based on one or more of the *shareholder-approved* business criteria, the achievement of which will determine the level of the payout actually earned, based on a performance matrix established by the committee.

■ After the end of the performance period, the committee certifies whether and to what extent the objective performance goals were achieved and calculates the resulting payout from the performance matrix.

[8] Due to a change in the SEC compensation disclosure rules in 2006, the chief financial officer (CFO) ceased to be covered by the I.R.C. § 162(m) $1 million deduction limit. This interpretation was affirmed by the IRS in Revenue Ruling 2007-49. It is likely that this inadvertent loophole will be closed in the future and the CFO will re-emerge as a covered employee for purposes of Section 162(m).

■ The performance goals must be entirely objective and the committee may not exercise discretion to *increase* the amount of the award that would otherwise be payable based on the rote application of the objective formula.

■ The committee may exercise ''negative discretion'' to pay less than the payout amount dictated by the performance matrix, but it cannot pay more than the formula amount.

■ The committee cannot exercise discretion to change the performance goals after the first 90 days of the performance period or to change the application of the stated goals in determining the incentive payments. This nondiscretion requirement can be harsh when unforeseen events occurring during the performance period have a substantial effect on the financial results and make the application of the performance goals unfair unless an adjustment is made. In order to avoid the need to exercise impermissible discretion, the performance goals can provide for mandatory *pre-established* adjustments that are designed to take into account specified, unusual, or nonrecurring events. The following is a typical list of ''shall make'' adjustment items:

— ''extraordinary items'' as defined in GAAP;
— cumulative results of accounting changes;
— income from discontinued operations;
— impact of natural disasters, such as floods, hurricanes, and earthquakes;
— narrowly defined ''triggering events.''

■ If the committee makes any adjustment to the bonus plan formula after the initial 90-day period other than any pre-specified mandatory adjustments, the payout will not qualify for the performance-based exemption. In that case, the full amount would count towards the covered officer's $1 million deduction limit for the year of payment.

— For example, assume the CEO had 2010 total compensation of $1,750,000, consisting of $750,000 in salary, a $900,000 bonus, and $100,000 of time-based restricted stock awards vesting in 2010. The Company would be able to deduct $1 million and would lose a corporate income tax deduction on $750,000. Assuming a corporate tax rate of 40 percent, the ''tax cost'' to the Company would be $300,000.

— Alternatively, if the bonus had qualified for the Section 162(m) performance-based compensation exemption, the Company could deduct the full $1,750,000, because the only nonexempt amounts (salary and restricted stock vesting) would have been less than $1 million.

Many companies use a ''plan within a plan'' design for annual bonus plans as a means of complying with the Section 162(m) performance-based exemption while allowing the compensation committee a degree of flexibility to make adjustments at the end of the period to account for unforeseen developments, individual performance or other subjective factors. Under this plan design, achievement under the ''outer plan'' performance goal is used to establish an artificially high default bonus amount for each participant, or perhaps a maximum bonus pool from which all participant bonuses (or all executive officer bonuses) are paid. The ''inner plan'' goals are used to inform the committee's exercise of negative discretion to determine a bonus payout that is less than the maximum payout established under the ''outer plan.''

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■ For example, if the selected business criterion for the outer plan is EBITDA,[9] the performance goal might be having *positive* EBITDA, in which case a maximum bonus will be payable to each participant, subject to the committee's discretion to use negative discretion to pay a lesser amount. That satisfies the objectively determinable performance goal requirement of Section 162(m). At the beginning of the performance period, the compensation committee also establishes the ''inner plan'' consisting of separate performance goals for determining how the bonus will be paid below that stated maximum. In other words, achievement against the inner plan goals is considered as guide to the compensation committee in the exercise of its negative discretion with respect to the outer plan payout. The committee has flexibility to make adjustments to the pay matrix resulting from the inner plan goals as long as the final bonus amount is less than the maximum payout under the outer plan. In this way, the general bonus framework is based on defined performance goals, which are generally (but not slavishly) objective in application.

Code Section 162(m), while seemingly simple in concept, is full of nuances and easy to misunderstand and misapply. It is important to keep in mind that it is not illegal to have a plan that does not meet the strict requirements for the performance-based exemption. Compliance is simply a matter of how much tax deduction the company is permitted to take in a given year. Many companies and their advisers feel that Section 162(m) is a tax regulation that has outlived its intended purpose, is easy to circumvent, and simply serves to make compensation plans unnecessarily contrived and difficult to understand. Because of this, most companies state in their proxy statements that, while the compensation committee considers the deduction limitation in designing compensation plans and overseeing awards under those plans, it also considers many other factors and retains the discretion to pay nondeductible amounts in order to recognize and motivate executive officers as circumstances warrant.

[9] Earnings Before Interest, Taxes, Depreciation and Amortization.