



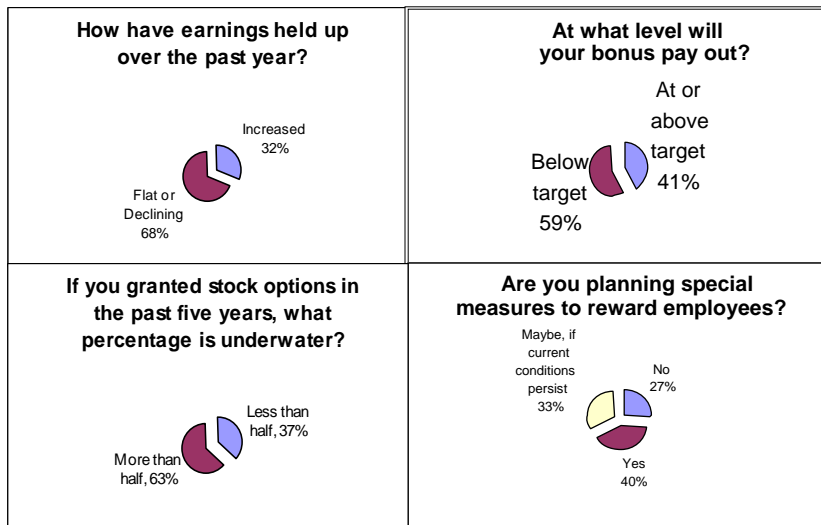
Compensation Advice for Boards of Directors and Executives during a Financial Crisis

Quarter 4, 2008

In the second half of 2008 the global stock market has been on a wild ride due to the banking industry crisis and worries about an economic slowdown. Who would have thought Lehman Brothers, Merrill Lynch and Bear Stearns would all disappear? These difficulties have strained the financial condition of many companies and a number of firms are reviewing salary increases, bonus payments and whether or not to exchange underwater stock options.

Survey results published by the Wall Street Journal on October 13, 2008, indicate companies expect earnings to be

weak, bonuses to be low, and most stock options granted in the past five years to be underwater.



How should companies react to these challenges? Companies must be careful when considering changes to their compensation plan. Quick changes to your compensation program, in response to rapidly changing economic conditions, can result in unintended

consequences such as windfall payouts, excessive turnover and negative accounting. And while it may be attractive to stick with the current compensation program and wait to see if the economy stabilizes, there are a number of compensation action items for you to consider that will balance market competitiveness, retention concerns and affordability.



Base Salary

Base salary represents the “fixed” cost of the compensation program. The fixed costs of your business remain the same, regardless of your level of sales. In a weakening economy it is important to keep your fixed costs as low as possible to offset flat or declining revenue. Base salary levels also impact benefit costs, such as retirement, which is often funded by employers on a percent of salary basis. How do you manage salaries in this economy and hold down salary costs? Here are a few possibilities to consider.

1. Set a budget for overall salary increases that is limited to the rate of the company’s increase in sales. If sales are flat or declining, there will be no salary increase because the economics of the business cannot support it. (Although this is not something that will be popular with employees, it should be communicated as a measure to retain jobs and address the financial realities of a slowing economy.)
2. Set a budget allowing for a modest salary increase, 2%-3%, but allocate 80% of the budget to the top 20% of the employees to retain key talent.
3. Set a modest budget and allocate an across the board increase, giving the same percent increase for everyone. Although the increase will be small, everyone will be treated the same and this will help morale. Suspend using the tradition salary increase matrix that is based on a combination of performance rating and position within the salary grade range; because of the limited salary increase budget, it will be difficult to provide a meaningful differentiation between strong and weak performers.



Annual Incentives

Clearly, there has been an increase in pay-for-performance in the United States and the world. A recent WorldatWork survey shows variable pay has grown in prevalence since the early 1990s, with 80 percent of responding companies currently offering at least one type of broad-based variable pay plan, compared with 51 percent in 1991. As base pay increases remain stable for 2008, more companies are relying on variable pay - performance-related awards that must be re-earned each year - to attract, motivate and retain employees. The problem is when incentives become an entitlement.

Variable pay must be a win-win as employers manage their costs and reward employees, and, at the same time, motivate and drive business results. Employees like variable pay programs that have a clear line of sight between their job activities and the bonus and feel like they have more control than they do in earning base salary increases. The key to a successful variable pay program is to create meaningful goals and to effectively communicate the program to employees. Employees should also make sure they understand their manager's expectations, get as specific as possible about measuring results, and ask for performance updates throughout the year. One of the underlying premises to justify annual incentive plans is that these plans allow compensation costs to vary with the performance of the company. If performance is good, you get a bonus-if not, you don't. The corollary of incentive pay is that the company can keep more people in lean times given total compensation costs will vary relative to the performance of the business. If this is your policy-tell your employees and follow it. Reduce incentives, in relation to business performance, and lay-off fewer workers.



Here are three things to consider:

1. Make sure total company payouts vary with total company performance, even though some incentive pay may be tied to individual performance goals.
2. Communicate that the incentive program is not an entitlement and that past payouts or participation does not guarantee anything. Set goals based on the probability of attainment-threshold should be met 80% of the time, target 50%-60% and maximum 10%-20%.
3. Communicate to employees that compensation will vary with company performance and lower incentives will allow us to layoff fewer employees

Long-Term Incentives

The drop in stock prices has put many stock options underwater and shareholders are not in a mood to rescue highly paid executives. However, many companies are concerned about retaining their key talent, especially in service industries where people *are* the key assets. What would you do if only a third of your compensation was guaranteed, with the rest depending on the company's stock price while the stock price drops 50% due to a recession or financial crisis? Would you listen to offers from companies with bargain basement stock options? Companies need to consider the following related to their long-term incentive programs:

1. Cash is king in a financial crisis and it may be necessary for the company to conserve cash to survive when bank loans or other funding sources are not available. Consider using restricted stock or stock options as a replacement for some cash compensation.



Black-Scholes Model for Granting Stock Option	
Current Salary	\$1,000,000
50th percentile of market for long-term incentive grant	\$783,526
Current Stock Price	\$20.00
Black-Scholes Value	\$6.00
Stock Options Needed	130,588
Modified Approach for Granting Stock Options	
Future Value of \$783,526 in 5 Years at 5%	\$1,000,000
Current Price	\$20.00
52 Week High	\$60.00
Difference	\$40.00
Number of Stock Options Required	25,000

2. Forget using the Black-Scholes model to determine the size of stock option awards. When the stock price is low, the model will require the company to use an extraordinary amount of stock to reach the 50th percentile of the market. Instead use a modified approach by starting with the amount of value to be delivered in the future—say 5 years—with historical growth projections. If the stock price recovers close to its 52 week

trading high in the next five years, significant value will be delivered.

3. Determine if an underwater option exchange makes sense and review the possible accounting implications.

To determine the number of replacement options we calculate the Black-Scholes value of the underwater options and determine how many new

options or restricted shares equal the value of the underwater options. The replacement option calculation is an accounting-driven application focused on the goal of cost neutrality. No additional charges to a company's earnings will be incurred as long as the

Replacing Underwater Options		
	<i>Underwater</i>	<i>Replacement</i>
Price Today	\$100.00	\$100.00
Exercise Price	\$300.00	\$100.00
Volatility	30.0%	30.0%
Risk-free-Rate of Return	3.0%	3.0%
Typical Holding Period	5	5
Dividend yield	1.0%	1.0%
Black-Scholes Value	\$3.0362	\$28.5784
Number of options outstanding	5,000,000	
Total value	\$15,181,017	
Replacement options		531,207
Replacement ratio	1 to	9.413
If replace options with restricted stock		151,810



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fair value of the new award is no greater than the fair value of the surrendered underwater options. The exchange typically allows companies to significantly reduce their overhang levels.

Industries that rely heavily on stock and bonus compensation -- such as technology and financial services -- have been hit hard by today's current economic downturn. If executives in these industries feel they can not get some relief from their underwater stock options, corporations may find that executives will be more inclined to move to an organization that offers them options at today's bargain- basement prices.

In today's economic environment, companies must be flexible and consider exceptions to the compensation program to keep key employees. In many organizations 20% of the employees deliver 80% of the value-if you lose these people your business may not recover. This could call for replacing underwater stock options, or a special cash bonus. Of course, some experts say that in today's economy, workers are less likely to jump ship. This is the time when board compensation committees must determine the best pay strategy to preserve key talent. Some solutions for companies in this position include reviewing the organization's development plan to identify key talent , redesigning compensation programs to meet specific issues and effective communication so that employees understand the reasons behind compensation changes that are likely to be unpopular. Strong and trusted leadership goes a long way in assuring employees that their best interests are being balanced with the financial challenges confronting most businesses at this time, for the worst job change is no job at all.

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