Center On Executive Compensation

The Basics of Executive Pay Packages

Executive compensation differs substantially from typical pay packages for hourly paid workers, professional and management salaried employees in that executive pay is primarily designed to reward for company results and stock price appreciation. Executive compensation is intended to align pay with the company's short and long-term performance. If a company underperforms, the executives typically receive a smaller fraction of their potential pay. Conversely, if a company meets or exceeds its objectives and the stock price responds long term, the executives stand to receive at or above their targeted payout.

Executive pay is also uniquely different than non-executive pay because of the various stakeholders that have an interest and may influence the pay programs. While this summary is not intended to go into depth into the motivations of stakeholder groups, it is important to know that investors, proxy advisory firms, government / regulatory agencies, the media and employees all play a role in the board's determination of executive pay.

The pay packages given to the senior executives of corporations typically consist of six components:

- Base salary
- Performance-based annual incentive (bonus)
- Performance-based long-term incentive (cash or equity)
- Benefits
- Executive perquisites
- Contingent payments (such as severance and change-in-control arrangements)

Executive pay is structured to reward company performance and align executive pay with shareholder value. As a result, unlike for most other employees, the majority of executive pay is at risk; in other words, executives may never receive it. However, if executives and the company perform well, executives along with the company's shareholders stand to gain much more from superior performance.

Base Pay

The base salary for executive pay is normally stated as an annual salary, although it is typically paid monthly or bi-weekly, similar to other salaried staff. Base salary is typically the smallest fraction of an executive's total compensation package as "at-risk" incentive pay is a significant portion of the overall compensation potential.

Performance-based annual incentive (bonus)

The purpose of the annual incentive is to compensate executives for achieving the company's short-term business strategy. Thus, it is based on achieving specific goals determined by the company's Board of Directors and/or Compensation Committee. The nature of these goals varies depending on the business, company strategy and other conditions.

Annual objectives can include such items as:

- increasing revenue or market share
- improving profit margins
- implementing a new corporate strategy
- development of new products
- expanding to a new market or completion of a critical project
- increasingly, ESG and DEI objectives

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Typically, the annual incentive is paid in cash and is expressed as a percentage of the executive's annual salary. Annual incentives generally comprise a three-tier structure: a threshold, which is the minimum performance level for which a payout can be earned, "target" level, which is the executive's normal expected performance, and a "stretch" component, meaning that the company would have to obtain extraordinary results for the maximum incentive to be paid. This is done to encourage executives to achieve superior results.

Section 162(m)

While the compensation paid to employees is generally deductible by the company, beginning in 1993, federal tax law has limited to $1 million the amount of cash compensation that companies can deduct as an expense for tax calculations. Under the 1993 law there was an exception to the $1 million cap on deductibility for certain compensation that is "performance-based" as designated by the statute. The performance-based exception was repealed under the 2017 Tax Cuts and Jobs Act and now corporate tax deductions for the CEO, CFO and the three other highest paid executives, known as Named Executive Officers (NEOs), are capped at $1 million regardless of whether compensation is performance-based, with transition rules for binding contracts in effect on or before November 2, 2017. The 2017 changes also provide that once an executive is covered under the provisions of Section 162(m), he or she will be subject to the $1 million cap for all payments received for the remainder of tenure with the company; this even applies to payments made after termination or retirement.

Long-term incentive (cash or equity)

By far the largest potential component of executive pay is the long-term incentive. The purpose of long-term incentives is to reward executives for achievement of the company's financial and strategic objectives that will maximize shareholder value. Long-term incentives are typically granted in the form of equity-based compensation, the value of which is based on stock price performance.

Common forms of equity incentives include:

- Restricted stock: Grants of stock that have restrictions such as vesting periods or other performance requirements before they are owned by the recipient.
- Stock options: Give the holder the right to purchase a fixed number of shares of company stock at a set price for a set period of time. Options are generally exercisable for a period of 10 years after an initial vesting period of three to five years. The price at which the options may be "exercised" is usually the price of the company's stock on the date the options are granted. If the company performs well, the stock price will increase over the exercise price, giving the options value and rewarding the executive for his or her role in the company's success.
- Stock Appreciation Rights (SAR): A type of equity-related compensation in which the recipient receives pay that represents the increase in the company's stock price over a specified period of time. Like stock options, SARs have a strike price, a vesting period and carry a certain term. For example, if a 500-unit SAR is granted when the stock price is $30, and after a 3-year vesting period, the price has risen to $50, the SAR would pay the $20 increase times the number of units or a total of $10,000. The payment could be made in cash or stock.

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- Performance-vested stock, options, or similar devices: Awarded for the achievement of performance over a set performance period. The performance period for a long-term incentive typically runs between three and five years, with the executive not receiving any pay from the incentive until the end of the performance period. Long-term incentive goals vary by company but the most prevalent are focused on relative total return to shareholders, earnings per share and other return measures, such as return on assets. Like annual incentives, long-term incentives typically have a minimum threshold, target and stretch component to encourage executives to achieve superior performance. Typically, the maximum awarded under a long-term incentive plan is 200% of target.
- Long-Term Incentive Cash Unit Plans: Non-equity based long-term grants that pay out in cash. The grantee will receive a payout after the vesting period and/or achievement of performance over a specified period of time. Sometimes used by public companies, but more common at private companies where share valuation is difficult.

Key terms related to equity compensation:

- Exercise (or Strike) Price: The price at which an option allows the holder to purchase a share of stock. The strike price is normally the market price on the date that the option is granted. Premium priced options set a strike price above the market price on the grant date.
- Vesting Requirement: The amount of time or the level of performance required before an individual has an unconditional right to exercise a stock option or SAR or sell restricted stock. Vesting can be "time based", such as three years, or "performance-based" in which some other objective must be met before the benefit is vested. Time vesting can be "graded" such as having 25% of granted stock options vest per year for 4 years or 'cliff' vesting when 100% is vested after a period of time.

Benefits

Benefit programs run the normal range familiar to salaried employees. They include statutory benefits such as Social Security, Medicare, Workers' Compensation, and Unemployment Insurance. Executives also participate in other company benefits such as vacation, holidays, sick days, severance pay, life insurance, and medical insurance.

In addition to the benefits provided to other salaried employees, executives are often eligible to participate in special retirement plans. These plans, unlike those that apply to all employees such as a 401(k), are not protected by federal tax and pension rules (ERISA) Instead, the amounts in these plans are at risk, and if the company is unable to pay them, such as due to insolvency or bankruptcy, the executive is at risk to lose such benefits.

These special plans include the following:

- Nonqualified deferred compensation plans which allow executives to voluntarily defer salary and bonus amounts until a certain date, death or retirement (much like a non-tax-favored 401(k) plan).
- Supplemental Employee Retirement Plans (SERPs) which are meant to supplement traditional pension plans.

Many nonqualified deferred compensation plans and SERPs are "restoration plans" designed to allow executives to save the same percentage of income as other employees may save in tax-favored plans. Non-qualified plans are governed under Section 409A of the IRC code which sets forth strict rules around deferral elections, deferral periods and timing of payouts.

Executive perquisites

Executive perquisites or "perks" constitute additional compensation for senior executives which are not available to other salaried employees. These extra benefits are normally structured to recognize the value of the executive to the company, extraordinary demands on his or her time and other unique conditions. However, this has been an area of

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recent scrutiny by the SEC and perks are subject to specific executive compensation disclosure requirements under the SEC's proxy disclosure rules.

Common perks include: convenient parking, installation of home communications systems, executive health physicals, financial planning, and even the use of company airplanes for personal travel. Many companies recognize the unique positions of executives, especially CEOs, by providing security both at home and when traveling. Typically, executive perks constitute a modest component of executive pay.

Contingent Payments

Many executives are also covered by severance which provides for payments to executives in the case of involuntary termination (except for cause.) Severance payments are typically paid to executives when dismissed without cause or due to a substantial reduction in duties and may include salary continuation/cash, acceleration of unvested equity and continuation of health benefits.

Change-in-control agreements, also known as "golden parachutes," compensate executives for loss of job due to mergers or sale. They are structured to provide additional protection to executives in the event of a change-in-control, allowing executives to focus on sale or merger opportunities that are in the best interests of shareholders without being overly concerned regarding the potential impact on their career.

Section 280G

This section of the U.S. tax code imposes a 20% excise tax on parachute payments that exceed 2.99 times the average of the executive's W-2 reported income over the last 5 years. This was designed to limit the size of "golden parachute" payments made to executives in the event of a change-in-control of the company. A best practice is for companies to design a "double trigger" clause whereby in order for the executive to receive the change-in-control amount, there must be both a change-in-control and the executive must lose his or her job or have "good reason" (such as reduction in duties or pay) for voluntary termination.

For additional information on executive compensation and governance topics, please refer to the Center On Executive Compensation website.

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