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Executive Employment Agreements: Why, When, and What

Increasingly we are being asked for our views on whether a company should have employment agreements with one or more of its top executives and, if so, what practices we would suggest. Often the inquiry is prompted by a reconsideration of current arrangements. The focus on corporate governance in recent years is causing many companies and Compensation Committees to reexamine the rationale for, and terms and conditions of, executive contracts.

In determining whether and when to use contracts for executives, Hay Group believes that it is critical to examine an organization's specific facts and circumstances and to understand why employment agreements have been used or are under consideration. At many companies it is helpful to review the basic approaches for executive contracts and then consider the pros and cons of these agreements.

Approaches

The use of employment agreements for executives can vary considerably among companies, often depending on the organization's culture and the views and philosophy of the Board of Directors, the Compensation Committee and the Chief Executive Officer. We have observed four basic approaches:

- Some employers do not use contracts at all, instead relying on general policies or more limited agreements to address specific issues such as severance, change in control, confidentiality and non-competition.
- Other companies limit employment agreements to new hire situations, especially where a sought-after executive is reluctant to join a new and largely unfamiliar organization without the protections of a contract.
- Many organizations extend employment agreements to some or all of the top team of executives. Certain employers may have a contract with only their CEOs, while others enter into written agreements with a dozen or so executives. Hay Group's 2006 Executive Severance Policies Survey found that 82% of responding companies used employment contracts with their CEOs; this compares to 70% in our 2004 survey.

- A few companies use employment agreements to document their employment relationships with all executives above a certain level (e.g., vice president).

Rationale for Contracts

An executive contract sets out the key terms and conditions of the employment relationship. While contracts typically address salary, bonus compensation, long term incentives (often equity-based), benefits and perquisites, there is little need for a contract if the objective simply is to memorialize these items. We have found that the most important reasons for an employment agreement generally are to:

- specify and make clear what an executive will receive upon various events resulting in a termination of employment (e.g., death, disability, retirement, resignation, resignation for good reason, dismissal and dismissal for cause);
- address the impact of a change in control of the employer; and
- impose reasonable post-employment restrictions applicable to the executive (e.g., restrictive covenants addressing such matters as confidentiality and non-disclosure, non-competition, non-solicitation of employees and/or customers and non-disparagement).

If properly drafted, employment contracts can help secure the future services of key employees critical to the organization's success. These agreements establish the respective rights, duties, obligations and responsibilities of the parties at a harmonious time; from this perspective they have much in common with premarital agreements.

Arguments against Employment Agreements

While both the employer and the executive can be well-served by documenting the employment relationship through a contract, another view is that such agreements are either unnecessary or overly favor executives. Arguments sometimes advanced against executive employment agreements include:

“Pay for Failure” – The focus on executive compensation in recent years has highlighted instances where an executive dismissed for poor performance was entitled to large severance pay based on the terms of an employment agreement. This view maintains that any payments would have been more reasonable if no contract had been in place and the executive had to negotiate a severance package in connection with his or her termination.

“Performance Equals Security” – Others maintain that the protection provided by an employment contract is unnecessary for a top executive who is doing a good job and that an executive should not have this protection if he or she is not performing well. However, the increased turnover among CEOs and other senior executives in recent years (a shorter job “life expectancy”) causes many executives to believe contractual protection is necessary.

Employment contracts can help secure the future services of key employees critical to the organization's success.

Key Provisions and Usage

Severance and change in control protections generally are the most critical provisions for executives while employers seek the benefits of restrictive covenants. Both parties receive certainty (assuming the agreement is well-drafted) of the terms that will apply in identified circumstances (especially various termination events). From an employer's perspective, a contract may discourage a competitor from recruiting an executive in jurisdictions that provide for tort damages for interference with the relationship of an executive under contract. An agreement may enable an employer to determine what state law will apply where there are contacts in multiple jurisdictions and, if desired, mandate arbitration of disputes regarding employment matters.

Hay Group believes that the focus should be on improving the contents of executive agreements rather than reducing their usage. A consensus is developing regarding best practices which should be considered for employment agreements.

Hay Group has prepared a checklist that can be helpful when considering a new contract or evaluating a current contract.

Employment Agreement Checklist

- ❑ **1. “Evergreen” renewal.** Evergreens typically provide for automatic extension or renewal unless a specified advance notice is given. Procedures should be implemented to review these agreements before any such extension becomes effective. An employer’s advance notice not to extend the contract term or renew the agreement should not trigger severance pay.
- ❑ **2. Critical definitions.** The definitions of “change in control,” “cause” and “good reason” should be particularly scrutinized. In reaction to some widely publicized severance payments to executives who were dismissed or resigned after poor corporate performance, the current view is to expand cause definitions and to constrict good reason definitions.
- ❑ **3. Calculating “pay.”** Where any payments are based on pay, a determination is needed on what amounts should be included. According to the Hay Group 2006 Executive Severance Policies Survey, 57% of companies use base salary, 28% use salary plus bonus, and only 3% include salary, bonus and long-term incentives. Also annual bonus can be variously defined so the method of its calculation should be specified.
- ❑ **4. Potential cost of retirement benefits or enhancements.** Shareholder groups may object to provisions that provide “deemed service credit” to increase an executive’s retirement package (often coordinated with SERP benefits). While that approach may be needed to recruit a mid-career executive to make up for benefits foregone at a former employer, the cost should be calculated and understood and the rationale documented.
- ❑ **5. Severance pay.** Any severance payments should be conditioned on the executive’s agreement to reasonable restrictive covenants. Depending on what is permitted (and enforceable) under the laws of the relevant jurisdiction(s), covenants relating to non-competition, non-solicitation (of customers/clients and employees), non-disclosure of confidential information and non-disparagement of the employer may be considered.
- ❑ **6. Overall cost analysis.** The potential costs for all payments directly or indirectly impacted by an executive’s contract should be determined on a worst case (most costly) basis. These costs should be reviewed periodically to make sure the employer understands how changes in base salary, for instance, may affect these payments.
- ❑ **7. Vesting on a change in control.** Accelerated vesting would generally be appropriate where there is a non-cause dismissal of the executive following a change in control or where the executive would have no continuing equity interest in a merged entity. In other cases, it may be appropriate to continue the vesting or provide for discretion in the Board to accelerate vesting.
- ❑ **8. Trigger event.** Any change in control severance benefits should require a “double trigger” for payment rather than simply the change in control event (“single trigger”).
- ❑ **9. Section 409A.** The potential application of Internal Revenue Code section 409A (regarding nonqualified deferred compensation arrangements) should be considered when determining payment provisions. Since there are various exceptions and alternative approaches for compliance, section 409A can affect design and not merely legal language.
- ❑ **10. Responsibility for drafting.** The employer should have the contract drafted by its advisors, not by someone representing the executive’s interests. The drafting process should be within control of the Board. Also, a general counsel should not be put in the position of negotiating contract terms with an executive to whom he or she may have to report. ■

Addressing the Challenge of the New Executive Pay Disclosure Rules

Substantially enhanced executive and director compensation disclosure rules were adopted this August by the Securities and Exchange Commission (SEC). These far-reaching changes generally are effective for proxy statements filed for fiscal years ending on or after December 15, 2006.

The new rules require disclosure of all elements executive and director compensation through additional and expanded tables. Particular emphasis is placed on the last column of a revised Summary Compensation Table—it sums up the other columns to show a single “total compensation” figure for each covered individual. In addition, there is a focus on providing a narrative explanation of a company’s compensation policies and the actual decisions made regarding the individuals covered by the disclosure standards.

Compensation Discussion and Analysis

The most significant change from previous disclosure rules involves the Compensation Discussion and Analysis (CD&A) section that now must be included in annual proxy statements. Since the CD&A is a totally new approach for executive pay disclosure, companies need to understand the scope of what is required.

In its commentary on the CD&A, the SEC envisions the section as “overview providing narrative disclosure that puts into context the compensation disclosure provided elsewhere” for a company’s named executive officers. The expressed objective is to “explain material elements” of these executives’ compensation through six questions that must be addressed:

- What are the objectives of the company’s compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?

- How does the company determine the amount (and, where applicable, the formula) for each element?
- How do each element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements?

Objectives of CD&A. At many companies the Compensation Committee Reports in recent years became standardized and furnished little meaningful guidance on how executive pay actually was determined. Due to its dissatisfaction with such reports, the SEC decided to create the new CD&A section and develop a new form of Compensation Committee Report.

In requiring a CD&A, key SEC goals are to encourage much more thoughtful analysis by Compensation Committees in determining executive pay and to have these pay considerations thoroughly disclosed and explained. Many statements in the CD&A will need significant elaboration; it is not sufficient to state that “pay is based on performance” or that “compensation is targeted at the median of comparable organizations.” Rather, “how” these standards are applied should be described, along with relevant policies, factors and regulatory impact. The discussion then should address “why” various decisions were made, such as the incentive vehicles chosen.

Relation of CD&A to New Compensation Committee Report

Although the CD&A needs to discuss compensation policies and decisions, it does not address the Compensation Committee’s deliberations since it is not a report of the Compensation Committee; rather the CD&A is the company’s responsibility. However, increased responsibilities for disclosure also are placed on the Compensation Committee through an SEC rule that mandates a new form of Compensation Committee Report in which the Committee must state whether:

- It has reviewed and discussed the CD&A with management; and
- Based on such review and discussions, the Committee recommended to the Board of Directors that the CD&A be included in the company’s annual report and proxy.

The company’s principal executive officer and principal financial officer will be entitled to rely upon this Compensation Committee Report when they provide their annual report certifications (on Form 10-K) required by the Sarbanes-Oxley Act. The SEC clearly anticipates that these changes should result in increased attention to compensation design and the explanations of compensation policies and decisions.

Issues to address in the CD&A

The CD&A is “principles-based” (rather than rules-based) and the SEC believes it should provide perspective on the numbers and other executive pay information contained in required tables and elsewhere. In our work assisting companies with the CD&A process, a significant challenge at some organizations has been articulating the rationale underlying the components of the executive compensation package for each named executive officer. The SEC has provided non-exclusive examples of potentially appropriate issues that might reasonably be addressed in the CD&A; each should be considered in light of the organization’s particular facts and circumstances. The CD&A must be comprehensive in scope; a company should describe any compensation policies it applies, even if not covered in the SEC’s examples. The discussion also should address post-employment arrangements relating to compensation.

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Besides the breadth of the CD&A’s requirements, greater depth is called for than has been customary in Compensation Committee Reports. While a CD&A generally should avoid repetition of the exhaustive information presented in tables and other portions of the proxy, it should identify material differences in compensation policies and decisions applicable

to individual named executive officers. Considerable thought and effort is required to determine what should be discussed and then to prepare the appropriate explanation—which must be written in “plain English.”

Areas that may require particular attention

In expanding the scope of executive pay disclosure, the SEC implicitly furnishes its views on items that should be considered in executive compensation design.

- The SEC identifies the familiar concept of “benchmarking” as a subject for disclosure. Information will be needed on the benchmark for any material element of an executive’s compensation, including the component companies used for the benchmark. This requirement should increase the focus on having an appropriate peer group and choosing reasonable and appropriate benchmarks.
- The well-publicized concerns at scores of companies regarding the timing and pricing of stock options caused the SEC to specifically provide for extensive disclosure regarding the timing and pricing of option grants. Various elements and questions are identified by the SEC for disclosure; these should be considered in determining the appropriate use and design of stock options in a company’s executive pay program.
- Since the impact of the accounting and tax treatment of a particular form of compensation is one issue that the SEC views as potentially appropriate for discussion, an organization should consider the role played by various regulatory provisions (e.g., new income tax and accounting rules) in selecting the form and design of awards.

Also, as Compensation Committees consider executive pay programs in the future, they would be well-served by thinking about the SEC’s examples of potentially appropriate issues for a company to address in the CD&A.

Action Priority

The magnitude of the changes made by the new executive compensation disclosure standards make it advisable that any company commence the process without delay to be ready for the 2007 proxy filings. As parties understand the new rules, they should develop an appreciation of the significant effort that will be required to satisfy the enhanced disclosure standards. Companies need to assure that they have sufficient time and resources to fully vet all compensation issues that may require discussion and analysis. ■

data

2006 Survey of Executive Severance Policies

Earlier this year, Hay Group conducted a survey of severance policies applicable to senior executives. Our primary objective was to obtain current data on the prevalence of various executive severance practices among employers of all sizes and across a broad group of industries.

We last conducted a survey on executive severance policies two years ago. In the interim, executive compensation has received heightened scrutiny and we sought to identify any trends affecting these policies. We were particularly interested in the extent to which companies use contractual arrangements to implement executive severance policies that extend beyond broad-based severance programs. Similar to our 2004 Executive Severance Survey (“2004 survey”), we limited our study to severance programs in non-change in control situations to focus on severance during the normal course of business.

Use and Formalization of Severance Policies

Approximately 70% of the organizations participating in the 2006 survey reported an executive severance policy. Only one-quarter of this group formally define this policy, which is a significant decrease from our 2004 survey where we found that approximately one-half of the group had a formal policy.

Employment Agreements

The use of employment contracts to memorialize severance policies and related pay is fairly common across the survey group. The prevalence of employment contracts is largely a function of an executive’s position—ranging from 82% for chief executive officers (CEOs) to approximately 32% for vice presidents.

Determination of Severance Amounts

Organizations calculate severance benefits in various ways. We found the largest number (34%) of survey participants determines severance benefits based on a continuation of pay through a specified date. Another very common approach (32%) is to calculate severance benefits as a fixed multiple of “pay.”

- Unsurprisingly, CEOs had the greatest had the greatest variation in the multiple of pay, ranging from up to 1 year (31%) to 3 years (17%).
- For Executive/Senior Vice Presidents and Vice Presidents, a one year multiple was the overwhelming consensus for the survey group.

Most organizations base severance payments on some definition of “pay.” In the 2006 survey group, the most common definition of “pay” for severance purposes was base salary (57%); this compares to 63% in our 2004 survey. Another 28% of the respondents define “pay” as base salary and bonus; only 3% of companies define “pay” as base salary plus bonus plus long-term incentives, a practice which has been widely criticized.

The majority (47%) of survey participants pay severance benefits on a salary continuation basis. Lump sum payments were the next most prevalent method of payment (28%). We note that respondents likely still were revising these arrangements to comply with Section 409A of the Internal Revenue Code and that their ultimate decisions may result in a decline in the use of installment payments.

Restrictive Covenants

It is common for employers to include restrictive covenants in their executive severance policies. Examples of typical covenants include:

- **Non-competition:** No competition with current employer for a specified period of time following termination.
- **Non-solicitation:** No solicitation of employer's customers/clients and/or employees for a certain period of time
- **Confidentiality:** No disclosure of confidential company information.

Confidentiality, non-solicitation of employees and non-competition, in declining order, were the most prevalent covenants across the 2006 survey participants. Among companies using such covenants, the most common time periods were up to 1 year and 1 to 2 years.

Termination Triggers

Executive severance policies generally define triggering events that entitle an executive to payment. Events that typically authorize payment are a voluntary "good reason" resignation by an executive and a dismissal other than "for cause." However, good reason and cause can vary substantially in scope; "executive-friendly" definitions have broad good reason and narrow cause definitions.

The three most prevalent definitions of "Good Reason" among the 2006 survey participants were:

- Reduction in duty or title
- Relocation of office beyond a mutually agreed upon geographic area
- Reduction in compensation.

The three most prevalent definitions of "For Cause" among the 2006 survey participants were:

- Misconduct affecting the scope of employment (e.g., fraud)
- Non-performance (willful failure or refusal to perform duties)
- Conduct that has a material adverse effect on employer.

Welfare Benefits

Among the survey participants, health insurance is the most likely welfare benefit to be maintained post-termination. Other benefits that often are continued are life insurance and long-term disability ("LTD").

This year's responses indicate that the most prevalent practice is to continue providing health insurance benefits for a period of less than a year after termination. These benefits are in addition to any continuation rights that an executive may have under COBRA to pay for his or her coverage for a statutorily-mandated period. The most prevalent continuation practice for life insurance and LTD is to provide benefits through the contract term.

The majority (47%) of survey participants pay severance benefits on a salary continuation basis.

Approximately 65% of the survey participants include outplacement services in their executive severance policies. Of this group, the majority defines the outplacement benefit via a fixed period of time, with the remaining participants using a fixed dollar amount to measure the maximum benefit.

Consistent with the 2004 survey, almost half (44%) of the 2006 survey participants use "clawbacks" to enforce their covenants. (A clawback provision requires an executive to return or otherwise forfeit previously paid compensation if he or she violates an existing covenant.) The prevalence of long-term incentives subject to clawbacks rose to 32%, a substantial increase from 12% in our 2004 survey.

Recap

Severance policies and contracts are tools that many organizations use to help define the relationship with their top executives. These arrangements can represent significant obligations and should be reviewed and updated for all executives periodically. In the changing executive compensation landscape, companies cannot afford to overlook these potential liabilities. The increased focus on executive compensation has caused many companies to scrutinize their executive severance policies and, as a result, many previously accepted practices are being questioned. ■

If your organization is interested in participating in future executive pay surveys, contact us at exceedition@haygroup.com.

trends and hot topics

Increasing Accountability for Executive Compensation within Not-for-Profit Organizations

Governmental and public scrutiny of for-profit executive compensation programs have been increasing steadily over the past decade. However, not-for-profit organizations are arguably subject to even higher standards of conduct. These more rigorous standards, combined with a difficult regulatory environment, place enormous pressure on Boards and management in designing competitive executive pay programs to attract and retain senior talent.

The Changing Landscape for Executive Compensation

A significant change in the governance landscape for all organizations occurred when the Sarbanes-Oxley Act (SOX) was enacted in 2002. SOX requires that a company have comprehensive procedures and standards for reviewing and assessing the effectiveness of its internal controls over financial reporting and operations.

While tax-exempt and other not-for-profit organizations are not subject to most provisions of SOX, they too have felt the legislation's impact. The Internal Revenue Service (IRS), for example, has increased its reporting oversight by overhauling Form 1023 for organizations seeking to gain 501(c)(3) tax-exempt status; changes to the return for tax-exempt organizations (Form 990) are on the horizon. The General Accountability Office (GAO) has increased the call for greater auditor independence within not-for-profit healthcare organizations that receive federal research funding.

Of increasing importance, many not-for-profit Board members come from the for-profit world, and are dealing with SOX in their other affiliations. We expect that not-for-profit organizations increasingly will find that the mandates being imposed on public companies are likely to become best practices for the not-for-profit organizations as well.

Intermediate Sanctions and the Taxpayer Bill of Rights 2 (TBOR2)

Particularly relevant to tax-exempt organizations are the "intermediate sanctions" established by the Taxpayer Bill of Rights 2 (TBOR2) as section 4958 of the Internal Revenue Code. Failure to comply with these provisions can result in substantial financial penalties on both executives and Board members of 501(c)(3) and 501(c)(4) organizations where compensation levels are determined to be unreasonable. The term "intermediate sanctions" refers to the Congressional purpose of avoiding the "all or nothing" choice that the IRS previously faced—either revoke the organization's tax exemption or overlook the problem. Although the intermediate sanctions were

enacted in 1996 legislation, it was not until the tax regulations were finalized in early 2002 that active enforcement began.

To avoid concerns with intermediate sanctions, tax-exempt organizations must be able to demonstrate that a covered executive's total executive compensation is reasonable.

To avoid concerns with intermediate sanctions, tax-exempt organizations must be able to demonstrate that a covered executive's total executive compensation is reasonable. In satisfying this standard, relevant considerations include Board oversight of the executive compensation process, comparability analyses and appropriate documentation. The provisions require that all reward elements be considered, including base compensation, incentive programs, and employee benefits. This means that issues relating to pay—the actual pay levels, the performance leverage, the decision-making processes in setting them, and the decision-makers involved—are open to scrutiny.

The basic issue is the reasonableness of the compensation package of each “disqualified person”—a person in a position to exert substantial influence over the affairs of a tax-exempt organization at any time during a five-year period. Top executive officers and Board members generally are disqualified persons. The value of all consideration and benefits received by a disqualified person is examined in determining whether there has been an “excess benefit transaction.” Both the individual receiving unreasonable compensation and the Board members who authorized payment of unreasonable compensation may be subject to tax sanctions under section 4958.

In demonstrating that compensation is reasonable, an organization can seek to establish a “rebuttable presumption” of reasonableness. When the conditions for this presumption are met, the burden of proof shifts to the IRS to prove that compensation is unreasonable. Otherwise the organization

and its affected executives need to show the aggregate compensation was reasonable so that there was no excess benefits transaction.

Processes to Demonstrate Reasonableness

To demonstrate the reasonableness of pay to disqualified persons, the Internal Revenue Service (IRS) has indicated that it would be helpful for the Board of Directors to undertake a process that involves the following steps:

- 1) **Referencing compensation comparability data for the positions in question and using this data to approve compensation levels.** This data may be obtained through compensation surveys, an examination of compensation of similar individuals in similar organizations, and/or an expert compensation study.
- 2) **Documenting the compensation decisions, including:**
 - The specific terms and conditions of the approved transaction and the date approved;
 - The members of the decision-making body who were present during debate on the transaction that was approved and their votes;
 - The comparability data that was relied on by the decision-making body and how the data was obtained; and
 - Any actions by a member of the decision-making body having a conflict of interest, as well as an articulation of any perceived conflict.
- 3) **Preparing the documentation before the later of the next meeting, or 60 days after the final actions of the decision-making body.**

How Boards Can Respond

In addition to the IRS guidance, Hay Group believes that a good governance process for executive compensation involves certain actions by a not-for-profit Board:

- 1) **Take a total remuneration approach to pricing executive positions.** Remember that the IRS looks at the value of all

cash, benefits and other consideration received in determining reasonableness of compensation. Therefore, simply evaluating the competitiveness of cash programs technically will not satisfy the tax standards. Many organizations have addressed this by evaluating the competitiveness of cash programs and the competitiveness of the design of their benefits programs. However, in order to be fully compliant, organizations should undertake a study that examines the cash value of the aggregate of all programs relative to the market.

2) Develop and rationalize a compensation philosophy.

A critical component of a good governance process involves articulating and then following the organization's compensation philosophy. In our experience, a good compensation philosophy incorporates multi-stakeholder agreement on:

- Alignment between the organization's mission, values, strategic objectives, and the view of compensation as a driver of performance;
- Components of pay delivered, including the purpose and design of each;
- Competitive and geographic market for talent, including organizations (which may include for-profit, evenly publicly-held, organizations) with which the employer competes for talent; and
- Desired pay positioning with the competitive market for talent and the rationale of that positioning.

A formal compensation philosophy can furnish critical guidance for the Board, the Compensation Committee and executive leadership in making consistent pay decisions, and is a key document for the IRS to review in an audit.

3) **Have the Board drive the executive compensation decision making process.** The days of not-for-profit Boards being able to "rubber stamp" pay decisions are over. The IRS expects more of today's Boards and, in appropriate instances, will hold Board members accountable for unreasonable compensation. To evaluate the

degree to which the Board is driving these decisions, the IRS can access the Board's documentation to understand the processes in place, including compensation committee and Board minutes, documentation of decision making, rationale for the market positioning of specific executives, and the Board's compensation philosophy.

4) **Engage a third party to assess reasonableness.** An independent third party that is qualified to assess compensation can help demonstrate the reasonableness of compensation. If such a third party conducts an analysis of total remuneration levels and finds that compensation levels are within a reasonable range, its opinion letter can create the rebuttable presumption of reasonableness and shift the burden onto the IRS to overcome this showing.

In today's environment where the press, the general public and shareholders all vie in railing against perceived excesses in executive pay, it is crucial that not-for-profit organizations and their Boards understand and implement practices that will result in sound and reasonable compensation programs and avoid concerns regarding excessive payments. ■

worldwide

Board Pay Packages in Germany: Expected Impact of Changes in Legal Standards

Legal Background

The German Corporate Governance Code (GCGC), first introduced in 2002, strives for transparency and standards in

the compensation of individual members of the Management Board at corporations with listed stock. It provides guidance for a balanced system of variable compensation and performance management instruments.

Complying with the GCGC helps to ensure that good performance is rewarded adequately and provides transparency to the system. But the implications have been unclear for the last few years since the codex represents best practice and is not legally binding (“comply-or-explain”). However, the legal foundation has been created with this law (VorstOG) requiring the disclosure of the total compensation of the Management Board.

The law calls for the disclosure and definition of individual remuneration of members of the Management Board at corporations with listed stock, including various benefits as well as severance awards if they differ significantly from the awards granted to employees. The adoption of the VorstOG was required for the first time for the Annual and the Consolidated Financial Statements for the Financial Year beginning after Dec. 31, 2005.

According to the GCGC, the Supervisory Board discusses and regularly reviews the structure of the Management Board compensation system. The basis for the compensation is a performance assessment of the members of the Management Board.

The total remuneration of members of the Management Board includes base pay plus annual variable pay (short term incentives) and long term incentives, as well as benefits such as pensions (which can get very expensive) and perquisites (e.g., company cars). These components of total remuneration are associated with different roles within the company and differ among those roles. The short term incentives have to be connected very closely to business performance in general as well as to the performance of the individual Board member. The value of long term incentives (including company stock) must be limited by a cap that cannot be exceeded; the objective is to limit the maximum gain. However, no details are provided that define this cap.

The German Two Tier Board System in Stock Corporations

The Stock Corporation Act requires German stock corporations to have both a Supervisory Board (Aufsichtsrat) and a Management Board (Vorstand). These boards are separate; no individual may be a member of both. Both the members of the Management Board and the members of the Supervisory Board must exercise the standard of care of a diligent business person to the company.

The Management Board is responsible for managing the company and representing the company in its dealings with third parties. The Management Board also is required to ensure appropriate risk management within the corporation and to establish an internal monitoring system.

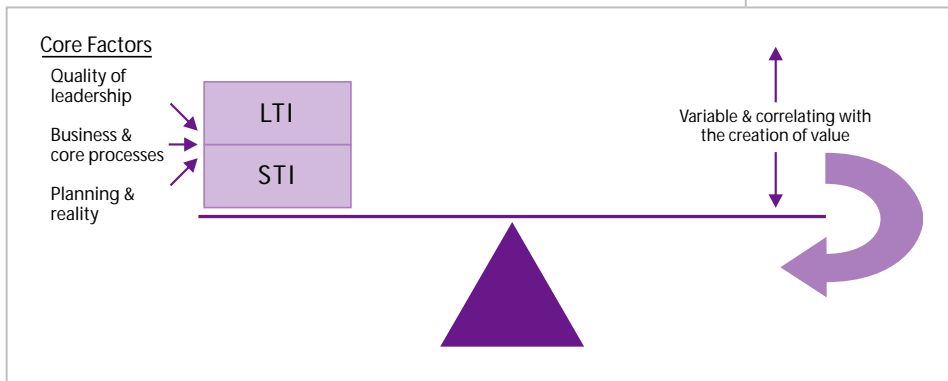
The Supervisory Board appoints and dismisses the members of the Management Board. It also may appoint a chairperson of the Management Board. Although it is not permitted to make management decisions, the Supervisory Board has comprehensive monitoring functions.

Expected Impact

The disclosure of the total compensation of members of the Management Board has two major effects. First, the data prepared for the financial statements allows for external and international comparisons. The compensation packages in the company can be examined in light of the level and composition of the compensation of Management Board members at other companies in the same industry in the same or different countries. On the one hand, this can be an instrument for the company itself to measure the competitiveness of its own performance management system. It also provides a market observation tool for external interested parties to assess the performance orientation.

Second, the disclosure also provides internal comparability. It delivers a summary of the composition and the level of total remuneration for the Management Board and its development over time. These internal comparisons can be used for an examination of amplitudes in the key performance indicators (KPIs) over the years within the same company and for considering whether these amplitudes correlate with the total compensation of members of the Management Board. The correlation between the KPIs and compensation can indicate the quality of the performance management—including the quality of planning processes, of business and core processes, and of leadership in the whole company. A balance between KPIs and total compensation can be the basis for an effective performance management system.

The quality of managing the core factors has a strong impact on the indirect costs of variable pay:



Consequences

The large proportion of variable pay in the compensation of the members of the Management Board results in a focus on the company's performance management. The performance management measures have to be brought into alignment with the business strategy and the general character of the company. Only measures that support the value-added process will have the implications necessary for successful business activities. This mutual process of closely connecting KPIs and compensation also has implications for the interaction and co-determination within companies in Germany. The culture of consensus is forced to shift towards a more rigorous way of decision making, of holding people accountable for delivering results and for the achievement of objectives. Fast and sometimes unpopular decisions might be necessary to react adequately and in a way that best supports the business. The culture of consensus will more and more shift towards a culture of dialogue.

The disclosure of the total compensation of the Management Board holds many uncertainties concerning the future implications on how business is done in Germany; these will become apparent as time goes by. Especially in the context of the dual board structure of stock-listed corporations in Germany, the disclosure

will not only change the public knowledge in terms of executive compensation, but also is expected to impact the pay and the performance management of the next reporting levels. ■

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