BONUS PAYOUT DEBATE: FORMULA VS DISCRETION!

By Brent Longnecker, Chris Crawford and Ian Keas

Nearly every employee, shareholder, board member and newspaper reader seems to have his or her own opinion regarding formulas and discretion in determining executive incentive payouts. Over the past several years, the amount of attention and heat on this topic has escalated as the Securities and Exchange Commission (SEC), proxy advisors like Institutional Shareholder Services (ISS) and Glass Lewis, shareholder activists, and activist law firms continually push for more transparency, more linkage to pay and performance, and more formulas in company incentive programs. Conversely, shareholders have elected compensation committees and boards to determine fair and reasonable compensation in light of many factors, including but not limited to market competitive costs, complexity and size of the organization, tenure of the executive, and yes performance. These board members, better than anyone, know the industry and company, as well as what it takes to attract, retain, motivate and reward key executives appropriately. As a result, there is an escalating power struggle between company boards and institutional advisors over the fairness and reasonableness of incentive compensation payouts.

Many companies are being encouraged to establish purely formulaic incentive plans at the beginning of the year. Proponents of formulaic bonuses indicate they can accomplish the following:

- Reduce the amount of gaming perceived to occur by boards and management
- Provide transparency on the company's goals and objectives
- Reinforce decision making that should be in shareholders' best interests
- Create connections between employees, executives, board members and shareholders where interests are aligned
- Directly link actual pay with actual performance of the company

These tenets of formulaic incentives are reasonable. However, the last one is the crux of the matter. Said another way by a respected compensation committee chair, "I know better at the end of the year how our company did than an excel spreadsheet would predict at the beginning of the year." Predictive modeling has always been tricky business, but when you consider the volatility of the 21st century economy, it's downright near impossible.

The coming 2016 proxy statements filed by oil and gas companies will be "exhibit A" for this ongoing debate. Oil and gas prices didn't look great in the third and fourth quarter of 2014, plummeting from $112/barrel earlier in the year to $60/barrel at the end of the year. However, very few saw the perfect storm of economic events that drove prices below $30/barrel and have seriously plagued the industry in 2015 and so far this year. The result? Many exploration and production companies with 2015 formulaic bonuses pushed by ISS, institutions and activist investors have produced above target payouts while stock prices dropped in half or more. Compensation committees across the U.S. have wrestled with what we should do. Is it best to let the formula payout retain credibility in the plan or make a discretionary call to recognize an imperfect formula at the beginning of the year? Every compensation committee seems to have weighed their own set of facts and circumstances to derive their own conclusions. While there doesn't seem to be a perfect answer for this difficult dilemma, those companies that stuck to the formula may likely face more serious criticism and "votes against say on pay" by the very institutions that encouraged the formulaic incentive in the first place.

It's early in the proxy season, and this debate will certainly escalate in the coming months and years. However, we at L&A conclude with several guiding principles to good incentive plan design practices as it relates to formula versus discretion:

- The ability for a compensation committee and management to use both positive and negative discretion is an important element to factor into annual incentive payouts.
- The discretionary portion, or weighting as a part of the whole payout, should be established in the beginning. For example, if a CEO has a targeted payout of 100% of base salary, 20%-50% of the final payout may be tied to discretionary decision making. This allows the compensation committee and management to adjust for unforeseen events and resulting performance.
- The company may have key objectives it routinely assesses in discretionary decision making. In that case, these overarching objectives should be communicated to employees and shareholders.
- If the compensation committee or management utilizes discretion — whether positive or negative — that produces an incentive payout result different than the formula, the committee should crisply articulate the why behind the decision making for the benefit of employees and shareholders.
- The final incentive payout and total compensation provided to the executive team should pass the smell test. If company performance was great, incentive payouts should be great. If company performance was not great, incentive payouts should not be great.

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11011 Jones Road, Suite 200 | Houston, Texas 77070 | 281.378.1350 | **longnecker.com**