## § 6.02 Short-Term Incentive Compensation

### [1]—Methodology of Bonus Determination

In any short-term compensation program (e.g., a program covering a performance period of approximately one year or less) the critical question is the method of determining the amount payable to an individual employee. Short-term Cash Plans can basically be divided into two categories:

(1) those that are intended to pay executives a bonus each year in a relatively predictable amount; and
(2) those that provide benefits geared to performance.

The former type of program is not really a bonus—it is a mechanism to defer payment of salary, thereby penalizing an executive who quits. The second type of program is a real incentive program intended to place the executive's fortunes on an equal footing with those of the employer. These two approaches are not mutually exclusive; a single Cash Plan can provide a minimum bonus up to a specified level and have a real incentive above such level.

An employer who adopts a particular type of Cash Plan should always keep in mind that it is not wedded to that kind of plan or the way the plan operates. Employee expectations will always need to be considered, but (except for Section 162(m)) there is generally no reason why an employer can't change from one form of program, or one performance objective, to another if business circumstances warrant such a change. A short-term plan that no longer suits the employer's business needs is merely a way to throw money away. Thus, to maximize the effectiveness of an annual incentive program, an employer should periodically review its objectives and, when appropriate, revise the method by which the "incentive" compensation payable is to be determined or measured. For example, in a down market a bonus program tied to operating income would be ineffective as an incentive because executives would expect that no bonuses would be paid despite their efforts. In such circumstances, bonuses for that year could be made part of each executive's basic compensation so as to add a reward for remaining employed during a difficult period, or tied to other attainable performance objectives, such as attaining a particular level of cost savings or staying within budget.

As is alluded to above, multiple performance measures may be used to achieve more than one objective, but care must be taken to assure that the objectives integrate properly, if that is intended. Failure to integrate the objectives properly will lead to excessive results at either end of the spectrum: good performance can lead to little or no compensation if the combined requirements are too

high, or poor performance can be adequate to generate cash payments if the balance proves to be too attainable.

Of course, problems can still arise in a plan with multiple objectives that are separate and additive. For example, if all of the objectives can not be attained, executives may have an incentive to direct all their energies to achieving one of the objectives and letting the others fail miserably (rather than working toward achieving as much of each of the objectives as is possible), or they may be encouraged to refocus their performance on a second objective exclusively, once the first objective is well in hand. My college economics professor used to described these kinds of separate bonus objectives as being a major detriment in the old Soviet economy. His favorite illustration involved separate objectives regarding either the total number of nails produced or the total number of pounds of nails manufactured. When shortages in metal or equipment precluded the managers of the factories from achieving more than one objective, the factories would produce millions of very thin nails (when, for example, metal was in short supply) or a small number of enormous spikes (when the machinery was not available to produce a sufficient quantity of useful nails).

### [2]—Annual Bonus as Part of Basic Compensation

Some employers treat an annual "bonus" payable in cash as part of their basic compensation package. This kind of program provides the greatest amount of certainty to an individual, but it is the least attractive from the employer's point of view. Such a program pays a fixed percentage of salary if the individual is still employed at the end of the fiscal year (or, alternatively, at the time the bonus is paid) and if the individual has met satisfactory individual performance objectives. The "bonus" is used as a salary alternative that gives the executive an incentive to remain employed through the end of the year, and protects the employer against a particularly bad year or particularly poor individual performance by enabling the employer to reduce basic compensation on a retroactive basis by reducing or eliminating the annual bonus. For example, an executive making $150,000 may be scheduled to receive a bonus equal to 20% of the executive's base salary at the end of the year if he is still employed on the last day of the fiscal year. If that executive quits six months into the fiscal year, the employer saves $15,000 ([$150,000 x .2] x 6 months/12 months) by structuring part of the executive's basic compensation as a bonus rather than as part of his base salary.

Many employers use short-term programs that are based on achieving at least a minimal level of acceptable performance. Some of these programs are based solely on enterprise wide objectives (e.g., attaining a certain level of profit, revenues, cash flow or sales) while others use a combination of objectives (e.g., the bonus is

based on several component pieces: corporate, divisional and individual performance). This approach is comparable to one that is merely part of the executive's basic compensation, but increases the employer's ability to deviate from anticipated bonus levels based on specific performance objectives. While it generally does not encourage executives to achieve a higher level of performance, it does provide a mechanism to penalize poor performance or to reduce expenses in a poor year without overly penalizing good performers.

### [3]—Annual Bonus Based on Performance

Some short-term Cash Plans are actually incentive plans where the bonus is tied directly to the achievement of corporate, divisional or business unit performance objectives. The most common approach used by such performance based plans is the establishment of a "bonus pool" from which executives receive their payments. This approach identifies a specified amount of income determined using a formula tied to various objective criteria, which is allocated (on a book-entry basis) to an account for participating executives. A simple bonus pool might be based on a fixed percentage of earnings before income taxes ("EBIT"). Having a specific corporate performance objective upon which the bonus or bonus pool is based will aid a public company in complying with disclosure requirements under federal securities laws and in assuring that compensation it pays is deductible for federal income tax purposes. Any proxy statement delivered in connection with a shareholders' meeting at which directors are to be elected must include a report of the public company's compensation committee describing the relationship of executive compensation to the company's performance.[1] A specific objective(s) in an annual plan will make writing the report easier.[2] Moreover, to qualify for the Code Section 162(m) performance-based compensation exception to the deduction limit, the performance objectives must be pre-established and based on objective criteria that a third party familiar with performance results could calculate.[3] A fixed objective should readily help meet this requirement.[4] One significant design question that must be

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[1] 17 C.F.R. § 230.402(j).

[2] However, when more than one such criterion is used, the committee's report must state the weight applied to each objective. Also, when the criteria are not satisfied, the report should note that fact and explain the effect on bonuses. Thus, in good years a specified objective may be quite positive and in bad years it can be a disclosure albatross.

[3] Treas. Reg. § 1.162-27(e)(2)(i), (ii).

[4] A public company can have multiple objectives, achievement of any one of which will permit the maximum payout available under the plan. Treas. Reg. at

addressed when using a pool approach in a short-term plan is whether an executive's interest in a pool is to be allocated at the beginning or at the end of the year. With an up-front allocation, an executive is assured of receiving a certain level of bonus if the performance of the enterprise is good (perhaps subject to defeasance if the executive's own performance is poor). Allocations following the end of the performance period provide maximum flexibility for the employer to draw specific distinctions based on actual performance during the year so that unique effort, promotions and other adjustments occurring during the year can be readily taken into account without having to build in additional administrative complexity. If the bonus pool is designed to meet the requirements of Section 162(m), the maximum opportunity for covered executives must be fixed within the first quarter of the performance period, but can be reduced through the use of negative discretion.[5] This again encourages a Section 162(m) plan to overstate the maximum to assure that an appropriate amount can be paid even if unanticipated circumstances should arrive.

From the executive's prospective, a bonus pool that guarantees he or she will receive a particular level of benefit from the pool (provided there is an amount credited to the pool) is preferable to a wholly discretionary program where the selection criteria that may apply can be quite subjective. An employer would prefer to have the ability to assure that those executives who are most deserving based on their current performance receive a fair and just award, and that no one who underperforms gets overpaid. To invoke a sports analogy, year-end allocations cause an executive to treat each year as though it is the last year of his/her contract, encouraging him/her to post the big numbers to attain the big bucks.

Both executives and the employer could be made reasonably happy by allocating a meaningful percentage of the pool up front (say, 50-75%) and reserving the remainder to reward outstanding performance. The executives would know what their minimum bonus opportunity will be, and will still be encouraged to work hard to obtain a share of the remainder of the pool to be awarded. Allocating the full pool at the beginning of the period, however, would allow for "free riders"–that is, for one, two or a small group of executives not to work hard toward the goal, choosing instead to benefit from the labors of others. Moreover, it leaves no flexibility for promotions or new hires, or merely to reward the exceptional performers. By allocating a significant portion of the pool, but reserving a meaningful portion for discretionary awards, the employer, for example, will be able to express its satisfaction with exceptional individual performance in monetary terms. This discretion also assures that the employer will not overpay many

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§ 1.162-27(e)(2)(iii).

[5] Treas. Reg. § 1.62-27(e)(2)(I), (iv).

people by a substantial amount. Having no upfront allocations, however, may adversely affect the incentive intended to be generated by the program. Human beings are by nature largely skeptical and often distrustful; U.S. society has fostered and cultivated the “show me the money” mentality. Under this view of human nature, it is likely that an executive who is assured of getting a piece of the pie will work harder to make the pie bigger than if such executive is concerned that he might only get the crumbs that fall to the floor.

Another approach commonly used in short-term plans with a meaningful performance objective is to establish a target award opportunity for an executive which will be paid if the corporate performance objectives are attained. The target will usually be a fixed percentage of the executive’s annual base salary, which percentage is generally established based on the executive’s position or salary grade level. The amount payable is sometimes designed to fluctuate if the corporate objectives are exceeded, or if substantially all of the objectives are achieved but total performance falls slightly short of the mark. A normal plan might therefore establish a target of 30% of annual base salary for all vice presidents, and pay 150% of target (i.e., 45% of annual base salary) if corporate performance is double the performance targets and 50% of target (i.e., 15% of annual base salary) if corporate performance is at least 80-85% of the targeted objectives.

Other Cash Plans use a multi-factored approach intended to reward an individual who does good work, even when the organization or the executive’s business unit does not do so well. This approach also protects the employer from being committed to pay sizable bonuses when its performance does not justify such payments and from having to pay a bonus to individuals whose personal performance does not justify the award. Such a Cash Plan might work as follows. An executive will have a bonus target of 30% of his annual base salary. One third of such opportunity (i.e., 10% of base salary) will depend on the entity obtaining specified corporate objectives, one-third will dependon the executive’s business unit meeting its objectives and one-third would be tied to an evaluation of the executive’s own performance. If the executive and the unit do well, but the entity’s overall performance is poor, the executive will get a bonus equal to 20% of the annual base salary. Alternatively, if the executive and the unit fail to meet expectations, but the enterprise as a whole performs well, the executive would receive a bonus of 10% of the annual base salary.