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The Global Economic Crisis

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Incentive Strategies for Canadian Executives in Troubled Times

by Christina Medland

The Problem

Many public companies are having to reduce compensation costs to survive the current economic conditions. Doing so makes it difficult to retain and motivate the best employees and executives, who are essential to a company's survival during these difficult times.

If you want to be well-positioned to survive and emerge as a stronger and better competitor, now is the time to think about what you can do to retain your key talent.

Some companies may try to do so merely by hoping that fewer employment opportunities will be available in the marketplace. This strategy seems short-sighted, because the best and brightest will always have other opportunities, even in troubled times. During the stronger economic conditions of the recent past, shareholder pressure drove companies away from awarding stock options and toward compensation such as performance share units. While there are good historical reasons for this shift in compensation strategy, the present circumstances require cash-tight companies to use rewards with greater upside and a longer-term focus to keep key talent.

The Solution

If you are experiencing financial difficulties in the current economic environment, you should

- reduce cash costs, such as salaries and payments under cash incentive plans;
- remove or reduce annually measured incentives, such as annual bonuses and performance share units that vest on the achievement of annual financial targets, both of which are unlikely to be achieved in the short term, given global economic conditions; and
- provide incentive compensation to retain and motivate your leadership to weather the turmoil and build for the future.

A combination of (i) reduced salary, (ii) reduced or no annual cash bonus plans, and (iii) generous option grants may solve the problems you are currently facing.

Returning to the use of options as a compensation tool may garner public criticism, but companies should be able to defend this criticism by emphasizing the need to conserve cash and retain key personnel and by adopting the measures suggested below, which will avoid the problems created by option-granting practices in the past.

Options are taxed favourably to the optionholder, who can defer tax and be taxed at capital gains rates. Cash-starved companies can satisfy their obligation with treasury shares. Companies that have funds available can satisfy stock appreciation rights in cash and benefit from a tax deduction while retaining capital gains tax rates for the optionholder.

Options with an exercise price at current market prices are likely to be perceived as valuable by employees, who should see significant upside potential.

Options can vest over time, either in installments (e.g., 25% of grants vesting per year) or as cliff-vesting (e.g., vest all grants at the end of three years). This makes options an effective retention tool.

To prevent some of the abuses and shortcomings attributed to options in the past, you may add features such as

- requiring executives to give significant advance notice (e.g., three to six months) to exercise options, to avoid executives creating or playing on share price volatility and to require them to focus on long-term value creation.
- requiring executives to hold options during employment and prohibiting the exercise of options for a period of time (e.g., three to six months) after resignation.
- adding performance-vesting criteria, to prevent an option payout if the company's performance is well below that of comparable companies but an improvement in the overall market raises the share price.

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