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A White Paper

EXECUTIVE BENEFITS ADJUSTING FOR LIMITATIONS

Executive benefits are employee benefits that are supplemented in order to be appropriate for executives. In many cases statutory rules and regulations place limits on employee benefits.

Executive benefits are excess benefits designed to fill in those gaps created by the various limitations. Income replacement, income protection, future financial security, pay for time not worked, and deferred compensation all fall under the category of executive benefits.

WHEN MORE THAN PRIDE IS INJURED: INCOME REPLACEMENT

An executive suffering from an extended illness or injury can have drastic consequences not only on the executive, but on the organization as well. The short-term and long-term disability packages offered to rank-and-file employees just aren't sufficient for a highly paid executive. The goal of any income replacement plan should be to ensure that executives are able to maintain their standard of living when faced with a short- or long-term disability or illness. It's a good incentive for an executive to come on board, as well as a good incentive for him to stick around.

KEEPING EXECS IN GOOD FORM

Most companies don't distinguish between top executives and the rank-and-file work force when it comes to health benefits. As health care costs skyrocket and employees pay higher premiums, co-pays, and deductibles, employers have a tough time asking employees to shoulder more of the burden while executives pay no penalties. Despite all of this, certain extra medical benefits for executives are reasonable. Any time a benefit can have a positive impact on the health and security of an executive, it should be considered necessary because executive health is an asset to the company. Annual physical exams are a low-cost, high value benefit for a company to offer. Aside from this one exception, medical benefits for executives should mirror those of rank-and-file employees.

When it comes to life insurance policies, supplemental benefits are also often needed for executives. Many employers pay two times base salary up to a maximum of \$100,000, and allow employees to buy supplemental life insurance, which comes in additional multiples of the salary. Executives should be provided the same deal that all employees are provided *without* the artificial cap.

THE GOLDEN YEARS ARE GREEN TOO: FUTURE FINANCIAL SECURITY

The Supplemental Executive Retirement Plan (SERP) has become an increasingly important tool for recruiting new executives in mid career. This is because in most cases, retirement vehicles like Social Security, regular retirement plans, and 401(k) plans cap out and would cover only a small portion of their pay. The SERP should be designed to ensure that executives maintain their standard of living when they retire, but these plans should not replace wealth creation.

The typical SERP is based on average salary and bonus, as well as years of service. Where things get out of hand is when the plan treats long-term incentive awards and grants of restricted stock as annual pay. Then, the value of the retirement plan stands to increase dramatically. Also, the cost of the SERPs was rarely shared with shareholders. This is why some critics have labeled SERPs “camouflage compensation.”

In 1974 Congress passed legislation that required companies to fund the pensions they promised to their employees, and to keep pensions of execs proportional to those of regular employees. But instead of dissuading companies from giving execs excessive retirement pay as intended, it encouraged them to set up separate retirement plans for executives. And before you knew it, stock options, bonuses, and other long-term incentives snuck into the retirement calculations. Now, the SEC has stepped in with new rules and regulations designed to make SERPs more transparent.

Organizations should be wary of how their SERPs are perceived. Many organizations have cut or frozen pension plans for regular employees while executive pension plans have grown unchecked. Not only do SERPs create issues with the company’s finances, they also send a bad message. While we certainly believe that execs are entitled to the same retirement benefits as rank-and-file employees on a proportional level, we believe excessive retirement payouts are costly to the company and to shareholders. Most pension plans replace 20-35% of a regular employees income. By contrast, execs often get 60% or higher. Pension plans should replace wealth, but they shouldn’t create it.

RECHARGING THE BATTERIES: PAY FOR TIME NOT WORKED

Most major organizations provide ten days of holidays and upward of four weeks of vacation for top-level executives. If you are recruiting an executive from Europe this won't cut it, but it should be perfectly sufficient for most U.S. executives. In addition to normal vacations and holidays, we firmly believe that executives should be able to recharge their competitive juices by taking a sabbatical every three to five years. The sabbatical should be less than six months, but longer than two.

GO AHEAD, PILE ON THE DEBT: DEFERRED COMPENSATION

A deferred compensation plan allows executives to defer big portions of their salary and bonuses plus gains from exercising stock options until retirement. The sums grow tax-free, and sometimes the plan increases at an above-market interest rate guaranteed by the company. Some companies even make contributions to deferred compensation plans under certain circumstances.

Deferred comp plans are a great way for companies to attract and retain top talent. But shareholders often look on them less kindly because they are debt that must be deducted from a company's earnings each quarter reducing company profits. Similar to many executive retirement plans, deferred compensation isn't funded. However, most companies informally fund their deferred compensation plans using Corporate Owned Life Insurance (COLI).

Deferred compensation plans have enjoyed their share of controversy and have been seen as a way to secretly ratchet up executive pay. Since deferred compensation has joined the newsworthy ranks of swollen retirement packages and backdated options, Congress has decided to step in and keep this liability under control by tax code 409A, which regulates various types of deferred compensation arrangements. Code 409A is designed to cut down on abuses related to election timing, distribution timing, and the ability to accelerate payouts. The law is costly, confusing, and possibly incomplete.

And under the category "good Congressional intentions gone bad" regulations relating to golden parachute rules (280G) and the million-dollar cap (162(m)) on employer deductions were designed to reign in excessive executive pay, but in both cases the regulations encouraged organizations to find loopholes. After every well-intentioned attempt to keep executive compensation at reasonable levels, it just got higher. Will 409A be more of the same? We will have to wait and see.