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Additional Disclosure Needed On Supplemental Retirement Plans

By Daniel J. Ryterband

Following in the footsteps of rising equity compensation values, the next executive pay element to become subject to intense scrutiny appears to be the nonqualified retirement plans that provide supplemental benefits to highly paid employees. In fact, many institutional investors have already expressed concern over these arrangements and one major institution, TIAA-CREF, has published articles expressing its viewpoints.[(1)]

While supplemental plans can support many valid objectives, proxy disclosure of these plans is generally poor. This limits the ability of shareholders and other interested parties to accurately assess the true benefit levels accruing under these programs and the related employer costs, which often raises skepticism about the motives of employers that provide such plans.

This essay proposes changes to the current proxy rules intended to improve shareholders' ability to assess the benefits attributable to supplemental plans relative to the objectives they are intended to support. As background, it provides a basic framework for classifying the different types of supplemental retirement plans, how they can best be used, the shortcomings of the current proxy disclosure rules, and suggested improvements to help discourage potential abuses that result in unreasonable shareholder expense.

BASIC BACKGROUND

When discussing nonqualified retirement plans and arrangements, it is important to distinguish among the various types. For purposes of this discussion, we classify them into three categories:

- **Restoration plans**—these plans provide benefits to employees that would otherwise be paid from a qualified plan, absent the IRS limits on plan compensation, contributions, and benefits levels. In other words, they seek to mitigate IRS restrictions that result in lower-paid employees receiving a relatively more valuable benefit than the higher-paid group.

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(1) "The Costly Link Between Executive Pensions and Executive Pay: Part One - The Problem" and "Part Two - The Solution", which appeared in the December 1997 and February 1998 issues of *Director's Monthly*, respectively.

As such, the benefit formula in a restoration plan simply mirrors that of the underlying qualified plan.

- **Supplemental executive retirement plans (SERPs)**—these plans are formal arrangements that provide *greater* benefits than the qualified plan formula would produce for a select group of executives or highly paid employees. They often take into account additional elements of compensation, such as bonus or other amounts excluded from the qualified plan formula, or they may provide a more generous benefit formula by enhancing the accrual rate, crediting additional years of service, providing a minimum guaranteed benefit, or modifying other features of the qualified plan (e.g., early retirement reduction factors, optional forms of payment).

- **Special deals**—these arrangements typically resemble SERPs in their design, but are usually negotiated individually between the company and a specific executive. These may use a restoration plan or a formal SERP as their platform, but often include additional bells and whistles not offered to the larger executive group.

Restoration plan participation generally extends to all highly paid employees affected by the IRS limits, while participation in SERPs and special deals is typically much more exclusive. Restoration plans are quite common, particularly among large employers, and offer no potential for abuse. It is typically the latter two that present the greatest concern to shareholders.

TRADITIONAL USES

As described below, nonqualified retirement plans can support many legitimate business objectives. However, to ensure that the plan does not become a vehicle to deliver unwarranted compensation, the plans must be closely linked with a company's strategic objectives.

Maintaining Internal Equity

As direct compensation levels increase, IRS limits on qualified plans act to provide disproportionately lower benefits to executives relative to those received by lower paid employees. Restoration plans, as described above, simply ensure that the underlying qualified plan is applied in a uniform way, and that compensation levels that reflect the relative value of each participant, rather than arbitrary IRS limits, drive individual benefit levels.

Recognizing Incentive Compensation

As companies continue to shift the mix of executive compensation to variable forms, pressure mounts to include all or a part of annual incentive pay in the definition of plan compensation. This is a real need in many cases, but companies should consider the issues on the following page:

- Nature of the compensation—companies must balance the contrasting objectives of pensions and incentive compensation when considering how much variable pay to include. The primary purpose of a pension is generally to provide a sufficient level of income to maintain a reasonable standard of living after retirement. In contrast, incentive compensation functions to reward executives for value-added performance during active service.

- Internal equity issues—to the extent that executives are trading salary for additional bonus opportunity, it seems reasonable to consider such amounts in the definition of compensation. However, in many cases, the same issues may exist deeper into the organization, where bonus, overtime, and other variable pay elements may be excluded.

- Executive responsibility—the advent of the 401(k) plan has shifted some of the responsibility for retirement savings from the employer to the employee. When considering the need to provide replacement income to executives, it seems reasonable to place an even heavier responsibility on executives, who are financially astute and typically have high levels of disposable income. As such, companies may want to place a cap on how much bonus can actually be included. Also, executives who receive both stock options and other equity-based long-term incentives might be expected to provide some of their retirement needs through equity capital accumulation.

- Impact on retirement decisions—the inclusion of annual bonus can result in dramatic change in accrued benefit levels over relatively short time periods. This is particularly true in cyclical industries or changing economic climates. As expectations regarding the future change, executive decisions regarding retirement may follow suit, creating a bottleneck of executives who are waiting for improved bonuses, or a shortage when good times lead to earlier retirement.

Supporting Mid-Career Hiring Needs

Just as companies often need to offer large sign-on bonuses and stock option grants to “buy-out” unvested prior employer benefits forfeited by key new hires, they often feel compelled to restore the pension benefit loss of the same executives. The danger in this case is that the agreement is sometimes made as a last consideration in the negotiation, and often without recognition of the potential cost.

Attracting and Retaining Key Executives

Often times, competitive pressure encourages companies to provide special benefits beyond those provided to other employees. While this is a real need in many cases, companies must exercise caution to avoid unjust expense and internal inequity, just as they should in addressing competitive pressure to increase direct compensation.

Recognizing Extraordinary Performance

Another rationale proposed by companies for delivering benefit enhancements, particularly to CEOs and other key executives, has been past performance. This is generally tough to defend, since retirement benefits are seldom performance based, except that the underlying compensation used to determine benefits reflects performance. As such, the changes are made after the fact, which means the executive has all of the upside, but very little risk.

In addition, assuming the incentive compensation program contains appropriate performance linkages, recognition of outstanding results should already be reflected in the value of incentive plan earn-outs and equity grant gains. Rather than increasing retirement benefits at company expense, many organizations have implemented programs designed to maximize executive ability to build their estate and save for their retirement on a tax efficient basis. Such programs include traditional deferred compensation plans, stock option gain deferral arrangements, and the use of transferable options.

DISCLOSURE PROBLEMS AND POTENTIAL ABUSE

In defense of their nonqualified plans, companies generally claim that the arrangements support one or more of the uses described above. However, the proxy disclosure rules provide insufficient information for shareholders to determine if the benefit being accrued under these plans is commensurate with the human resource value claimed by the company.

Under existing proxy disclosure rules, companies must disclose the following:

- Defined contribution plans—companies must disclose the annual contribution or allocation for each named executive in the "All Other Compensation" column of the Summary Compensation Table. The disclosure must include amounts contributed or credited during the reporting year to all defined contribution plans, including qualified and nonqualified arrangements, whether vested or not. However, nowhere in the table or elsewhere in the proxy is the company required to disclose the earnings attributable to such arrangements (unless the earnings are above market) or the total obligation accrued to date, which is a direct cost to the company in the case of nonqualified plans.

- Defined benefit plans—for plans that determine benefits primarily based on final compensation and years of service, companies are generally required to provide a separate Pension Plan Table showing estimated benefits at retirement for different covered compensation levels. The table must illustrate specified compensation and years of service classifications, and include benefits attributable to all qualified and non-qualified pension plans. The company must also disclose the definition of covered compensation, the estimated years of credited service for each named executive, the basis upon which the benefits are computed, and whether any offsets apply. Actual disclosure under these requirements varies significantly by company.

In contrast to the rules applicable to direct compensation elements (e.g., salary, bonus, long-term incentives), those applicable to retirement plans provide ample opportunity to shield the benefits accruing to proxy-named executives from shareholder scrutiny.

With regard to defined contribution plans, the rules require disclosure of the annual contribution cost, but provide little information about the ongoing expense attributable to credited investment earnings in nonqualified plans. The exact reverse is true with defined benefit plans, where the estimated value of the ultimate benefit is disclosed, but no information is available about the annual cost associated with funding this obligation on a per participant basis.

To mitigate potential abuse of SERPs and special deals, institutional investors and shareholder activist groups have begun to more closely examine the nature and cost of such plans. However, in the absence of better data, this is a difficult if not impossible task.

PROPOSED SOLUTION

Improving the proxy disclosure rules applicable to nonqualified benefit obligations will encourage employers to self-police the growing benefit levels. Since improved disclosure will subject executive accruals to greater public scrutiny, companies would be strongly encouraged to consider the cost impact of their plans more carefully and the reasonableness of benefit levels.

Two Approaches

Since changes to the existing disclosure rules would generate extensive debate and controversy, we propose two approaches that require relatively minor change to the existing rules, rather than a complete overhaul.

Approach A - Individual Accrued Benefits and Account Balances

This approach would require changes to the pension table, as described below and illustrated in the attached exhibit:

- Defined contribution plans - annual contributions no longer would be disclosed in the "All Other Compensation" column of the Summary Compensation Table (note that above-market interest credited in deferred compensation plans would continue to be disclosed here). Instead, annual employer contributions under qualified and nonqualified arrangements would be disclosed as a line item for each proxy-named executive in a modified pension plan table (discussed below). In addition, the total benefit obligation accrued to date would also be disclosed and a footnote would provide a basic description of the plan, including contribution rates, covered pay, and investment options.

- Defined benefit plans - the Pension Plan Table would be modified to illustrate specific benefit levels for each named executive officer, rather than the current non-specific compensation and years of service descriptions. This table would illustrate the annual benefit accrued under the plan and the incremental change from the prior year, as well as the estimated retirement benefit payable at the earliest and normal retirement ages attributable to all plans in which the executive participates (i.e., an aggregate amount). Existing rules requiring disclosure of the definition of covered compensation, the estimated years of credited service, the basis upon which benefits are computed, and whether any offsets apply would be maintained.

Approach B - Individual Annual Accrued Costs

A simpler alternative to the above would be to leave the pension table unchanged and add defined benefit annual accrual costs (calculated based on the same assumptions used for accounting purposes) to the "All Other Compensation" column of the Summary Compensation Table. Defined contribution plan disclosure would be unchanged.

While this approach would illustrate the incremental accrual value, it would not necessarily indicate the true value to the executive due to the uneven accrual pattern typical of defined benefit programs.

POTENTIAL RESISTANCE

Either of the above approaches will illustrate incremental change in employer-funded retirement benefits in a consistent manner for both defined benefit and defined contribution plans. They will also improve the information needed to estimate the *annualized* benefit accrual rate over an executive's service with the company. This is particularly important with regard to defined benefit SERPs and special deals, where incremental changes in accrued benefits are often dramatic in certain years (due to the granting of additional service or inclusion of new pay elements), but then taper off thereafter.

Opponents may argue that it is difficult to determine pension cost for individual participants. While the mechanics of performing such calculations need to be well documented to ensure consistency across companies, the actuaries who perform annual ERISA and FAS valuations have all of the needed information.

Opponents may also argue that additional disclosure will simply result in escalating SERP benefits, since it will provide companies with improved data to compare their programs to that of others and recognize "deficiencies." But compensation professionals know that these comparisons are occurring today and that, for the most part, plan descriptions can be obtained for specific companies through various means (e.g., custom surveys, consultant databases, SEC filings, etc.). Therefore, additional disclosure will simply level the playing field by enabling shareholders and other interested parties to evaluate the costs and merits of a company's plans without conducting costly studies.

CONCLUSION

In the absence of improved disclosure, investors will continually grow skeptical of the true intentions of companies that provide supplemental retirement benefits. While there are undoubtedly some companies that use the limited disclosure requirements as an opportunity to shield compensation from shareholder scrutiny, there are many more that legitimately use the plans to support sound strategic objectives.

Improved disclosure rules will remove the mystery currently surrounding nonqualified plans and enhance the ability of an investor to examine the cost and benefit to the company. As a result, companies that provide generous nonqualified plans will be forced to justify the related expense, which provides current and potential investors with better information to make decisions.

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General questions regarding this letter may be addressed to Dan Ryterband in our New York office (212-986-6330 or djryterband@fwcook.com). Specific technical questions should be addressed to appropriate counsel.

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Exhibit

PENSION PLAN TABLE

	Executive 1	Executive 2	Executive 3	Executive 4	Executive 5
Defined Contribution Plans					
Annual contribution or credit					
— Qualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Nonqualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Total	XXXX	XXXX	XXXX	XXXX	XXXX
Benefit obligation accrued to Date					
— Qualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Nonqualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Total	XXXX	XXXX	XXXX	XXXX	XXXX
Defined Benefit Plans					
Annual Benefit Accrued to Date					
— Qualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Nonqualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Total	XXXX	XXXX	XXXX	XXXX	XXXX
Annual Benefit Payable at NRA					
— Qualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Nonqualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Total	XXXX	XXXX	XXXX	XXXX	XXXX
Estimated Annual Benefit Payable at ERA					
— Qualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Nonqualified plans	XXXX	XXXX	XXXX	XXXX	XXXX
— Total	XXXX	XXXX	XXXX	XXXX	XXXX