

Performance-Oriented Stock Rewards

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Time-vested restricted stock, while retention-oriented and linked to shareholder value, is often criticized as mere "pay to stay" because participants receive shares regardless of performance. A fresh way to add performance linkage to restricted stock without having to set performance goals is a concept we call leveraged restricted stock (LRS).

As do regular restricted stock awards, LRS awards specify a number of shares and set a vesting period. But they also stipulate that the number of shares ultimately received will vary with the change in the stock price over the vesting period. For example, boards can design awards so that a 10 percent increase or decrease in stock price will result in participants' earning 10 percent more or fewer shares than the number specified in the award.

LRS does not necessarily assure participants that they will receive any particular number of shares. Rather, the number granted at the outset is a target. This design means that no value is guaranteed – that a dwindling stock price could result in the delivery of no shares whatsoever. To the extent that LRS awards are at risk, they make a compelling performance story for institutional investors and proxy advisory services.

Yet awards can be designed to deliver *some* shares regardless of the stock price. This is accomplished by setting a floor – for example, 50 percent of the target.

The degree of leverage in LRS awards can be adjusted through the use of design features such as factors. For example, when a factor of 2X is used, if the stock price increases 10 percent, participants receive 20 percent more shares. If the price decreases 20 percent, participants receive 40 percent fewer shares. Factors can be applied asymmetrically – for example, 2X the increase and 1X the decrease.

Another way to adjust leverage is to subtract a fixed number of percentage points from the change in the stock price. When awards are designed to subtract 10 points, a 10 percent stock price decrease would mean a 20 percent reduction in shares. A 20 percent price increase would result in a 10 percent increase in shares. This design feature reduces rewards if the stock price is flat.

Thus, LRS enables compensation committees to manipulate leverage according to corporate circumstances and strategic goals.

Because of its design flexibility, LRS can be used to meet the executive motivation and retention needs of most large public companies. (The concept could also be applied to director compensation, though this would run counter to a general disinclination to use performance-based pay for directors.) Using LRS in a company's mix of long-term incentives is most appropriate when:

- There is a desire for both retention and performance aspects in long-term incentive plans.
- Economic factors or market conditions make it especially difficult to set performance goals.
- The unique nature or circumstances of the company make it difficult to select a peer group (companies of similar size, industry and complexity) for performance comparisons.

- The stock market is relatively healthy — free of bubbles and historic lows.
- The influence of stock options in an LTI program has waned, perhaps due to share-price fluctuations or concerns about share consumption from shareholder-approved pools.

Depending on how LRS awards are designed, companies might be able to deliver the same value using fewer shares than they would through a combination of stock options and regular restricted stock. Moreover, companies can set a cap on the number of shares that can be earned – for example, 150 percent of the target. Thus, LRS can help companies conserve shares and limit windfalls – excessive compensation resulting from factors unrelated to executive performance.

LRS has both the leverage characteristic of options and the value characteristic of plain restricted stock. As a result, it can be used in lieu of plain restricted stock, where appropriate, to increase performance motivation while preserving the retention benefit.

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