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## EXECUTIVE COMPENSATION

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MR. L. K. BUDD CRATON: A definition of executive compensation must be made with reference to the persons for whom it is being undertaken. One definition would have to do with a group of people at the top of any organization who make it run, contribute to the strategic decisions, and in general have the accountability for the success of the enterprise. Another definition, or dimension, has to do with levels of pay. Today those people earning about twice the Social Security taxable wage base, or roughly \$60,000 per year, frequently are in a position where they can influence results, although not necessarily so.

The first part of the definition is obvious. It is traditional, and in most organizations we know who those people are. The second dimension is the result of the significant protections coming out of our public system: the retirement income replacement for lower paid people, the equivalent of about \$300,000 of life insurance protection from survivor benefits for a younger person with a family earning close to the taxable wage base, and disability benefits that can exceed retirement benefits. All of these influence benefit design at the executive level, because of the limit on the taxable wage base and the resulting reduction of income replacement or survivor protection above that level.

Another important factor connected with compensation levels is the influence of the progressive income tax schedule, which necessitates structuring compensation programs for their tax effectiveness. We may be dealing with as few as five or ten people in a small company, or several hundred people in a large organization. Executive compensation is not merely paying the top people, but paying them properly as well.

The definition of who is an executive is central to how compensation programs are conducted. For companies of any size, there is still only a small number of people who influence long term results. But an increasing number typically influence short term results, especially in decentralized organizations where there are divisions or groups. There can be a very sizeable group of people having an important influence on short term profits.

There is an increasingly large number of people who are paid at a level where tax considerations are important, even though their influence on short or long term results is difficult to measure.

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Let's discuss base salaries. Base salary is the "stake in the ground," if you will, of executive compensation. Establishing ground rules for the proper levels of the executive's paycheck is the starting point of executive pay program design. It is the building block of nearly all other values of the total compensation package, so it is very important that we have a good handle on salaries and carry out where to pay people relative to the outside world. The policy line for salary levels can be very different in different organizations. Competitive industry practice typically governs, or at least sets a reference point for it. On the other hand, the management style and objectives of an organization can have an important influence on where that policy line is fixed.

Some industries, retailing, securities and brokerage come to mind, tend to minimize fixed salary costs and maximize variable costs related to profit success. At the other end of the spectrum are regulated industries, such as utilities, which pay basically nothing but salary with very little variable long or short term cash compensation. But it is perhaps in the benefits area that setting the right salary level is most important. Group life, disability and retirement values all depend on and are keyed from base salaries.

Until ten or twelve years ago, most top management people were rather indifferent toward the benefit part of their pay programs, and were not overly worried about salaries. But the stock market performance, starting in about 1968 or 1969, started to change their perception about where compensation was going. Prior to that time, executives' stock option gains had so overwhelmed the other parts of their compensation package that they could afford to be indifferent toward pensions or life insurance. Over the past ten years or so, much more attention has been given to paying the right base salaries and building the right short term incentive programs. Long term programs have not been ignored, but have become relatively less important.

Fortunately, during the last ten to fifteen years, there has been much more information available about how people are compensated by area, by industry and by company size. We have a wealth of information, and it is statistically quite valid. It provides the companies themselves, and especially us consultants, with a very valid reference point from which we can build base salary programs and also measure total cash compensation for almost any situation. Even better, the data is beginning to be compiled in ways that are statistically very useful. We have a number of measures of central tendencies, good measures of dispersions, so that we can compute market position by percentile. Thus, we know what is going on in the real world. The cycle of these surveys is frequent enough around the year that we have a source of fresh data fairly often.

We can have confidence dealing with base salaries in most organizations and in fixing bonus levels that companies can relate to their market place, however they choose to define it. Salary appears to have its highest correlation to company size, although there has been much research done to measure the influence of other factors on base salaries. Size is the one we tend to rely on most frequently. It is fairly obvious that larger companies tend to pay more for the same job than smaller companies. The relationship of compensation to size has been fairly stable over time.

A doubling of size will produce about 20% higher salaries and total cash compensation opportunities. This is an average observation, not an absolute fact.

Given this kind of information, each company can decide where they want to be with respect to the market, and I have an interesting observation about this: most companies and boards of directors are happy to relate themselves to the average of the community around them, as it is observed. Some are a little more aggressive and want to be above average, but nobody wants to be below average. Over time this probably leads to another inflationary component in the way executive salaries move. Everybody's chasing the averages.

Let's discuss the other parts of the executive pay package. This is where all the excitement is, and where we spend a good part of our time dealing with client problems. I will just mention them and then discuss them in more detail as we go along.

Short term incentives are obviously at the head of everybody's list and are certainly the dominant practice today among public and private companies in most industries. Capital accumulation programs are still very important, these include stock options, long term performance plans, and that type of thing. You also might include pensions under capital accumulation, because they have a rather high capital value. Executive benefits include survivor benefits, supplemental medical programs, special disability benefits above insured plan maximums, and supplemental non-qualified umbrella pension plans. Then, of course, there are the executive perks: cars, clubs, city clubs, country clubs, first class air fare, spouse's travel - you can go down a long list of items that are frequently furnished to executives. Some of these have tax implications to the executive, others do not.

#### Short Term Incentives

Short term incentives are typically cash bonuses. They are paid after the end of a measuring period, usually the fiscal year of the company, and are usually tied to some measure of profit success. It can be an increase in profits, perhaps an absolute standard of return to the shareholders, perhaps merely related to growth over the previous year. Their values are seldom lower than 10% of salary at lower management levels, at least as a plan or target value, up to perhaps 60% or 70% of base salary at the top of an organization. Usually there is an upside potential of 1½ to 2 times those percentages for various superior profit successes. If executives significantly overachieve their goals, the funding formula is typically right up to, and maybe double, the target levels of cash incentives.

In good years short term incentives can equal the base salary of the top two or three people in the organization. They have been known to be even higher, as was the case a few years ago in the automobile industry. Lower level bonus eligible positions can look forward to, in very good years, maybe 20% or 30% of their base salaries. This is a very important component of the pay package: it's cash, it's here, and it's now, although some companies will space out their payments for two or three

years. We discourage spreading, because we believe that rewards lose their incentive value if not tied closely to the behavior that produced the profit success.

Our experience suggests that short term incentives can influence behavior in ways that lead to desirable profit results for an organization. But we think it occurs only if certain important ingredients are in the plan. Participants must know the ground rules at the beginning: what the profit measures are, and what personal goals they are expected to achieve in order to share in available bonus funds. For certain types of people, salesmen for example, there is a very simple set of ground rules - produce more and you will receive more. It is a bit more complicated in dealing with management positions, but it is possible. Good planning and good management style that clarifies objectives and states financial goals, both short term and long term, are important. If the program is organized well and communicated well, participants will behave in ways that will bring about the desired results.

Many people have criticized the motivational value of bonuses, and question whether they really pay off. This criticism may be appropriate for many programs, which are administered essentially as profit sharing arrangements, in that everyone receives his pro-rata share of the bonus fund without regard to how he contributed to it. This type of administration can be a major disincentive. Why should a person work hard and do a better job if he is going to receive the same reward anyway?

We think that people can significantly change their behavior if they understand how the program is put together and how they can make it succeed. We had one client a few years ago that decided to put in a management incentive plan. They were a highly divisionalized company, and we found that those divisions had a rather significant control over two major elements of capital - inventories and receivables. Management felt that certain divisions had not done well in managing these controllable assets, so a significant part of the bonus funding was tied to obtaining a high return on these controllable assets. In the first year of the program, they almost doubled their return on controllable assets. After scurrying around trying to find out how they were so lucky, management came to the conclusion that the bonus plan effectively communicated to those managers that they would be rewarded for managing their assets well.

#### Long Term Incentives

There is much criticism today about American industry focusing too much on short term results, to the detriment of a healthy long term situation. There may be some validity to that criticism. In terms of values produced, however, I would submit that the long term incentives, even today, may produce far more values for executives than their base salaries and their short term cash incentives. The weighting of program design has not overly emphasized the short term results. For example, as we put long term incentive programs into place, we are typically dealing with the top of an organization. Given profit success, the chief executive officer should have an opportunity to earn long term incentives with a value of one to two times his annual salary, compared with 50% to 60% in short term incentives. Now these programs don't pay off every

year, or provide cash tomorrow, but when the value is accumulated over three to five year periods, the amounts can be staggering if goals have been achieved.

For lower level people the targeted values from the long term programs are typically on the same order as their bonus opportunity, perhaps higher. But for the people on top, the gain potential from the long term incentives and measured against long term profit success can produce two or three times the value of short term cash. Thus, the way programs are being designed, there is no particular incentive for executives to maximize short term results to increase their cash bonus to the detriment of long term gains that may come out of options or other programs.

### Stock Options

Techniques for producing long term rewards can vary widely, but the dominant practice today is still the stock option. Stock options are related to stock success, not necessarily company performance, but there is usually a correlation of time between the two. About 80% to 90% of public companies today use stock options. About half use them exclusively, the other half in combination with related programs tied to company performance.

Qualified stock options are about to be buried - May 21, 1981 is the last date on which anyone holding a qualified stock option can exercise it in a tax favored manner. For all practical purposes, however, we have considered qualified stock options to have been dead since 1969, at least for the higher paid people in an organization. The 1969 tax law created a taxable event upon exercise of a qualified option. The spread at the time of exercise between the option price and the price on the day of exercise became tax preference income, subject to a 10% tax (with some exclusions and set-asides). I remember one client who, shortly after the law went into effect, borrowed every penny he could in order to exercise some options that were favorable at the time. This led to a tax liability of \$45,000, and he could not find the money to pay it.

For lower level people, the qualified stock option still had some value. Their gains could be kept within the exclusions on tax preference income and, given the financing ability to hold the options for three years, they could obtain the favorable tax treatment on them. At about the same time, however, many accountants and compensation consultants were saying, "What's wrong with non-qualified options?". They are really much more tax effective than the qualified option was, anyway. While the gains to the executive are taxed as ordinary income upon exercise, the company receives a deduction for the same amount. Given our typical flair for simplicity, if each has a marginal tax rate of 50%, it costs a dollar to get a dollar through to the executive. On the qualified option, where the tax to the executive could exceed 50% with no deduction to the company, there could be a cost of a dollar to get 50 cents, or even less through to the executive. Because of this and the fact that qualified options were taxed so unfairly, non-qualified options came into very widespread use and are the dominant practice today.

Non-qualified options have, however, introduced a very serious cash flow problem for the executive. He first must raise the money to pay the underlying price of the option and then has to pay his marginal tax rate

(usually 50%) on the gains realized when he exercised. If the price doubles, he has to pay in cash about 75% of the then market value.

For most employees who are not Section 16(b) insiders (officers, directors and 5% shareholders), if the stock is properly registered in the plan there is no problem with liquidity. They can literally exercise one day and sell the next. The statutory insiders, however, may not sell until six months after they have exercised the option. Many of these people do not like to sell their stock anyway, thus the severe liquidity problem.

### Stock Appreciation Rights

This leads to another device that became a companion to the non-qualified stock option, it is called a stock appreciation right (SAR). The officer being granted an SAR can surrender an option share and receive in cash the spread between his option price and the market value when he calls the SAR, so he does not have to take the property. He can just take the gains. A properly structured program would award SAR's on part of the stock, not necessarily all of it, and can work out to a situation where there is no cash flow between the executive and the company, with the executive owning perhaps only a portion of the option shares free and clear after the transaction. Going back to my doubling example, if SAR's were attached to 75% of the option shares, these could be called, resulting in enough cash left over after paying taxes to purchase 25% of the option shares free and clear. A doubling would produce a no cash cost position of about 25% of the original option grant. Larger gains in the stock would produce a higher residual ownership after paying all the cash costs.

The SAR, however, is an expense - it appears on the company's profit and loss statement. The non-qualified option is a balance sheet transaction - it increases paid-in capital and reduces the tax liability, but never appears on the profit and loss statement. The stockholders, of course, pay a cost in the form of additional dilution in spreading the earnings over more shares. Not only is the SAR an expense, but the accountants have come along with a rather complicated formula to recognize the expense. In this formula, it is presumed that the executive would always call the SAR and never exercise the option. A strong case can be made that that is the rational thing to do. Essentially, the formula is based on observing the price of the stock at the end of each quarter as well as the number of shares having to be recognized during that quarter, and computing an expense charge if the stock price goes up. This can lead to some rather wild fluctuations on the profit and loss statement when there is a large increase in the price of the company's stock. If the stock price goes down, the entry is reversed. For these reasons, then, good consultants do not recommend the widespread use of SAR's.

We restrict their use to statutory insiders, and we recommend that clients do not award them on all option shares granted but only on part of them, depending on their expectations of the price of their stock. We also recommend that they cap the gain potential in each SAR to perhaps  $1\frac{1}{2}$  to 2 times the underlying option price. The company should be able to estimate their exposure over time and measure that average cost exposure against profit success to see if it is in a reasonable relationship. Of the 100 largest California companies, about 60% of those having non-qualified stock options also have SAR's.

### Performance Shares

Aside from plans involving a piece of property, there are other long term incentive programs, and they go by a variety of names; performance shares, performance units, phantom shares, book value plans and several others. These have some common characteristics. Their cost is recognized as an expense ratably over the performance period. They are typically cash cost plans, although some pay out cash and stock. In general non-qualified options are not a cash cost, and they frequently generate cash to the company. The performance share-type programs are tied to some measure of profit success for the company. Perhaps their biggest disadvantage is that the boards and management have to look ahead three or four years and pick a level of return on investment or profit growth, or other factor, that will make sense three or four years from now. It has been increasingly difficult, in the decade of the 1970's to do that with any degree of certainty.

When some of these plans started appearing in the early 1970's, a performance target might have been a 10% return to the investors. For a plan starting in 1973 and maturing in 1978, 10% was the rate of inflation, not good performance. We recently installed a performance plan which is tied to target values for a very small handful of executives in a company. Certain profit performance measures were chosen based on the implicit recognition that this company had an internal rate of inflation of about 8%, however the plan gives the board of directors the ability even to go back on awards already made. On new awards they have the opportunity to revise the targets, but they can also revise awards already in place. This company is trying to achieve a profit growth in real terms of around 7% to 8%, so that any significant change in the assumed inflation rate can very significantly influence the award values.

### Restricted Stock

There is another use of company stock, known as restricted stock, in which awards are simply made to people. It is under Section 83 of the Internal Revenue Code. The employer can give stock to an employee without any tax incidence at the time of the award, provided there is a substantial risk of forfeiture. The risk of forfeiture can simply be that the employee has to remain with the company for a certain number of years (usually three to five) before those restrictions lapse and he has a right to the property. The employee can receive dividends on the shares, he can vote them, but if he walks away from the company the shares revert to the company.

As the restrictions lapse on those shares, the executive has a tax incidence, and the company has a tax deduction in like amount. As to accounting treatment, the bargain element at the time of grant must be expensed ratably over the life of the restrictions. The gains in price after the award is made are treated like option gains - they are a balance sheet transaction and not part of the profit and loss statement. The cost is known, simply the amount to be expensed each year as these awards are made. The company is not concerned about the upside gain because it does not have to be expensed.

Restricted stock is particularly useful in certain situations. It should not be used for the very top management of the organization. This would create a situation where, if the stockholders do not have the profit success they expect, and the executive still receives a reward out of bargain restricted stock, it could lead to a conflict between board and management. One situation where restricted stock can be used is further down in the organization in recruiting executives. Perhaps the executive has walked away from a company where he had to leave some values on the table. One way to recruit him, assuming he will stay, for values of forfeitures in a pension or profit sharing plan, bonuses that had been deferred, etc., is to award him restricted stock. This may be preferable to paying a front end cash bonus.

Another area where restricted stock is very useful is in situations where the company wants to keep people. For example, scarce technical talent such as earth scientists, petroleum engineers, or geologists are receiving frequent and lucrative job offers. If the company offers them significant restricted stock if they will stay for two or three years, they will think twice about leaving. This is one of the better "golden handcuffs," but we favor its use only on a very limited basis, primarily for the two conditions mentioned.

We have installed a performance plan for top management using restricted stock. The restrictions would lapse without regard to performance ten years from the date of award. But within that ten year period, if executives achieved certain levels of profit growth and return on capital, the shares would free up in years one, two, three and four. The better the performance, the faster the restrictions lapsed. We assumed in designing the plan that if these managers did not make the company succeed within the ten year period, they probably would not be around anyway. So restricted stock can be used in a performance mode, but you must have a date certain on which those restrictions will lapse. If you do not do that, the entire value of the property as the restrictions lapse becomes an expense to the company. Both the shares and the price must be determinable at the time of the award in order to obtain the particularly favored accounting treatment available to restricted stock.

What are some of the reasons that companies use companion plans, rather than stock plans exclusively? One reason is that available shares of stock in the company are a limited resource, in terms of acceptable dilution exposure, in rewarding the group of people the company wants to reward. A rule of thumb is that any more than 10% authorized or outstanding in options starts to become an unacceptable overhang on the price and potential earnings dilution of any company. The percentage should be lower for larger companies. If there is not enough stock available to produce competitive gains to executives, a companion long term performance plan makes sense. The companion plan also has the virtue of being able to produce cash for the exercise of the options, particularly for statutory insiders.

A reason for using companion plans instead of SAR's is that there is much more predictable and even cost impact on the company from a companion plan.



What is on the scene in front of us now? Last year two bills were introduced in Congress which would have restored tax favor to stock options. One of them almost passed. Given the mood in Congress today, there may be a very high probability that we will see tax favored options coming back again. There is a lot of sentiment in the business community to restore the tax favor, particularly in the area of the cash flow - liquidity problem. There is even some sentiment for going back further to the pre-1964 restricted stock option.

The pre-1964 option could be granted at 85% of fair market value, not 100%. The holding period was then six months. The sentiment is now toward a one year holding period. In addition, there may be even more favorable capital gains treatment coming out of this Congress. The bill that came out of Ways and Means yesterday would reduce the maximum tax on unearned income from 70% to 50%, a measure, I think, which is also in the President's recommendations to Congress. If that is the case, we would then have a 50% tax rate on 40% of the capital gains, or a maximum tax of 20% of capital gains. That would begin to make any kind of tax favored stock option very attractive.

#### Executive Benefits

As I mentioned earlier, executives are far more concerned today about their benefit values than they were in the past. One of the reasons is that inflation scares them as badly as anyone else. Job mobility has created a situation of generally shorter tenure with the company than we were seeing 20 or 30 years ago. Not too many executives, except for a few industries, go to work for a company out of college and stay with them the rest of their lives. So we see frequent job changes in mid-career for executives, while typically designing pension plans around 30-35 year careers. ERISA maximums have limited the benefits under defined benefit programs for the very highly paid, and supplemental pension programs have come in to redress that problem. In a number of cases, disappointing investment results from defined contribution plans have eroded the retirement values for many executives. This is especially true for those who depend solely on these plans. They could come up to retirement at a time when the asset value of their accounts is very low. All these forces have led to a much wider use of umbrella programs. These non-qualified plans supplement the values emerging out of primary Social Security, qualified plan benefits, and not infrequently, benefits earned from a prior employer.

The purpose of these programs is very simple. It is to guarantee a reasonable replacement income for senior officers of the corporation where the other plans do not do so. Given the shorter periods of service for these people that are switching in mid-career, it makes a lot of sense. Removing the investment risk for executives in defined contribution plans also has a good deal of merit.

Another area receiving attention today is life insurance. These concerns arise out of several conditions. First, there are often unreasonably low maximums in the group term life program, although these have been rising rapidly over the last few years. There is a growing need for estate liquidity, simply because an executive cannot have a taxable estate that is going to have a large tax bite on it if there will not be enough

cash to pay it, because his assets are in his house and perhaps in his company's stock in a way that is not easily liquidated at that point in time. Obviously there is the classic need for survivor income protection and a growing concern for better post-retirement protection. On the latter point, too often the executive is insured for two to four times salary until he retires, at which point his protection reduces to \$5,000 burial money.

Some of these concerns can be addressed and solved by changes in the group plan. Others cannot so easily. My personal experience over the last 20 years has been to counsel clients away from whole life products. We felt that their basic inefficiencies simply did not justify their use in executive compensation situations. Recently, however, a series of things has happened that can make an ordinary life product a cost and tax effective way of meeting some of these executive needs. Probably the higher interest returns in the insurance portfolios have been influencing dividends favorably and those dividends do not have a current tax incidence. Perhaps in a minor way mortality might have also helped dividends. The tax deductibility on policy loans gives a double barreled leverage to these things. Given a proper split dollar structure where, at some point in time, the company recaptures their investment in the policy while the individual continues to own it, they just come out better. Our actuaries have been looking at these things, and they find that you probably can pass more net death benefits through to an executive by an ordinary life product than in the group term plus a retired life reserve. They are becoming cost effective, and as long as the executive owns the policy or can direct ownership of it, you can get benefits through to people more tax effectively than any other way. Those dollars get through to the trust or the spouse on a net basis from estate tax and income tax. It makes an efficient vehicle, compared to alternatives.

Executive medical reimbursement received a jolt in the 1978 tax law changes. Starting in 1980, you could no longer self-insure those benefits on a discriminatory basis. So the consultants and brokers and the insurance companies began to invent insured products with a slight load on them. They are still legal. Many of our clients use them simply because the cost is deductible to the corporation and it is not a tax incidence to the executive. These plans cover any medical cost not otherwise paid for by the underlying medical insurance program.

In the area of executive disability, I consider this an almost trivial issue, but we find some of our clients receive a certain sense of security from providing a slightly higher benefit above the typical maximums that exist in most programs. We have run into situations often where, for whatever reasons, they have kept unrealistically low maximums in the disability programs. Most of the carriers are responding very favorably today to putting the maximums up at more competitive levels, and companies are simply self-insuring the added benefit above the insured plan maximum, perhaps on 50% of earnings in excess of that amount.

In summary, executive compensation is alive and well, and the values are increasing at rates well above inflation. Those values are taking forms different from cash now, and are much more security oriented today. We may begin to see some tax law changes that will be more useful to executive capital accumulation programs or for other long term incentives.

It may not necessarily be any more tax effective, but they will certainly receive wider acceptance.

COMMENT: I heard you say that you thought executive disability benefits to be trivial.

MR. CRATON: Even insurance companies recognize that executives are motivated to the point that they do not often become disabled in the same frequency or incidence than happens in the lower levels of the organization. My remark was only in that context.

QUESTION: The programs you discussed seem to be for larger companies. Do you have any idea what place some of these programs might have in smaller companies, for example those with less than \$50 million in assets?

MR. CRATON: Almost any of the things I discussed in a broad way can theoretically be used in almost any size company. Companies with as little as \$25 million commonly use options and bring these other programs into effect. You tend to see umbrella retirement plans confined to much larger companies. Small companies are typically younger.

QUESTION: Do you see any use of deferred compensation plans, perhaps using some degree of funding such as deferred annuities with single premiums, having yields tied to the prime rate?

MR. CRATON: There is some of that going on today. My view of it has been that deferred compensation as a program or as an option makes sense only when two things exist: the executive is old enough to know what his retirement plans are, and his expected marginal tax rate after retirement should be lower than his current marginal tax rate. Many companies permit executives to defer compensation, and it is up to their own individual tax planning. Such programs are sometimes funded, but typically are not. Often companies find it convenient, when the executive retires, to roll over the accumulated balances into an annuity. It is a very clean transaction for the company. The company owns the annuity, but they begin to receive deductions for the payments less the interest attribution.

QUESTION: You referred earlier to the use of individual life insurance policies to fund non-qualified deferred compensation programs. We have been looking at several of those lately, and I am surprised to hear you say that they may be more efficient. In our scrutiny of these policies, the rate of return seems to be so low and the expenses so high, and the tax incidence being what it is, could you explain how such a policy can be deemed efficient for that purpose?

MR. CRATON: The policies in my discussion were not used to fund deferred compensation. Whenever the company owns and is the beneficiary of an ordinary life insurance policy, it is a fundamentally inefficient way to fund some promise to pay a survivor benefit or post-retirement benefits. The promise to pay on a present value basis is includable in the estate, and the payments are also subject to income tax. I was talking about a situation where the executive owns the policy or can direct the ownership

of it, where the company invests a set amount of money for a given period of time under a split dollar arrangement and recaptures that money, in effect giving the executive an interest-free loan. One of the advantages of this arrangement is that the program is disclosed in the proxy, but there is no remuneration because year to year accounting ignores interest or opportunity cost of money. The numbers coming out today, using roughly equivalent assumptions for a retired life reserve program, show that ordinary life products can be very efficient in getting death benefits through to the executive.

QUESTION: You commented that the umbrella pension plans are more common among larger companies than smaller ones. Can you provide any more detail on how common they are in larger companies?

MR. CRATON: I don't have statistics on that, but for those large companies where the CEO's and top officers are earnings \$400,000 to \$500,000 or more, the plan formula will usually provide them with benefits in excess of ERISA maximums. The umbrella program is typically used to provide the difference between the plan formula and the ERISA maximum. The other type of situation where this need arises is when the company goes out to recruit top management people. An executive comes in at age 50, and he can work for 15 years under a 1½% plan. He may not want to come to work for this company under those circumstances, unless the company can do something to make his retirement income more adequate. I also mentioned the problem with defined contribution plans.

When you are dealing with a non-qualified plan, you do not have to confine yourself to any of the qualified plan ground rules. A different non-qualified plan can be created for each executive in the company. Most larger companies tend to put some general guides in place. For example, they may define an overall benefit objective, such as 50% of compensation after 15 years of service, with early retirement permitted only at age 62. The vesting in these plans tends to be fairly rigid - there may be no vesting before the first permissible retirement age.

QUESTION: What would you suggest to a small, closely held corporation, which really doesn't want to grant stock options?

MR. CRATON: You can go to phantom or stock related plans if they are willing to disclose financials to the people they want to reward. If they do not want to do that, then you must stay away from the company books and perhaps use some other technique. We still think that the opportunity for ownership and the excitement of ownership in that type of situation is the way to go.