The $1 Salary: Lessons Learned

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Periodically we receive requests from our clients to profile advantages, challenges, and best practices associated with administering pay programs that combine a very modest base salary with large equity grants. The **$1 Salary Plan** is the most extreme version of this approach, and the symbolism of such a program has proven attractive to a handful of CEOs.

To be clear, we are not speaking here of programs where CEOs decline any compensation other than a symbolic $1 salary. Where used, this approach typically is indicative of a founder who has already attained significant wealth from their existing holdings, and believes that the limited resource represented by compensation foregone (whether cash or new equity awards) is better invested elsewhere in the company. Instead, we are focusing on **executives who still receive an annual compensation program in general alignment with opportunities provided by competitors, but denominated almost entirely in equity awards**.

Advantages

Nearly all public company executive compensation philosophy statements are built on the cornerstone objective of alignment of pay with performance and the interests of long-term investors. So long as criteria to earn awards are meaningful—whether in terms of service or performance requirements—a $1 Salary Plan clearly sends a strong signal to all stakeholders that the CEO is committed to the Company and believes in its long-term value creation potential.

Moving any compensation from cash to equity will benefit cash-strapped companies, or companies who are prioritizing investments in R&D or servicing debt. While the modification of a CEO compensation program is unlikely to provide material benefit in most of these situations, it does underscore leadership's commitment to managing cash.

Relative to a more typical program that includes cash bonuses linked to discrete, short-term financial and operational performance measures, a program that is nearly 100% equity maintains focus on the long-term success of the Company as a whole. This approach is well suited for businesses that realize value through innovation and expansion into new markets, where experimentation and long-term thinking take precedence over short-term margin expansion or efficiency capture.

Of course, the form of equity chosen can optimize the plan for alignment with specific business strategy and human capital management priorities. Consider:

- Regular awards of simple service-vested stock options promote alignment with value creation, but at the risk of providing little motivation to "protect the downside" and little retention in the event of a substantial downturn.
- Service-vested restricted stock provides excellent retention and mitigates equity plan dilution, but a program entirely comprised of such awards may be criticized as "pay for a pulse".
- Performance-vested restricted stock can be tailored to specific long-term goals, but necessitates careful consideration of performance priorities (to inform the categories of measurement selected) and goal calibration (to inform what level of performance is associated each vesting trigger).

Many companies are migrating towards using multi-year financial measures (such as ROIC or combinations of revenue growth and profit) as the foundation of the performance-vested restricted stock programs, while stock price and dividend performance—measured on either an absolute basis or relative to an index of competitors—is used as a modifier.

Challenges

The three key challenges associated with a $1 Salary Plan are:

1) **Accountability**. In absence of specific financial or operational goals (as typically captured in an annual cash incentive), plans may eliminate the opportunity to directly link compensation to achievement of these milestones that cascade from the strategic business plan. This is less of an issue in sectors where stock price movement is seen as largely reflective of management's strategic planning and execution; where stock price is largely driven by economic cycles and factors outside of management's control, compensation should have a stronger link to items beyond stock price movement. And, of course, inclusion of performance-vested restricted stock tied to financial or operational goals can address this challenge.

2) **Alignment**. Performance-based cash bonuses, tied to achievement of company-wide metrics, are a vehicle for aligning executive team members to a common purpose—and research suggests that annual incentives often have outsize behavior impact compared to long-term equity incentives. Fostering a relatively similar pay mix across the leadership team also promotes alignment of pay outcomes, and avoids the risk of creating "winners" and "losers" based not on performance, but assignment of pay vehicles. To the extent that the CEO's equity program (vehicles and vesting criteria) mimics that of his or her team, this challenge can be mitigated although not entirely eliminated.

3) **Opportunity Cost.** Each additional $1 million in target value delivered in the form of equity equates to additional spend with respect to equity plan dilution. While many companies may conclude that this dilution is preferable to additional cash spend, careful consideration must be given in circumstances where annual equity burn rates are already drawing investor skepticism. If the end result of this consideration is confirmation that the additional burn rate is acceptable, companies must still consider whether that incremental burn may be better allocated to other team members or recruiting efforts.

Logistics

Key decision points when developing a program may include:

- **Pay Position.** Factors including prior compensation, company performance, current ownership position and form of award may all impact desired position relative to market for target total compensation. Companies may conclude that the greater risk associated with $1 Salary Plan supports an above median target pay opportunity. However, this argument is more difficult to defend if the form of equity skews towards service-vested restricted stock.

- **Determining "Target" Shares.** If using performance-vested restricted stock, FASB-prescribed valuation methods can drive a higher-than-expected disclosed (and expensed) amount, especially if market conditions (such as relative TSR or absolute stock price hurdles) are the performance criteria. A compensation committee that assumes the disclosed value will simply be equal to (target # of shares) x (stock price on date of grant) may receive an unwelcome surprise. Committees should understand the implications of the design on the expense that will be recognized per “target” share, and take this into account when approving the quantum of shares.

- **Administering Benefits and Risk Mitigators.**
  - Stock ownership guidelines are not meaningful if expressed as a multiple of salary; a fixed number of shares or target dollar value should be referenced instead.
  - Severance programs are not meaningful if expressed as a multiple of salary or salary plus bonus; however, vesting provisions tied to equity awards can achieve the same objectives as cash-settled severance.
  - The absence of salary means that medical insurance premiums may not be deducted from pre-tax pay. 401k matches are also foregone in the absence of a cash-settled bonus.

- **Developing an Alternative Pay Program.** Many companies with a $1 Salary Plan disclose that they have offered market competitive base salaries and / or target bonus opportunities, which the CEO declines. This disclosure underscores the CEO’s belief in the company’s long-term value creation opportunity.

- **Disclosure.** This atypical compensation program is a powerful signaling mechanism, and that messaging has even greater impact when the “how” and “why” behind the pay decisions are clearly described in the proxy statement. We would also encourage companies to consider language that emphasizes that the $1 Salary Plan approach will be revisited as part of the regular annual compensation planning cycle. If the approach is viewed as tailored to address specific circumstances—rather than a static commitment—than it will be easier in future years to describe why a new approach was implemented once circumstances changed.

Conclusion

We expect that $1 Salary Plans will receive heightened interest in the event of a prolonged economic downturn. While this article provides (we hope) a useful roadmap for preliminary considerations, the devil is in the details. We encourage compensation committees and CEOs to thoroughly vet proposals including modeling potential payouts across a wide variety of performance and termination scenarios before taking any action on this concept.