

THE SHERIDAN ROAD MAP

The Best Route to Financial Success



June 2009

Volume 3 • Issue 6



Welcome to the Sheridan Road Map! Your source of monthly insight into the financial world. Sheridan Road provides a one stop financial solution for middle-market companies, their executives and employees. We are the premier provider of Corporate Advisory, Corporate Retirement Advisory, and Wealth Management Services, by providing holistic and independent advice to our corporate and individual clients. The Sheridan Road Map will provide insight into both historical and topical issues, a calendar of upcoming events, industry news and analysis. "Let us help you navigate your Financial Road!" Visit us at www.sheridanroad.com.

RETIREMENT PLANNING: ESTATE TAX UP FOR DEBATE

Congress must take some action this year, as estate tax vanishes in 2010.

One issue that will be a big debate in Congress this year is the estate tax. Congress must take some action this year, because the way it stands now, the estate tax is set to disappear in January 1, 2010, but then spring back to life come 2011. In 2011 the estate tax exemption level returns to \$1 million for individual estate tax exemption and \$1.3 million estate tax exemption for family-owned businesses. The tax rate will also return to its original maximum rate of 55% with 5% surtax on estates over \$10 million.

Sen. Max Baucus (D-MT), chairman of the Senate Finance Committee, said last December that Congress will make the 2009 estate tax exemption limit (those estates greater than \$3.5 million are taxed at a 45% rate) under current law permanent and indexed for inflation this year. On March 26, Baucus introduced a bill (S. 722) that would do just that. While Senators Jon Kyl (R-AZ) and Blanche Lincoln (R-AR) introduced an amendment to the budget bill that would bump up the exemption to \$5 million and set a 35% tax rate—which has received some support from prominent Senators—Mark West, assistant VP, advanced solutions, at Principal Financial Group, anticipates that Congress will indeed decide this year to stick to the \$3.5 million exemption and 45% tax rate.

West says there are a number of "positives" in Baucus's bill, including an indexing-for-inflation provision. He also likes the so-called portability provision which says, a husband and wife each have \$3.5 million of exemption and "whatever the husband or wife, whichever one dies first, doesn't use up can be transferred to the surviving spouse so that you make sure you take full advantage of the full \$7 million" allotted for the couple.

The bill also reunifies the estate and gift tax exemption equivalent. Based on current law, West says, the exemption equivalent at death is \$3.5 million. "For example, if a person has a \$3.5 million estate, no estate tax is due. If the same person makes a gift today of \$3.5 million, only \$1 million is exempt from gift tax," he says. The Baucus proposal would "unify" the estate and gift tax exemption at \$3.5 million "which means that whether a gift was made or assets passed at death, no gift or estate tax would be due up to \$3.5 million. Prior to the 2001 changes, the gift and estate exemptions were unified."

Under current law, the annual exclusion is \$13,000 per year, West says; the Baucus bill would not change that amount. An individual could make multiple annual gifts of \$13,000 per person (not just their children) without reducing his/her lifetime exemption (currently \$1 million) or triggering any gift tax. On the House side, Rep. Earl Pomeroy (D-ND) introduced January 9 H. 436, Certain Estate Tax Relief Act of 2009. The legislation would restore the tax on estates and generation-skipping transfers and the step-up in basis provisions for property acquired from a decedent, previously repealed by the Bush Administration's Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Pomeroy's bill also sets the estate tax exclusion at \$3.5 million and imposes a maximum estate tax rate of 45%. The bill would also restore the phaseout of graduated estate tax rates and the unified credit against the estate tax, and sets forth estate valuation rules for certain transfers of non-business assets. Pomeroy's legislation would also limit estate tax discounts for certain individuals with minority interests in a business acquired from a decedent.

The battle over executive compensation and what it means for you.

When it comes to the public outcry over executive compensation, the sounds of protest may have faded but the fury lives on. Bands of placard-carrying citizens have disappeared from lower Manhattan, but efforts to rein in what many perceive as outrageous paydays are intensifying. From Capitol Hill to boardrooms across the country, efforts are under way to restrict the compensation of executives of all publicly traded companies, even those far removed from any form of bailout.

A Watson Wyatt survey found that nearly two-thirds of board members believe companies need to change their executive compensation plans in response to the current political and market pressures.

A Volatile Mix

It is political pressure in particular that has many observers, not to mention CFOs, seeing red. Soon Congress is expected to unveil a slate of executive pay legislation that could extend the government's recent rules for companies receiving federal dollars from the Troubled Asset Relief Program to other publicly traded companies. "The sad thing about AIG and the TARP regulations on executive pay is that successful, careful companies will be painted with the same broad brush, affecting their ability to compete in the global marketplace," says Jeffrey A. Burchill, senior vice president and CFO of FM Global.

If the remarks coming from the two primary movers in Congress—House Financial Services Committee chairman Barney Frank (D-MA) and Senate Banking, Housing, and Urban Affairs Committee chairman Christopher Dodd (D-CT)—are any indication, companies can expect substantive changes, although the full scope is anyone's guess. "Specific caps on compensation are not very likely," says Alexander Cwirko-Godycki, research manager at compensation benchmarking firm Equilar Inc., "but there is definite momentum behind say-on-pay provisions, mandates for wider clawback policies, and increased compensation disclosure requirements, among others." It remains to be seen which of these, if any, will become law.

"Situations of excessive pay are not rampant," says Brent Longnecker, chairman and CEO of Longnecker & Associates, a Houston-based compensation consultancy. "Only about 2% of companies have rewarded failure, but the government is keen to do something to appease the public's outrage."

In a worst-case scenario, some or all of the compensation provisions in TARP would be extended to all public companies. While that's a long shot, even the possibility has many people raising a battle cry. "If companies don't get out in front of this issue now, with their compensation committees leading the

charge, the government will get in and make things worse," says Ben W. Heineman Jr., former General Electric senior vice president and general counsel and currently a senior fellow at Harvard University's schools of law and public policy.

"The question is how far Congress will go," says Claudia Allen, chair of the corporate-governance practice at Chicago-based law firm Neal, Gerber & Eisenberg. "You have politics and the law getting stirred in the same pot, and it is a volatile mix."

Many observers fear the law of unintended consequences, and point to the 1993 creation of Section 162(m) of the Internal Revenue Code as Exhibit A. The regulation forbade corporate tax deductions for salaries exceeding \$1 million, but made an

exception for performance-based incentive compensation, such as stock options vesting at a particular date. Not surprisingly companies shifted from high salaries to high stock options and bonuses, while also lifting the salaries of many seemingly underpaid CEOs and other senior executives to \$1 million. Now the Obama Administration is considering revising 162(m) downward, disallowing tax deductions above \$500,000 and closing the loophole for stock options. "As we've seen happen in the past with respect to executive pay, the government has a way of making things worse," Longnecker says.

*"Abolishing bonuses
isn't the answer:
managing risk is.
As long as finance has
a say, everybody wins."*

Marc Rosenblum
CFO of Clarins USA

CFOs React

"This country was built on capitalism, on people wanting to better themselves, working long hours to achieve cherished dreams of success," says Marc Rosenblum, CFO of cosmetics company Clarins USA. "Unlike socialist societies, people could become rich if their companies became successful. We have to be very careful not to make this country a place where dreams can no longer be realized."

"If the government begins setting bright-line tests limiting compensation and enacts one-size-fits-all regulations," says Holly Koeppel, CFO at Midwest utility American Electric Power (AEP), "it may change the perception and motivations of managers, ultimately rendering the organization less competitive."

Rosenblum, however, concedes that some reforms are needed. "You cannot reward someone for sales volume without regard for whether or not it's good for the business," he says, taking a swipe at AIG. "I don't blame traders there for getting bonuses—they should be compensated for bringing in volume. But it's the CFO's job to make sure that what they're selling is not too risky." He suggests, in fact, that CFOs should play a key role in bringing sanity to bear on compensation. "Abolishing bonuses isn't the answer: managing risk is. As long as finance has a say, everybody wins."

In Search of Better Metrics

There may be a lesson in that for compensation committees. Myrna Hellerman, senior vice president at Sibson Consulting says “Committees will have to make [vital] decisions about what stays and what goes in 2010 compensation plans.” RiskMetrics’s McGurn agrees, adding that “AIG and other egregious examples of ‘pay-for-failure’ have served as a consciousness-raising exercise for boards and compensation committees.”

“I think that compensation committees should be in the crosshairs on this issue,” says Lester A. Hudson, chairman of the Human Resources Committee of AEP’s board, “and not the executives receiving incentive compensation. The problems

reside with the directors; many just don’t understand the implications of their plans. It is their responsibility to ensure that incentive compensation doesn’t increase the risk level of the company, and some committees failed to grasp this.”

As for what such committees might do, Bruce Ellig, a compensation adviser and author of *Complete Guide to Executive Compensation*, echoes Koepfel’s comments on metrics in general and cash flow in particular. “There are a number of ways that boards can address these issues before the government [steps in],” he says. “For example, they may want to use both net income and cash flow as pay-for-performance measures, as opposed to just net income. Cash flow is much harder to fudge—you either have it or you don’t.”

FM Global’s compensation program links incentive compensation to three key metrics: profitability, customer retention (measured as revenues from the existing customer base), and new customers (measured as additional revenues). If profitability falls precipitously and the other two metrics rise, executive compensation suffers—the reverse of the equation used by AIG. “Of the three key metrics, profitability is the one weighted largest, accounting for 50%,” Burchill says. “Customer retention is 40%, and only 10% is new business. You have to have company results before you pay incentive compensation.”

Despite the uncertainty regarding legislation, many companies are addressing compensation issues already. The Watson Wyatt survey found that fully 55% have frozen salaries—34 percentage points higher than the consultancy’s December 2008 survey recorded. Thirty-eight percent of respondents also are making changes to their annual incentive-plan performance measures and 30% are making changes to their long-term incentive-plan measures. About one-third have already shifted to time-based restricted stock and performance-based shares, and another third have changed or are considering changes to their executive-pay programs to address excessive risk.

Tensions and Checkpoints

Given that companies seem to be taking action, however belatedly, many argue that no government intervention is needed. Mylle Harvey Mangum, chairman and CEO of IBT Holdings, a designer and builder of retail environments for bank branches sits on several boards and currently chairs two compensation committees, at Haverty Furniture and Collective Brands.

“Compensation committees are in the best and most knowledgeable position to address the perceived abuses,” she says.

“Directors today are chosen by other board members and voted on by the shareholders. Nobody slips by anymore.”

To assure that executive pay is aligned with company

performance, she says, compensation committees should consider scenario-planning exercises in which the key metrics governing an executive’s pay are put through different circumstances. On the two compensation committees she chairs, “we use tally sheets to plot the financial metrics against salary and performance-based compensation to see where things might end up down the line. Each company is different, which is why one-size-fits-all regulations just don’t work. You want to set up healthy tensions and checkpoints that encourage salespeople to sell like crazy, but then have a finance person who has to approve the pricing and margins before things get out of control.”

Such checks and balances also are in play at AEP. Koepfel assists the board in linking business outcomes with compensation metrics. “We take the board through new scenarios every year,” she says, noting that finance provided “a wider range of possible outcomes this year in light of the economy.”

AEP’s board has the discretion to make adjustments to the compensation plan if they perceive it to have negative unintended consequences. Directors did that earlier this year, when the company lowered its 2009 earnings guidance. The board changed AEP’s methodology for annual incentive compensation by increasing the threshold earnings per share needed to fund the program, moving it to the midpoint, rather than the low end, of the company’s earnings guidance. The board decided that “requiring employees to work harder to achieve incentive awards more-appropriately balanced employee and shareholder interests, since shareholders would be negatively impacted by the lower anticipated earnings,” Koepfel says.

Such best practices may be moot, however. “The die has been cast,” says Kay. “We’re in a deep recession and people are looking for victims. Executive compensation is number one on that list. The government is getting high marks from the public. For the time being, Corporate America cannot defend itself.”

“Compensation committees are in the best and most knowledgeable position to address the perceived abuses.”

**Mylle Harvey Mangum
Chairman & CEO of IBT Holdings**

PENSION HEADACHES

Underfunded pensions are weighing down corporate balance sheets.

As if company executives didn't have enough on their plates, pension issues can be added to the list of concerns amid the wallowing economy. Some estimates predict as many as 360 companies in the S&P 500 will have underfunded pension plans this year. The silver lining, at least for dealmakers, is that these companies will be looking for ways to plug their pension holes, which will drive some to divest assets they would otherwise want to hold on to.

"Cash flow is a major issue this year; if companies have the money, they don't want to spend it," Howard Silverblatt, a senior index analyst at Standard & Poor's.

In December, former President George W. Bush granted a stay of execution for many companies confronting a dramatic drop in asset values. He signed a law easing funding requirements for employer-sponsored pension plans, allowing a limited form of "asset smoothing." The legislation came in the wake of the Pension Protection Act of 2006 (PPA), which had accelerated and tightened capital requirements for underfunded pension plans and removed much of the flexibility built into the prior regime. The PPA, itself an amendment to ERISA, generally requires underfunded companies to plug any deficit over a period of seven years.

"If you take a big hit to the pension, you'll have to account for it this year," describes Lawrence Cagney, who chairs Debevoise & Plimpton's employee benefits and executive compensation group.

A number of companies have indeed taken big hits. Equities held by private benefit plans lost nearly \$1 trillion last year, according to data from the Center of Retirement Research at Boston College. Because of that, many corporations are facing deficits that can't be shunted aside in the hopes that the market will simply bounce back.

Credit Suisse analyst David Zion issued research in January that predicted almost 75% of the S&P 500 companies would have underfunded pensions this year. Of those facing shortfalls, Zion wrote that almost one in five could face pension deficits as large as 10% of their respective market caps.

Whirlpool Corp. might serve as an increasingly typical case study. The company, when it reported earnings in February, showed a pension deficit of \$1.3 billion for 2008, more than double

its \$500 million deficit from a year prior. The shortfall represented roughly 45% of the company's \$2.85 billion market cap.

The impact goes beyond simple funding requirements, which usually don't kick in until 20-plus months after the shortfall is first documented. Companies with pension issues also face higher costs of capital, as their credit ratings are impacted, and they could see their book value contract, introducing the possibility of covenant issues. While some executives may be counting on new legislation to put off the day of reckoning, most realize that the pension problem can't be ignored.

The New York Times Co. spent much of the past year trying to shore up its balance sheet. It raised \$250 million from Mexican investor Carlos Slim and put its nearly 20% stake in New England Sports Ventures on the block. The company also raised \$225 million through a sale-leaseback of its corporate headquarters and threatened to shutter the money-losing Boston Globe if the Boston paper was unable to find \$20 million in savings through union concessions. While other forces are also at play, the New York Times' underfunded pension obligation of \$625 million is surely a major consideration.

Moreover, Whirlpool, when it acquired domestic rival Maytag in 2005, assumed benefit obligations of \$1.4 billion, \$555 million of which was attributable to the company's pension plan.

The Pension Protection Act at the time of the Maytag deal was merely a proposal swirling around Congressional circles. With the law in place and recent market volatility, dealmakers are much more cognizant of pension liabilities in negotiations.

That means buyers will increasingly negotiate around how benefit plans are transferred. Sellers may seek to hand off all of the liabilities whereas acquirers may push back, angling for the sellers to keep the legacy pensions on their own books. If buyers are going to take on the liabilities, they will work the risk into their valuation calculus even if the plans are fully funded. This is especially true in the small and mid market, where even a million-dollar liability can have a tremendous impact on a company's bottom line.

In the meantime, however, buyers will have their antennas raised for opportunities.



Ken MacFadyen • Mergers & Acquisitions, June, 2009



Sheridan Road Financial, LLC
707 Skokie Blvd, Suite 250
Northbrook, IL 60062
Tel: 847-205-9073
Fax: 847-205-9385
www.sheridanroad.com

For more information please call
Sheryl Lewis at 847-205-9073.

Securities offered through NRP Financial, Inc. Member FINRA/SIPC.
Advisory services provided by NRP Advisors, Inc.