



## Executive Compensation News & Views

Third Quarter 2009

### Trends in REIT Executive Compensation

Stock prices experienced meaningful declines in 2008: the S&P plummeted by over 33%, while the Morgan Stanley REIT Index dropped by nearly 38%. The significant declines in stock prices accompanied with the recessionary environment and concerns regarding liquidity, shareholder dilution, limited share reserves and increased public scrutiny affected the determination of appropriate compensation levels in 2008. SMG has recently completed its annual comprehensive review and analysis of executive compensation programs, and the following details our key findings and how REIT executive compensation has been affected by the current economic crisis.

#### REIT Total Compensation Trends

Total compensation levels showed overall decreases in 2008 of approximately 10-15% at the median. Compensation committees focused on company-specific performance (as opposed to industry-related performance) to determine compensation levels. The metrics used were generally as follows:

- Market performance – Total Return to Shareholders (TRS)
- Internal company performance – FFO, occupancy levels, etc.
- Management of risk vs. reward
- Balance sheet management, including liquidity levels

#### REIT Annual Bonus Trends

As expected, 2008 executive annual bonus levels, including cash bonuses and equity awards were down significantly compared to 2007 bonus amounts. Overall, REIT executives experienced a median decline of approximately 25%, but actual year-over-year changes ranged from moderate increases of approximately 3% to decreases of over 50% (between the 25th and 75th percentiles).

*Cash Bonuses.* Cash bonuses decreased at the median by 10%, but ranged from increases of 15% to decreases of over 50% at REITs with liquidity and operating performance issues. As a result of the uncertain economic environment, there was an increase in the use of discretionary bonus programs or discretion as a component of formulaic bonus plans. In addition, companies wanted to ensure that bonuses could be adjusted based on qualitative and quantitative factors affecting the company that might not be included in the current program. Of the REITs surveyed, 46% used

### Critical Executive Compensation Considerations for 2009

Companies are approaching an important period of compensation planning, decision-making and review for year-end 2009. It will be critical for companies to complete a comprehensive review and analysis of executive compensation programs in light of the newly proposed modifications to the Securities and Exchange Commission (SEC) proxy rules and the current economic environment. The following compensation matters need to be addressed to ensure meaningful programs are in place given the current economic and corporate governance concerns:

- **Properly Evaluating Appropriate Levels of Risk-Taking** – It is important for a company to create a performance metric portfolio within its bonus program that balances performance levels with the appropriate degree of leveraged payouts. In particular, shareholders have become concerned with the amount of potential upside incorporated into short-term bonus programs and the effects it may have on the executives' willingness to engage in "excessive risk-taking." Risk assessments should be included in year-end compensation reviews to ensure that reward opportunities reflect reasonable levels.

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## New SEC Rule Proposals – A Brief Overview

On July 10, 2009, the Securities and Exchange Commission (“SEC”) released proposed rules that would require additional disclosure in companies’ annual reports and proxy statements. In this process, the SEC worked hand-in-hand with the Treasury Department and the Obama Administration. The required additional disclosure is related to the relationship of a company’s overall compensation policies to risk, director and nominee qualifications, company leadership structure, and the potential conflicts of interest of compensation consultants, among other items.

### Enhanced Compensation Discussion and Analysis (“CD&A”) Disclosure

The SEC’s proposed rules would expand the scope of the CD&A, requiring a discussion and analysis of a company’s compensation policies and overall actual compensation practices for non-executive employees, if the risks arising from those compensation practices could materially impact the company. This was a topic of discussion in the prior version of the proxy disclosure rules; however, the SEC decided to shelve the issue as it generated so many comments. The proposed rules call for an expanded discussion to provide investors with a deeper level of transparency regarding how compensation policies may lead to increased, excessive or inappropriate risk taking by both executives and non-executive employees.

Examples provided by the SEC regarding this type of disclosure include, but are not limited to, compensation policies and practices at a business unit or units of the company that:

- Carries a significant portion of the company’s risk profile
- Are meaningfully more profitable than other units within the company

- Show compensation expense to be a significant percentage of the unit’s revenues
- Vary significantly from the overall risk and reward structure of the company

Should a company determine that additional disclosure is needed under the proposed rules, the SEC noted the types of issues appropriate for discussion and analysis based on a company’s particular circumstances include (but are not limited to):

- The general design philosophy of the company’s compensation policies for employees whose behavior would be most affected by the incentives established by the policies, and the manner of implementation
- The company’s risk assessment or incentive considerations in structuring compensation policies or awarding and paying compensation
- How compensation policies relate to the realization of risks resulting from the actions of employees in both the short and long term, including clawback policies and holding periods
- Policies regarding adjustments to compensation policies to address changes in a company’s risk profile
- Material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile
- The extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to providing incentives to its employees

Beyond the proposed rules noted above, the SEC also solicited public comments on compensation disclosure in proxy statements generally. Notably,

the SEC asked for comments on whether performance targets should be disclosed regardless of potential competitive harm, or, as an alternative, whether performance targets should only be required to be disclosed after the performance related to the reward is measured.

### Revised Stock and Option Award Disclosure in Compensation Tables

The SEC’s proposed rules would revise the disclosure required in compensation tables currently found in proxy statements. Stock and option awards would be disclosed as the aggregate grant date fair value of awards computed in accordance with Statement of Financial Accounting Standards (FAS) No. 123R, rather than the currently required disclosure to more accurately reflect the full grant date fair value of the awards. If adopted, the proposed rules would be effective for the 2010 proxy season; however, the SEC has not decided whether companies will need to include prior fiscal years.

### Relationship with the Compensation Consultant

Due to the on-going concerns regarding potential conflict of interests with outside compensation consultants, the SEC has proposed additional disclosure, but only if the consultant or any affiliates provide additional services to the company. The SEC’s proposal would require that such additional services and fees be identified as well as the fees paid for work related to executive and director compensation. Additionally, companies would need to disclose the consultant’s role in determining or recommending the amount and form of executive and/or director compensation, whether management was involved in the selection of the

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## **New SEC Rule Proposals – A Brief Overview**

consultant and whether the board of directors or compensation committee approved the additional services.

### **Experience of Board Members**

The SEC is proposing increased disclosure detailing experience, qualifications, attributes or skills that qualify a person to serve on the board of directors and any of its committees. Additionally, it would require the disclosure of any director positions held within the past 5 years and also increase the time period to disclose any legal proceedings in which the director or nominee was involved from 5 years to 10 years.

### **Disclosure of Leadership Structure**

The proposed rules would require disclosure in a proxy statement of a company's leadership structure and a discussion about why the company believes the current leadership structure is the best for the company. In particular, a discussion should be included regarding the (i) principal executive officer, chair person and whether these roles are separate and (ii) if there is a lead independent and the role of this person.

### **Disclosure of the Board's Role in the Risk Management Process**

The SEC's proposal requires disclosure in a proxy statement about the role of the board in the company's risk management process, and any effect that this may have on the way the company has organized its leadership structure. The purpose is to provide information about how a company views the role of its board and the relationship between the board and senior management in managing risks facing the company.

### **Compensation Planning**

The SEC's public comment period

closed on September 15, 2009. As we head into the 2010 proxy season, it is important to consider the possible impact of the proposed rules and how they will affect what is reported in the proxy statement. It is critical that companies re-evaluate and discuss each of these items and determine whether and where enhanced disclosure will be required.

SMG will provide you with real time updates of the SEC disclosure requirements as they are finalized.

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### *cont'd from page 1* **Critical Executive Compensation Considerations for 2009**

- **Appropriate Tax and Accounting Considerations** – During these difficult economic times, it is important to fully understand the impact on earnings (i.e., EPS, FFO/share, etc.) of the accounting and tax treatment of all compensation components. A detailed analysis by tax and accounting professionals should be completed so that a compensation plan that can mitigate some of the associated tax and accounting cost may be implemented.

- **Effective Utilization of Equity Compensation** – Many REITs have a limited number of shares available under their equity incentive plans. Additionally, depressed stock prices further enhance the issue of providing appropriate levels of equity compensation to key employees. Until an equity incentive plan upsizing can be approved by shareholders, it is important to effectively manage grants

under these plans. In order to select the most appropriate equity compensation vehicle(s) for year-end 2009 and 2010, it is important to complete a comprehensive analysis of the various equity compensation alternatives, including the potential value to recipients at various stock prices, accounting cost and tax considerations. Also, many companies completed equity issuances in 2009, which should create an opportunity to receive additional capacity through a plan upsizing.

- **Strong Governance over Executive Compensation** – Unless a company has in place appropriate governance guidelines, the intended objectives of the executive compensation programs may not be achieved. For instance, stock ownership guidelines and mandatory holding requirements help to ensure that the equity compensation program fosters the alignment of executives and shareholders' interests. Also, clawback policies, beyond Sarbanes-Oxley requirements, provide the company with the ability to recoup money for awards that were not actually earned by recipients.

It is important for companies to complete a comprehensive review in order to ensure that proper programs are put into place, guidelines are rigorously followed and all facts and figures are thoroughly checked. Also, companies should focus on developing and implementing a comprehensive executive compensation program that will most effectively attract, retain and reward a high-quality executive management team critical to achieving success in today's highly complex and competitive market.

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## Trends in REIT Executive Compensation

discretionary plans, 28% used formulaic plans, and 26% used a combination of the two.

*Equity Incentives.* The equity component of REITs' annual bonus programs experienced more significant declines of approximately 30% at the median, but ranged from flat to declines of over 60%. The significant decrease in equity awards was generally a direct result of the depressed stock prices in the REIT industry. However, equity compensation decreased by approximately 30% at the median, while the RMS declined by nearly

38%. Adjustments to 2008 equity compensation amounts generally reflected the following multi-pronged approach: (i) a flat to marginal increase in the number of time-based share awards, and (ii) the increased utilization of performance-based equity awards, including performance shares and stock options.

### Recent Trends in Executive Compensation

As a result of the difficulty in determining proper 2008

compensation levels, many companies are revisiting their existing compensation plans as they are based on criteria that may no longer be applicable in the current economic and business environment. Recently, a number of companies have redesigned bonus plan performance metrics to focus on specific business plans as opposed to generic industry criteria. This is the result of companies shifting focus away from acquisitions/dispositions and earnings growth and toward strengthening the balance sheet and improving liquidity.

## The Top Performers

### Top 10 REITs Based on Year-to-Date TRS Gain:

	Company	Ticker Symbol	Year-to-Date TRS (1/1/09-9/28/09)
1	Newcastle Investment Corporation	NCT	269.05%
2	Ashford Hospitality Trust, Inc.	AHT	221.74%
3	Arlington Asset Investment Corp.	AI	199.59%
4	KKR Financial Corp	KFN	197.47%
5	Alesco Financial	AFN	181.82%
6	FelCor Lodging Trust Incorporated	FCH	167.39%
7	HRPT Properties Trust, Inc.	HRP	154.95%
8	CapLease, Inc.	LSE	150.74%
9	Gramercy Capital Corp.	GKK	132.03%
10	Developers Diversified Realty Corporation	DDR	105.65%

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## The Schonbraun McCann Group Executive Compensation Team

Larry Portal, Senior Managing Director ❖ Anthony Saitta, Managing Director

### About The Schonbraun McCann Group

The Schonbraun McCann Group, an FTI Company, is recognized for assisting companies to maximize the enterprise value of their business. We provide a full range of strategic advisory and financial services in the following areas - Mergers & Acquisitions, Real Estate Due Diligence, REIT Services, IPO Advisory, Tax Structuring & Compliance, State & Local Tax Services, Private Client Tax & Advisory Services, Restructuring & Bankruptcy, Lease Consulting, Strategy Development, Hospitality, Litigation Support, Cost Segregation, Valuation Services and Financial Outsourcing.

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