Agency Cost Problems in Executive Compensation: An Evaluation of Dividend Equivalent Rights on Restricted Stocks

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by

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Table of Contents

PART I ........................................................................................................................................ 3
INTRODUCTION ............................................................................................................................ 3

PART II ........................................................................................................................................ 4
RESTRICTED STOCKS .................................................................................................................... 4
   i. Restricted and Performance Based Stocks as a Form of Executive Compensation .............. 5

PART III ....................................................................................................................................... 5
DIVIDEND EQUIVALENT RIGHTS ............................................................................................... 5
   ▪ EVIDENCE OF THE PRACTICE OF ISSUING DIVIDEND EQUIVALENT RIGHTS TO
     EXECUTIVES .......................................................................................................................... 5
   ▪ COMPANIES THAT HAVE PAID DIVIDEND EQUIVALENTS ON RESTRICTED STOCKS .... 5
     i. Richard Goldstein - International Flavors & Fragrances Inc. ............................................ 5
     ii. Mr. Paul Anderson - Duke Energy Corp. .......................................................................... 6
     iii. James E. Rogers - Duke Energy Corp. ............................................................................ 7
     iv. Mr. Jeffrey Immelt - General Electric ............................................................................ 7
     v. Louis C. Camilleri - Altria Group Inc. and Philip Morris International ............................ 9
   ▪ COMPANIES THAT HAVE DEFERRED PAYMENT OF DIVIDENDS EQUIVALENTS UNTIL AN
     EXECUTIVE EARN THE SHARES ...................................................................................... 10
     i. Microsoft ......................................................................................................................... 10
     ii. Intel ................................................................................................................................. 10
     iii. PepsiCo Inc. .................................................................................................................. 11
     iv. Sara Lee Corp. ............................................................................................................... 11
     v. DuPont Co. ..................................................................................................................... 11

PART IV ....................................................................................................................................... 12
CRITICISM OF DIVIDEND EQUIVALENT RIGHTS .................................................................. 12

PART V ....................................................................................................................................... 13
AGENCY COST BENEFITS OF DIVIDEND EQUIVALENT RIGHTS ............................................. 13

PART VI ....................................................................................................................................... 15
PROPOSITION FOR POLICY REFORMS .................................................................................... 15
   i. Deferral of payment of dividend equivalents until the stocks are vested ............................. 15
   ii. Detailed Pre-disclosure and Shareholder Approval ......................................................... 18

PART VII ................................................................................................................................... 21
CONCLUSION ................................................................................................................................. 21

I. Introduction

Some authors argue that the integration of stock options\(^1\) as well as restricted stocks into executive compensation may reduce the conflicts between shareholders and management but may at the same time give rise to other agency problems connected to debt.\(^2\) While this line of argument may hold some merit, the structure of executive compensation packages, has over the years, focused less on stock options and more on restricted stocks.\(^3\) A classic example of this trend is Microsoft, who in 2003, switched from using stock options to restricted stock.

Compensating executives through restricted stocks has recently come under scrutiny due to the fact that some of these executives receive dividend equivalents on restricted stocks even before the vesting period.\(^4\) One recent example of a company that has received such criticism is CA. Inc. CA’s executives received as much as $19,530 apiece on dividend equivalents from stock that they do not own.\(^5\) The relevant question that follows is whether executives are extracting additional compensation from shareholders using dividend equivalents or are dividend equivalents appropriate incentives to executives.

This paper will examine the concept of restricted stocks as part of executive compensation and the motivation of companies in using this compensation policy to address the agency costs problem. I will also examine practical examples of CEO’s who have received dividend equivalent payments on restricted stocks, variations of corporate treatment of dividend equivalent rights and the motivation of some companies who chose to defer payment on dividend equivalents until an executive earns the shares.

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1 Although there are a lot of papers about stock options as a means to address the agency problem, this paper will not be contributing to the existing literature on stock options.
5 Id.
This paper will further examine, whether there are agency cost benefits of dividend equivalent rights, which merit a strong case for its use. I conclude that there are a quite a number of significant agency cost benefits of dividend equivalent rights, one of which includes the fact that it helps executives focus on, and rewards them for managing the business to produce cash that is capable of being distributed to shareholders in the form of a dividend.

I will also look at some of the criticisms that have been asserted by shareholder activist groups as to how dividend equivalent rights reduce firm value, increase agency costs, and fails to achieve the objectives of adopting restricted stocks as a performance enhancing compensation package. I will describe the criticisms with a view to determining the basis of the criticisms and I conclude that while the criticisms are well founded, calling for complete elimination of dividend equivalent rights is not an appropriate solution to the agency cost problem.

Finally, I will put forward my recommendations for policy reforms.

II. Restricted Stocks

i. Restricted and Performance Based Stocks as a Form of Executive Compensation

As corporate executive compensation policies evolved, corporations drifted from traditional stock options executive compensation policy to restricted stocks, and performance stock policy with dividend equivalent rights. The motivation for this was that there was a hand-full of criticisms of stock options policy in that executives often manipulate the structure to increase their pay-out value, thereby increasing the agency cost to shareholders and the company.6

A restricted stock is a grant of company stock in which the recipient’s rights in the stock are restricted until the shares vest (or lapse in restrictions). The restricted period is called

6 Lucian A. Bebchuk and Jesse M. Fried, Pay without Performance: Overview of the Issues, October 2005
a vesting period. Once the vesting requirements are met, the recipient owns the shares outright and may treat them as he would any other share of stock in his account.

Restricted stocks generally require continued employment. The most common forms are time-vested stocks, meaning the executives do not have ownership rights on the stocks until several years after they are awarded. Performance or “phantom,” stocks on the other hand, are a form of restricted stocks paid to an executive only if the company meets certain performance targets. However, quite a number of companies tend to pay executives dividend equivalents on these unvested phantom shares, regardless of performance, and before the shares vest. For example, Robert Kotick, CEO of Activision Blizzard, Inc. (ATVI), who after getting a $56,000 raise from 2009 to 2010 and an addition $47,677 salary increase on January 1, 2011, was paid $411,000 in dividend equivalents on his restricted stock units.

III. Dividend Equivalent Rights

a. Evidence of the Practice of Issuing Dividend Equivalent Rights to Executives

Some companies offer dividend equivalent rights to holders of restricted stocks to give them an amount equal to the dividends they would have received if they owned the shares. Part b of this section provides detailed information about specific companies that have offered and paid dividend equivalents on restricted stocks to their executives, during the period in which those stocks were unvested.

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7 Under a time-vested restricted stock agreement, a CEO is compensated with stock holding but is only entitled to the actual ownership of these shares upon completion of a certain amount of service, typically three to five years; See, Christopher D. Mast, Responsible Executive Compensation, Pg. 6.
10Id.
11 Sonya Hubbard, Rocking the Comp at Activision Blizzard, April 19, 2011, available at
b. Companies that Have Paid Dividend Equivalents on Restricted Stocks

i. Richard Goldstein - International Flavors & Fragrances Inc.

In 2002, Richard Goldstein, former CEO of International Flavors & Fragrances Inc. (IFF) was awarded 200,000 performance shares, tied to how well IFF's stock fared compared with rivals through 2007. Mr. Goldstein became eligible for the first chunk of shares in 2005 but IFF stock failed to beat the designated rivals, and so he didn't receive them. He was however paid $506,000 in dividends on the shares. According to Dennis Meany, IFF's general counsel and secretary at the time, the dividend payments were part of a compensation package for Mr. Goldstein recommended by an outside consultant in 2002. Mr. Meany stated, “whether or not it would be recommended today, I do not know.” He however noted that the company had subsequently granted executives restricted stock units that do not include dividend payments before the shares are earned.

Today, IFF's Form 10-K discloses that the company still grants restricted stock units but such restricted stocks are calculated based on the market price of the company's stock at the date of grant, with an adjustment to reflect the fact that such awards do not participate in dividend rights.

ii. Mr. Paul Anderson - Duke Energy Corp.

In 2003, Duke Energy entered into an employment agreement with Paul Anderson, which became effective on November 1, 2003, upon his election as Chairman of the Board and CEO. On April 4, 2006, the Company entered into an amendment to the agreement which made it clear that Mr. Anderson would serve as Chairman rather than as Chairman and CEO. The agreement also provided as follows:

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14 Id.
15 Id.
a) That Mr. Anderson was to be awarded a performance share grant for 360,000 shares and a phantom stock grant for 285,000 units under the Duke Energy 1998 Long-Term Incentive Plan.

b) That Mr. Anderson’s compensation will be paid primarily through these equity awards and that Mr. Anderson will not be paid a base salary and will not participate in any other annual cash bonus program.

c) Vested performance shares and phantom stock units will be paid to Mr. Anderson in shares of Duke Energy common stock following termination of his Duke Energy employment.

d) Dividend equivalents granted to Mr. Anderson with respect to the performance share and phantom stock awards provided for payment of dividend equivalents in cash on vested and unvested performance shares and phantom stock units while the awards remained outstanding but unpaid.\(^\text{18}\)

The company’s response to the compensation awarded was that it believed the value of compensation earned by Mr. Anderson during 2004 was appropriate and reasonable considering Duke Energy's outstanding 2004 financial performance.\(^\text{19}\) Mr. Anderson was paid $700,000 in dividends on unvested shares in 2004.\(^\text{20}\)

\textbf{iii. James E. Rogers - Duke Energy Corp.}

In April 2007, James E. Rogers became CEO after Duke Energy Corp. completed its acquisition of Cinergy Corp., where Mr. Rogers had been CEO. Under his Cinergy contract, he received compensation valued at roughly $24.7 million as part of the Duke takeover. At Duke, he agreed to a contract with no base salary and no bonus. At the time, the company announced in a press release, that his compensation was "stock-based and tied directly to the performance of Duke Energy." He however received dividends on unvested performance shares totaling more than $700,000 a year. Mr. Rogers's no-salary,

\(^{18}\) \textit{Id.}

\(^{19}\) http://google.brand.edgaronline.com/EFX_dII/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=3573442-104727-173399&SessionID=aruSH6ACwI-r6A7

no-bonus, all-equity contract followed a similar deal struck by former CEO Paul Anderson when he took over in 2003.21

iv. Mr. Jeffrey Immelt - General Electric

General Electric (GE) has been paying dividends on restricted stock units since it started issuing them in 1990. In 2006, CEO of GE, Jeffrey Immelt, received more than $1 million in dividends on unearned restricted and performance shares.22 The 2006 proxy statement of the company disclosed that Mr. Immelt had a total of 1.3 million units of restricted stock and performance shares as of December 31, 2005, which would amount to $1.3 million in “dividend-equivalent payments,” an amount equal to 40% of his 2005 salary of $3,225,000, if such payments had been made on all the units for all of 2005.23

In response to the shareholders concern and criticisms, the Compensation Committee of GE stated, they had compensated the CEO with Performance Share Units because they believed that the CEO’s equity-based compensation should be focused entirely on incentives for performance and alignment with investors.24 The Committee further stated that the performance share units would convert into shares of GE stock at the end of the five-year performance period only if the specified performance objectives had been achieved.25

In 2009, some shareholders of General Electric Company sent a proposal to the board of directors of the company requesting the stop of payment of dividends or dividend equivalents on stocks that the executives have not yet earned.26 In their supporting statement, the shareholders stated in part, as follows, “The 2006-2008 proxy statements disclose that senior executives of the Company have received millions of dollars of

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21 Id.
22 Id.
24 Id.
25 Id.
dividends or dividend-equivalent payments on grants of equity compensation that they do not own. These are payments on shares that the executives may never earn if the Company fails to meet certain performance targets...In addition, our analysis of the 2006-2008 Proxy Statements indicates that the five senior officers have collectively been paid in excess of $12.5 million in dividends or dividend equivalent payments for the eleven quarters after January 1, 2006. We believe it is a blatant contradiction of the principle of pay for performance to give senior executives millions of dollars in ‘dividends’ for stock that they do not own, and may fail to earn in the future. If the purpose of a grant of performance shares is to make compensation contingent on the achievement of specified performance objectives, as the Compensation Committee stated in the 2006 proxy statement, we submit that no ‘dividends’ should be paid on those shares until an executive has actually earned full ownership rights”.

The board of directors recommended a vote against the above proposal. The board acknowledged that the company does award restricted stock units to the CEO and even other executives and that during the restricted period, each restricted stock unit entitles the executive to receive quarterly payments from GE equal to the quarterly dividends on one share of GE stock. According to the board of directors, the goal of providing such dividend equivalent payments is to mirror the income generation associated with stock ownership and to reward and retain executives, as the final amount of any compensation received is linked to the price of GE stock. The board of directors also believed that their practices regarding the provision of dividend equivalent payments are competitive and provided the appropriate risk-reward balance for the company’s senior executives.

v. Louis C. Camilleri - Altria Group Inc and Philip Morris International

In 2005, former CEO of Altria Group, Louis Camilleri, received more than $2 million in dividends on restricted stock, even though he had not earned some of the shares.

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27 Id.
28 Id.
29 Id.
30 Id.
31 Supra note 9.
Today, Philip Morris International (PMI), which until 2008 was an operating company of Altria Group, continues to make equity awards that are granted to management employees under a performance incentive plan. Recipients receive cash dividends or dividend equivalents on unvested shares of restricted or deferred stock. The company’s rationale is that this aids in fully aligning the interests of employees with stockholders.

On February 10, 2011, PMI disclosed, that some of its executives had received equity awards in 2010, in the form of restricted or deferred shares of PMI stock. The dividend equivalents on these stocks are payable on a quarterly basis through the restriction. The company further reported that dividend equivalents were also paid in 2010 to some of its executive.

c. Companies that Have Deferred Payment of Dividend Equivalents until an Executive Earns the Shares

i. Microsoft

On July 8, 2003, Microsoft announced that it would no longer issue stock options to its employees. In place of stock options, the company stated that it would grant restricted stocks. However, Microsoft never pays dividends on restricted stocks. This means that full ownership rights must have been earned before dividends can accrue. For Microsoft, dividend equivalents accrue when and as dividends are paid on the Company's common stock and become exercisable proportionately with the restricted stock units to which they relate.

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33 The following named executives received equity awards: Mr. Camilleri, $153,540 shares, $9,119, 509; Mr. Bernick, 73,850 shares, $4,358,406; Mr. Calantzopoulous, $90850 shares, $5,396,036, Mr. Pellegrini, 42,790 shares, $2,541, 513; and Mr. Waldermer, $73, 880 shares, $4,358,406.
35 The vesting period for this equity awards is February 19, 2014.
37 Id.
39 Denny F. Wong & Graham & Dunn PC, Goodbye Stock Options, Hello Restricted Stocks – Microsoft Leads the Way
ii. Intel

Intel never pays dividends on restricted stocks. Executives receive dividend equivalents on the final shares earned and vested. A standard condition relating to Intel’s restricted stock is that dividend equivalents will vest at the same time as their corresponding restricted stock units and convert into the right to receive shares of Common Stock.

iii. PepsiCo Inc.

Like Microsoft and Intel, PepsiCo Inc. does not pay dividends on restricted stocks until the stocks have vested. A standard PepsiCo Restricted Stock Unit Retention Award provides that “during the vesting period, the Participant shall accumulate dividend equivalents with respect to the Restricted Stock Units, which dividend equivalents shall be paid in cash (without interest) to the Participant only if and when the applicable Restricted Stock Units vest and become payable.”

iv. Sara Lee Corp.

Sara Lee usually reviews and approves awards to key executives based upon their individual performance. In 2005, an executive officer received a combination of performance and service-based restricted stock units. According to the company, the idea behind this grant was to align executives’ and stockholders’ interests, provide retention value and link rewards to the achievement of specific financial goals. The company does not however pay dividend on restricted stocks until the shares have been earned. There is a three-year performance cycle and the payment of any award is usually contingent upon achieving specific performance goals. For

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40 Supra note 38.
43 Supra note 38.
Sara Lee, performance goals consist of earnings per share and “value added earnings”, which the company views as a measure of economic profit.\(^45\)

v. DuPont Co.

For Dupont Co., restricted stock units are a means to ensure that directors act in the best interest of the company. The company uses a lot of time-vested restricted stock units that vest over a period of three years. Like many of the previously discussed companies, Dupont Co. does not pay dividend equivalents on restricted stocks before the shares are vested.

IV. Criticism of Dividend Equivalent Rights

Proponents of dividend equivalent rights assert that they are issued to encourage executives to raise cash to be distributed as dividend. There is however ample evidence to show that when companies have high cash flow, executives do not necessarily declare dividend.\(^46\) As a result, critics rely on this failure to declare dividend even when there is high cash flow, to strengthen their case against the use of dividend equivalents.

Critics also argue amongst others,\(^47\) that paying dividend equivalents on restricted stocks erodes the pay-for-performance objective, which is one of the key motivations for adopting restricted stock executive compensation policy. According to Brian Foley, managing director of Brian Foley & Co., "There's a sleight of hand there that's

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\(^47\) Others criticisms include the fact that dividend equivalents constitute double compensation to the executive, which increases the agency costs of the firm and reduces the aggregate firm value and that dividend equivalents are not fully disclosed in corporate proxy filings with the Securities and Exchange Commission. Dividend payments usually aren't included in proxies, so investors in most cases have to track those down and do their own math. According to Paul Hodgson, it's more stealth compensation and should be disclosed as exactly that; See, Phyllis Plitch, Moving the Market: Executives Find Restricted Stock Pays Dividends From the Get-Go, 28 February, 2005.
frustrating" when companies tout pay-for performance plans but pay executives dividends.\textsuperscript{48}

Another criticism of dividend equivalents is that since we have performance vesting for restricted stocks, it might not be a bad policy to adopt a vesting period for dividend equivalent payments. This is similar to what companies like Microsoft, Intel and Sara Lee have all adopted. The idea here is that the dividend equivalents should not be paid until the shares have vested or performance hurdle(s) attained.

Finally, critics argue that the dividend equivalent payments made to the executives are inappropriate as the executives may never own those stocks upon which dividend equivalents are paid on, because of their failure or inability to meet the performance hurdles or the time requirements under the compensation agreement.\textsuperscript{49}

\section*{V. Agency Cost Benefits of Dividend Equivalent Rights}

Notwithstanding the criticisms of dividend equivalent rights, a number of significant agency costs benefits have been put forward, that merit a strong case as against stock options.\textsuperscript{50} One of such benefits is the argument that it helps executives focus on, and rewards them for managing the business to produce cash that is capable of being distributed to shareholders in the form of a dividend. This benefit stems from what is often referred to as the free cash flow hypothesis. The free cash flow hypothesis suggests that self-interested managers have the tendency to consume perks and to invest in negative NPV projects to satiate their empire building ambition. Dividend payments are


\textsuperscript{49} See David Pauly, Dividends Are Real on 'Phantom' Stock and Quirks, Bloomberg, August 31, 2006.

\textsuperscript{50} Some proponents of dividend equivalent rights argue that it aligns the interests of the executives with the long-term interest of the shareholders and motivates executives to put optimal performance that increases overall firm value; Others argue that it discourages executives from engaging in insider dealing, which can be easily exploited under stock option compensation policy.
therefore used as a disciplinary role reducing funds at managers’ disposal, and as a result limiting their opportunistic behavior.\textsuperscript{51}

Although this benefit has some merit, a counter argument that is often identified is that when such cash is produced, it is still not distributed to shareholders as dividend but used as a tool for empire building, mergers & acquisition, and other lavish activities of executives. According to Jensen, conflicts of interest between shareholders and management over payout policies are especially severe when the organization generates substantial free cash flow.\textsuperscript{52} This does not mean that dividend equivalents are bad but it does leave the possibility that they may not be powerful enough to overcome agency costs problems.

Many other economists, financial analysts and even certain executives hold similar views that indicate that managers often chose to retain excessive cash flow and make value-decreasing acquisitions instead of distributing it to shareholders.\textsuperscript{53} Warren Buffet for example, in a letter to shareholders stated, “managers like to withhold unrestricted, readily distributable earnings from shareholders, to expand their corporate empire over which the managers rule, to operate from a position of exceptional financial comfort.”\textsuperscript{54}

The rationale behind this view is that manager’s act in this way because by increasing firm size, they serve their private interests in various ways.\textsuperscript{55} Companies like Cisco,\textsuperscript{56} Microsoft\textsuperscript{57} and Dell\textsuperscript{58} have been accused in the past of withholding significant amounts of cash,\textsuperscript{59} usually to pursue acquisitions, notoriety and eventual increase of CEO pay.

\textsuperscript{51} Meg Mi Luo and Marlene Plumke, Voluntary Disclosure and Dividend Policy, December 2008.
\textsuperscript{56} Earlier this year, Cisco announced it would start paying a quarterly dividend.
\textsuperscript{57} Microsoft generated over $22 billion in free cash flow in 2010, a 72% increase from 2006.
VI. Proposition for Policy Reforms

I have, in the foregoing parts described some of the criticisms against the payment of dividend on restricted stocks before they are earned by, and or vested on the executives. I have also shown that there are significant agency cost benefits of dividend equivalents payments to executives, which includes stimulation of the executives to make decisions that are geared towards producing earnings that would be paid out to shareholders as dividends, thereby increasing aggregate shareholder value.

In view of the foregoing, there is need for a policy reform that would strike a balance between need for continued motivation of the executives, through the payment of dividends equivalents on restricted stocks on the one hand, and the need to decrease the agency costs implication of this form of executive incentive on the other hand.

In this part, I would make two recommendations that may achieve the needed balance to motivate executives through dividend equivalent payment on restricted stocks on the one hand, and reduction in the agency costs associated with the payment of dividend equivalents on restricted stocks on the other hand. Firstly, I would make a case for the deferral of payment of dividend equivalents on restricted stocks until the stocks are earned or are vested on the executive. Secondly, I would recommend detailed pre-disclosure to the shareholders of the components of the restricted stocks, and the shareholders approval of the dividend equivalent payments thereof.

Deferral of payment of dividend equivalents until stocks are vested
The major factor that motivated a number of firms to drift from the grant of stock options as executive compensation to the grant of restricted stocks with dividend equivalent rights is to eliminate or reduce the escalating agency costs associated with stock options. As has been shown by Professor Jesse Fried, stock options encourage executives to show

58 Critics assert that Dell is hoarding more than $13 billion in cash — more than enough to fund a substantial dividend payout. In addition, its free cash flow increased from $3,073 millions in 2007 to $3,525 million in 2011.
59 Id.
bias against payment of dividend to shareholders in favor of stock repurchases, which reduces aggregated shareholder value and increases the payout value of the executives. Dividend equivalent rights on restricted stocks on the other hand, are used to encourage executives to pay dividends to stockholders since the executives themselves benefit from the dividend payments. This arguably provides the relevant incentives to the executives to perform optimally, and earns revenue for the firm.

In recognition of the fact that dividend equivalent payments are made on stocks that some executives do not own at the time of payment, and may never own in the future if the executives fail to meet the performance hurdle and/or serve out the time line designated for the stocks to vest, it is therefore also argued that dividend equivalent payments constitute a significant agency cost to the firm. The key concern here is that upon failure of the executive to earn the stocks, and thereby becoming a stockowner and legally entitled to the dividend paid on the stocks, the firm would have incurred a huge cost in dividend equivalent payment to a non-performing executive. The firm would lose these payments.

In order to plug this apparent risk and agency cost, while still retaining the dividend equivalent rights on restricted stocks, I propose that the payment of dividends on restricted stocks be accrued and deferred until the executive earn the stocks or the stocks vest by virtue of lapse of time. The idea here should be to accrue all the dividend equivalents due on the restricted stocks granted to an executive and payout the value to the executive when she becomes the owner of the stock in line with the terms of the restricted stocks grant. In doing this, the executive would be paid the accrued dividend equivalent upon the vesting of the stock. On the other hand, if the stocks, for any reason,

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60 Jesse M. Fried, Share Repurchases, Equity Issuances, and The Optimal Design of Executive Pay, January 2011.

61 Deferral based entirely on lapse of time basis is not in my opinion ideal because some executives may simply chose to wait out the period and get paid once the stocks vest thereby defeating the purpose of issuing the restricted stocks. However, it appears to be a better option than paying dividend equivalents on restricted stocks prior to the shares vesting. According to Justin Martin, “the compensation strategy most likely to be widely adopted is performance-based restricted stock.” See Martin, Justin. (2004). Raising the pay bar. Chief Executive, Retrieved Sept. 27, 2004, from the Business & Company Resource Center database.
do not vest or the executive fails to earn the stocks, no dividend equivalents would be paid to the executive.

Requiring a deferral on such payments might have certain tax implications especially in view of Section 409A of the Internal Revenue Code. Section 409A is however designed to protect creditors and applies to compensation that workers earn in one year, but is paid in a future year. It may be the case that rather than focus on creditors, Section 409A may be amended to protect shareholders as well. The tax implications of Section 409A is however beyond the scope of this paper.

One argument that the executive may raise against deferring the payment of dividend equivalents until the vesting date of the stocks is that the time value of money would impact the accrued sum that would be paid to the executive upon vesting. This line of argument has more significance especially in cases where we are dealing with executives whose contracts are based on a no-bonus, no salary/all equity contract. Executives could argue that if the dividend equivalent are paid during the period prior to the stocks vesting, they would deploy the cash to profitable investments, which would yield returns between the original due date and the vesting date. Thus, if the executive eventually earns the stock, and the dividend equivalent is paid, the executive may lose significant amounts of money and some investment opportunities that could have been made if dividend equivalents were paid to the executive when the shareholders were paid.

To address the above concern of the executives regarding the deferral of their dividend equivalent payment until the time the stocks are earned or vested, one option may be for companies to escrow the dividend equivalent proceeds in an interest yielding escrow account. Another viable option that would appreciate the value of the accrued dividend is to invest the fund in a short-term investment portfolio. Since the typical vesting period for restricted stocks is between three to five years, the accrued dividend may be invested in bonds that have such maturity period. In the event that the stocks vest, the principal

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62 For example, James Rogers & Paul Anderson of Duke Energy signed a no-salary and no bonus contract upon becoming CEO for the company.
sum of the accrued dividend equivalent and the interest earned to date would be paid out to the executive. This way, the executive would be receiving a premium for the deferred payment. On the other hand, if the executives fail to earn the stocks, the firm would also have earned some interests on the principal sum accrued.

As previously discussed, a number of firms have voluntarily implemented the deferral policy for dividend equivalent payments on restricted stocks. My view is that there is no need for a bright line regulation that would make it obligatory for firms to defer payment of dividends on restricted stocks until the stocks are earned or vest on the executives. Rather, companies may adopt the use of deferral on dividend equivalents on restricted stocks as a matter of policy. This would guarantee the saving of the agency costs that are associated with the payments prior to vesting of the stocks.

Detailed Pre-disclosure and Shareholder Approval
Companies are required to disclose in the detail, in their periodic proxy filings, the components of the compensations paid or to be paid to the executives. However, companies are not required to disclose dividends payments in detail in their proxy filings. It is therefore not surprising for the details of the dividend equivalents paid to executives on restricted stocks not to be disclosed to the shareholders. Thus, shareholders are often unable to determine the extent of payments that executives received as dividend equivalents since most management argue that dividend equivalent payments are not compensation but dividends on stocks. One possible solution that may be taken to increase the shareholders’ stake in deciding whether or not an executive should be entitled to dividend equivalent payments is to put the payment of the dividend equivalent on restricted stocks to shareholders vote for approval before it is granted. The shareholders should have the authority to pre-approve any dividend equivalent payment to any executive. This would possibly provide the shareholders the opportunity to assess the extent of the agency cost that the payment would require, and make an informed

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63 Campbell Soup, International Paper, and General Electric have already made the switch to performance-restricted plans: See Christopher D. Mast, Responsible Executive Compensation, Pg. 6, available at http://www.colorado.edu/ArtsSciences/PWR/occasions/list.html
64 The SEC requires disclosure of compensation paid to executives in Forms 8K, 10Q etc.
decision as to the cost-benefit implication of the payment. If the shareholders fail to approve the payment, then, no dividend equivalent would be paid to the executive, and vice versa. If the shareholders pre-approve the payment, they would no longer be in a position to complain, as done by General Electric shareholders. Providing the shareholders the opportunity to pre-approve the payment of dividend equivalents to the executives would arguably give the shareholders the sense of belonging, and create a moral obligation on the executives to perform optimally to increase the aggregate firm value, bearing in mind that they have to reciprocate the gesture of the shareholders by making the shareholders happy as well through earnings that can be paid out as dividends to the shareholders.

By empowering shareholders to vote on the payment of dividend equivalents on restricted stocks, I am not recommending a mandatory rule but simply an adoption by the company as a matter of policy. Should mandatory rules be put in place by the Federal Government, then I would recommend that the votes that follow from those rules not be binding on the board in the same way that Dodd-Frank has made the vote on Say on Pay merely advisory. Like Say on Pay, the failure to obtain shareholder approval on dividend equivalents would be indicative of shareholders’ disapproval of such payments and may have potentially significant impact on shareholder relations.

Another reason for recommending an advisory vote is that states like Delaware have a problem with mandating how the board decides on specific substantive business. A perfect example of how Delaware views such mandate to the board is the case of C.A. Inc v. AFSCME Employees Pension Plan.65 In that case, the court held that it is well established under Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather to define the process and procedures by which those decisions are made. Again it might be argued that giving shareholders this approval power looks like you are micro-managing the firm. While this is a valid objection, it is also important to point out that shareholders have a right to vote on fundamental decisions. My view on this is that dividend equivalents are

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65 953 A. 2d 227 (Del. 208)
fundamental because they provide a means to deal with empire building, important enough to give to shareholders.

Another counter argument against making shareholder approval a requirement for dividend equivalents on restricted stocks is that even if shareholders are empowered to vote on this, they will most likely not approve this time of payment. The most obvious reason for their refusal is that such dividends are seen as additional compensation to the executives through the back door. Another possible reason is that shareholders may be reluctant to approve dividend equivalents on restricted stocks because not only do the executives not own the stocks at the time the dividend equivalents are paid, but they may never earn the stocks. Approving such payments may lead to cases where the shareholders would have lost that payment to the executives without a corresponding value added to the shareholders. The agency cost of the firm would also have been increased.

It can also be argued that requiring shareholders vote like this is not necessary because shareholders are rationally apathetic. More strength is given to this line of argument especially because shareholder’s proposals calling for the elimination of dividend equivalent rights are not common. This raises the question whether paying dividend equivalents on restricted stocks is such a bad idea, and if it is why are more shareholders not calling for its elimination.

Be that as it may, there is need for the shareholders to adequately consider the value to be added to the firm by motivating the executives through dividend equivalent rights on restricted stocks before declining approval. The extent of dividend equivalent payment to be paid to the executives and the associated agency costs has to be weighed against the value that the executives would add to the firm and the agency costs that would be saved if the value is added to the firm. Given that paying dividend equivalent on restricted stocks has significant agency cost benefits to the firm, the shareholders exercise of their

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66 Part V of this paper details some of the agency cost benefits of dividend equivalents on restricted stocks.
discretion to approve or disapprove has to be objectively considered to ensure that the decision to approve or disapprove would be in the overall interest of the firm and shareholders. The shareholders should not blindly disapprove the payment or the extent of dividend equivalent to the executives mainly because the payment would amount to additional compensation. If the shareholders approval requirement is implemented alongside the requirement for deferral of the dividend equivalent payments due to the executives, it would be easier for the shareholders to vote for approval of the payment. This is because in giving their approval, the shareholders would be confident that the dividend equivalent would not be paid until the executives have earned the stocks or the stocks vest by lapse of time.

The recommendations outlined above would adequately protect the shareholders’ interest as well as the firm value from the risk of increased agency costs associated with the payment of dividend equivalent on restricted stocks.

VII. Conclusion

Recently, restricted stocks have come under criticisms mainly because of the dividend equivalents that are paid on these stocks prior to the vesting of the stocks. Some authors call for the complete elimination of dividend equivalents, while others insist on its continued use as a means to align the interests of management and shareholders.

In my view, I do not recommend the complete elimination of dividend equivalents on restricted stocks because, as has been shown, there are some agency costs benefits to companies when they issue restricted stocks with dividend equivalents rights. Rather than completely eliminate the use of dividend equivalents, companies can retain its use provided these dividends are not paid until executives have earned the stocks. The key benefit of deferring dividend equivalent payment in my opinion is that until the stocks are earned or vested, the non-vesting stocks result in increased agency costs to the shareholders. The implication is that if the executives work to earn the stocks, they
would have met the performance hurdle, which would increase the aggregate shareholder value, thereby offsetting the associated agency costs.