

# Employee Benefit ■ Plan Review

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## The Executive Compensation Dilemma: What Should the Board and Compensation Committee Be Doing?

Following the highly publicized Disney shareholder lawsuit where shareholders sued The Walt Disney Company board of directors, alleging violations of fiduciary duties based on the employment agreement entered into with former Disney executive, Michael Ovitz, and several other high profile compensation related suits against directors of public companies, public company executive pay began to be increasingly scrutinized. The option backdating controversy and new SEC rules requiring increased disclosure of what public companies pay their executives further intensified public and regulatory scrutiny over executive compensation and resulted in proposed federal legislation<sup>1</sup> to address executive compensation issues. In addition, activist shareholders offered “Say on Pay” proposals in record numbers during the 2008 proxy season,<sup>2</sup> requesting greater shareholder input or advisory notes on what executives make. The economic crisis highlighted issues with excessive risks attributed to incentive compensation arrangements received by executives in the financial services industry which encouraged management to focus on annual performance and take excessive risk. Finally, the \$700 billion federal legislation<sup>3</sup> enacted to address the country’s economic woes included restrictions on executive compensation for companies participating in certain programs offered by this legislation.

Amidst these scandals and focus on executive pay and severance packages, the headlines also include news of departures from executive positions with public companies for positions with private companies by several high level executives such as Bob Nardelli, the former CEO of Home Depot. In light of recent court decisions, changes in SEC rules related to executive compensation disclosure, federal legislation and greater institutional investor scrutiny of executive compensation, combined with departures from public companies by high level executives, directors must carefully consider how to provide sufficient, competitive compensation to retain and motivate performing, qualified

senior executives. This article analyzes what the board of directors and members of its compensation committee should be doing when addressing compensation decisions. With appropriate analyses, thoughtful questioning and a careful process, a board of directors and its compensation committee can potentially build corporate value by creating appropriate incentives for key employees, effectively protect itself, avoid excessive risk to the organization, provide adequate disclosure to its shareholders and avoid problems such as the departure of valuable executives and embarrassing and expensive litigation.

### BE FAMILIAR WITH CHANGES TO SEC DISCLOSURE AND OTHER REQUIREMENTS AFFECTING EXECUTIVE COMPENSATION

During 2006, the Securities and Exchange Commission adopted extensive changes to its rules governing executive compensation disclosure. These changes reflect the SEC’s most far-reaching executive compensation disclosure reforms in nearly 14 years. The amended rules affect disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements and agreements. These amended rules are intended to provide investors with clearer and more complete disclosure of executive compensation. The new rules require most compensation disclosures in the proxy statement to be written in “clear, concise and understandable” language, commonly known as “plain English.” Under the new rules, executive compensation is disclosed through a series of tables which have been revised to provide additional information as well as narrative disclosure. The amended rules also require a new section entitled “Compensation Discussion and Analysis.”

The SEC’s amended executive compensation rules require a section entitled “Compensation Discussion and Analysis” which addresses the objectives and implementation of executive compensation programs, thus providing investors with

significantly more information than was previously allowed through *de facto* recitation of SEC rules. This principles based disclosure is designed to focus on the most important factors underlying each company's compensation policies and decisions and must be included in public company proxy statements. The disclosure must provide an overview explaining the material elements of compensation for the named executive officers addressing issues including the following:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each compensation element?
- How does each compensation element and the company's decisions regarding that element fit into overall compensation objectives and affect decisions regarding other compensation elements?

Given these requirements, a compensation consultant may be necessary to assist in the preparation of these materials as well as preparation of benchmark data.

In light of the option backdating controversy, the SEC also provided additional guidance regarding disclosure of company programs, plans and practices relating to the granting of options, including the timing of option grants in coordination with the release of material, nonpublic information and the selection of exercise prices that differ from the underlying stock's price on the grant date. The amended rules will require new disclosures regarding option granting practices.

The Emergency Economic Stabilization Act of 2008 requires, among other things, limits on

executive compensation of companies participating in the Troubled Asset Relief Program (referred to as TARP), which includes the Capital Purchase Program (CAP). These requirements necessitate compensation committees of companies participating in these programs to examine the compensation arrangements with the company's executives to determine whether they encourage unnecessary and excessive risk which could threaten the value of the institution and limit such arrangements.<sup>4</sup> It has been suggested that given the current regulatory environment, these requirements could be applied to all public companies. The SEC Staff has also indicated that it is their belief that all companies should explain in the Compensation Discussion and Analysis section of their proxy statements the risks related to targets set for executives and explain the process executives must take to achieve such targets.

#### **RETAIN A COMPENSATION CONSULTANT**

Given the multitude of issues confronting a compensation committee today, the assistance of experts is often crucial. If a compensation expert is retained, this firm or individual should be retained directly by and report to the compensation committee, not management, to avoid actual or perceived bias. The consultant should also be independent (i.e., does not regularly advise management on compensation issues) and expert in analyzing and advising corporations on compensation and benefits matters.

#### **COMPARABLES**

The compensation committee should utilize published, benchmark data or hire a compensation consultant to generate data on "comparable" executive officer pay for similar businesses, usually based on size measured in terms of revenues and/or capitalization of the organization within certain industry segments.

This data should be reviewed and evaluated for:

- Assurance that total compensation, including stock based awards, is included;
- Determination of how the values of stock based awards are calculated in the data;
- Performance factors used by the comparable companies, particularly with respect to contingent/bonus payments; and
- Critical analysis on the appropriateness of the comparables used in terms of size of revenues, market capitalization, employees, comparable industries managed, and comparability of the executive roles.

#### **BONUSES**

While wage compensation is generally clear, bonuses tied to financial targets, corporate finance transactions, including merger and acquisition transactions, or specific financial or product development results must be clearly understood by the compensation committee and included in total compensation to determine the reasonableness relative to "comparable" executive pay. Calculating these contingent amounts often results in a range of possible values that then must be totaled and clearly disclosed, as indicated below.

In addition, bonuses and other financial incentives tied strictly to performancebased objectives could produce an "Enron-like culture," and have been attributed to financial issues experienced in the financial services industry, which companies now obviously seek to avoid. Additionally, incentives based on financial goals that are not balanced or too heavily weighted on one financial goal, may expose the company to excessive risk. Finding a balance between financial-based objectives and other qualitative measures of performance, such as compliance, customer satisfaction, engagement of employees, fostering a learning culture or adherence to good corporate governance principles, should be the goal of an

effective bonus program. In addition, a compensation structure that rewards multi-year performance as well as avoids excessive risk, should be emphasized as opposed to short-term performance-based targets.

### **STOCK COMPENSATION**

With the advent of Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 123, Share-Based Payment (SFAS 123R), and new SEC rules related to executive compensation requiring disclosure in a public company's proxy statement of the SFAS 123R value of all equity compensation, companies now have the added responsibility of determining the fair market value of stock based compensation, such as options, and expensing these options. In determining the value of executive compensation plans that include stock or stock based compensation or incentives, the board's compensation committee should ask the company's financial advisor or internal accounting staff to provide a clear and auditable work product to determine the value of stock based compensation and include information on the following:

- If the length of time to expiration of the stock based compensation is comparable to "market";
- What the different assumptions regarding the company's stock volatility were, given that stock volatility significantly impacts on the value of options;
- What the implied range of values of the stock-based compensation is over the foreseeable future; and
- If other provisions, such as vesting of the stock based awards, are comparable to those of other executives serving in comparable businesses and if any elements of the stock based award have been or can be "reset," including exercise prices.

In addition, given the recent emphasis on components in executive compensation arrangements

that contribute to risk of the organization, compensation committees should consider the percentage of compensation which is stock vs. cash and options vs. restricted stock. Consideration needs to be given as to whether too much emphasis on "pay for performance," in the absence of other factors, subjects the company to additional or excessive risk.

### **SEVERANCE AND PERQUISITES—THESE BENEFITS REALLY ADD UP!**

If anything is to be learned from the Disney case, it is that totaling the cost to the corporation of proposed severance and perquisites is a critical component of compensation necessary for a committee or the board to review in determining the reasonableness of the compensation. Often these costs are a function of estimated usage by the executive and involve a variety of cost categories and assumptions. For example, the originally undisclosed and extremely generous post retirement lifetime use by the former CEO of General Electric (GE) of a corporate aircraft, a corporate apartment, chauffeur services, and an automobile resulted in first year post-retirement costs to GE of approximately \$2.5 million—undisclosed and perhaps not understood by the compensation committee and/or board.<sup>5</sup> As a result of its disclosure failure, GE consented to an SEC cease and desist order with respect to the company's disclosure of these post-retirement benefits. Similarly, in the Disney case,<sup>6</sup> the compensation committee and the board apparently failed to determine the aggregate cost to the company of severance payments to a terminated executive, resulting in shareholder litigation based on allegations that the board breached its duty of good faith in approving this severance. In the Disney shareholder lawsuit involving Michael Ovitz's compensation it came to light that the then-CEO, Michael Eisner announced the Ovitz hiring before the board as a whole had evaluated

and considered Ovitz's employment agreement. When Ovitz was fired only 14 months later, the no-fault termination provisions in his employment agreement entitled him to an additional \$38 million in cash and the immediate vesting of options to acquire three million shares of Disney stock worth \$91.5 million.<sup>7</sup> The resulting shareholder litigation charged the board with breach of fiduciary duty. Ultimately, the Disney board successfully defended itself against these shareholder claims; however in the final decision, the Delaware Supreme Court agreed with the vice chancellor of the Delaware Chancery Court who indicated that the actions of the board of directors in this matter did not live up to the best practices of ideal corporate governance.<sup>8</sup>

As a result of the high profile Disney litigation, SEC disclosure requirements aimed at highlighting changes in corporate control and resulting severance or termination payments require extensive disclosure of these payments, whether or not made, as well as quantitative disclosure of what such officers would receive if a termination or corporate change in control occurs. These disclosures are intended to highlight the costs of termination for shareholders before they occur. The Emergency Economic Stabilization Act of 2008 limits the deductibility of parachute payments in connection with any involuntary dismissal of the four highest paid executive officers of companies participating in government-sponsored capitalization programs such as CAP.<sup>9</sup> Given the regulatory environment, it is likely that this kind of requirement could be applied to all public companies in the future. In addition, shareholder activists will likely continue to focus on parachute payments during the 2009 proxy season.

### **FINANCIAL ASSESSMENT AND DISCLOSURE**

A simple, but obvious task of the compensation committee is to

insist on reading the source documents such as employment, option, noncompete and related proposed agreements, sum up the total possible payments in the form of actual compensation, perquisites, and the value of in-kind payments that can be paid to executives under various scenarios, including termination with or without cause, merger or acquisition, death, disability, normal retirement, etc. and determine if these amounts are (1) reasonable; and (2) adequately disclosed. Next, the committee should ask: does the proposed pay package motivate executives to work to maximize shareholder value?

A well informed and effective board of directors recognizes and understands key factors which increase shareholder value, and works to assure that compensation programs motivate executives to increase shareholder value. Business factors that drive shareholder value differ by company and industry and typically include quantitative financial measurements such as increasing returns on investment, increasing profitable revenues or driving supplier decisions to increase gross profits. Operating factors often include new product development, successful completion of acquisitions or improvements in overseas sourcing, in addition to qualitative factors such as increasing workforce diversity.

#### **EVALUATE THE COMPENSATION PROCESS**

As a matter of good corporate governance, most compensation committees, frequently with the assistance of counsel, perform a self-assessment of the committee, its charter, operations and actions taken, typically on an annual basis. The goal of this process is to improve the compensation committee's effectiveness and correct any deficiencies in the compensation committee process.

The evaluation process involves a crucial look at the committee's role, structure, culture, access to

information and resources, as well as a review of the committee's charter, practices, and follow-through on important issues. This year a new factor to consider should be whether the compensation process included a risk analysis of compensation packages provided to management. This review should also include an assessment of the independence of the committee members based on applicable exchange rules.

#### **PROCESS MATTERS!**

In addition, given the option backdating controversy and SEC rules requiring disclosure of option granting practices, it is critical that compensation guidelines be established and consistently followed to avoid creating potentially negative issues for the company, its shareholders and executives, such as financial restatements or the loss of incentive stock option treatment for tax purposes. The practice of timing option grants to the release of material, non-public information and delegating authority to officers to grant options should be avoided. If the compensation committee or in-house counsel is not familiar with the detailed requirements applicable to option grants, it is important that they seek the advice of competent counsel before granting options.

#### **DELIBERATIONS AND DOCUMENTATION**

Meetings of the compensation committee should be held regularly throughout the year with additional meetings scheduled prior to finalizing the company's proxy materials so that the compensation committee can review the "Compensation Discussion and Analysis" section and finalize the compensation committee's report, both of which are included in the company's proxy materials. Compensation committee meetings should be documented in the same manner as board minutes and kept with the corporate records.

Careful documentation is important for several reasons. First, the details of option grants need to be carefully documented as well as any delegated authority to officers to grant awards, a practice that should be avoided. This practice is intended to avoid some of the issues that came to light in connection with the option backdating issues experienced by many public companies. Second, because disclosure must include a discussion of information regarding why the company chose to pay a particular element of compensation and how the company determined the amount for each element, as well as other factors related to executive compensation, the consideration of these factors by the compensation committee and the careful documentation of these discussions will be invaluable when preparing the "Compensation Discussion and Analysis" section of the proxy.

#### **NEXT STEPS**

In sum, the compensation committee or the board should be asking the following before making executive compensation decisions:

1. Have total compensation payments, contingent and otherwise, been summed and deemed not excessive relative to comparable measures?
2. Does compensation motivate executives to build shareholder value and avoid excessive risk?
3. Is the disclosure to the compensation committee and the board adequate—in other words, are the compensation committee and the board being provided all relevant documents proposed or entered into by the company that affect compensation and have the members of the board and/or the compensation committee actually read and discussed these documents?
4. Has adequate data been gathered and analyzed by the compensation committee in a deliberate and thorough manner?

5. How will these compensation discussions impact the company's proxy statement disclosures and the "Compensation Discussion and Analysis" section? ☉

**NOTES**

1. See Senate Bill S2866 "Corporate Executive Compensation Accountability and Transparency Act" introduced by Senator Hillary Clinton and Senate Bill S1181 "Shareholder Vote on Executive Compensation Act" introduced by Senator Obama which was passed in the U.S. House of Representatives.
2. Walton, L. Reed, "U.S. Midseason Review," Risk & Governance Weekly. May 23, 2008.
3. See Section 111 of the Emergency Economic Stabilization Act of 2008.
4. See generally, Section 111 of the Emergency Economic Stabilization Act of 2008.
5. In the Matter of General Electric Company, Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Exchange Act Release No. 50,426, 2004 SEC LEXIS 2174 (Sept. 23, 2004), available at <http://www.sec.gov/litigation/admin/34-50426.htm>.
6. In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006).
7. *Id.* at 56-57.
8. *Id.* at 56.
9. See Section 111 of the Emergency Economic Stabilization Act of 2008.

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