Executive Compensation
& Benefits

September 17, 2009

Executive Pay Reform Poses Complex Risks for Compensation Committees

by Scott E. Landau, Kathleen D. Bardunias, and Bradley Benedict

Compensation committees serving public corporations are facing unprecedented scrutiny as they react to recent executive pay reform efforts led by federal lawmakers and agencies, institutional shareholders and corporate governance watchdogs. The most sweeping impact on executive compensation practices may come from the Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Act").

As part of Washington's focus on reforming executive compensation practices that have been criticized for being partially responsible for the economic crisis of 2008, the Act embodies broad principles that have been embraced by the White House and Congress, along with other reform proponents. These include the following core ideas: executive compensation practices should be meaningfully related to performance; interests of executives should be aligned with the company and its shareholders; and unreasonable and imprudent risk-taking should not be incentivized. In addition, the process of establishing executive compensation schemes should be transparent, protect against bias and provide for enhanced accountability.

The Act constitutes the first broad-based legislative effort to promote these goals, building on methods that have gained popularity among companies at the forefront of compensation reform as well as on recent law-making aimed at financial institutions under the Emergency Economic Stabilization Act of 2008 ("EESA") and the American Recovery and Reinvestment Act of 2009 ("ARRA"). The Act was passed by the House of Representatives in July and awaits consideration in the Senate this fall.[1]

A major element of the prospective legislation requires the independence of compensation committees and their consultants and other advisors. The independence requirements apply to all public companies, although the SEC has the authority to exempt appropriate classes of issuers, such as small reporting companies. Under the Act, all compensation committee members must be independent of the company. Compensation committees are often seen as being too connected with corporate management to exercise fully

[1] The descriptions of the Act in this article are based on H.R. 3269, as passed by the House of Representatives on July 31, 2009. It is expected that the Senate will make changes to the bill, particularly with respect to the more controversial section on regulating the compensation arrangements of large financial institutions.

independent discretion. And even in situations where bias is not a problem, legislators are concerned that compensation committees may lack sufficient authority to act effectively when bargaining with executives or may be hampered by advisors whose decisions are tainted by their own conflicts of interest. The Act, therefore, requires that compensation committees have sole authority to retain and oversee outside consultants to assist them. Further, certain advisors ("compensation consultants and other similar advisors") retained by the compensation committee must also meet separate standards of independence to ultimately be determined by the SEC.

The House Financial Services Committee's draft of the bill specifically required that legal counsel advising compensation committees meet these independence standards as well. Although the House struck this language from the bill, regulators are clearly concerned about curbing conflicts of interests to the fullest extent practicable and ensuring a fair, transparent and accountable process. In fact, elsewhere in the Act, compensation committees are given the authority, in their sole discretion, "to retain and obtain the advice of independent counsel … meeting the Commission's standards of independence." Striking the mandate to retain only independent legal counsel should be seen as an accommodation to the variety of circumstances under which firms with tangential connections to the company may nevertheless appropriately give advice on compensation matters. The takeaway of this change should not be that the independence of outside counsel is not important. In fact, the consensus for best practices will no doubt be that all compensation committee advisors, including legal counsel, should be independent whenever practicable. This will provide the committee maximum protection against accusations of bias or imprudence when selecting outside consultants. Well-documented decisions made with the input of demonstrably independent advisors are easier to justify to shareholders and regulators and much easier to defend in the event of litigation.

Increasing governmental regulation is only one aspect of the rapidly changing landscape of executive compensation. As companies seek to improve the methods they use to attain their compensation policy goals, compensation committees are adopting innovative new "best practices." Under the Act, compensation committees will have the full responsibility and authority necessary to ensure that shareholder interests are fully reflected in the company's compensation policies. This paper highlights just some of the developments in executive pay practices and the challenges for compensation committees at a time when compensation arrangements are receiving intense scrutiny from shareholders and the general public, as well as increasing regulation from lawmakers and agencies.

Equity-Based Compensation Policies and Practices

Share Ownership and Retention Guidelines

Company stock ownership and holding requirements are among the most prominently recommended practices to ensure that interests of the company's top management are aligned with those of the general shareholders. Ownership of a significant amount of company shares that must be held for a sufficiently long period strongly encourages executives to focus on building long-term share value. Ownership policies often require an executive to acquire a target number of shares over a period of time and then maintain that level of ownership for a specified period. The amount of stock is usually equal to a multiple of fixed salary, for example, 1 to 5 times the executive's base pay. Alternative arrangements, which may be less onerous to the executive, include "retention ratios" or "holding periods," under which a portion of the executive's equity-based compensation must be held in company stock during employment or for some specified period. These alternatives will often result in the executive obtaining an increasing equity stake in the company. Issues to consider when designing ownership and retention policies include:

- Which executives should the policy apply to?
- What level of ownership is appropriate and what holding periods should apply?
- Should equity-based compensation have independent retention requirements?
- Should executives be required to hold equity awards until retirement or beyond?
- Should the executive's overall ownership percentage affect retention requirements (*e.g.*, is an exception to a retention ratio appropriate for executives who already hold a substantial ownership interest in the company)?
- When should the executive's holdings and the per share value be measured?
- Should outstanding restricted or non-vested equity awards be counted toward ownership levels?
- What exceptions to retention requirements, if any, should the plan incorporate (*e.g.*, financial hardship, unforeseeable emergency)?
- What consequences should result from noncompliance? (For example, the policy could limit future bonus or incentive-based pay awards, or replace other payable compensation in an amount equal to the shortfall with restricted shares that do not vest until the holding period expires.)
- Should the company have any discretion in administering the policy or is an automatic penalty for noncompliance preferable, notwithstanding?
- What contingencies are desirable in the event of a change of control?

Selecting Equity-Based Awards

Equity-based compensation may be the most important (and most valuable) element in an executive's pay package. It is crucial that compensation committees select the most appropriate mix of equity-based awards and grants for a company to achieve its compensation program's short- and long-term goals. Types of equity-based awards include stock options (both incentive stock options and nonstatutory), stock appreciation rights, restricted stock and restricted stock units, performance-based shares and performance-based units. Vesting and forfeiture features provide additional ways to tailor equity-based pay. Choosing the appropriate type of award is a decision that goes beyond compensation strategy; it also involves accounting and financial reporting considerations, tax-related issues (for the company and for the recipient), SEC disclosure requirements as well as the potential effect on company stock. Among the many circumstances that can impact this decision are:

- Availability of cash to pay awards;
- Competitive practices and industry expectations;
- Company culture and the demographics of likely recipients;
- International regulatory and taxation issues that may apply to non-U.S. employee recipients;
- The potential dilution effect and other shareholder-based concerns; and

- The anticipated prospects and volatility of the company's stock price.

Stock Option Issues

Although options continue to be a popular form of executive compensation, critics point out their flaws as pay-for-performance tools. For example, the value of an option grant may be highly volatile or depend on extrinsic factors affecting share price (since option value is based only on the appreciation in share value); options may incentivize the option holder to focus on short-term goals in anticipation of exercise; and options represent a potentially substantial upside reward relative to downside risk for the optionee (an underwater option's value is zero no matter how out of the money it is), which may encourage excessive risk-taking. Other drawbacks are that option awards may be perceived as less valuable than their attributed accounting (and disclosure) costs since most options are granted with a strike price of fair market value on the grant date and only acquire value over time. Others focus on the dilutive effects of options because a substantial number of option shares are usually required to provide the desired level of compensation in a struggling or uncertain market.

Another critical issue, particularly in light of the recent market downturn, is what to do about underwater options. Outstanding options that are well out of the money can affect morale and employee retention efforts as well as hamper the company's ability to gain shareholder approval for new issuances of stock. Option repricing, replacement or buyouts may be employed to deal with this situation, but such programs pose their own challenges. Among other factors, accounting standards, SEC disclosure rules and exchange listing standards may affect the implementation and design of a repricing, replacement or buyout program. Also, effective employee and shareholder communication is always a key component of a successful strategy. Compensation committees must be aware of the requirements and the potential pitfalls associated with undertaking any of these alternatives.

Incentive-Based Compensation

Executive compensation best practices traditionally highlight the importance of tying compensation more closely to performance. Renewed efforts are being made to ensure that the performance criteria used for incentive-based pay—and the periods during which they are applied—are properly selected to further the company's strategic goals. A carefully constructed mix of financial, operational and strategic metrics can be used to maximize the effectiveness of both short- and long-term incentive awards. Performance criteria should not be applied in a cookie-cutter fashion to all eligible employees. Incentive measures are most effective when they are customized to the roles individual executives play in the company's business plan and the measurable effects they are expected to have. These compensation committee decisions have a tremendous impact on the success of performance-based pay plans.

Volatile economic conditions can complicate the selection of effective performance criteria, as financial indicators do not necessarily accurately reflect underlying conditions and trends. This disconnect occurs, for example, when equity-based awards are granted during a period when the company's share price is uncharacteristically undervalued, perhaps as a result of a general market decline that is expected to rebound. Such awards can result in an unintended windfall as the company's stock regains its value. It is important to consider such non-performance-based effects that can affect incentive compensation schemes.

Risk assessment of incentive-based pay practices is another major area of current reform efforts. Under EESA, financial institutions receiving government assistance must conduct and disclose risk assessments of their compensation programs ensuring that their pay structures do not undermine long-term strategic goals or have adverse systemic effects. The Act, in its current form, places similar disclosure requirements on all large financial institutions and would prohibit any compensation arrangement or feature that unreasonably incentivizes undue risk-taking that could threaten the firm or have serious adverse effects on economic conditions or financial stability. The SEC's revised disclosure rules (discussed further below) take risk assessment requirements beyond the banks and financial institutions. Going forward, most public companies will have to assess whether their compensation policies could have a "material effect" on the company in order to comply with compensation-related proxy disclosures. As compensation committees take on increased responsibility and accountability, they will have to work with the company's risk managers to gauge the risks that their recommended incentive-based schemes may have in practice. Analyzing and mitigating compensation-related risks is new territory, but companies have begun to acknowledge risk analysis as one reason for adopting tactics such as:

- Ensuring a significant proportion of incentive-based pay is based on long-term performance to discourage excessive risk-taking;
- Forgoing incentive awards based on return on equity or EBITDA, which can result in overleveraging;
- Providing a sufficient base salary as a percentage of total pay to minimize the incentive for excessive risk-taking;
- Increasing vesting periods for certain compensation;
- Capping bonus awards;
- Reducing oversized severance and pension benefits;
- Establishing ownership requirements and/or mandatory holding periods for equity compensation; and
- Adopting clawback policies.

Issues Relating to Employment/Severance Agreements

Clawbacks

An increasing number of companies are adopting policies and provisions allowing them to recoup amounts of previously paid (or payable) compensation in the event of a financial restatement due to error or fraud. Generally, clawbacks require the return of any amount paid in excess of what would have been owed under an accurate financial statement. Clawback provisions may also be used for breaches of non-compete, non-solicitation and similar severance agreement covenants. Such company-imposed measures operate separately from the narrowly focused clawback provisions found in the Sarbanes-Oxley Act and ARRA, which do not provide for a private enforcement mechanism. Important questions to consider when designing an appropriate recovery policy include the following:

- Should the company adopt a broad-based policy or incorporate clawback or other penalty provisions into individual compensation agreements and incentive plans?
- Which employees will be covered and what elements of compensation will be susceptible to recovery?
- Should there be a "fault" trigger, limiting recovery to cases where the recipient is responsible for the inaccurate data? In a recent enforcement action under Sarbanes-Oxley, the SEC took the position that

fault was not a necessary element to require repayment. (Although the ARRA clawback explicitly applies even if the executive is unaware of the error or misstatement, the Sarbanes-Oxley provision is silent on the issue.) What influence will the SEC's stance have on private clawback procedures?

- Will there be a time limitation on the application of the clawback; how far back should it reach?
- What steps are required to implement such a policy retroactively?
- Should the company have any discretion in exercising its right to recover funds?
- What contingencies are desirable in the event of a change of control?

Defining Contract Terms

It is vital for compensation committees to take advantage of all the expertise necessary to ensure that their carefully formulated compensation strategy is soundly implemented. The devil is in the details, and contract definitions may be the most devilish of all. Too often such agreements are cobbled together from borrowed boilerplate or inappropriate model language. Drafting clear and precise definitions of key contract and plan terms will not only avoid inadvertent misunderstandings and contentious disputes, but also smooth the way for administrative efficiency. A few examples follow.

Severance for Poor Performance (and Definition of "Cause"). A company's pay-for-performance model is undermined when an executive is entitled to a substantial separation package regardless of the reason for termination. Poor performance is traditionally not among the reasons for which a company may terminate employment for "cause," which can relieve the company from its obligation to pay a severance bonus, but this is beginning to change. Of course, an executive will resist an agreement granting the employer unfettered discretion in determining when poor performance constitutes cause. Balancing these interests is a major challenge in negotiating effective severance provisions in employment agreements that protect both the company from rewarding failure and the executive from an arbitrarily punitive termination. Compensation committees should explore how objective criteria may be incorporated into their employment agreements' definition of "cause" to achieve a workable solution.

"Good Reason" Terminations. A similar problem can occur when an employment contract or change of control arrangement provides for generous benefits that may prompt an executive to seek a separation that nevertheless entitles him or her to receive separation pay (or at least use this right to renegotiate a contract). Many companies use language from Code Section 409A's safe harbor definition of termination for "good reason" to determine circumstances under which an employee's voluntary departure will be deemed "involuntary" and not cause him or her to lose separation benefits. Such a provision might read:

> "Separation for good reason requires that the employer take actions resulting in a material diminution in (i) base salary, (ii) the employee's authority, duties or responsibilities, (iii) the authority, duties or responsibilities of the individual(s) or entity the employee reports to, or (iv) the budget over which the employee retains authority; a material change in the geographic location at which services must be performed; or any other action or inaction that constitutes a material breach by the employer of this agreement."

Such language may be overly broad and is much too vague. It fails to take into consideration situations in which an executive's authority or job responsibilities may legitimately be in flux for a short period of time (*e.g.*, immediately following a change in control). Moreover, without a definition of "materiality" that lends meaning to each of the clauses, the outcome will too often be an irresoluble argument over the sufficiency of a status or other change, which can easily wind up in court or contract renegotiations. In some circumstances, using objective and concrete materiality thresholds should be considered.

"Change of Control." The change of control definition may be the most complicated in many compensation-related agreements. It is not surprising, then, that it is also one of the most problematic. Once careful consideration leads to an acceptable formulation of a change of control definition for one purpose, the term is often used elsewhere in the document (or related or unrelated documents) in a way that makes little sense. For example, whereas the definition invariably requires completion of the contemplated transaction, it does not always make sense to condition an executive's related bonus payment on consummation since the deal might fall through for some unforeseeable reason. Changes of control can also adversely affect other contract provisions when certain other terms are no longer applicable due to the change. It is important to consider the effect a change of control will have on all aspects of compensation arrangements.

Compensation committees must examine the effect a change of control will have on all affected compensation agreements to prepare for any unexpected consequences, such as duplication of benefits, excessive payouts due to additional service or compensation credits applied to pension or severance benefit formulas, post-employment benefit triggers, or the like. Structuring a framework for managing change-of-control compensatory decisions that can be incorporated into a company's compensation arrangements before a transaction is contemplated is ideal. Further, such agreements should be drafted to ensure smooth transition periods and include any necessary and appropriate general releases and non-competition, non-disclosure, and non-solicitation covenants.

Role of Perquisites

There has been only a modest decline in the value of named executive perks since they became subject to enhanced proxy disclosure rules (and some report a year-over-year increase for 2009) despite recent media attention on lavish executive giveaways. Many companies argue that perks constitute an important element of an executive's overall compensation package and are useful in attracting and retaining executives and in negotiating their pay. Some perks almost certainly assist executives in performing their duties, but others—such as excessive personal use of corporate aircraft, excessive death benefits, and tax gross-ups on other benefits—have become particular targets of shareholder advocacy groups. As in other areas of executive compensation, transparency as to perks may be the best policy to placate shareholders and skeptical investors. Companies and their compensation committees must be prepared to justify their use of perks and demonstrate that the expenditure is not excessive. Discussions of the company's compensation strategy should acknowledge how perks offered by the company are selected and the value they are intended to provide.

Non-Competition/Non-Disclosure/Non-Solicitation Covenants

Properly drafted non-competition, non-disclosure and non-solicitation covenants can provide additional protection to a company throughout an executive's term of employment and for a period post-employment. These provisions place certain restrictions on the executive from directly competing with the company after a termination of employment, disclosing confidential company information and soliciting current company employees away from the company. It is critical that such provisions clearly articulate what the executive may or may not do, as well as the period of such restrictions since many of these provisions may be affected by the governing state law or additional compensation received as consideration. For example, a compensation committee may consider providing for some severance-related compensation in an employment agreement when an executive voluntarily resigns or is terminated for cause in order to increase the enforceability of a non-competition clause. Also, in the context of a merger or acquisition, these types of provisions will likely be subject to scrutiny and could impact the pricing of the transaction.

Therefore, these clauses should be reviewed with a watchful eye and appropriate legal review enlisted to ensure that they will be enforceable, if necessary.

Other Current and Evolving Compensation Practices Include:

- Use of shorter-termed employment, severance, incentive and other compensation-related contracts, which are updated to reflect changed circumstances with respect to strategic planning, performance expectations, the executive's accrual of company stock and deferred compensation, and other considerations. Automatic renewal of and "evergreen" clauses in compensation arrangements are likewise discouraged.

- Use of meaningful double triggers in change of control situations to reduce unnecessary golden parachute payments and encourage executive retention after corporate transactions and reorganizations.

- Elimination of gross-up provisions, which can add significant amounts to a company's compensation expense without any meaningful link to services provided or performance.

Disclosure Issues

SEC Regulations

In July 2009, the SEC issued revised rules on compensation disclosure which may become effective in time for the 2010 proxy season. These rules echo the concerns of reformers that executive compensation practices often fail to reflect shareholder interests and sometimes give rise to perverse incentives among corporate management and other employees. Changes proposed by the agency require enhanced disclosures including a risk analysis discussion for compensation schemes that pose material risks to a registering company; information on leadership structures related to compensation decision-making and potential compensation consultant conflicts of interest; the board's risk management process; and enhanced director and nominee qualification information. The SEC is also returning to its former position requiring aggregate full value FAS 123R reporting of stock and option awards in the Compensation Discussion and Analysis ("CD&A") summary compensation table (rather than the amount representing the company's accounting expense taken for the year).

Effective communication between compensation committees and shareholders and other stakeholders will be increasingly important. In addition to presenting their recommendations, these committees should be prepared to explain their decision-making procedures, including their review of existing and proposed compensation schemes, decisions to seek outside consultants and other counsel, monitoring duties with respect to their retained advisors and plan administrators, and the analysis leading to their ultimate recommendations.

Say-on-Pay

The Act brings a long-expected say-on-pay requirement to all public companies (subject to the SEC's authority to exclude an appropriate class of issuer). Shareholders will have an annual nonbinding vote on the company's compensation practices. The vote is to approve the contents of the company's proxy CD&A and related information, as required by the SEC. Golden parachute arrangements for named executive officers connected with certain corporate transactions must also be approved by shareholders if they have not already been the subject of a prior say-on-pay vote. Although the say-on-pay votes are nonbinding, and do not require any follow-up action on the part of the board of directors, this heightened transparency and accountability provides even more incentive for compensation committees to adopt best practices in the design and implementation of compensation policies.

Corporate Governance Issues

Compensation Committee Charter

Compensation committees should have clear purpose and directive from the company so that the members of the committee clearly understand the role of the compensation committee and what responsibilities it will have. A detailed written charter outlining these goals and responsibilities allows the company to specify what role the committee will play in the corporate governance structure as well as providing committee members with a blueprint for the year's agenda. All New York Stock Exchange listed companies are required to have such a written charter. However, a written charter is clearly a best practice for all compensation committees since it will assist the company as well as the committee in determining who is responsible for which decision-making in connection with compensation decisions and what the expectations are for all committee members. A compensation committee should consider reviewing its current charter, if available, to determine where there might be gaps in the document and how it can be properly drafted to include all relevant details and information to provide the committee with clear guidance.

Committee Structure

The composition, qualifications and selection process for a compensation committee member should be relevant to the company and its expectations for such a committee. On average, committees are generally composed of between three to five members, although this number may vary based on the workload expectations. Also, the committee cannot be too small or too large that it loses its effectiveness. A company should also have clear guidelines as to how compensation committee members will be selected and what qualifications are required for consideration. For example, the entire board of directors may select the committee members or a separate board committee could be charged with the task to appoint the members of the compensation committee. In addition, a company may wish to consider providing certain term limitations on each compensation committee member in order to ensure that new individuals join the committee and provide a fresh perspective in the area of compensation. While it is clear from the proposed legislation and certain exchange requirements that committee members must be "independent," a company should determine what other skills and knowledge are critical for its compensation committee members. A company may wish to ensure that its committee members have a certain level of expertise in the area of executive compensation or previous professional experiences that will bring certain skill sets to the committee. These issues relating to structure may be included in the committee charter.

General Business and Decision-Making

In order for a compensation committee member to make a truly informed decision, he or she must have a clear understanding of compensation issues in general. Training should be provided to all committee members regarding general compensation and employee benefits issues, alternative compensation design structures, terminology and anticipated outcomes allowing the committee to utilize outside consultants more effectively and make well-considered decisions for the company. For example, a company with a defined benefit pension plan should ensure that its compensation committee has a working knowledge of relevant actuarial terms so that the committee members can competently review the plan's actuarial reports. This type of training enables the committee not only to determine what outside consultants are necessary and monitor their activities, but also to understand the information and reports the consultants provide. The inevitable result is improved decision-making on the part of the committee.

The compensation committee should also have written and detailed procedures for developing meeting agendas, calendars, minutes and presentations. The committee and the company should always know the process utilized by the committee to reach a decision and what types of communications they can expect to receive from each other and outside groups.

Delegation of Authority

There should always be specific delegations of authority to make decisions regarding such things as employee benefit plans and CEO compensation and benefit arrangements. If the compensation committee is charged with the administration of U.S. employee benefit plans, the committee will be subject to fiduciary rules under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the committee must be made fully aware of its obligations under that law. If the compensation committee delegates certain pension plan decisions to a separate committee, the delegated committee may acquire fiduciary obligations with respect to the plan, but the compensation committee retains at least the duty to monitor the delegated committee. Therefore, such delegations of authority must be explicit and provided with sufficient detail so each party understands its role and to limit potential exposure regarding fiduciary decisions. Written delegations of authority provide the company with records regarding what entity and/or individual is responsible for each compensation- and employee benefits-related decisions within the company. These delegations may also specify certain "materiality thresholds" that determine at what levels an individual has decision-making authority. For example, a Senior Vice President of Human Resources may be granted the authority to unilaterally enter into employee benefits related contracts that are valued under $10,000, $100,000 or $1 million. These details should be provided in written delegations.

International Issues

While the compensation committee may not be involved in the direct day-to-day decisions of non-U.S. entities in a global company, it must have an understanding of international laws and the impact the committee decisions may have on its non-U.S. entities and employees. International laws and authorities treat compensation and benefits-related arrangements differently than U.S. law with respect to issues such as non-discrimination requirements or benefit cutbacks. In some cases, these distinctions could cause the company to take on certain ongoing obligations that were not originally intended. Compensation committees should review any applicable decisions with legal counsel to determine if there may be any unintended impact on the company relating to international markets and employees.

Conclusion

The Corporate and Financial Institution Compensation Fairness Act of 2009 is likely to be addressed by the Senate before the end of the year. The Act will likely have a substantial impact on executive compensation practices as well as on compensation committees. Notwithstanding passage of the Act, evolving corporate governance practices and pressure from shareholder advocates will ensure an enhanced role for compensation committees in fashioning the next generation of executive compensation policies and programs. Companies should not hesitate to review their compensation committee structure, practices and procedures and determine how changes could improve the effectiveness of their compensation programs. Such action will not only help the company achieve its strategic goals, but also position it to meet the compliance challenges of any new legislative requirements on executive pay.

If you have any questions about the content of this white paper, please contact the Pillsbury attorney with whom you regularly work, or the authors listed below.

Scott E. Landau (bio)
New York
+1.212.858.1598
scott.landau@pillsburylaw.com

Kathleen D. Bardunias (bio)
New York
+1.212.858.1905
kathleen.bardunias@pillsburylaw.com

Bradley A. Benedict
New York
+1.212.858.1523
bradley.benedict@pillsburylaw.com