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Compensation Committee Evolving Trends

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On February 4, 2009, Foley & Lardner LLP presented "Compensation Committee Evolving Trends" as part of its National Directors Institute — 2009 Web Conference Series. Jay O. Rothman, Foley Partner and Chair of the firm's Transactional & Securities Practice, led the panel discussion. The panel included Ted Buyniski, Senior Vice President, Radford Consulting; Evelyn Dilsaver, Director, Longs Drugs, Aeropostale, and Tamalpais Bank; Mathew Gorringe, Partner, Eversheds LLP; and Randolph (Randy) K. Harrison, Director, Human Capital, Deloitte Consulting LLP.

Effects of the Financial Crisis on Executive Compensation

Bonuses and Missed Targets
In the past year, many companies have recorded financial results short of targets established under their incentive compensation plans. In some cases, these results were attributable at least in part to the difficult economic environment and not entirely to individual performance factors. The overall role the economy has played in financial performance and in considerations of employee motivation, morale, and retention may cause some compensation committees to consider whether some acknowledgement of excellent individual performance is appropriate, despite missed performance targets. Several considerations may play a role in evaluating whether to pay bonuses despite missed performance targets:

- Alternatives to cash bonuses: Grants of equity in lieu of cash bonuses may be one means of addressing missed performance targets. In particular, equity awards subject to long-term vesting, mandatory deferral, or long-term holding requirements may be an effective response to the uncertainty many companies face concerning future results.
- Recipients: Many companies have eliminated bonuses for the top-tier executives in response to disappointing overall results, but bonuses to mid-level employees may be appropriate on a selective basis to reward individuals or groups for outstanding performance.
- Propriety: Compensation committees should consider losses suffered by shareholders when evaluating whether bonuses are appropriate. In light of the increasing focus on executive compensation by investors, the media, and the public, compensation committees may want to consider any potential negative impact that paying bonuses could have on a company's image. In evaluating the propriety of bonus amounts, some compensation committees may consider the percentage of revenue the bonuses represent.

In a recent survey of its clients concerning their plans regarding employee bonuses, Deloitte & Touche LLP found that approximately 75 percent of participants were planning to adhere to the bonus arrangements they had established. According to the survey, a limited number of companies were establishing discretionary bonus pools that were significantly reduced from what the companies had originally targeted. Other changes in response to the current economic environment include implementing shorter performance periods and awarding restricted stock or options on an individual basis in lieu of bonuses, or granting off-cycle awards for purposes of retention. Companies with adjustment provisions in their bonus plans are considering whether these provisions were triggered by the economic crisis and, if so, whether to take advantage of such provisions. Some companies are removing especially volatile elements — such as foreign currency or commodity prices — as factors in determining bonuses.

''Underwater'' Stock Options
The recent decline in stock market prices has increased the number of significantly underwater stock options — options that have exercise prices significantly higher than the market value of the underlying stock. Such options can detract from employee morale and motivation, as employees may view such options as lost opportunities and no longer likely provide a reward for performance. Among companies assessing alternatives for responding to underwater stock options, a number of trends are developing:

- Many companies that have substantial pools of equity available under existing plans are taking advantage of their situation to grant restricted stock or additional options to compensate for the lost opportunities.
- Some companies that do not have large equity pools available are considering or implementing stock-option exchange programs that comply with the recommendations of institutional voting advisors — i.e., cost-neutrality, reset vesting periods, and strike prices higher than the 52-week high of the underlying stock.

An option-exchange program may be appropriate for companies whose stock options are significantly underwater and who have broad-based option plans. Exchanges involving plans that are not broad-based may reclaim only a few shares and are less likely to be worth the cost and effort involved in implementing the exchange.

Legislation and Shareholder Activism

Legislative Response to the Financial Crisis
In response to the credit crisis, the U.S. government enacted the Emergency Economic Stabilization Act of 2008 and established the Troubled Asset Relief Program (TARP), which was intended to provide assistance to certain financial institutions. This legislation imposed certain executive-compensation-related restrictions on TARP participants. These restrictions, as implemented by the U.S. Department of the Treasury (Treasury), included:

- Compensation committees of TARP participants were required to review senior executive officer incentive compensation arrangements with their companies' senior risk officers to (i) ensure that the TARP participant's incentive compensation arrangements did not encourage the senior executive officers to take unnecessary and excessive risks that threatened the value of the TARP participant; (ii) identify any features that so encouraged senior executive officers; (iii) certify that the review had taken place; and (iv) limit any such features. "Senior executive officers" were defined generally as the top five officers of the TARP participant.
- Remuneration paid to the chief executive officer, chief financial officer, or any of the three next most highly paid executives of a TARP participant that had sold more than $300 million of assets under TARP was deductible only to the extent that the remuneration did not exceed $500,000.
- TARP participants were required to ensure that senior executive officer bonus and incentive compensation was subject to recovery by the TARP participant if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

- Golden-parachute payments, defined to include specified payments made in connection with termination of employment, were not permitted to senior executive officers of TARP participants.

On February 4, 2009, the Treasury announced a number of largely prospective revisions to the restrictions under TARP, including an expansion of the required "clawback" policy to include an additional 20 senior executives, an extension of the prohibition on golden-parachute payments to additional executives, additional disclosure requirements, and a mandatory "luxury expenditures" policy for TARP participants. *[Editor's note: Since the date of this Web conference, the executive compensation provisions under TARP have been altered significantly by the American Recovery and Reinvestment Act of 2009, which was signed into law on February 17, 2009. Please see Foley's Legal News Alert: Financial Crisis Response Team, "Executive Compensation Restrictions Under the American Recovery and Reinvestment Act of 2009," available at http://www.foley.com/publications/pub_detail.aspx?pubid=5740.]*

Some commentators believe that the application of the executive compensation limitation embodied in TARP will be expanded, either through legislation or voluntary "best practices," to companies not participating in TARP, noting that the legislative environment in the United States is generally receptive to imposing limitations on executive compensation. The broader applicability of the TARP restrictions may be limited to some degree by differences in pay practices outside of the financial services industry — which generally focus heavily on long-term incentive compensation — but some spillover is already occurring. Some of the anticipated TARP-inspired changes include caps on bonus opportunities, holdbacks ranging from one to three years under annual bonus plans, share ownership requirements, perquisite reductions, and elimination of severance arrangements (except for new hires). Compensation arrangements may be simplified to "core" elements to consist of cash and equity only. Other trends include eliminating evergreen clauses in employment contracts for executives other than chief executive officers, imposing mandatory deferral of bonuses, and implementing "hold 'til retirement" policies.

In evaluating these practices, however, compensation committees should not lose sight of their companies' long-term relationship with management. If their companies have in place management teams that work well, a cautious approach to implementing change may be appropriate. If compensation committees too quickly implement too many restrictions that executives perceive as "take-aways," the executives' morale, motivation, and desire to remain with the company may be negatively impacted.

Say on Pay

In its February 4, 2009 announcement, the Treasury also addressed a proposed requirement that certain TARP participants conduct an advisory shareholder vote on executive compensation — so-called "say on pay." In evaluating say on pay in the United States, it may be helpful to consider the example of the United Kingdom, where say on pay has been mandatory for public companies for a number of years.

In the United Kingdom, say on pay has been implemented by means of disclosure in the form of a "remuneration report" and an advisory vote of shareholders on the report at a general meeting. Negative shareholder votes on remuneration reports have been rare in the past in the United Kingdom, but they are becoming more frequent as the economic environment deteriorates. One criticism of say on pay has been that, since the vote is structured as a single "yes" or "no" vote on the entire compensation structure, in the event of a "no" vote, companies may not be certain which element or elements were disapproved of, and therefore be uncertain as to an appropriate response. This difficulty may be exacerbated in the United States because companies in the United States may have a more diverse shareholder base. In the United Kingdom, companies often carry on a dialogue with their significant shareholders concerning executive pay to determine which elements are objectionable. The larger number of shareholders in the United States may make it more difficult to carry on such a dialogue, and therefore may make it more difficult for such companies to adjust their executive pay practices to reflect their shareholders' preferences. Say on pay in the United States could result in a process involving significant public relations activity and a simplification of compensation arrangements for the purpose of facilitating disclosure to a large number of shareholders.

Proxy Statement Disclosure of Executive Compensation

As companies enter the third year under the U.S. Securities and Exchange Commission's (SEC's) new rules on proxy statement disclosure of executive compensation, the substantive rules remain the same as they were in the previous year. Some technical changes in proxy statement disclosure may result from additional guidance that has been released in the SEC's updated Compliance and Disclosure Interpretations. The director of the SEC's Division of Corporation Finance suggested in an October 2008 speech that, in preparing their Compensation Discussion and Analysis (CD&A) disclosures, companies "should be carefully considering if and how recent economic and financial events" have affected their compensation programs and "should not merely be marking up last year's disclosure." Some commentators, however, do not expect significant changes in most companies' CD&As other than disclosures relating to the adoption of new pay practices — for example, hold 'til retirement policies — or attempts to simplify CD&A presentation. Disclosure of the effects of the economy on pay practices may be more fully reflected in CD&As in 2010.

Issues in Structuring Executive Compensation

Setting Performance Targets

The current economic environment has reduced visibility concerning financial performance for many companies, and the lack of visibility can complicate the process of setting appropriate performance targets. Compensation committees may want to consider the following methods of responding to these challenges:

- Shorter performance periods: Many companies have moved or are considering moving to quarterly or semi-annual performance periods on at least a temporary basis. These shorter time frames may make setting appropriate performance goals easier while keeping management and employees focused.
- Relative performance plans: Some companies are maintaining longer-term performance periods but setting targets in terms of their performance versus the performance of other companies in their market sector. Such plans commonly use total shareholder return over a multi-year period as a performance measure and include a proviso that there will be no payout regardless of relative performance if total shareholder return is negative. Performance-share plans of this type are often coupled with a stock-ownership requirement with the expectation that the awards under the plan will fund the executive's ownership requirement if the targets are met.

Setting Pay Levels
Some commentators have encouraged compensation committees to consider an executive's "wealth accumulation" — the total amount of compensation the executive has earned during his or her tenure with the company — in determining compensation levels. Others, however, caution that reducing an executive's compensation on the basis of past awards may make the executive more attractive to competitors by reducing the competitiveness of the executive's current pay package. This effect may be mitigated by retention devices such as long vesting periods and mandatory pay deferrals. Some commentators also have suggested comparing an executive's total pay with shareholder returns generated during the executive's tenure.

European Developments
Executive pay in Europe, as in the United States, is under public scrutiny. Public reaction to significantly reduced bonuses recently announced by a large Swiss bank was largely negative. European governments and companies have begun to take some measures in response to these developments. The government of France, for example, has implemented a limitation on tax deductibility for golden-parachute payments. The current climate around executive pay in Europe may cause companies to move away from cash-bonus-type arrangements and toward equity compensation linked to measures that will ensure that executives are rewarded only for performance that also benefits shareholders.

Change-in-Control Arrangements

Agreements with executives providing for payments or other benefits in the event their companies undergo a change in control have long been subject to scrutiny in the media and from some shareholders. Focus on such "change-in-control" arrangements has only increased in the current economic environment, and recently TARP imposed strict limitations on payments under such arrangements for TARP participants. If current trends continue, change-in-control arrangements may play a reduced role in the future. Some commentators expect such arrangements to be used only in limited circumstances (e.g., when a company is confronted with a potentially hostile takeover attempt) and on a temporary basis, and to provide for fewer benefits than in the past. In particular, "gross-ups" — payments to make executives whole for taxes — in connection with change-in-control benefits are becoming less common.

Compensation Consultants

Compensation consultants are most effectively used as a resource for compensation committees to provide information on market levels of pay and the best ways to achieve directors' goals with respect to executive compensation. Compensation committees, however, should be careful not to abdicate their responsibilities to establish their goals for executive compensation in light of their companies' specific compensation issues, to communicate their companies' goals to the consultant, and to make the ultimate determination of how much they believe their executives should be paid.

Executive Pushback on Changes to Compensation Practices

In implementing significant changes to executive compensation practices, compensation committees may encounter some resistance from the affected executives. Unilateral implementation of such changes may have a negative effect on the motivation of affected executives. Accordingly, compensation committees may carry on a dialogue with executives concerning any contemplated changes in order to seek basic agreement on the goals of the changes and the method of accomplishing the goals.

For More Information

For more information on this session or Foley's National Directors Institute — 2009 Web Conference Series, visit Foley.com/ndi or contact Jay O. Rothman, Foley moderator of this session.

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