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Executive and Board Compensation Trends

2007 NATIONAL DIRECTORS INSTITUTE

EXECUTIVE AND BOARD COMPENSATION TRENDS

Executive and director compensation has been one of the hottest topics in board governance during the past year. Fueling the compensation debate are such factors as U.S. Securities and Exchange Commission (SEC) disclosure reforms, continued concerns over the size of pay and severance packages, and increased activism in the U.S. Congress relative to executive compensation issues, among others.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Executive and Director Compensation Trends" was a featured session moderated by Jay Rothman, partner and chair, Transactional and Securities Practice, Foley & Lardner LLP. The panel included David Chun, chief executive officer and founder, Equilar, Inc.; Timothy E. Flanigan, senior vice president and general counsel, Tyco International Ltd.; Michael Kesner, principal, Executive Compensation Practice, Deloitte & Touche LLP; Patrick McGurn, executive vice president and special counsel, Institutional Shareholder Services; and David E. Schwartz, vice president, assistant general counsel, and secretary, TECO Energy, Inc.

Congressman Barney Frank's "Say on Pay" Legislation

The panel discussion began with Patrick McGurn providing a brief overview of Congressman Barney Frank's "say on pay" legislation. He explained that the legislation requires an annual nonbinding vote on executive compensation as well as provides for a nonbinding vote when a company gives a new, not-yet-disclosed "golden parachute" while simultaneously negotiating to buy or sell a company. Congressman Frank's committee was holding hearings on the date of the panel discussion — March 8, 2007. The Congressman spoke to many investor groups prior to offering his legislation and Mr. McGurn believes his proposal was "stripped down" relative to a previous version in hopes that the legislation would be passed quickly.

Congressman Frank's "say on pay" legislation is very similar to legislation already in place in the United Kingdom. However, Michael Kesner noted that it works there because executive compensation is much more uniform in the United Kingdom than in the United States. He questioned whether a "no" vote would mean that shareholders did not like a specific aspect of an executive's pay, the overall level, or something else entirely. He also noted that, for the proposal to work, a communication channel should exist that allows shareholders to express specific concerns directly to the board of the company.

Timothy Flanigan commented that it would be helpful if, before such a vote were mandated, several states experimented with various proposals to better understand the potential impacts. Mr. McGurn countered that, thus far, states have "dropped the ball" on experimenting with such proposals.

The panel debate on this subject concluded with Jay Rothman quoting Martin Lipton, a well-known corporate attorney. Mr. Lipton believes that "every effort" must be made to defeat this proposal because, if such a proposal were enacted, it would interfere with executive compensation being set by the board of directors, which is the group Mr. Lipton believes should set compensation.

Impact of New SEC Disclosure Rules

New SEC disclosure rules relating to executive compensation have improved transparency, according to Mr. Kesner. He has seen perquisites replaced by an increase in base salary and compensation committees place a greater emphasis on pay for performance.

The new rules have impacted compensation committees dramatically, noted Mr. Flanigan, and the committees are building processes around the enhanced disclosure requirements. He believes there could be unintended consequences due to compensation being laid out in more detail, and that there is a potential for a "comparative compensation" game, whereby executives will be able to argue more effectively for compensation at levels of similarly situated executives. Additionally, with the large amount of information now more easily available, it may be worthwhile to consider bringing a compensation consultant in-house.

The rules require additional information be laid out in a uniform format; David Schwartz questioned whether the increased transparency would lead to compensation levels and practices becoming more uniform in the long-term. In addition to getting his compensation committee members up-to-speed on the new rules and reviewing with them an early draft of the Compensation Discussion and Analysis (CD&A), Mr. Schwartz also expanded the information on executive compensation provided to the full board and presented the anticipated disclosure to them several months in advance of the proxy filing.

The volume of disclosures on proxy statements released thus far has been surprising, according to David Chun, who noted that the Baker-Hughes CD&A contained approximately 14,000 words. He also is seeing a trend in companies disclosing peer groups but has not seen much disclosure surrounding performance metrics (such as performance relative to target EPS). He noted that most companies have yet to file their proxy statements.

Compensation Committee Best Practices

Mr. Kesner said he has seen too much reliance on survey data, as much of the survey data captures data points from a different period. He recommended that companies look at more than one set of data points. Mr. Kesner also noted that some commentators are raising concerns about potential conflicts with compensation consultants. He said that some compensation consultants to the compensation committee also are retained to provide other services to the company. However, Mr. Kesner noted that larger compensation consulting firms may have expertise in more areas than an independent boutique firm. To address the potential conflict of interest raised by retaining a firm that provides multiple services, Mr. Kesner advises clients to disclose the amount of fees paid for compensation consulting.

Mr. McGurn suggested that the compensation consultant report directly to the compensation committee. Additionally, he advised that consulting fees around executive compensation be disclosed in the tabular format currently seen in audit fees. He raised the possibility of disclosing the personal identity — as opposed to simply the name of the firm — of the compensation consultant.

Trends in Retirement and Severance Packages

In setting severance amounts, Mr. Kesner again warned of relying too heavily on survey data. For example, some surveys show that market amounts for severance payments is three times salary with certain bonus amounts included. However, the current market trend is much closer to two times salary with no bonus amounts. Mr. Kesner noted that boards and compensation committees should use common sense: If it doesn't "smell right," don't do it.

Compensation committee members need to be aware of the terms of each executive's severance package. Mr. Schwartz suggested including the values in tally sheets. He also said that compensation committee members should look at plans or agreements that were approved many years ago to ensure they are still appropriate in the current environment.

Mr. Kesner recommended exploring the use of wealth caps for executives. He noted that the original purpose of severance payments was to provide an executive with a monetary bridge between jobs. With some executives already owning a large amount of the equity worth tens of millions of dollars, this purpose no longer is being served.

Some supplemental pension plans for senior executives are becoming a wealth-creation vehicle, according to Mr. McGurn, causing some compensation committee members to be surprised due to their large dollar value.

Some companies are adjusting their pension plans. Mr. Chun noted that FedEx is eliminating its defined benefit plan in favor of beefing up its 401(k) plan and that Hershey has eliminated its SERP plan for executives going forward.

Equity Awards

Mr. Kesner described some best practices in the granting of equity based awards. He suggests that such awards be granted on the same date every year and that the number of shares be based on the average price a few days before the grant date. One of his clients had set the number of shares a few months before the grant and the share price had risen such that the award was worth considerably more than was intended. For new hires, he suggests companies make grants based on the end-of-the-month price to avoid the administrative burden of tracking various dates. In general, he advised that the timing of equity award grants should be put on "auto pilot" as much as possible.

The panel then discussed spring-loaded and bullet-dodging concerns. Spring-loaded options are granted prior to the release of material information that is likely to send the stock price higher while bullet-dodging takes place when options are granted after the release of materially damaging information. Mr. Rothman questioned panelists about whether a company should proceed with an option grant even if the company was in the midst of a potential not-yet-disclosed major transaction. Mr. Flanigan recommended going ahead with such a grant provided there is a history of granting such awards on the same date. He felt there was enough protection against potential liability for compensation committee or board members based on historical practice.

Mr. Chun commented on trends in equity compensation by noting that more companies are using a mix of different types of equity compensation awards compared to the recent past where many companies used options exclusively. He noted that approximately two thirds of the S&P 500 granted restricted stock or restricted stock units. He further noted that options account for approximately 60 percent of the value of equity awards given while restricted stock units make up the balance. He also said that two thirds of the S&P 500 companies have ownership guidelines, but holding requirements are utilized less frequently.

Board Compensation

Board compensation has been an issue with which Mr. Flanigan has dealt recently because his company is spinning off large divisions. Consequently, the board of directors must analyze how much its members should be paid because the size of the company will be much smaller.

Mr. Kesner said that he likes to see a 50/50 mix of cash and equity for board compensation and recommends the equity compensation be deferred stock and not vest until retirement from the board. He prefers directors do not receive meeting fees because such fees could be perceived as an incentive to board members to hold more meetings, and it increases the administrative hassle of determining what constitutes a meeting. In place of meeting fees, he suggests having a supplemental retainer fee for directors who serve on committees that require additional time.

Summary

The new SEC disclosure rules have altered the executive compensation disclosure landscape significantly. While only a few proxy statements have been filed under the new rules, it is clear there will be increased public focus on the amount and types of compensation. This has been evidenced in Washington, D.C., where the U.S. Congress is considering whether to force companies to provide shareholders with an annual vote on compensation. While the impact of the recent dramatic changes to executive compensation disclosure is difficult to predict, it is clear that this issue will remain a major issue in corporate governance for years to come.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.