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Executive Compensation Updates

2008 NATIONAL DIRECTORS INSTITUTE

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"Executive Compensation Updates" was a featured breakout session at the seventh annual National Directors Institute hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The panel discussion was led by Jay Rothman, Partner and Chair of Foley's Transactional and Securities Practice. The panel included Ted Buyniski, Senior Vice President, Radford Consulting; Michael Kesner, Principal, Deloitte Consulting LLP; and Patrick McGurn, Executive Vice President and Special Counsel, RiskMetrics Group. The panel focused on the following topics:

Advisory shareholder votes on executive compensation — so-called say on pay — appear likely to increase in the near future, either through voluntary adoption or legislation, but the effects may be mixed.

In April 2007, the U.S. House of Representatives passed legislation that would mandate "say on pay." A similar measure has been introduced in the Senate but has not yet been subject to a vote. In light of these actions, as well as increased shareholder and media activity in this area, some definitive action on legislation relating to say on pay seems likely in the near future. The prospects for such legislation being signed into law, however, may depend on the outcome of the 2008 elections. If enacted, say on pay legislation may have mixed consequences for companies. Potential downsides include the "one-size-fits-all" nature of legislated (as opposed to voluntary) say on pay, the increased time and expense on the part of compensation committees that may be associated with explaining pay programs to shareholders, and the potential that say on pay that is merely advisory will not achieve its intended result of influencing pay practices.

The new executive compensation disclosure proxy rules have triggered some changes in executive compensation and, on the whole, improved companies' analyses of their compensation practices but have not necessarily resulted in clearer disclosure in every case.

The recent heightened scrutiny of executive compensation has led to some changes in executive compensation practices; for example, a number of chief executive officers have forgone their bonuses and the issues around subprime mortgages have led some companies to amend executive compensation programs to ensure that executives are focused on risk management. A number of companies, on the other hand, have adjusted targets under their incentive plans in the wake of the subprime meltdown to permit executives to receive a payout despite missing targets.

The new executive compensation disclosure rules have focused compensation committees on why they are using certain compensation structures; in light of the increased visibility, there has been an increase in the amount of compensation "at risk"; companies may be setting more challenging performance targets; and a number of companies have overhauled their executives' severance packages. While some companies have resisted the transparency imposed by the new rules, others have taken advantage of the change in regimes to simplify pay structures.

Mr. McGurn indicated that he has seen a marked improvement in 2007 disclosure over 2006 disclosure under the new rules and that, thus far, 2008 also has represented an improvement over 2007. There has been increased disclosure of performance hurdles and more graphics and less narrative, even when not required by the rules. In view of these trends, companies that resist disclosing performance targets may face increasing scrutiny and, in some cases, withhold vote campaigns.

The U.S. Securities and Exchange Committee (SEC) has signaled that one area of continuing focus in the second year under the disclosure rules will be disclosure of performance targets. Some companies are reluctant to disclose targets, especially with respect to multiyear performance, because the targets may represent the company's strategic plan. In these cases, the companies may be concerned that disclosing these targets could give competitors and other interested parties an advantage by exposing the company's plans and that disclosing these targets would permit shareholders rather than the board of directors to manage the company. The SEC and RiskMetrics Group, however, have expressed the view that the purpose of the performance target disclosure requirement is not to permit shareholders to manage what performance goals are selected but instead to make certain that compensation programs are established in such a way as to encourage the achievement of the strategic goals of the company. Examples of executive compensation programs that do not encourage the achievement of such goals are those that encourage executives to "swing for the fences" every time by providing large potential upsides and little downside.

The recent stock market declines will likely make executive retention and compensation more challenging; however, compensation committees should be careful not to overreact to potentially lower compensation numbers resulting from the downturn.

A flat or declining stock market poses challenges to effective executive compensation. In a flat or declining market, equity-based compensation may lose much of its ability to delivery value to executives and performance targets may become more difficult to achieve. These hurdles may cause compensation committees to become concerned about the ability of their existing compensation arrangements to motivate and retain executives. In this environment, however, it may not be advisable for compensation committees to reflexively increase compensation to retain executives. Compensation committees should consider whether a potentially slower job market may affect what levels of compensation are considered competitive. Concerns over retention may be somewhat overstated in an economically challenging environment. At underperforming companies, in particular, it may be easy for compensation committees to overestimate the need to accommodate executives for retention purposes. As a method of rewarding achievement even in an economically stagnant environment, compensation committees may consider tying incentive compensation to relative performance measured against similar companies. A relative measure of performance can avoid providing windfalls for executives who are merely benefiting from a rising economy but also avoid punishing them for overall declines when they are outperforming competitors in a challenging environment.

Use of internal pay equity and wealth accumulation analyses in determining compensation may reveal succession planning and internal development concerns.

Pay equity analysis — an analysis of the compensation of a chief executive officer compared to other employees, usually other executives, at the same company — has become an increasingly popular tool in setting compensation. A chief executive officer being compensated at an excessive multiple compared to the other members of a company's management team may suggest consideration of whether a company has done adequate succession planning and whether additional focus on internal development is desirable.

Compensation committees should consider asking their compensation consultants to recommend best practices.

Some key areas to examine may include the following:

- Whether a company's existing retirement and severance programs make sense given its current circumstances. For example, significant retention value may not be gained by providing valuable severance protections to executives who have accumulated significant wealth through equity grants.

- Whether their compensation programs are outdated in any respect. For example, many companies' change-in-control agreements have not been updated to reflect changing practices.

- How a company's compensation elements relate to each other, and how they can interact to create different overall levels of compensation. For example, pension, severance, and accelerated equity vesting may together create a larger-than-expected payout when an executive's employment terminates.

FOR MORE INFORMATION

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and panelists directly.

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