

CLIENT ALERT

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Executive Compensation – Best Practices in Today’s Business and Regulatory Climate

What should boards of directors of public companies be considering in structuring their executive compensation programs today?

Companies should be aware of “best practices” that reward executives when they create long-term value for shareholders. In today’s environment, compensation committees of boards of directors need advice on those practices that will avoid criticism from shareholders and the media. SEC disclosure issues must be considered at the time that compensation decisions are made. Boards must engage in an analysis of their compensation policies each year which is included in the annual proxy statement “compensation discussion and analysis” section.

What are best practices today in executive compensation programs?

First, there should be a strong linkage between long-term value creation for shareholders and the individual executives’ reward programs. The executives’ wealth opportunity must be aligned with the shareholders.

Second, “pay for performance,” and not for merely continued tenure with the company (ie., vesting of stock options for “continuing to fog a mirror!”).

Third, the compensation committee should pay close attention to establishing appropriate performance metrics in its performance pay plans.

Fourth, the compensation committee should retain consultants and legal advisors that are independent and do not provide other services to the company or management.

Do these concepts apply to privately held companies in their pay policies?

Absolutely. Often an early stage private company will not have independent board members or a compensation committee. However, assuring that the executives have proper incentives aligned with shareholders is equally important in the private company. Other best practices in privately held companies can be listed:

First, avoid “offer letters” and informal communications of the terms of employment. These can create binding legal obligations, and company founders should understand the legal risks in relying on these informal letters at the initiation of employment.

Second, if the company awards stock to its executives, be sure that he or she signs a shareholder agreement restricting the transfer of the shares.

Third, consider substitution of non-equity or “synthetic equity” awards rather than diluting stock ownership. For example, an executive could be awarded a “stock appreciation right” which pays him a cash bonus upon exercise that is equal to the appreciation in the value of the underlying shares during the term of the award.

What compensation policies will assist in creating a long-term perspective for a compensation program?

Many compensation committees are implementing a “hold ‘til retirement” policy for top executives requiring them to retain all company stock that is acquired under stock options or restricted stock programs until their retirement. Others are establishing a required holding of company stock (for example, the CEO minimum is fixed at 3 times his base compensation). In reaching the required holdings, the officer is required to retain all shares he acquires under the stock incentive plan (net of those sold to pay his income taxes).

What are “clawbacks” and how can they be used in today’s compensation programs?

Clawbacks are perceived positively and have been enacted as part of the Sarbanes-Oxley Act of 2002 and the Obama administration’s TARP program (applicable to financial institutions receiving government assistance). For example, an annual or short-term performance bonus plan may provide that if it is discovered that there is an error related to the company’s financial statements or any other criteria for the payment of bonuses, executives must disgorge all profits based on that criteria. (This is legally required under Sarbanes-Oxley for chief executive and chief financial officers of a company whose stock is publicly traded.)

What are best practices with regard to severance pay programs and change of control agreements?

Boards are under a great deal of scrutiny today to “tally” the total compensation that an executive officer realizes upon a change of control under his employment agreement and all other compensation programs. This figure must be disclosed in the company’s proxy statement each year.

Many companies are scaling back or not renewing severance pay programs and change of control agreements. Best practice would be to enter into these agreements only if they contain a “sunset” provision, and are not for an indefinite term. Some companies, such as JPMorgan Chase Bank, do not have change of control agreements, “golden parachutes,” or special severance packages for executives as a matter of policy.

In attracting a key executive, it may be necessary and appropriate to offer severance pay or change of control protection, to match the executive’s existing pay package, or to recognize that his or her equity awards and long-term incentives would not yet be earned or could be forfeited upon termination or a change of control in the near term. However, these agreements should “sunset” and be reconsidered after a period of time.

What types of equity awards are used by companies with good pay practices?

Stock options are not in favor. They may encourage excessive risk-taking and, as described above, shareholders do not like to see executives profiting from short-term volatility in a company's stock price.

Restricted stock units (RSU's) with performance-vesting criteria are in use by many companies. When an award of RSUs is made, it is a promise to deliver shares in the future upon achievement of the vesting targets. (No shares are issued, such as in a restricted stock grant.)

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