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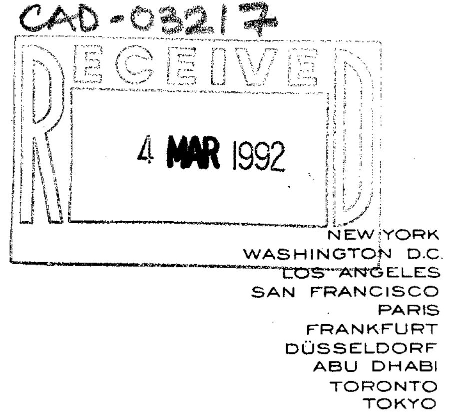

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March 2, 1992

Memorandum to Clients and other Interested Persons

Enclosed please find a memorandum entitled **Executive pay: The Heat is on**, dated February 1992.

Should you have any questions regarding the enclosed document, please contact Henry C. Blackiston, III or Linda E. Rappaport at the number shown on the front cover of the document.

Thank you.

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Enclosure

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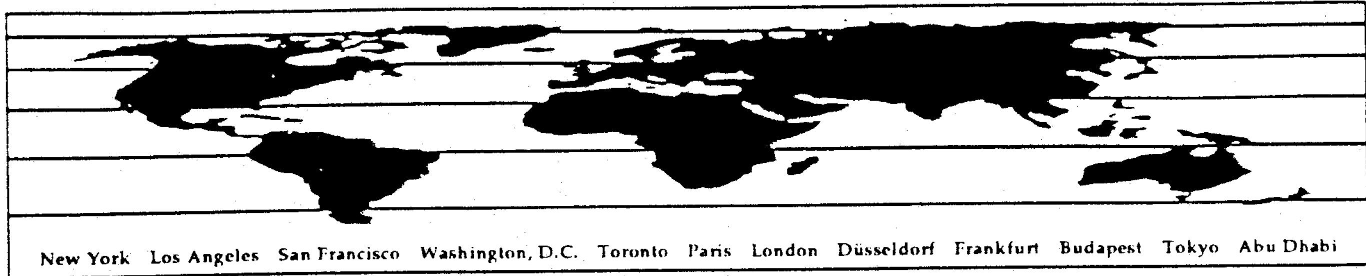

COMPENSATION & BENEFITS NOTES

EXECUTIVE PAY: THE HEAT IS ON

FEBRUARY, 1992

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- Introduction
- Shareholder Complaints
- Shareholders' Reform Proposals
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- What Corporations Can Do

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I. INTRODUCTION

What do Vice President Quayle, Pat Buchanan and Bill Clinton have in common? Answer: They are all speaking out against what they call unacceptable pay levels for corporate executives.

And they are not alone. Negative comments have also been heard from the press, from the academic world, and from shareholder activists. Several bills have been introduced in Congress in an attempt to address this issue. Very recently, the SEC has announced that it is modifying its proxy rules to allow shareholders to vote on advisory proposals relating to executive pay matters.

President Bush's recent trip to Japan with top executives only further fueled the outcry. In addition, the rise in the stock market over the past 12 months has given the critics further ammunition by enhancing the value of many top executives' stock options in the midst of a recession and widespread layoffs.

The purpose of this communication is to summarize the nature of these criticisms and to highlight some legal issues that have arisen in the area. We also suggest some ways in which our corporate clients can reduce the risk of successful shareholder criticism of their executive compensation programs.

II. SHAREHOLDER COMPLAINTS

Under state law, directors are granted broad discretion in setting executives' compensation, protected by the presumption of the business judgment rule that they have acted in good faith and in the best interests of the shareholders. Shareholder activists have argued, to the contrary, that many directors today do not represent shareholders' interests in the executive compensation area, citing the following reasons:

- *Independent Directors*. Shareholders fear that many directors who are not employees of the corporation are nonetheless not really independent from management, and therefore do not objectively determine management compensation. Fact patterns raising shareholder concerns about independence include situations where there are reciprocal directorships, or where the management team and outside directors have similar change in control or compensation arrangements.
- *Erosion of Case Law Protection*. Shareholders have complained that the judicial system has been too lenient in enforcing the duty of directors to uphold shareholder interests. Shareholders claim that the business judgment rule, and the related duties of care and loyalty, have been eroded by judicial decisions which fail to scrutinize directors' actions. Furthermore, shareholders have also complained that courts have failed to effectively enforce the "corporate waste" doctrine as a means of attacking excessive executive pay.
- *Pay v. Performance*. Shareholders have complained that current executive compensation systems do not provide the intended incentives for performance. Shareholders point to studies which show that executive pay has continued to rise during this recession, when it should have fallen in accordance with corporate performance. *Business Week*, for example, reported that as profits fell 7% in 1990, the average CEO's pay *rose* 7% (including gains from long-term compensation plans). While the compensation of many executives has fallen dramatically during the recession (the *Business Week* study noting that one third have suffered decreases), the increasing compensation paid to other executives at a time of diminishing financial results is used to argue that at least some compensation programs are flawed. The presumed remedy for this problem is, according to the activists, more shareholder involvement in compensation decisions through the voting process.

- *Lack of SEC Involvement.* Shareholders complain that the SEC has not been aggressive enough in protecting shareholder rights in this area. Historically, SEC rules have generally permitted a public company to exclude compensation-related shareholder proposals from proxy statements, on the theory that allowing such proposals would interfere with the corporation's ability to conduct ordinary business operations. But that is changing. In January of 1990, the SEC first allowed a shareholder proposal relating to change in control compensation to be included in a proxy statement. In addition, and in response to mounting pressure from Congress and shareholder activists, the SEC has very recently announced a new policy that will enable shareholders for the first time to vote on advisory proposals relating to top management compensation.

  Shareholders also complain that the SEC does not require adequate disclosure of executive compensation. In particular, while profit realized by executives upon exercise of stock options is reported, some activists argue that companies should be required to report the value of stock options at the time they are granted. In response to this criticism, the SEC has very recently announced that it will propose revisions to its proxy rules that would require companies to set forth in a new summary table the present value of stock option grants as well as cash compensation. Such proposals will also include other revisions, such as a comparison between company performance and CEO pay, and a description of criteria used by boards in awarding incentive compensation.

- *Alignment of Interests.* Shareholders complain that the interests of management should be more closely aligned with that of shareholders so that management experiences the potential for loss as well as for gain. Particularly galling to the shareholders is the repricing of "underwater" stock options, whereby management, unlike the shareholder, is protected against a stock price decline.

III. SHAREHOLDERS' REFORM PROPOSALS

Independence of Directors. Shareholders' concerns with the independence of directors stem from directors' ties to executives, which create conflicts of interest when directors determine executive pay. Shareholder activists have argued that rules should be established that mandate boards comprised of a majority of outside directors and set strict criteria for the independence of these outside directors. The Council of Institutional Investors has publicized its definition of an "independent director" as a director "whose only material connection to a corporation is that person's directorship." Thus, directors who are (a) current or former employees of a corporation, (b) partners or employees of law, accounting and investment banking firms advising the corporation, (c) officials of foundations and universities receiving significant contributions from the corporation or (d) employed by an entity on whose board of directors the chief executive officer of the corporation serves, would fail to satisfy the proposed standard of independence.

Enhanced Voting Rights. One of the key proposals for reform is to require enhanced shareholder voting rights in approving executive compensation. For example, in cases where shareholder approval is commonly obtained already, such as the establishment of stock option plans, the United Shareholders Association has argued for legislation or SEC rules which would require confidential voting and clearer disclosure regarding such matters. Other suggestions for reform would include allowing broad shareholder proposals addressing all forms of executive compensation, including the size of cash compensation packages.

Voting Criteria. Some activists have urged shareholders to apply certain criteria in evaluating compensation proposals being put before shareholders for a vote. For example, Calpers, the California state employees' pension fund, has developed voting criteria that emphasize the independence of directors and the generosity of incentive compensation arrangements. In January, 1991, Institutional Shareholder Services ("ISS") circulated guidelines that shareholder clients may use to approve or reject compensation arrangements submitted to a vote. In these guidelines, ISS generally recommends voting against option plans in which the strike prices of stock options granted to executives holding large blocks of stock are not in excess of the market price. The guidelines also express a preference for incentive plans in which participation is contingent on forfeiting some cash compensation.

IV. THE RESPONSE OF CONGRESS

In an attempt to respond to shareholder concerns, Congress has chosen to focus on the SEC's role in corporate governance rather than to adopt legislation directly affecting the amount of permissible executive pay, although the Senate has scheduled hearings which could address the latter topic.

Senator Carl Levin of Michigan has introduced a bill, the "Corporate Pay Responsibility Act," that provides greater scope for shareholder proposals regarding compensation, mandates expanded disclosure of management remuneration and permits corporate officer nominations by shareholders. The bill would amend the Securities Exchange Act of 1934 to authorize specific shareholder proxy proposals on compensation, and to require additional disclosure regarding executive compensation. The bill also provides that any person or group that beneficially owns at least three percent of the issuer's voting power or $1,000,000 of the issuer's securities may nominate persons for the board of directors, and require that materials relating to such nominations be included in the proxy statement.

A more recent bill introduced by Senator William Cohen of Maine also provides for direct shareholder nomination of directors and encourages the SEC to expand the type of shareholder proposals relating to executive compensation that would be considered proper for shareholder action.

Representative Martin Sabo of Minnesota has made the most drastic proposal in the form of a bill that would disallow tax deductions for executive pay in excess of 25 times the pay of the employer's lowest-paid employee.

Although these bills are unlikely to be enacted into law, their introduction indicates the high level of concern about the executive pay issue. If the SEC's efforts to police executive compensation are perceived as ineffective, other similar proposals may be introduced in Congress in 1992.

VI. WHAT CORPORATIONS CAN DO

The public debate over executive compensation should, we believe, elicit a two-pronged response from public companies. First, companies should ensure that compensation decisions are made in a manner that will help insulate them against successful challenge under existing legal principles. Second, and potentially more significant in the long run, companies should consider ways to structure their compensation practices that will deflect potential criticism.

Protecting the decisions of a Compensation Committee under current law involves essentially two elements: independence and process.

- *Compensation Committee Independence.* Where the independence of the Compensation Committee is questionable, there is a much greater risk that the Board's duty of loyalty to shareholders under state law could be successfully attacked. In selecting

members of the compensation committee, Boards are well advised to select outside directors who do not have close relationships with the CEO or other senior executives. Compensation Committee members must exercise their fiduciary duties energetically and take care to preserve independence of judgment. (This may be made easier if the Committee retains its own professional advisers such as an independent consulting firm and independent counsel.)

- *The Importance of Process.* It is vitally important that executive compensation decisions be made following a careful process in which the Compensation Committee critically reviews management recommendations and business justifications, consults with specialists, deliberates at length regarding proposed actions, and keeps a written record of its deliberations. The importance of being fully informed cannot be overemphasized.

- *Avoid Undue Reliance on Surveys.* Compensation surveys are a useful benchmark to assess how competitive a company's executive compensation practices are. Survey data, however, is no substitute for company-tailored pay levels that match corporate and individual performance. In establishing its record supporting specific compensation programs, Compensation Committees should be careful to guard against excessive reliance on surveys.

While observing the substance and formalities of corporate law will help protect compensation decisions in the event of challenge, most companies will want to take steps to assure shareholders that the companies' executives are being compensated at reasonable and appropriate levels. The following suggestions are intended to help avoid conditions that lead to shareholder criticism.

- *Take Pay for Performance Seriously.* With respect to compensation design, we find that the key shareholder concern is that the pay-for-performance concept be observed with care and consistency:

  - Performance measurements should be selected that are directly linked to the company's business plan and current objectives. After setting the initial measures and targets, manipulations or amendments should be avoided unless justified by truly extraordinary events. Options should be repriced only in the most unusual of circumstances.

  - Downside risk should be preserved by encouraging investment in stock by the executive, either through a purchase of shares with personal funds, or through the replacement of a portion of the executive's cash bonus with stock or restricted stock.

  - Features should be considered that adjust plans to reflect economy-wide, market-wide, or industry-wide changes, so that executives do not benefit or suffer from economic developments that do not reflect the relative strength of the corporation or the executive's individual contribution.

- *Communication.* Open lines of communication with a company's principal institutional shareholders can help shareholders better understand the rationale for a company's compensation practices, and, conversely, can help sensitize management to shareholder concerns. Increasingly, shareholder activists have sought to negotiate compensation issues with directors rather that initiate proxy challenges or shareholder lawsuits. Companies such as ITT and UAL Corporation have recently

avoided proxy battles by discussing concerns with large institutional shareholders and by modifying compensation proposals to address those concerns. In appropriate situations, companies may also consider offering a seat on the Board, and the Compensation Committee, to a nominee of a major institutional shareholder.

- *View Compensation Packages as a Whole.* Decisions on the components of compensation should never be made in isolation. The Board or Compensation Committee should always be aware of the potential total dollar value of the package being offered, and new programs should not simply be added on to old ones unless the total package remains reasonable. Too often, Compensation Committees allow compensation plans and awards to pile up upon one another, while losing track of the accumulated effect of these arrangements and grants. The notion that compensation should provide incentives to performance becomes obscured when a company has so many different incentive programs, with different goals and targets, that executives are likely to receive value under at least one program under almost any set of circumstances.

* * * * *

The controversy over executive compensation is likely to continue. The above is intended only as a general discussion of these matters. If you would like additional information, please call Henry C. Blackiston, III (212) 848-7001 or Linda E. Rappaport (212) 848-7004 of our offices.

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cc Sir Adrian

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12th March, 1992

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Dear Jim,

Sir Adrian mentioned to me this morning that he finds your comments on the draft of Part 1 most constructive, but there is one point on which he is uncertain what you have in mind and would be grateful for clarification. This is your comment on section 3, that the report needs to distinguish between the legal framework (position of shareholders etc) and the additional arrangements that make up corporate governance. Could you elucidate, please? Subject to your views, our inclination would be to stick with paragraphs 3.1 and 3.2.

Yours sincerely,

Nigel Peace

Nigel Peace
Secretary