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Current Issues in Executive Compensation: What Directors Should Know

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Executive compensation was hot news in 2006 and is likely to remain in the news for some time. The stories did not go unnoticed by the public, and the issue will almost certainly remain an attractive one for regulators and potential litigants as well. This update summarizes recent developments in the law, describes some new disclosure requirements that directors should understand, and identifies some practical considerations for directors who make or approve compensation decisions.

The year 2006 saw activity on several fronts. The Delaware Supreme Court finally issued its last opinion in the long-running *Disney* litigation in which shareholders challenged a severance agreement that paid Michael Ovitz $130 million for 14 months of work. In New York, Attorney General Eliot Spitzer continued to pursue claims against The New York Stock Exchange, its former chairman, Richard Grasso, and the former chairman of its compensation committee for the return of more than $100 million paid to Grasso in an unusual suit peculiar to the legal terrain of the NYSE.

On the regulatory front, the SEC issued a sweeping overhaul of rules governing the disclosure of executive compensation. This SEC initiative provides a striking illustration of heightened public awareness of executive compensation decisions as it provoked more comments than any other proposal in the SEC's 72-year history.

This update will (1) describe the relevance of the main litigation developments in 2006, (2) explain elements of the SEC disclosure requirements that directors need to know, and (3) list some practical considerations for directors making decisions about executive compensation.

Setting Compensation: The *Disney* Litigation

For directors, the starting point is the process for setting compensation. Although the substance of compensation decisions is not irrelevant to courts and regulators, the law's unmistakable focus in 2006 was on the process that directors follow when they set compensation. The most important case in this area was the long-running—and now concluded—*Disney* litigation. This matter illustrates the hazards that confront directors in making compensation decisions as well as the potential limits to their liability for damages.

In *Disney*, shareholders alleged that the company's directors had breached their fiduciary duties by approving an excessive no-fault termination package for Disney president Michael Ovitz. The directors initially tried to have the lawsuit dismissed. They argued that, even if the shareholders' allegations were true, the board could not be directly sued because Ovitz's employment agreement was based on a reasonable exercise of business judgment. The board members asserted the need for such a compensation package in order to entice Ovitz to join Disney and further claimed that the no-fault termination provision would help the company avoid protracted litigation over his severance.

The court refused to dismiss the complaint because the shareholders had alleged facts in their complaint that, if true, could show that the directors had not followed the appropriate procedures in approving the Ovitz package. The court explained that the facts alleged "imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."

At the highly publicized trial that ensued, the directors were required to testify at length. Based on the evidence produced at trial, the court drew some embarrassing conclusions about how the board went about its work, but ultimately concluded that the board had not violated its duties to shareholders. The courts did not, as some observers had feared, impose stricter requirements on board decisions about executive compensation. Instead, the courts reaffirmed the long-standing business judgment rule. This rule gives boards substan-

tial leeway by prohibiting courts from interfering in decisions that are reached through proper procedures, regardless of how "controversial, unpopular or even wrong such a decision might turn out to be."

Although Disney and the directors prevailed, the court roundly criticized the directors. The court wrote that "many aspects of the defendants' conduct…fell significantly short of the best practices of ideal corporate governance." The court also singled out Chairman and CEO Michael Eisner: "His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement." The trial court concluded that "these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position." All of this added up to a "failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself."

Disney shows that the business judgment rule still protects directors against the second guessing of their decisions. But it also illustrates some hazards that confront directors. The directors' victory was something of a close call, and they won only after enduring costly litigation that dragged on for a full nine years. In the process, they suffered public criticism from a respected court. Directors who heed the lessons of *Disney* will conduct their decision making in a way that enables them to avoid litigation altogether, or, at least, to get it dismissed at the outset. We review some of those lessons below.

The media have followed the *Grasso* case even more closely than *Disney*. That suit, however, is less relevant to publicly-held companies, because Attorney General Spitzer filed his suit based on a New York statute that mandates that non-profit corporations—which the New York Stock Exchange was at the time—pay only "reasonable" compensation. There is no corresponding obligation under ordinary business law that for-profit corporations pay only "reasonable" compensation. The *Grasso* case still is noteworthy, however, in demonstrating the creative approaches that litigants are prepared to explore once an executive compensation package gains notoriety as excessive or controversial. Careful directors will have to expect that litigants will look beyond the traditional shareholder suits for breach of fiduciary duty.

Disclosing Compensation: The New SEC Regulations

In contrast to the interest of the courts in the process a board follows in setting executive compensation as illustrated in cases like *Disney*, the SEC is primarily concerned with disclosure of the process followed and the substantive terms of executive compensation set by compensation committees and boards.

Prior disclosures under these rules had been criticized as too opaque. On July 26, 2006, the SEC overhauled the rules to give investors a clearer picture of compensation paid to principal executive officers, principal financial officers, and the highest paid executive officers and directors. On December 22, 2006, the SEC announced several additional revisions. Companies must comply with the new provisions in Forms 10-K, proxy and information statements required to contain compensation information and registration statements—including amendments—for filings made on or after December 15, 2006.

Under the new rules:

- A narrative disclosure entitled the Compensation Discussion and Analysis (the CD&A) is required to enhance the quality of disclosure regarding executive compensation policies and decisions. The CD&A will be a focus of the next proxy statement and, because of its novel features, will be the most difficult section of the proxy statement to draft. It is intended to provide a narrative overview of compensation received by a company's executive officers and must describe in plain English, avoiding boilerplate answers, the policies that underlie a company's decisions on compensation. Specifically, a company must explain the objectives of its compensation program, the elements of compensation and the purpose of each, and how the amount of each element is determined. The CD&A must also fully disclose the timing of stock option grants and how any material, non-public information is used in granting options. If option exercise prices are based on the stock's price on some date other than date of the actual grant, then that practice must be disclosed. The CD&A will be "filed," meaning that the CEO and CFO certifications required under the Sarbanes-Oxley Act must address the CD&A.
- The existing Summary Compensation Table will now include new columns reporting the dollar value for all equity-based awards expensed during the year, the amount of compensation under non-equity incentive plans earned during the year, the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation, perquisites and other compensation, and total compensation. The purpose of the Summary Compensation

Table is to permit stockholders to compare compensation between different companies and over different time periods. The Summary Compensation Table must supply information for the three most recent fiscal years for the company's principal executive officer, principal financial officer and the other three most highly compensated executive officers, although there is a transition period permitting one year of compensation information for the first proxy statement required to be filed under the new rules and two years of compensation information for the second proxy statement required to be filed under the new rules.

- Several other new executive compensation tables are required, such as tables disclosing grants of plan-based awards, holdings and exercises and vesting of previously granted awards, pensions benefits, and nonqualified deferred compensation. In addition, potential payments upon termination and change of control have to be described and quantified.
- Director compensation during the last fiscal year will also be disclosed on a new Director Compensation Table.
- Corporate governance disclosures must describe the roles taken by the compensation committee, management, and compensation consultants in setting executive compensation. Companies must disclose the identity of compensation consultants, whether they are engaged by the compensation committee or by someone else, their assignment, and material instructions they are given about how it is to be conducted.

One more change may be forthcoming from the SEC. It has proposed that companies disclose the compensation paid to up to three employees who earn more than any of the named executive officers of the company. The proposal was dubbed the "Katie Couric clause" because, as originally drafted, it could have required the disclosure of the well-known network anchor's compensation. The SEC reasoned that this information on highly compensated non-executive officers may be needed by investors to gain a fuller understanding of the company's compensation program. The rule was first proposed along with the SEC's other new disclosure rules but was left out of the SEC's final rule adopted in July. In response to criticism, the SEC modified the proposal to apply only to employees who also had responsibility for significant policy decisions and were employed by large public companies with a value of $700 million or more. The comment period for the modified proposal is now closed and the SEC has yet to decide whether to adopt the rule.

The work of compensation consultants has generated attention from other quarters. A coalition of pension funds representing $849.5 billion in assets recently sent letters to the compensation committee chairs of the 25 largest U.S. companies. In the letters, the pension fund coalition expressed concern over the potential conflict of interest arising whenever compensation consultants recommend compensation for executives of the same companies that pay them to provide advice on other matters. The coalition asked for disclosure of these companies' current constraints on consultants assuming these dual roles, and the companies' willingness to adopt formal policies to prohibit the practice. The effort was led by the principal fiduciary of the Connecticut Retirement Plans and Trust Funds. The SEC has also expressed interest in the role of compensation consultants, particularly in companies being investigated for stock-option backdating.

For more detail about the new SEC compensation rules, please see our Securities Updates entitled "SEC Significantly Revises Executive Compensation and Related Person Disclosure Requirements," dated August 29, 2006, which you can find on our website at http://www.mayerbrownrowe.com/publications/article.asp?id=2943&nid=6 and "SEC Revises Its New Executive Compensation Disclosure Requirement" dated January 5, 2007, at http://www.mayerbrownrowe.com/publications/article.asp?id=3204&nid=6.

Some Practical Considerations For Directors

Disney shows that the law continues to protect compensation decisions that directors make in good faith and with appropriate diligence. To obtain maximum benefit from that protection—and to best serve their companies' interests—directors should keep in mind some practical considerations.

Obtain and review relevant information. To obtain the protection of the business judgment rule, directors should inform themselves of material information relating to compensation decisions. In *Disney*, the Delaware Supreme Court noted the existence of a set of "best practices" for compensation committees that, even though not mandated by law, would yield "no basis for litigation . . . over what information was furnished to the committee members or when it was furnished." For compensation committees, the court recommended that (1) all committee members receive, before or at the committee's first meeting, a spreadsheet or similar document prepared by (or with the

assistance of) a compensation expert; (2) the spreadsheet disclose the amounts that the officer would receive under the employment agreement under each circumstance that might foreseeably arise; (3) the contents of the spreadsheet be explained to the committee members, either by the expert who prepared it or by a fellow committee member similarly knowledgeable about the subject; (4) the spreadsheet form the basis of the committee's deliberations and decision; and (5) the spreadsheet be included as an exhibit to the minutes of the committee meeting.

Create a paper record of the board's involvement and deliberation. One of the lessons from *Disney* is that courts can refuse to dismiss cases where it is not clear whether directors seriously considered, or were properly informed about, significant compensation decisions. Accordingly, the company should keep a record of the materials that the board considered. In addition, meeting minutes should document the involvement of board members in the relevant deliberations. As the *Disney* court noted with some exasperation, "it would have been extremely helpful to the Court if the minutes had indicated…that the discussion relating to the Ovitz Employment Agreement was longer and more substantial than the discussion relating to the myriad of other issues brought before the compensation committee that morning."

Consult executive compensation professionals. The *Disney* court specifically recommended that directors consult appropriate compensation experts.

Consider including an "exculpation" provision in the corporate charter. Under Delaware General Corporation Law Section 102(b)(7) (and the law of some other states), corporations can write into their charters a provision that eliminates director liability for money damages for breach of fiduciary duty, absent disloyalty or "bad faith." Even if "grossly negligent" in attending to compensation decisions, a director would not thus be liable for money damages. The *Disney* court observed that Section 102(b)(7) was designed to "encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith."

The following suggestions may also help companies as they prepare their first disclosures of executive compensation under the new rules:

Create mechanisms to effectively track all of the elements of executive compensation. The totality of compensation includes perquisites, pension benefits, and severance and change of control benefits. In order to maintain a complete picture of executive compensation, companies will likely need to involve a wide circle of people in collecting and analyzing information. Some informal procedures previously used by the compensation committee in granting compensation may need to be formalized in order to aid in disclosure.

Consider updating disclosure controls and procedures. Consider whether any changes to current disclosure controls and procedures are needed to ensure that the persons in the company responsible for the relevant SEC filings receive all the information that the new rules require.

Review the relationship between pay and performance. A review could include the current policies for granting stock options and other forms of equity. To the extent they are not already used, industry benchmarks could be adopted in setting compensation.

Examine each of the perquisites that executives receive. The new disclosures may provide an opportunity to reconsider the perquisites that executives receive. In approving any additional perquisites, the compensation committee may want to consider whether they are appropriate for all of the projected recipients.

Prepare for criticism following the filing of the first disclosures. The total compensation column of the summary compensation table may surprise some, and generate challenges to how these totals relate to the performance of the company.

Conclusion

Executive compensation will remain the focus of intense scrutiny in the years ahead. Careful attention will be needed to both the current legal landscape and any additional strictures that the courts or regulators may impose.

If you have any questions regarding executive compensation, we would be pleased to speak with you. For more information, please contact any of the attorneys listed below. If you would prefer to receive distributions electronically and are not receiving them that way now, please send your e-mail address to mnoonan@mayerbrownrowe.com.

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