

Pay, Performance and Proxies: The Latest in Executive Compensation

Major Funds Are Exercising Clout On Executive Pay

By Vincent R. Cappucci, Entwistle & Cappucci LLP

Changes in law, regulation and culture are helping investors achieve increasing success in their ongoing fight to rein in excessive executive compensation and to closely tie pay to corporate performance.

Shareholders at more companies than ever before will vote this proxy season on pay-related proposals submitted by activist investors. In addition, the new SEC compensation disclosure rules are now in effect, and legislation to require shareholder advisory votes on executive pay packages is moving forward.

Still, resistance and uncertainty remain, with many companies opposing important shareholder objectives. Significant legal developments are also underway, as courts tackle the explosion of options backdating cases, and 2007 undoubtedly will see compensation practices continue to grow as a hot button issue.

Legislative, Regulatory Efforts

The House Financial Services Committee held a hearing March 8th on the recently introduced "Shareholder Vote on Executive Compensation Act," which would require public companies to include in their annual proxies a non-binding shareholder advisory vote on executive pay.

The bill, H.R. 1257, would also require a separate advisory vote on "golden parachute compensation" in connection with certain changes in control. This legislation seeks to build upon last year's new Securities and Exchange Commission (SEC) rules that introduced the Compensation Discussion and Analysis (CDA) section, thereby vastly increasing disclosure and transparency regarding compensation.

Those SEC rules, adopted last summer, mandate detailed disclosures in companies' annual reports and proxy statements regarding the amount and type of compensation paid to the chief executive officer, chief financial officer and the three other most highly compensated executive officers

They also require that the CDA explain all material elements of a company's executive compensation programs. Companies now must disclose the criteria used in reaching executive compensation decisions and the degree of the relationship between the company's executive compensation

practices and corporate performance, as well as potential severance costs and "parachute pay" top executives are eligible to collect.

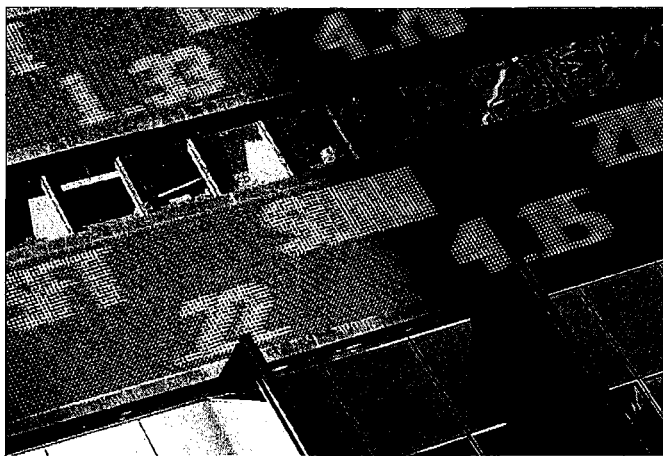
An important goal of these enhanced disclosure rules is to avoid what might be termed "remuneration by surprise," as seen in the ongoing controversy over former New York Stock Exchange chief Dick Grasso's \$187.5 million compensation package, significant aspects of which NYSE's compensation committee was found to be unaware.

Newly elected New York State Attorney General Andrew Cuomo recently announced that his office will "aggressively pursue" the case, launched in 2004 by former AG Eliot Spitzer before the NYSE went public, charging that Grasso's compensation was excessive under the state's not-for-profit laws. Grasso is currently appealing a New York state court ruling requiring him to repay \$100 million of it, finding that, as CEO, Grasso had "an affirmative fiduciary duty" to make sure "that the committee had all of the information it needed to make an informed decision," and that "Mr. Grasso's failure to disclose the amount of [his compensation plan] thwarted the Compensation Committee from performing its duty of care and obedience."

While the new SEC rules were widely supported by institutional investors, the Commission's surprise amending of those rules in late December—before an opportunity for public comment—was decried by investors.

One effect of the amendments is generally to reduce the total amount of stock and option grants shown in the Summary Compensation Table—which the SEC described as the "cornerstone" of the new disclosure regime—by allowing them to be spread out over time, rather than at their full present value at grant date.

Although the full grant date fair value still must be reported in the year of the grant, such disclosure is now relegated to an extra column added to the Grants of Plan-Based Awards Table, while the amounts reported in the Summary Compensation Table are those required to be reported under FASB Statement 123R, Share-Based Payment (FAS 123R), but without regard to estimates of forfeiture.



“Adding pressure to the SEC has been criticism from Congress, which normally prefers to let the SEC make its own regulations, but which has been known to mandate SEC policy from time to time.”

Critics of the reversal contend that it will cause confusion and unnecessary complexity. In addition, the Council of Institutional Investors—a leading U.S. shareowner-rights organization whose member funds manage more than \$3 trillion—pointed out that “the companies that will receive the greatest benefit from the reversal are the more than 800 companies, many in the high technology industry, which accelerated the vesting of employee stock options prior to the adoption of Statement 123R.”

The Council’s January 25, 2007, letter to the SEC further noted that it has been “estimated that those companies ‘dodged’ the reporting of more than \$4.7 billion in after tax compensation costs in their earnings statements [and now] will again avoid the reporting of some portion of those costs in the Summary Compensation Table.” It remains to be seen whether the SEC will be responsive to these concerns raised by institutional investors.

Adding pressure to the SEC has been criticism from Congress, which normally prefers to let the SEC make its own regulations, but which has been known to mandate SEC policy from time to time.

“This slippage is regrettable both substantively and for not having been open to more public discussion,” House Financial Services Committee Chairman Barney Frank (D-Mass) said in a statement, adding that “backtracking by the SEC on this important matter of stock options reinforces my determination that Congress must act to deal with the problem of executive compensation.”

In any event, how companies should best value employee stock option grants under FAS 123R is still being explored. The SEC recently gave a qualified go-ahead to Zions Bancorporation to use a novel market-based approach, involving the creation of a derivative instrument, “Employee Stock Option Appreciation Rights” or “ESOARs,” which would be auctioned to competitive bidders and linked to the trading price of the shares on the date the employees exercise their options.

The price of the ESOARs would be used to value the options granted to employees for FAS 123R purposes. In a February 23, 2007, letter responding to points raised by the Council of Institutional Investors, SEC Chief Accountant Conrad Hewitt stated that he “believe[s] that bringing market forces to bear on the valuation of employee stock options has the potential to improve the quality of financial reporting in this area.”

Shareholder, Fund Initiatives

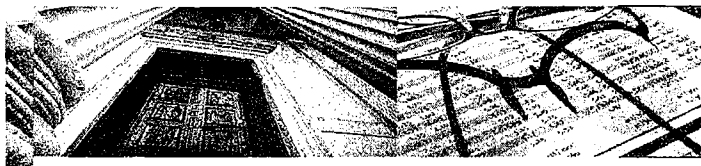
Regardless of the potential for action—or the lack thereof—in Washington, other battles will be fought at thousands of annual meetings outside the beltway, as major funds are exercising their voting muscle this proxy season to advance pay-related and other governance reforms.

The American Federation of State, County and Municipal Employees (AFSCME), the largest public service employees union in the U.S., has thrown down the gauntlet. “Until the SEC finally embraces proxy access and allows shareholders to nominate and elect directors who will put the company’s best interests ahead of the personal financial interests of greedy CEOs, shareholders will have to push the issues themselves,” it recently stated, adding that “our proposals are designed to give shareholders the tools to make boards listen.”

Two of AFSCME’s proposals this year directly seek to better align management and shareholder interests—one would require that executives who exercise stock options also increase their overall share ownership, and the other would add performance-based vesting measures to restricted stock awarded to executives “instead of simply based on the length of time served, a standard known as ‘pay for pulse.’”

Similarly, the California Public Employees’ Retirement System (CalPERS), the nation’s largest public pension fund with more than \$230 billion in assets, is focusing its proxy voting strategy on “aligning the interests of executive management with those of shareowners through performance-based equity plans and enhancing compensation committee accountability.”

Shareholders scored victories at Hewlett Packard’s March 14 annual meeting, with two activist shareholder proposals passing over management opposition; one to require shareholder approval of “poison



pill” plans, which deter hostile takeovers, and the other for the board to adopt a policy “that a significant portion of future long-term equity compensation to senior executives shall be performance based.” They passed with 72% and 53% of shares voted, respectively. Investors were also encouraged by the 39% support for a closely watched proxy access proposal that would have allowed shareholders to nominate candidates for the board of directors.

Shareholder advisory votes on executive compensation—so called “say on pay” proposals, that seek to give shareholders a non-binding, up-or-down vote on top executives’ compensation—have also grown to be a major focus this proxy season, with AFSCME and overseas investors leading the charge.

A global coalition of thirteen funds, with an aggregate of \$1.5 trillion under management, wrote to SEC Chairman Christopher Cox in January to express their support for advisory votes on executive pay.

Drawing on their positive experience with companies in the U.K. and Australia, which require such votes, and in the Netherlands, where such votes are binding, the group set forth numerous benefits of shareholder votes, including improving communication between shareholders and directors, encouraging pay-for-performance practices that better align the interests of executives and shareholders, and providing a “counter-weight to upward pressure on executive compensation from enhanced disclosure requirements.”

Indeed, SEC Commissioner Campos recently stated that “shareholder advisory votes are the future of executive compensation,” noting evidence, including a U.K. study finding that executive pay there is declining, that the benefits of shareholder advisory votes are “real and will likely lead to better relations between boards and shareholders.”

And Congress heard testimony at the March 8th hearing detailing the beneficial effects of shareholder advisory votes, including from Stephen Davis of the Millstein Center for Corporate Governance and Performance at Yale, who noted that leading U.K. funds have been directly engaging companies over pay practices and “report having had striking success in persuading boards to tie incentive pay directly to performance.”

Pressure from activist investors has led to voluntary reforms at some companies, including Aflac, which became the first large U.S. company to agree to submit its executive pay packages to a shareholder vote, beginning in 2009.

And other major companies, including Pfizer, Intel, Bristol-Myers Squibb, Schering-Plough, AIG, JPMorgan Chase and Colgate-Palmolive, are engaging in a dialogue with investors regarding shareholder approval of pay packages. In February, the companies met for the first time in a recently formed working group, led by AFSCME and investment firm Walden Asset Management, to discuss the issue.



“Pressure from activist investors has led to voluntary reforms at some companies, including Aflac, which became the first large U.S. company to agree to submit its executive pay packages to a shareholder vote, beginning in 2009.”

Company Push-back

Talking is one thing and action is another. Despite growing support for shareholder empowerment, many companies are resistant. Tyco, for instance, has come under fire for its recent weakening of the company’s performance-based reward program. Moreover, numerous companies have asked the SEC for permission to exclude say on pay proposals from their proxy materials. The SEC, however, generally has been forcing companies to include the proposals (including AT&T, Northrop Grumman, Capital One, Clear Channel Communications and Verizon), so long as the proposals are properly submitted and acceptably worded, targeting the compensation set forth in the Summary Compensation Table.

(In contrast, the SEC has allowed exclusion of proposals, such as at WellPoint, if the proposals seek a vote to approve the report of the Compensation Committee. Institutional investors have criticized the SEC’s no action letters in those cases, saying that a semantic technicality should not bar the proposals. It’s a good bet that the vast majority of say on pay proposals will be technically correct by the time the 2008 proxy season rolls around.)

The SEC also recently refused a request by Bristol-Myers Squibb to exclude a proposal to amend the company’s bylaws to require that the compensation of the chief executive officer be approved or ratified by at least three-quarters of the company’s independent directors.

Shareholder Push-back

Where there is not the opportunity to vote directly on compensation, investors have reverted to an old technique to express their dissatisfaction; they are withholding votes from recalcitrant directors, as Toll Brothers just experienced. Shareholders controlling a quarter of the company’s shares withheld their votes

from the chair of the luxury homebuilder's executive compensation committee in protest of what some major investors perceived to be the board's "fail[ure] to protect the interests of shareholders by granting excessive and unjustifiable compensation to board Chairman and CEO Robert Toll."

Withhold votes, however, are largely symbolic. But that could change as more and more companies adopt majority voting standards—another cause championed by activist institutional investors. Notably, Lehman Brothers, Honeywell, Wells Fargo and CA, Inc. each recently amended their bylaws to provide for majority voting in the face of proposals that would have forced them to do so.

Litigation is another tool investors continue to use to block or recoup allegedly unjustified pay. Former UnitedHealth CEO William McGuire was enjoined last November from receiving retirement pay or exercising options, together valued at over \$1 billion, while CalPERS' backdating lawsuit against him and the company proceeds.

CBS Corp. recently announced that CEO Sumner Redstone's salary will be reduced, and that the majority of his compensation "will now be determined directly by performance of [the company's] stock and returns to its shareholders," settling in principle litigation over its pay practices.

And two pension funds suing British Petroleum over alleged governance and management errors, are seeking to prevent outgoing CEO John Browne (who is to resign more than a year earlier than planned amid eroding investor confidence) from receiving or keeping over \$140 million in retirement pay and other compensation, claiming it is excessive and undeserved.

It remains to be seen how the court will ultimately deal with Browne's pay package. Last June, in one of the most significant decisions on executive pay in recent years, the Delaware Supreme Court affirmed the trial court's determination that Disney directors did not breach their fiduciary duties with respect to the hiring and firing of Michael Ovitz, nor in connection with his severance payout of \$130 million that plaintiffs claimed was a waste of corporate assets.

The court's primary focus was on whether Disney's compensation committee members had adequately informed themselves about the full magnitude of the potentially huge payout to Ovitz under his employment agreement. While the court agreed that the compensation committee's informational and decision-making process "fell significantly short of the best practices of ideal corporate governance," it found that it was not in bad faith or below the level required for a proper exercise of due care.

CEO Contracts Are Changing

Boards of directors are increasingly reacting to outrage over large, unwarranted pay packages. Pfizer said it was "contractually obligated" to pay former CEO Henry McKinnell a \$180 million exit package; it's no accident that new Pfizer CEO Jeffrey Kindler has no employment contract, a much lower annual salary and more pay tied to the stock's performance.

Home Depot also did an about face after Robert Nardelli, whose \$25 million-a-year pay (plus millions more in options) exemplified to many "pay for failure," was forced out in a victory for activist investors but nonetheless received a \$210 million severance package.

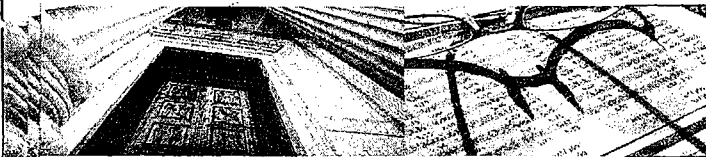
New CEO Frank Blake will be paid only a fraction of what his predecessor was, and investors applauded the company's unusual move of not including any severance package for Blake, who will receive a base salary of \$975,000, with additional compensation dependant on the company meeting specific performance targets. Home Depot also reached an agreement with Relational Investors to install one of the fund's representatives on the board so as to head off a proxy contest, further proof of the growing influence of activist investors.

Options: Backdating, Spring-loading and Bullet-dodging

With hundreds of companies and executives being investigated or sued in connection with option grants and numerous executives being charged criminally, courts have started addressing options backdating, as well as the related practices of granting "spring-loaded" and "bullet dodging" options.

(Whereas backdated option grants take advantage of historically favorable share prices, "spring-loaded" options are granted to executives before the release of material information reasonably expected to drive the price of the options higher. "Bullet dodging" is achieved by postponing an options grant until after the release of materially damaging information. Both have been suggested to constitute a form of insider trading under federal securities laws, though whether they do has yet to be decided.)

Among the closely watched cases now on the docket is the SEC's civil suit against former Brocade executives for their roles in the backdating scandal that rocked the company last year. (Brocade and the SEC reportedly have reached a tentative \$7 million settlement of the allegations against the company, pending a vote by the Commissioners. This settlement is expected by many to set the tone for the resolution of other backdating enforcement actions.)



2007 Fund Management Legal & Regulatory Report

The Brocade executives are arguing that the case against them should be dismissed because options backdating supposedly is “immaterial” to investors, and that there is “no victim.” Investors and the SEC, of course, disagree, given that option backdating and undisclosed option timing has the effect of transferring wealth from shareholders to employees.

As agents of the company’s shareholders, management owes a duty to be conscientious stewards of the assets entrusted to them by shareholders, and certainly not to covertly enrich themselves at shareholders’ expense. Oral argument in the Brocade case, SEC v. Reyes, No. C 06-04435 (N.D. Ca.), is slated for May.

Shareowners were heartened by a pair of first impression Delaware decisions in February establishing that deliberate backdating and spring-loading violate directors’ duty of loyalty and do not constitute good faith conduct. The court allowed suits to proceed against directors at Tyson and Maxim Integrated Products.

In the Maxim case, *Ryan v. Gifford*, No. 2213-N, 2007 Del. Ch. LEXIS 22 (Del. Ch. Feb. 6, 2007), the court held that “backdating options qualifies as one of those rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.”

The spring-loading case, *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, No. 1106-N, 2007 Del. Ch. LEXIS 19 (Del. Ch. Feb. 6, 2007), may be harder for plaintiffs to prove, notwithstanding that the court held that they “adequately alleged that the Compensation Committee violated a fiduciary duty by acting disloyally and in bad faith with regard to the grant of options.”

That’s because while “the backdating of options always involves a factual misrepresentation to shareholders,” spring-loading, the court wrote, entails a “much more subtle deception.”

The new wave of criminal cases against executives involved in options shenanigans, including the former CEO of Take-Two Interactive Software and a former senior vice president of the company that owns Monster.com (both of whom have pled guilty), and the former general counsel of McAfee, Inc. (who has pled not guilty), has led to speculation as to who might be next and what will happen to companies involved.

Notably, shareholders of Take-Two Interactive are reportedly banding together to take over its board and potentially oust the CEO. And Apple reportedly is being criminally investigated in connection with thousands of improperly backdated options granted between 1997 and 2002, and particularly two large options grants given to CEO Steve Jobs in 2001.

Apple’s internal investigation “found that CEO Steve Jobs was aware or recommended the selection of some favorable grant dates,” although “he did not receive or financially benefit from these grants or appreciate the accounting implications.”

It appears doubtful for a variety of reasons that Jobs will be indicted. However, the mere fact that he did not profit from the grants would alone not necessarily be enough to stave off prosecution. Indeed, the felony charges being pursued against former McAfee general counsel Kent Roberts do not allege that he cashed out any of the backdated options. Rather, the wrongdoing is claimed to have occurred at the time he allegedly manipulated the date of the grants.

Conclusion

Executive compensation will undoubtedly remain a primary area of concern for institutional investors for the foreseeable future, not only because, ultimately, it is the shareholders’ money being paid out, but also because of the connections (or lack thereof) between compensation and corporate performance.

Notably, a link between compensation paid to CEOs and the “overall credit risk” of the company was found by Moody’s Investor Service in a July 2005 study, with “dramatically higher default rates” in the companies with the highest “unexplained” bonuses and option grants. Moody’s observed that “large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud.”

Stay tuned for further developments in the compensation arena. In addition to the issues discussed above, expect companies’ use of (and ties to) compensation consultants to come under greater scrutiny. And companies’ payment of “tax gross-ups” (where the company pays an executive’s taxes on compensation) will also be further questioned by shareholders, given how large and inefficient such payments can be.

Mr. Cappucci is head of the Securities Litigation Department at Entwistle & Cappucci LLP. Michael H. Rosner, a senior litigation associate at the firm, assisted in the preparation of this article.

Vincent R. Cappucci, Esq.
Entwistle & Cappucci LLP
280 Park Avenue, 26th Floor West
New York, New York 10017, USA
vcappucci@Entwistle-Law.com

Tel: +1 212 894 7200 • Fax: +1 212 894 7272 • www.entwistle-law.com



ENTWISTLE & CAPPUCCI LLP

Counselors at Law

ARMONK • AUSTIN • CHICAGO • FLORHAM PARK, NJ • NEW YORK • TALLAHASSEE • WASHINGTON, DC