

Executive Pay and Loyalty: From Velvet Glove to Iron Fist

By Mark Poerio

Outrage over executive compensation has fueled—and promises to inflame—a global finger pointing at boards of directors.

- “How could you have approved such outrageous incentives?”
- “Where is the correlation of pay to corporate performance?”
- “Why are we providing rich exit packages to those who have failed, or who have already accumulated vast wealth from us?”

The past several years have seen calls for accountability—and independence—come globally, from shareholders, regulators, industry groups, the US Congress and the G-20. Expectations have emerged for consistent principles. These include basing executive compensation on long-term corporate goals and objectives, weighing the risk that variable incentives will encourage, and positioning to “claw back” or recover ill-gotten gains.

In banking circles, the G-20’s Financial Stability Board warned in November 2009 that “prompt remedial action, and, if necessary, appropriate corrective measures” should be taken to assure that “compensation systems take into appropriate consideration risk, capital, liquidity, and the likelihood and timeliness of earnings.”¹ The Swiss FINMA,² the UK Financial Services Authority,³ and the US Federal Reserve⁴ have each followed suit, with supervisory guidance that not only articulates standards for sound compensation practices, but that signals the need for immediate corrective action. All want fulsome disclosure, with the SEC recently announcing a loss of patience

with companies that continue to ignore its directives for proxy statements that explain the “why” behind executive compensation decisions.

The foregoing suggests that corporate boards should brace now for an escalating storm. In 2009, public outrage and governmental concern started their inevitable spill into courtrooms and hearing rooms. Litigation, headlines, and legislation sprang from front page headlines about executive excesses—from bonuses, to perquisites, to severance. Those who are accountable need to be proactive. It will be a win-win because corporate boards need to protect long-term corporate interests, while appropriately rewarding those responsible for long-term success.

Looking ahead to 2010, responsible boards may be expected to root out poor or outdated practices, and to be first movers for better practices.⁵ Getting started is as simple as running through the checklists at the end of this article. Once a board has identified executive compensation issues for deeper attention, the challenge becomes evaluation and correction.

Velvet Glove

For boards that find poor practices, step two should involve constructive dialogue about their elimination. The vehicle for change is an updating of the underlying plans and employment agreements. This almost always requires executive consent, which is where the rubber hits the road. In a general sense, boards have three avenues by which to effectuate change:

1. **Friendly.** Boards may unilaterally make changes on a prospective basis, such as through new award agreements. This may appease executives, but it also may perpetuate poor practices and slow better practices to a pace that some may consider glacial.

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2. Negotiated. Many executives rightly feel a “loss” when their companies want to eliminate previously bargained-for benefits, such as tax gross-ups or perquisites. A salary increase, stock award, or bonus opportunity may balance the loss—and thereby garner executive acceptance subject to a board’s comfort that the resulting executive compensation package is reasonable.
 3. Gloves-Off. Suppose a board feels the need to act promptly but encounters executives who are unwilling to part with the past contractual rights that have become questionable. Boards may take a hard line by presenting executives with a choice between accepting the change, and facing (1) substantially reduced or eliminated future incentive opportunities, to the extent allowable under a contract, (2) non-renewal of the existing employment agreement, or (3) termination of the executive’s employment, now or at a future date. These are extreme remedies, and best for consideration only if an executive resists pressure for what a board considers to be crucial changes required under sound compensation principles.

Iron Fist

Because our economy is knowledge-driven, it is generally critical for employers to aggressively protect their trade secrets, business strategies, and relationships with customers and key employees. The starting point is normally an agreement that carefully sets forth non-competition and other loyalty covenants. This may be done in employment agreements, or through separate stand alone agreements. Regardless, it is best to develop one cohesive approach that is well-crafted to business needs and applicable laws, and that is regularly updated for changes in either.

By contrast, an ad hoc or casual approach to claw-back and loyalty protections may lead to enforcement problems. This most often occurs when executive agreements fail to reflect vagaries between state and international laws. For example, Georgia’s Court of Appeals recently refused to enforce an executive’s loyalty covenants because

(i) the provision restricting the solicitation of clients was overly broad in that it covered clients that no longer had a relationship with the employer, and (ii) the hiring away of employees did not violate a non-solicitation prohibition because the new hires initiated contact with the former executive.⁶ The Georgia decision reflects the tough standards that state courts often apply when asked to enforce loyalty covenants.⁷ Employers should recognize this, and craft documents for maximum enforceability.

There is a complementary executive compensation strategy that employers should pursue, and it involves cash bonuses, stock awards, and deferred compensation plans. Any or all of these may be refined in a manner that both (i) better positions the employer to seek judicial enforcement of loyalty covenants, and (ii) provides for benefit forfeitures and claw-backs when disloyalty prevails. There is significant federal, state, and foreign case law supporting enforcement of these “golden handcuff” protections. Moreover, claw-back remedies have over the past few years become standard corporate precautions against executive fraud or misconduct, as well as disloyalty.

Directors who forego an iron-fisted approach to executive compensation should beware of iron fists that may come at them from angry shareholders and regulators. The NYSE board became an early target when its CEO (Dick Grasso) made front page headlines for the \$100 million plus supplemental pension that he received when retiring in 2003. About the same time, the wake of the Enron scandal prompted then Chief Justice Veasey of the Delaware Supreme Court to forewarn about today’s state of affairs, by urging—“boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint.”⁸

Delaware courts have subsequently refused to dismiss shareholder actions challenging board

members with breaching their fiduciary duties through actions alleged to involve:

- improperly authorizing a \$68 million severance payment to a fired CEO (holding that “the discretion of directors in setting executive compensation is not unlimited[,]” and the “outer limit” occurs when it is “so disproportionately large as to be unconscionable[.]”);⁹
- backdating stock options over a five-year period (holding that “I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith”);¹⁰ and
- granting about 2.8 million stock options to key employees on a “spring-loaded” basis just days before the company would issue press releases that were expected to drive stock prices higher (holding that a director “who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary”).¹¹

Conclusion

In the face of higher fiduciary expectations, an agitated public, and greater potential for judicial recourse, corporate directors should at a minimum be sure to act independently, to obtain independent advice, and to thoroughly document their deliberations. Such procedural diligence will often be critical to defending against fiduciary claims. The best defense will, of course, come from considering best practices, and shaping them into executive compensation decisions that advance and protect key corporate interests.

It has long been written that “for every wrong, there is a remedy.” Today, compensation

committees have the opportunity to remedy what is wrong with executive compensation, and in so doing to protect critical business interests. If they fail to do so, the remedies of law may soon be aimed at them.

Poor or Questionable Practices

- The absence of an independent advisor for a compensation committee.
- Evaluating executive or director compensation structures without regard to (i) carefully chosen peer groups, and (ii) a total compensation analysis.
- Incentive compensation that is solely or primarily based on stock options, annual bonuses, or other short-term incentives, without regard to risk horizons.
- The failure to prohibit executives from hedging their financial stake in employer stock received through equity awards.
- Any tax gross-ups payable to executives.
- Perquisites other than those tied directly to the business.
- Supplemental executive retirement plans with benefits based solely on pay and service.
- Severance benefits exceeding current market standards, or not conditioned on corporate performance or an executive’s claims release.
- Broad rights to resign *without* “good reason” following a change in control.
- Automatic accelerations of vesting on a change in control (with best practices being focused generally on maximizing company flexibility over how equity awards and other company-paid executive benefits will be handled in a corporate transaction).
- Severance that includes performance-based compensation even if targets are not met (because this could disqualify an

exemption from Code 162(m) deduction limitations).

- An absence of claw-back rights triggered by an executive's fraud, misconduct, or receipt of ill-gotten gains.

Best Practices

- The Compensation Committee's regular procedural diligence including attention to its charter, its policies for equity grants, and its access to independent counsel, consultants, and risk managers.
- Executive compensation structures that emphasize long-term incentives and that take into account the risk horizon for all performance-based awards.
- Determination of incentives first by identifying the business strategy, and then by establishing metrics that reflect the success or failure of that strategy.
- Compensation committee consideration of each executive's total compensation package, with attention to long-term wealth accumulation and total walk-away value upon leaving employment.
- Hold till retirement policies for equity awards and installment settlement of equity awards (in order to establish a post-employment stake in employer stock).
- Transparent disclosures that reflect the SEC's principles-based approach, and its

heightened expectations for improvement over past disclosures.

Notes

1. *FSB Principles for Sound Compensation Practices*, 25 Sept. 2009, page 5 (available at www.financialstability-board.org/publications/r_090925c.pdf).
2. "Remuneration Schemes," Circular 1010/1, released by FINMA on 11 Nov. 2009 (available at www.finma.ch/lektuell/Pages/Imm-rs-verguetungssysteme-20091111.aspx).
3. "Intensive Supervision: delivering the best outcomes" (speech delivered on 09 Nov. 2009 by the FSA's chief executive Hector Sants; reported at corporatelawandgovernance.blogspot.com/2009/11/uk-directors-ethics-and-fsa.html).
4. "Proposed Guidance on Sound Incentive Compensation Policies," released by the Federal Reserve on 22 Oct. 2009 (available at edocket.access.gpo.gov/2009/E9-25766.htm).
5. For a comprehensive and substantive guide to best practices, see The Conference Board's task force report on executive compensation (released Sept. 21, 2009); see www.conference-board.org/pdf_free/ExecCompensation2009.pdf.
6. *Wachovia Ins. Servs. Inc. v. Fallon*, 229 Ga. App. 440, 682 S.E.2d 657 (2009).
7. For further information, see Weirich & Hart, "Protecting Trade Secrets and Confidential Information in Georgia," *Mercer Law Review*, vol. 60, page 533 (2009).
8. "What's Wrong with Executive Compensation? A roundtable moderated by Charles Elson," *Harv. Bus. Rev.*, Jan. 2003, at 68, 76.
9. *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A. 2d 106, 138 (Del. Ch. 2009).
10. *Ryan v. Gifford*, 918 A. 2d 341, 358 (Del. Ch. 2007).
11. *In re Tyson Foods Inc. Consolidated Shareholder Litigation*, 919 A. 2d 563, 593 (Del. Ch. 2007).