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Candor for Compensation Committees

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"This is a failed 'say-on-pay' shareholder derivative action, arising from the Board's unwarranted and excessive spending on executive compensation."

So begins a recent complaint filed on Sept. 1 against directors of the former R.H. Donnelley, now reorganized as Dex One. They are far from alone in being singled out for potential personal liability.

A week earlier, a similar complaint against Johnson & Johnson's directors accused them of failing "to follow J&J's executive compensation philosophy and J&J's guiding principles for executive compensation," and concluded that "defendants have breached their duty of loyalty and candor."

Can it get worse? Yes. In a sharply worded ruling, an Ohio district court just refused to dismiss the fiduciary duty breach complaint against Cincinnati Bell's officers and directors, despite their business judgment rule arguments, a development that may leave directors feeling stuck between a rock (exhaustive executive compensation disclosure) and a hard place (shareholder activism). The 2011 proxy season saw numerous shareholder derivative lawsuits spring from unfavorable say-on-pay votes, and others spring from proxy statement disclosures relating to Section 162(m) of the Internal Revenue Code. The forum for these lawsuits has not been traditionally corporate-friendly Delaware, but instead, courts in Arkansas, California, Georgia, New Jersey, Ohio, Oregon, and Texas.

Risk of litigation related to executive compensation, whether stemming from a negative say-on-pay vote or from challenges to the adequacy of compensation disclosures, seems to be growing. While it remains to be seen if any of the most recent suits will be successful, two similar suits filed prior to the 2011 proxy season resulted in settlements requiring various corporate governance reforms. With the risk rising and litigation sure to result in unnecessary cost (money, time, and reputation) and unwanted media attention, directors are wise to react proactively as the 2012 proxy season approaches, keeping in mind the following:

Clear disclosure is mandatory. Public disclosures are being scrutinized and tested. In the current fishbowl, directors cannot afford to mix messages or to leave question marks in their public disclosures. Directors need to demonstrate their diligence by disclosing decisions that reflect sound thinking and careful execution.

Focus on performance-based comp. Boards invite criticism when they make sizable cash bonus or stock awards despite poor stock price performance. Several failed say-on-pay votes in 2011 trace to extraordinary awards that were glossed over in the proxy statement's compensation discussion and analysis (CD&A). Other failed votes trace directly to poor corporate performance standing in isolation. Whatever the reason, the days are gone when shareholders gave directors the benefit of the doubt over executive compensation matters.

Directors should consequently consider taking some precautions. First, develop a record that solidly supports whatever compensation decisions are made. Second, be careful to structure unusual or noteworthy awards in a manner assuring that vesting and payment terms reflect the achievement of long-term performance goals and with appropriate forfeiture and other business protections. Third, be sure to anticipate scrutiny of the proxy statement, and accordingly, take advantage of executive summaries and other shareholder communication alternatives.

Obtain independent advice and peer data. Everyone should expect executive compensation to be a lightning rod for attention. Boards that "go it alone" accentuate their exposure to second-guessing. Take the case of Exar Corp. whose unfavorable say-on-pay vote triggered litigation and which perhaps regrets the following decision set forth in its 2011 proxy statement: "In fiscal year 2011, the Compensation Committee determined that, due to the recent executive compensation review by Compensia, there was not a need to incur the added cost of retaining an independent compensation consultant to advise on fiscal year 2011 executive compensation. Instead, the Compensation Committee utilized the data provided."

By engaging its own independent consultant, a compensation committee should obtain multilevel protections in the form of better information about best and worst practices, better advice about governance and procedural improvements, better analysis of peer data, better insights into alternatives for structuring compensation, and better, clearer disclosure.

Should compensation committees also engage independent legal counsel? That usually depends on how directors weigh their confidence in the committee's consulting adviser, their desire for a second opinion to that of the company's general outside counsel, and the relative cost for the added protection. In many cases, a second set of independent eyes will involve a modest cost when compared to the benefit of adding a layer of protection from missteps and shareholder litigation.

Avoid red flags. ISS and other proxy advisory firms have singled out numerous executive compensation practices that are presumptively questionable. For example, in its 2011 U.S. Compensation Policy, ISS has identified the following as problematic pay practices:

- reprising or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting;

- new or extended agreements that provide for CIC payments exceeding three times base salary and average/target/most-recent bonus; CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers); CIC payments with excise tax gross-ups (including "modified" gross-ups);
- equity plans or arrangements that include a liberal CIC definition (such as a very low buyout threshold or a CIC occurring upon shareholder approval of a transaction, rather than its consummation), coupled with a provision for automatic full vesting upon a CIC, which are also more likely to receive a negative recommendation.

Compensation committees should be wary of acting in contravention of best-practice standards and should only do so under compelling circumstances with supporting disclosure tying the actions to clear company goals. Because there is sure to be intense public scrutiny when departing from best practices, boards should be certain to structure contract terms in a manner that demonstrably advances the employer's business objectives.

Become more active in proxy statement preparation. In an article aptly titled "The Nays Have It," the last edition of Corporate Board Member described the importance of being "more careful and more forthcoming" in proxy statement disclosures of executive compensation. Section 951(c) of the Dodd-Frank Act may state that the vote outcome "shall not be construed" to create any change or addition to the fiduciary duties of directors, but that has not discouraged shareholders from using unfavorable votes in 2011 as the springboard for shareholder derivative litigation in nearly one-fifth of the cases so far. Some pending complaints, such as the Dex One and Johnson & Johnson claims mentioned earlier, take a new tack against directors by alleging that the business judgment rule does not protect them with respect to securities disclosure claims that are premised on a disconnect between pay and performance. Directors should ensure that the CD&A clearly explains the business reasons for the executive compensation package and demonstrates the thorough process used by the committee.

Whatever the shareholder derivative claim relating to executive compensation, directors are the main targets. They cannot afford to be passive, last minute, or reactive. Just the opposite: Directors need to take ownership over executive compensation, from articulating a well-considered philosophy to selecting insightful advisers, to making sound executive compensation decisions and convincing public disclosures.

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