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CD&A Alert: Saying "To Be Competitive" Is Not Analysis

A Red Flag

As our readers start to grapple with providing the kind of analysis that the SEC will be looking for in this year's proxy statements, we are concerned that some companies will be lulled into a trap. What may appear at first blush to be an easy explanation for even very large compensation amounts—"we do it 'to be competitive'"—may, in fact, become a red flag to highlight compensation decisions that were made without critical analysis.

We are concerned that compensation committees and counsel may be setting themselves up for criticism—and potential exposure—by saying, in essence, "we do it because everyone else does it."

Critical Analysis

The SEC and others scrutinizing this year's CD&As will be looking for critical analysis of the elements of compensation, particularly in the context of the total current—and accumulated—compensation. They will be looking for justification for severance and retirement and change-in-control provisions, where a CEO may have already accumulated several lifetimes of "security" so that there is no longer a 'need' for safety net provisions (see, for example the model CD&A disclosures addressing severance and change-in-control set forth in the January-February 2008 issue of *The Corporate Executive*). They will also be looking for critical analysis of the need for ongoing large grants of stock options and restricted stock, where a CEO's carried interest is already so large that incremental increases in equity will not create additional motivation. They will be looking for why a company has not added long-term retention provisions to the equity granted to top executives so that the CEO and other key executives have skin in the game for the long term.

An Example

The Tally Sheet discussion in a recently filed proxy statement may help illustrate our concern. The company is to be lauded for providing a captioned section entitled "Tally Sheets." The first paragraph of that section provides a very good description of the tally sheet information that was considered by the compensation committee: "This includes an executive's salary, annual cash incentive award, equity-based compensation, perquisites, pension benefit accruals and other compensation. The tally sheet also shows holdings of [the company's] common stock and accumulated unrealized gains under prior equity-based compensation awards. In addition, the tally sheet shows amounts payable to the named executive officer upon termination of the executive's employment under various circumstances, including retirement or a change of control. The Compensation Committee uses tally sheets to estimate the total annual compensation of the named executive officers, and provide perspective on the named executive officers' wealth accumulation from our compensation programs and payouts to the named executive officers under a range of termination scenarios."

(We were struck by how close the language was to the model tally sheet language we provided in the January-February 2008 issue of *The Corporate Executive*.)

What we found troubling, however, was the "analysis" paragraph that followed: "While considered by the Compensation Committee, pension accruals and compensation previously paid to the named executive officers, including amounts realized or realizable under prior equity-based compensation awards, did not affect the Compensation Committee's compensation decisions for fiscal year 2007. This reflects the Compensation Committee's views that an executive's compensation levels should reflect the executive's performance and the market value of his services. The Compensation Committee further believes that reducing an executive's compensation based on the value of past compensation would weaken the competitiveness of our compensation program and make it more difficult to attract and retain executive talent."

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On the face of it, this sounds like analysis. It is really a candid statement that the committee decided **not to critically analyze** the total compensation—including whether there was any longer a 'need' for a severance or change-of-control provision or a costly gross-up provision or SERP for the CEO. In fact, in the company's pension benefits discussion it is reiterated: "While accrued pension benefits were included in the tally sheets used by the Compensation Committee, the Compensation Committee does not consider them when making compensation decisions for the named executive officers. As stated earlier, doing so is inconsistent with the principle of compensating executives for the value of their services and would adversely affect the competitiveness of our compensation program." And in the change of control section, the company states: "In setting the potential payments under these agreements, the Compensation Committee does not consider compensation previously paid to a named executive officer, including any accumulated gains under prior equity-based compensation grants."

[We note that the company also uses the name of its compensation consultant liberally in these discussions. We can understand why some critics are troubled by the use of consultants' names in the CD&A, implying that the consultant has blessed or taken part in the analysis. This practice would be particularly troublesome; for example, where representatives of the consulting firm have espoused the importance of a wealth accumulation analysis, which the company ignores. At a time when critics (including Congress) are questioning the role of consultants, it would seem particularly important for the company to disclose clearly whether the consulting firm: (a) suggested, (b) actively agreed with, (c) passively acceded to, or (d) disagreed with the analysis, especially since more and more consultants are questioning the need at the top for severance and change-in-control and gross-up provisions.]

Our Concerns

The statement about "adversely affecting the competitiveness of our compensation program" is a very broad, sweeping statement that is devoid of individual analysis of particular executives. What the SEC is looking for is specific analysis regarding the CEO, in particular, as well as the other individual named executive officers. As was forcefully and candidly presented by respected compensation consultant, Michael Kesner of Deloitte Consulting, during the lead panel for our "4th Annual Executive Compensation Conference" this past October, there are myths about the "to be competitive" mantra that need to be squarely addressed (both by the compensation committee and in the CD&A). For example, "the CEO will quit if we take away severance." As Kesner pointed out, several very successful companies do not have or have eliminated severance, including GE, DuPont and Johnson & Johnson. Another myth is "the CEO will go to private equity." First, as the panel at our Conference pointed out, the pressure and performance demands on CEOs of private equity companies and the daily scrutiny by those boards make for an environment that many public company CEOs would not find attractive. Perhaps even more telling was a response of a CEO who made the comparison to others' large amounts of compensation—when asked directly whether he would leave his respected position at the pinnacle of his highly respected company, he made very clear that he would not.

In addition to concerns about the failure of some boards to take into account wealth accumulation, we are concerned about the failure of some boards to analyze and adjust internal pay ratios. Again, the SEC, investors and critics (as well as plaintiffs' lawyers) will be looking closely at those companies that simply say in their CD&As that they followed surveys or comparisons of others' compensation without then analyzing the internal pay equity within the company itself. Where a CEO's total compensation and accumulated wealth has gotten out of line from the company's other executives, and the compensation committee has ignored the need for internal analysis, the company and the board and others involved in the process (and the disclosure) may be opening themselves up to unwanted scrutiny.

Suggestions

We don't pretend that one size fits all, but we urge our readers to look closely at the examples of CD&A disclosure prepared by David Lynn, former SEC Corp Fin Chief Counsel, in the current issue of *The Corporate Executive* as these examples illustrate the kind of critical analysis—and what needs to be done in response to that analysis—that is now expected in this year's CD&As.

—JMB

The Publisher of *The Corporate Counsel,* **Jesse M. Brill,** is a member of the New York and California Bars and received his J.D. from Yale Law School. Mr. Brill, formerly an attorney with the Securities & Exchange Commission, is securities counsel for one of the largest brokerage firms in the nation, and Chair of the NASPP, CompensationStandards.com and DealLawyers.com. Mr. Brill has chaired and participated on numerous panels and seminars.
Editor: **Michael Gettelman,** LL.B. Harvard University, Farella Braun + Martel LLP, San Francisco (mgettelman@fbm.com).

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