



# Corporate Officers & Directors Liability

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## Expert Analysis

### The Top Six Areas to Watch In Executive Compensation

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Changes in executive compensation over the next three to six months will affect not only pay for executives but also the oversight of board members and compensation committee members. There are six areas to watch in executive compensation in proxy season 2009:

- A reduction in cash compensation;
- Significant shifts in the long-term-incentive landscape;
- Stock option exchanges;
- The impact of turnover on executive pay packages;
- Evolving proxy disclosure; and
- Changes in compensation committee process.

#### *A Reduction in Cash Compensation*

With the economic downturn, tightness of cash has become a reality for many companies. Given these constraints, there will be pressure to reduce cash compensation over the next couple of months. Salaries likely will either be reduced or frozen given the financial state of companies, and many CEOs are even taking cuts in pay as other employees are laid off or have their salaries reduced or frozen.

Additionally, companies that are not profitable will most likely see bonuses that do not pay out above the targeted level, since these businesses will struggle with uncertain financials and may look to retool their bonus payout scales. However, companies that are profitable and exceed expectations for earnings may see modest executive bonus payouts as they post signs of recovery.

#### *A Significant Shift in the LTI Landscape*

There could be competing pressures in the long-term-incentive landscape. Downward pressure may come from:

- The continued influence of shareholder advocacy groups and institutional groups that has resulted in a multi-year decline in annual LTI award rates; and
- Board hesitancy to increase stock levels in the midst of flat or declining earnings.

However, pressure to increase LTI packages may result from executives' desire to trade off cash compensation for increased stock so they can "buy low and sell high," given the radically depressed nature of most stocks in the market today.

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*There will be pressure to reduce cash compensation over the next several months.*

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Also, a change in the portfolio of LTI awards may be on the horizon. In recent years companies have shifted significantly away from stock options and toward time- and performance-based restricted stock to reduce total award rates and provide more "efficient" vehicles. However, time-based restricted shares often are viewed as a giveaway, and economic uncertainty makes performance-based grants difficult. Therefore, given the upside leverage associated with stock options, companies may renew their focus on them.

### *Stock Option Exchanges*

Many companies were evaluating the advantages of stock option exchanges in 2008. Given the prolonged depression of stock prices, 2009 may be the year that many companies actually move forward with stock option exchanges. Companies may believe that significantly underwater stock options simply will not engage, retain or incentivize employees or executives. (When options are underwater, the fair market value of the stock is less than the strike price, meaning the option award has no current value to the executive.) To realign all employees with current goals, it will be important for companies to put in place powerful incentives to make that happen.

In the absence of cash, exchanges that give executives stock options with low exercise prices can increase retention and incentivize growth opportunity. Therefore, there may be an increased need to exchange

significantly underwater options for options with lower exercise prices.

### *The Impact of Turnover on Executive Pay Packages*

Turnover may continue to increase as boards seek executives who can lead in a downturn. As a result, there is likely to be some upward pressure on pay packages, particularly if boards are forced to look at outside candidates. Pay packages for external new hires almost always are significantly greater than those for an internal new hire. Additionally, these new outside-hire executives are likely to demand severance and change-in-control packages for their new roles since they may be leaving those behind when they take the new position. Boards may, however, be less inclined than ever to provide severance and change-in-control packages because of the negative view surrounding them in the current marketplace.

Also, there may be more of an emphasis on performance in these new-hire pay packages, structured like traditional private-equity-backed company pay packages, since this is both necessary and the correct strategy in a crisis environment. Companies will need strong strategies, given uncertain financials and limited visibility into the future, on how to structure these performance-based pay packages.

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*Companies may renew their focus on stock options.*

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### *Evolving Proxy Disclosure*

Proxy disclosure will continue to evolve to be more open and transparent, as boards understand the need for smoother communication with shareholders. This could also bring about the following changes in executive compensation:

- Severance packages that contain sunset provisions, and a reduction in total values and participation, particularly for new hires;
- Strengthened pay for performance;
- An increase in the use of "clawbacks" (the ability to recoup previously paid compensation or stock gains based on misstated financials or other acts of malfeasance); and

- A decrease in the focus on peer group data as last year's data are not indicative of the current environment.

### *Changes in the Compensation Committee Process*

Finally, there could be a significant shift in the compensation committee process in the following ways:

- Meetings will be longer and more frequent in order to enable a more thorough examination of proposed changes and programs;
- There will likely be a request for more data and modeling of potential plan outcomes. At the same time, however, there will be less of a focus on peer group data as the past is no longer an adequate predictor of the present; and
- Communication and perception will strongly factor into decision-making since committees will focus on balancing the different and often competing perspectives of the media, executives, shareholders and employees, particularly if stock prices remain depressed.

The next three to six months, which include the proxy season, could show some compelling changes in executive compensation disclosure and practices. Changes to executive compensation packages could be extensive as a result of the current market economy, bailout program, potential future legislation and the economics of companies coping with recession. Let's watch how the proxy season disclosure unfolds.



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