NACD PROGRAM

November 17, 2016

WHAT YOU DON'T KNOW ABOUT EXECUTIVE COMPENSATION CAN HURT YOU!

On November 17, the Chapter hosted a panel of compensation experts who gave attendees an overview of the current "hot" topics in the area of executive compensation. To present a comprehensive cross section of viewpoints, the panel included the Compensation Committee Chairs of four public and private companies of varying types, Jean Rankin (InterDigital, Inc.), Jerry Leamon (Korn/Ferry International), Tom Fuller (Tingley Corporation) and Pam Craven (Amber Road, Inc.). The panel also included one of the nation's leading compensation consultants, Mike Marino of Frederick W. Cook & Co.

Overall, Boards for all companies have to realize: compensation plans are tremendously effective in driving management behavior. Accordingly, they must be designed seriously and great care must be taken in order to avoid incenting unwanted behavior. The assistance of a qualified compensation consultant and a lawyer is highly recommended.

Companies must align their compensation plans with strategy. Directors should identify red flags and thoroughly analyze how the plan works if a significant risk becomes reality. It may sometimes make sense for different categories of management to be covered by different plans. In plan design, common sense trumps analytics. Although plan design is driven by the Compensation Committee, the entire Board is ultimately responsible. For public companies, the SEC requires the disclosure of any plan feature that could have a material adverse effect on company financials.

The panel discussed elements of good plan design for all companies, including nonprofits. Generally, and especially for short term plans, financial metrics should make up about 70% in determining awards. The rest should be nonfinancial (i.e., KPIs, or key performance indicators), in a proportion of not less than 20%, to encourage "good behavior." TSR, or total shareholder returns, should be merely one type of financial metric for a public company's long term plan and one that is not relevant for a private company. Awards should be capped so that management behavior does not get distorted. If a plan involves comparison of company performance with a peer group, great care must be taken to use peers that are really relevant. Private companies would be well advised to engage a consultant to assist them in structuring a meaningful peer group. Metrics must be realistically achievable, then tailored to individual cases and compared with the marketplace. Attention should be paid to how steep the compensation curve will be in rewarding great performance. Generally, since the 2008 recession, the curve is flattening. For long term plans properly designed, the highest payout should be achieved once or twice in a ten year period. There is no hard and fast rule for comparing how much compensation management earns vs. how much cash is left for shareholders.

Equity based compensation plans require the ability of an award recipient to monetize the award. Accordingly, private companies are led to establish cash only plans. Typically, stock option plans call for vesting over time, but shareholder groups are more and more pressing to see options vest with performance, not the mere passage of time. Plans that incorporate the notion of "intrinsic value," instead of market value, are disfavored because they involve too many assumptions to be really effective.

CEO employment agreements definitely need the involvement of a company lawyer. These agreements are mistakenly considered all too often as one sided deals. For example, the terms of a severance provision need to be carefully drafted to protect the company. Care must also be taken to insure that no one provision works in an unreasonable fashion, since courts have shown a tendency to void the whole agreement due to the presence of one or a few such provisions.

The panel also spent time on the often ignored topic of a Board setting the terms of its own compensation, an area of increasing litigation focus especially on the equity piece. To increase the dynamism of the board and encourage healthy director turnover, vesting periods for equity awards need to be reasonably short, but not too short that an activist might be tempted to attack it. Capped equity awards are definitely to be encouraged. The trend is to pay directors a retainer rather than on a per meeting basis, with an upside should a crisis hit that requires an unusual amount of director involvement. Committee Chairs would normally be paid more than others. Directors are advised not to be "low hanging fruit" for litigation and review their own plan at least every two or three years. Defensive measures that can be taken in advance include use of a qualified compensation consultant to design the plan and attention to the surveys the NACD does on the subject of director compensation. Although not yet a common practice, some companies are even considering asking for shareholder approval of Board compensation plan, in an effort to totally insulate the Board against charges of conflict of interest.

The discussion concluded with the observation that in seeking shareholder approval of a "say on pay" proposal, passive investors, such as exchange traded funds, can't be ignored, since a good number have adopted the policy of voting no even if only one proxy advisor is negative.

For a more complete outline of the the issues covered by the panel, and several others for which time had run out, please see the "Background Notes" [ADD LINK} that were distributed after the conclusion of the panel.