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Executive Compensation: Time For a Reality Check

Shareholder activists and regulators have for years sought to regulate or control executive compensation practices, with little success. That debate largely was confined to shareholder proposals, modest regulator initiatives and academic discussions within the business community. Only occasionally would the topic surface in the press or gain public attention.

The current financial crisis has dramatically changed the visibility of and emotions surrounding executive compensation issues. CEOs of many of the high profile financial institutions which contributed to the current financial crisis received huge compensation packages shortly before their companies' horrible financial conditions were disclosed. For example, during 2007:

- Bear Stearns' CEO, James Cayne, received $38 million;
- Lehman Brothers' CEO, Richard Fuld, received $34 million;
- Citigroup's CEO, Charles Prince, received $15 million;
- Countrywide Financial's CEO, Angelo Mozilo, received $21 million.

More recently, the huge bonus awards to lower level executives at many Wall Street firms and other financial institutions have been well documented. But, these compensation excesses are not limited just to the financial services industry. The average public company's CEO compensation today is reportedly 400 times that of the average employee. By contrast, the ratio of CEO pay to the average employee pay is reportedly about 22 in Britain, 20 in Canada, and 11 in Japan.

The issue of executive compensation is now at the forefront of any discussion relating to current problems with corporate America. There is a widespread perception that too many executives are being paid too much without regard to their performance. By adopting compensation practices which either ignore performance or focus only on short term performance, many believe that executives have been incentivized to make important company decisions based upon short term benefits or self-interest rather than based upon the long term goals of the company and the best interests of society. In other words, it appears that compensation arrangements for many executives encourage those executives to take large risks for short term gains without concern for the long term ramifications to the company and its constituents.

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As a result of the immense focus now being given to executive compensation, there is unprecedented pressure on directors from all industry sectors to reign in excessive compensation practices. Institutional and activist shareholders, regulators, legislators, elected officials, commentators and the general public all agree that reform is badly needed, but there is no consensus as to what form the reform should take. The following discussion identifies many of the reforms which are now, or which likely will be, adopted in response to this new and powerful antagonism towards excessive executive compensation practices, and discusses various D&O insurance issues relating to executive compensation claims.

A. Director and Shareholder Responses

Historically, when questions arose about executive compensation, directors strongly resisted attempts to impose limitations on the Board's discretion to compensate executives. To a large extent, that resistance was appropriate since the Board is best suited to define the executive's goals, incentivize the executive's performance and evaluate the executive's actual results. Shareholders and other outsiders are ill-equipped to perform that function and necessarily must evaluate an executive's performance based upon short term public metrics, such as stock performance and earnings per share. In some circumstances, an executive's performance is completely unrelated to those public metrics. For example, if the Board and senior management have agreed upon a major reorganization or redirection of the company, short term profitability and stock performance may suffer as the long term strategy is being implemented. Conversely, as demonstrated by the current financial crisis, short term profitability and stock performance may be very strong even though senior management is leading the company down a disastrous path.

Shareholders in the past have largely recognized the importance of allowing directors broad discretion in setting compensation levels for executives. Instead, shareholder efforts in reforming executive compensation practices have focused on disclosure of compensation packages and policies. With the help of the SEC, shareholders have gained more of that information in recent years. However, that increased disclosure has had no discernable impact on the overall size of compensation packages, which continue to grow despite greater disclosure. At best, the disclosures have resulted in some curtailment of executive perks, such as corporate jet privileges and club memberships.

It is now evident that increased disclosure alone will not change these practices. The following summarizes some of the more substantive reforms which are either being voluntarily adopted by some Boards or being proposed by shareholders:

1. ***Claw-Back.*** The most popular approach to recent self-regulation efforts is the adoption of a claw-back policy which typically requires executive officers to repay to the company all performance-based compensation in the event the company restates its financial statements due to misconduct on the part of the executive officer. Unlike a similar claw-back provision in the Sarbanes-Oxley Act ("SOX"), this provision applies to all high ranking executives, not just to the CEO and CFO. During the 2008 proxy season, approximately 300 companies reportedly adopted some form of this claw-back provision, which is in contrast to only 14 companies adopting such a policy just four years ago.

2. ***Say-On-Pay.*** Another popular shareholder proposal which seeks executive compensation reform is the so-called "say-on-pay" resolution, which allows for a non-binding or advisory shareholder vote on a company's executive compensation policies. Supporters of this type of resolution contend

that in order to avoid negative publicity and loss of credibility, directors will be forced to either comply with the shareholder advisory vote or convince shareholders that the current executive compensation policies of the company are appropriate. Opponents contend that the shareholder vote is meaningless and frequently uninformed, and that ultimately shareholders will be satisfied if the company's profitability and stock performance are acceptable regardless of the level of executive compensation.

3. ***Bonus Banking.*** Another compensation reform initiative which is supported by some shareholder activists is to require a portion of the executive's annual bonus to be withheld for at least three years and then recalculated based on updated corporate results. A related reform requires executives to hold a majority of their company stock and stock options until two years after retirement or termination. The goal of these types of reforms is to minimize the executive's focus on short term returns and to encourage a longer term perspective with respect to both incentivizing behavior and measuring performance.

4. ***Integration with Risk Management.*** A somewhat more subtle compensation reform is to integrate the company's enterprise risk management ("ERM") process with executive compensation policies. An effective ERM process identifies short and long term risks faced by the company that could harm its value or threaten its existence. There is now an increasing recognition that once those institutional risks are identified, directors should examine the features of the company's executive compensation program to see if that program could induce senior executives to take any of those institutional risks unnecessarily or in excess. Examples of potentially dangerous features of an executive compensation from an ERM perspective program include: (i) very low salary and high annual incentive pay; (ii) too simplistic an evaluation system that favors quantitative achievement without regard to "quality" of earnings, risks undertaken and other subjective considerations; (iii) financial goals that are so far above past performance as to require unacceptable risk-taking; (iv) very high threshold levels of performance are required to qualify for incentive compensation; and (v) huge stock option grants. To the extent the executive compensation program is viewed as potentially encouraging inappropriate risk behavior, those features should obviously be revised.

B. Regulation

Historically, there have been very few legislative or regulatory limitations on executive compensation, other than increasingly detailed disclosure rules. This reluctance to regulate the level of compensation has been widely viewed as appropriate since directors are more informed and better positioned to define reasonable incentives and rewards for executives.

However, that historical deference to the Board is being eroded as confidence in director decisions regarding executive compensation wanes. For example, in 2006, the SEC adopted much more comprehensive disclosure rules relating to executive compensation practices by public companies. Under these new rules, public companies must disclose not only the amount and type of compensation paid to its CEO, CFO and the three other most highly compensated officers, but also must disclose the criteria used in reaching executive compensation decisions and the degree of the relationship between the company's executive compensation practices and corporate performance. The cornerstone of this required disclosure is the Summary Compensation Table in a company's SEC annual report or proxy statement. That table includes both the total

compensation paid to these senior executives for the prior three fiscal years, as well as the components of the compensation packages for the last completed fiscal year. These components include information about stock option grants, pension plans, and other perks.

Following the corporate debacles during the Enron era, Congress for the first time attempted to regulate the amount of compensation to senior executives through Section 304 of the SOX. Pursuant to that statute, if a public company restates its financial statements as a result of misconduct, the company's CEO and CFO must disgorge to the company any bonus or other incentive-based or equity-based compensation received by the executive during the 12-month period following the publication of the financial statements which were later restated. In reality, that provision has been invoked rarely, and therefore it is unlikely the statute has served as a meaningful deterrent.

More recently, in February, 2009 Congress imposed severe executive compensation limitations in connection with the current federal government bailout program. Pursuant to the Troubled Asset Relief Program ("TARP"), companies that receive bailout funds are subject to sliding-scale limitations on the size of bonuses paid to executives and must submit a "say-on-pay" non-binding resolution to shareholders annually regarding the company's compensation policies. The legislation also prohibits golden parachute severance arrangements. President Obama reportedly intends to seek revisions to these limitations by imposing a $500,000 cap on the executives' base compensation as well. In a sobering signal of future executive compensation regulation, the President stated the following in connection with these new limitations:

We're going to examine the ways in which the means and manner of executive compensation have contributed to a reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system… We're going to be taking a look at broader reforms so that executives are compensated for sound risk management and rewarded for growth measured over years, not just days or weeks.

As a result, the unprecedented pressure and public outcry relating to executive compensation appears to be now giving rise to a new era of external oversight and regulation of executive compensation practices.

C. Litigation

Traditionally, courts have applied a classic business judgment rule analysis to executive compensation issues, concluding that courts are ill-equipped to make qualitative judgments about the amount or structure of executive compensation, so long as the compensation was approved by independent directors. Although some recent court decisions suggest a greater willingness by courts to second-guess compensation decisions in some contexts, generally courts continue to largely defer to the discretion of directors on this topic. For example, in the well-publicized Disney case, the Disney directors were sued for improperly approving an excessive employment contract for Michael Ovitz, who served as president of the company for a little over one year and was paid $140 million despite being a "spectacular failure" as president. The Delaware Chancery Court and Supreme Court concluded that the directors did not breach their fiduciary duties with respect to that employment arrangement, despite the "breathtaking amounts of severance pay" to Ovitz and his very poor performance. In re Walt Disney Co. Der. Lit., 2006 Del. LEXIS 307 (June 8, 2006). As explained by the Delaware Chancery Court in an earlier ruling in that case, "nature does not sink a ship merely because of its size, and neither do courts overrule a board's decision to approve and later honor a severance package, merely because of its size." 731 A.2d 342, 350.

Some recent court decisions, though, demonstrate that this judicial deference to directors is not limitless, particularly if the process used by the directors in approving the compensation was flawed. Examples of cases in which directors were found liable in connection with executive compensation decisions include:

- ***Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003).*** Directors of a bankrupt privately-held company were liable for approving excessive compensation payments and illegal dividends to the CEO because the two-person compensation committee that ratified the payments lacked true independence from the CEO, did not obtain outside advice from an executive compensation expert and did not review any comparable data regarding the salaries and performance of other executives with similar responsibilities.

- ***In re National Auto Credit, Inc. Shareholders Lit., 2003 Del. Ch. LEXIS 5 (2003).*** Directors were liable for approving a substantial compensation package to the CEO of a company that was essentially a passive corporation. According to the court, although "Delaware courts are loathe to find that executive compensation packages constitute corporate waste, the situation presented here is beyond the pale," particularly given the size of the compensation in relation to the value of the company and the fact that the CEO was being paid "essentially to sit idle."

- ***Hensley v. Poole, 910 So. 2d 96 (Ala. 2005).*** According to the Alabama Supreme Court, when evaluating executive compensation decisions under the business judgment rule, the appropriate inquiry is "whether the compensation is so excessive that it bears no reasonable relation to the value of services rendered."

In cases where courts are willing to consider whether the amount being paid to the executive is reasonably proportionate to the value of services rendered, courts usually consider one or more of the following criteria to judge the value of the services rendered: (i) the executive's ability and experience, (ii) the level of compensation paid to others in similar circumstances, (iii) the corporation's performance, (iv) whether the compensation was "shocking," or (v) whether the executive performed unusual or extraordinary services. More typically, though, courts do not perform this level of analysis and instead uphold the directors' compensation decision if the directors' decision-making process is adequate and there is no fraud or duress. For example, directors should create a record which demonstrates a thoughtful and informed decision, including support from a compensation consultant or other market data.

D. D&O Insurance Issues

Claims arising out of excessive executive compensation typically are asserted against both the directors who approved the compensation arrangement and the executives who received the allegedly excessive compensation. The coverage issues under a directors and officers liability insurance policy for such claims differ for the defendant directors and the defendant officers.

With respect to the defendant directors, coverage is typically available for that claim. The personal profit and illegal remuneration exclusions in the policy usually apply only to the Insured Person who actually receives the personal profit or illegal remuneration, and therefore those exclusions typically do not apply to the defendant directors. To confirm that result, some broad Side A policies expressly state that those conduct exclusions do not apply to outside directors. A few D&O policies, though, appear to apply those conduct exclusions to all Insureds if any Insured receives the personal profit or illegal remuneration. To avoid that

result, the conduct exclusions should not refer to personal profit or illegal remuneration received by "any" Insured, but instead should apply to any particular Insured only if "such" Insured received the personal profit or illegal remuneration.

With respect to officers who allegedly received the excessive compensation, these conduct exclusions may apply, and therefore the precise wording of the exclusions can be critically important. Historically, D&O policies contained a "remuneration" exclusion that was separate from the "personal profit" exclusion and that applied to claims for illegal remuneration paid without necessary shareholder approval. Because shareholders rarely are required to approve executive compensation, this exclusion in reality had little applicability. As a result, in more recent D&O policies, the illegal remuneration exclusion is included within the broader personal profit exclusion. There are several variations of this personal profit/illegal remuneration exclusion, and D&O policies respond to executive compensation claims differently depending on which version of the exclusion exists in the policy. Some of the questions to ask when evaluating a particular version are:

1. ***Does the exclusion apply to both Side A and Side B coverages?*** A few D&O policy forms apply the exclusion only to Side A and not to Side B coverage, based upon the premise that if a company is legally permitted to indemnify for the loss, then the insurer should cover that loss under Side B. Ironically, that type of exclusion results in less coverage under Side A than under Side B, which is contrary to conventional wisdom regarding the importance of very broad Side A coverage.

2. ***What is the trigger for applying the exclusion?*** Many policies today state that the exclusion does not apply unless there is a final adjudication that the Insured actually received personal profit or illegal remuneration. Some policies have alternative triggers which apply if, for example, the adjudication occurs in any proceeding (not just the underlying claim), or if the Insured admits under oath to receiving the personal profit or illegal remuneration, or if the Insured agrees to repay to the company the amount in question as part of a settlement of the underlying claim. Particularly in hard D&O insurance market cycles, this exclusion is amended to apply if the Insured "in fact" received the personal profit or illegal remuneration (i.e., no adjudication or admission under oath is required), although such a trigger is rare during softer insurance market cycles.

3. ***Does the exclusion apply only to the amount of the illegal remuneration or to other loss related to the illegal remuneration?*** Most exclusions are drafted broadly to apply to loss resulting from claims "based upon, arising out of or related to" the personal profit or illegal remuneration. As a result, if triggered, the exclusion applies to defense costs and other related loss. However, some versions of the exclusion, particularly in broad Side A policies, except from the exclusion (i.e., cover) defense costs.

Even if the exclusion does not apply for some reason, an insurer may nonetheless deny coverage for the amount of excessive compensation which is owed by the defendant officer to the company since such payment arguably constitutes the disgorgement or restitution of ill-gotten gain. Insurance case law in most states recognizes that such disgorgement or restitutionary damages are uninsurable pursuant to public policy, whether or not the policy terms exclude coverage for those amounts.

In summary, the widespread condemnation of huge executive compensation packages for senior officers of some of the worst performing companies has and will continue to forever change executive compensation

practices, rules and claims. Directors of all types of companies should recognize this significant change and should be more cautious, thorough and measured in its executive compensation decisions. Carefully scrutinizing executive compensation arrangements and fully disclosing the company's compensation policies, the size and terms of the executive compensation packages and the linkage of those compensation decisions with individual and company performance are now important loss prevention practices, not just ideal best practices. In addition, directors should confirm that their D&O insurance program properly protects them with respect to claims relating to executive compensation issues. Like most exposures, broad Side A policies generally afford the broadest protection for directors with respect to these types of claims, and therefore generous amounts of Side A coverage should be included within a company's D&O insurance program.

The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.