

Financial and Economic Crisis - Law Firms

Executive Compensation: Major Changes On The Way

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The Editor interviews Paul M. Ritter, Partner and Head of the Executive Compensation Practice at Kramer Levin Naftalis & Frankel LLP.

Editor: Please describe your professional background and principal practice area for our readers.

Ritter: My background is in tax, ERISA and executive compensation, and my practice involves representing senior executives and highly compensated financial professionals in connection with the negotiation of employment and severance agreements. I also represent companies and/or their compensation committees in connection with the design and implementation of compensation arrangements, including equity and deferred compensation arrangements, as well as negotiating employment and severance arrangements on their behalf.

Editor: Executive pay has been in the headlines for some time. What are your thoughts about the expanding role of government in compensation matters, which until now had been largely left to shareholders and boards of directors?

Ritter: The government actually has been very involved in executive compensation matters through the years. The SEC has had extensive rules about disclosing senior-level executive compensation since 1992, which was most recently overhauled and expanded in 2006. The Internal Revenue Code contains several provisions designed to reduce or otherwise affect executive compensation, most notably Section 162(m) (which generally provides for a \$1 million limit on compensation deductions for non-performance related compensation), Sections 280G and 4999 (the golden parachute provisions which make certain payments contingent on a change in control subject to a 20 percent excise tax and not deductible by the company) and Section 409A (the now infamous section dealing with nonqualified deferred compensation plans). While not part of the government, the stock exchanges have also been active in executive compensation matters through their listing requirements.

A recent announcement by SEC Chairman Shapiro indicates that the SEC disclosure rules will be amended to require companies to disclose, among other items, their overall compensation approach, presumably meaning that companies will have to explain its compensation to lower management levels. Disclosure is good under the notion that "sunshine is the best disinfectant" but only to the extent it gives shareholders and other interested parties useful information. However, sometimes disclosures are counterproductive. For example, the disclosure rules imposed in 1992 are believed to have led to significant increases in executive pay. In other instances, disclosures have been confusing, overwhelming and not particularly helpful.

Editor: Aren't the compensation limits in the TARP legislation, as a condition for receiving TARP benefits, rather unusual?

Ritter: There have been several attempts by the government over the years to impose rules on executive compensation. For example, in response to the outrage over excessive executive compensation that became a bipartisan campaign issue in the 1992 presidential election, I.R.C. Section 162(m) was added to the Code in 1993 to limit a company's deduction for compensation to each of its top five executives in excess of \$1,000,000 unless it is performance-based. Another example, in response to the "excessive" payments received by executives in connection with merger or acquisition transactions in the early 1980s, Sections 280G and 4999 were added in 1984 to impose a 20 percent excise tax and deny deductions for certain payments (referred to as excess parachute payments) made that are contingent on a change in control. Virtually all followers of the executive compensation area view these prior attempts to limit compensation as failures.

The TARP legislation did not generally limit the amount of total compensation payable to executives although it did limit the amount, form and timing of bonuses and retention payments and prohibit severance payments. Prohibiting severance payments, rather than imposing an excise tax on, or denying a deduction for, severance payments, is unusual. The TARP legislation also placed extra caps on the limitation on a TARP recipient's deduction for its compensation to a group of its executives. But I.R.C. Section 162(m) already provided for limitations on the deduction of compensation. The TARP legislation is more stringent by limiting deductions to \$500,000 and eliminating the existing exception for compensation based on performance. The rules for TARP recipients are certainly much tougher than the rules for companies not subject to TARP.

Editor: Now that the U.S. Treasury has allowed ten of the institutions that received TARP funds to repay them and thereby avoid the strictures that TARP imposed on bonus payments, is there a risk that these banks may yet return to the Treasury for further borrowings should the economy take another dip?

Ritter: Certainly, these institutions that repay the TARP money will have a significant competitive advantage over those institutions still subject to TARP when it comes to retaining and recruiting the most talented executives, traders and investment bankers.

Editor: Is the requirement that bonuses for the most highly compensated executives and employees of institutions that accept TARP funds not exceed one-third of their salaries likely to drive top personnel to unregulated rivals or allow traders outside those top 25 to receive even higher pay? What do you think would have been a better way to cap executive compensation at the time TARP was enacted, or do you agree that it should be capped at all?

Ritter: I am not a proponent of bonus caps imposed by the government. Virtually all of us working in the executive compensation area believe strongly that the amount and structure of incentives hugely influence the actions of executives. Caps and limited bonus structures may cause the most talented executives, traders and investment bankers to seek out employers that are not subject to those caps or structures. Under the notion of "pay for performance," it has generally been thought that the larger the percentage of compensation contingent on performance results the better. While some bonuses may have given executives incentive to take inordinate

risks, the fix is not to cap the incentives but to tie incentives to better measures of long-term investment return and related risks.

Editor: Do you believe that the "say on pay" proposals will be effective in limiting pay for corporate executives?

Ritter: I do believe that some form of "say on pay" is a foregone conclusion, but in some respects I am troubled by its implications. Developing an appropriate compensation program for executives is highly complex and requires significant knowledge, information and thought. In developing such a compensation program, one must consider and deal with the tax, labor and securities laws, the accounting rules, as well as the stock listing requirements. In addition, one must understand the company's business, its talent needs, and its short-term and long-term goals and the general market for executives. The compensation program must be able to attract new talent, as well as retain the company's existing talent. In virtually every compensation committee I deal with, the committee members, the compensation attorney and compensation experts spend an enormous amount of time and effort considering all of the foregoing, particularly the market compensation rate for various level executives, the particular talent needs of the company and the company's goals. Nevertheless, the design of the company's compensation structure and compensation amounts is often a compromise among competing concerns. I am concerned that non-institutional shareholders will not take the time to really understand the company, its industry, its executives and the company's reasons for a particular compensation structure or the amount of compensation and, even if such shareholders were to make such an effort, I question whether they would be qualified to make cogent and rationale decisions. I am also concerned about knee-jerk reactions by many shareholders to executive compensation issues. I am equally concerned about institutional investors relying on proxy advisors to guide them on how to vote even though the proxy advisors do not always have a nuanced view on executive compensation issues.

Editor: Do you agree with the argument of some academic economists that CEO compensation in a competitive market should vary in direct proportion to the market capitalization of a company, or some other financial ratio? Would pay for performance be a better criterion?

Ritter: Compensation based on capitalization will just encourage CEO's to acquire companies to make their companies bigger. And, as we know, mergers or acquisitions have not always been successful. We do not need to provide additional incentives for mergers and acquisitions. Nevertheless, there are a limited number of executives with the skills necessary to run a very large company, so certainly executives with such skills are going to get paid a lot of money.

While most of us in executive compensation agree with the "pay for performance" concept, the problem is in implementing it. As far as performance measurements go, I think the place to start is with the company determining its long-term and short-term goals and deciding which areas of the business its executives should focus on. And, the goals of the company may depend on where this company fits in the life cycle of a company - whether it's a start up, mature or turn-around, the type of industry the company is in and its position in the industry. The company should consider several different performance metrics for awarding bonuses and how such metrics relate to company goals. Common metrics include earnings per share, total shareholder return, cash

flow, and return on investment. Another metric I expect to become more common is the company's success relative to its competitors. If more than one metric is used, the weight of each metric must be determined.

Editor: Why should the financial industry be different from industrial companies in terms of highly compensating those who make large bets?

Ritter: I recently read an insightful discussion paper by Harvard professors Lucian Bebchuk and Holger Spamann on the capital structure of banks. According to the authors, excessive leverage and government backstops on deposits have resulted in distorted incentives for bank executives. They believe that compensation of bank executives requires totally different considerations than compensation for executives of other institutions. Their basic point is that because banks are so highly leveraged that they can only lose a limited amount of capital (the rest is other people's money), it makes sense for their executives to take bet-the-company risks. The depositors, the biggest source of other people's money, have little incentive to watch the risk being taken because they are protected to a large extent by the government either because of deposit insurance or because their banks are in the "too big to fail" category.

Editor: People outraged at the high compensation paid to executives of failed institutions sometimes point to the differential between top executive pay and the wages of the average worker having increased over time. Do you know if that gap has trended back within the past year or so?

Ritter: It is my understanding that overall executive pay went down last year because bonuses were significantly lower than they were the year before and fewer people received the top bonuses. Certainly, there were many jobs lost by lower-paid workers, but it's unclear whether the salaries of those workers who remained employed also went down and if so, by how much.

Editor: What direction do you expect the new pay principles being drafted for financial institutions by the Treasury to take in terms of encouraging banks to set compensation in a way that rewards responsible risk-taking? Do you anticipate these principles to apply broadly through the financial industry?

Ritter: It is a basic tenet of executive compensation practices that compensation contingent on performance is intended to discourage the executives from being too conservative and to encourage appropriate risk-taking. On the other hand, one of the biggest problems with compensation for executives of financial institutions was providing short-term, up-front bonuses for transactions with long-term horizons which only incentivized employees to think short-term and ignore long-term risks. I suspect that the new rules will try to address this by aligning the rewards to the executives with the much longer term risks of the transactions. One way to do this is to require executives to hold equity awards for significantly longer than is currently the case. Now executives usually are required to hold their securities four to five years. Under these proposed rules, it may well be that executives will have to hold equity awards until they terminate employment or retire, and perhaps for some period thereafter.

Editor: Do you expect compensation metrics to be set out in the regulations?

Ritter: That is a possibility but I think that, while metrics will be highlighted, no particular set of metrics will be required. I think that instead of an earnings per share metric, which is based on meeting common shareholders' needs, there may be an emphasis on other, broader measures. EPS doesn't necessarily enhance the value of the company to preferred shareholders (the position held by the government) or add protection for bond holders. There are metrics that would enhance the positions of preferred shareholders and bond holders as well as the common shareholders.

As to the effect on companies outside the financial industry, I believe that a lot of the TARP ideas, such as the broader use of clawbacks, are becoming or eventually will become best practices for corporations. While Sarbanes-Oxley provided for clawbacks of bonuses and equity based compensation related to a restatement of earnings, it applied only to the CEO and CFO and only if the restatement results from misconduct. Under TARP, clawbacks apply to a much broader group of employees. The notion under TARP is simply that if the numbers were wrong and you got something that you should not have gotten, then you have to give it back. I think clawbacks similar to those required under TARP will become more common among companies not subject to TARP. I also expect that there will be a longer holding period for equity awards - not necessarily longer vesting periods, but requirements that once vested, the equity award cannot be disposed of for a specific period of time.

Overall, all companies will realize that they have to consider whether their executive compensation arrangements encourage inordinate risk-taking.

Please email the interviewee at pritter@kramerlevin.com with questions about this interview.