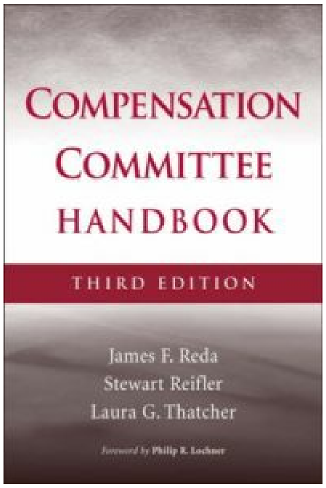

Book The Compensation Committee Handbook

James F. Reda, Stewart Reifler and Laura G. Thatcher
Wiley, 2007
First Edition:2001

Recommendation

Anyone involved in compensation issues will want to keep this handbook nearby. The author wrote it mainly for directors who serve on the compensation committees of publicly traded firms. But the book raises issues and advocates practices that many company managers should consider. Though much of the book is quite technical, this basic survey of compensation issues is appropriate for a broad professional audience. *BooksInShort* recommends it as a good first step toward more equitable and effective pay practices.

Take-Aways

- An effective compensation committee consists of competent independent members who stay informed of laws, regulations and company matters relevant to compensation.
- Director independence means more than not being an employee of the company.
- Ensuring smooth CEO succession is one of the compensation committee's duties.
- Directors deserve more pay because they face greater liability and have to commit more time.
- Many public companies are required to disclose and justify executive compensation.
- The complex issues that surround insider trading require directors' close attention.
- Directors must grasp the tax ramifications of the compensation plans they approve.
- Companies must observe special legal rights of certain types of at-will employees.
- Aligning the interests of CEOs and shareholders is a worthy exercise that may fail.
- Companies that pay lavish executive perquisites may invite public scrutiny.

Summary

Forming the Compensation Committee

Directors of public companies who chair compensation committees sit on a hot seat. This is the most complex job any director can have. Chairs of compensation committees must balance their duties to shareholders, management and other directors while ensuring that their companies achieve regulatory compliance in setting, paying and disclosing compensation.

> "One reason is that the compensation committee chair and committee members may often find themselves in a difficult-tug-of-war with management on pay matters."

An effective compensation committee has core precepts. It is properly organized and operated. The members are competent independent members who stay informed of laws, regulations and company matters relevant to compensation. They emphasize reasonableness in pay decisions and provide a convincing rationale for their decisions to shareholders.

> "The compensation committee chair is now widely considered the most difficult role on the board."

Effective compensation committees also communicate their actions clearly and frequently to anyone who needs to know. These committees determine the benchmark compensation levels within their companies' industries through research. They keep clear and informative minutes of their meetings, discussions and decisions. This is serious business. Compensation management affects not only a company's performance but also its exposure to lawsuits and negative media coverage.

Compensation Committee Membership

Careful formation of the compensation committee is important because the committee's impact on the company is profound. A nominating committee, formed from within the compensation committee, clearly defines a process for nominating, selecting and assessing candidates for various top jobs. The company's management will provide input. Recruiting programs may unfold if, for example, your company decides it wants more women and minorities to serve on its board of directors.

> "If history has taught us anything, it is that executive compensation – and thus compensation committees – will be at the center of controversy approximately every 10 years."

Independent directors who serve on the compensation committee must be truly independent. Avoiding direct employment by the company is one element of independence. Qualified candidates also have the experience to fulfill their duties and can commit to the work schedule required of independent directors.

Choosing and Assessing the CEO

Ensuring proper leadership of the firm and providing for an orderly transition in the position of chief executive officer are among the most important responsibilities of the board. The CEO may resign or get fired, become disabled or die. Ongoing evaluation of possible successors is a duty of the board and its compensation committee. Doing this confidentially is essential to avoid undermining the current CEO or candidates for the job.

> "At the end of the bull market of the 1990s, we saw a swing of the pendulum from an attitude of 'anything goes' to widespread negative attention on executive pay."

Another important part of the compensation committee's work is evaluating the current CEOs. The committee must have established criteria for job performance that are connected to the incentive portion of the CEO's compensation package. Developing such performance criteria will help your company hire the best CEO. This practice increases the odds that the CEO will meet the board's standards and that the performance standards contribute to your company's success.

Compensating Board Members

To attract the best talent to your board, understand the demands on directors. They work longer hours than ever. Some work several hundred hours a year on compensation committees. Directors serve on fewer boards than in the past and face more personal liability. Therefore, many companies have raised director pay. Study director compensation policies among your competitors and in related industries to ensure that your company is competitive. The many modes of director compensation include cash, stock, retainers and project fees. Some companies also cover travel expenses and provide other perquisites to board members. All records of director compensation must conform to generally accepted accounting principles.

Governing the Corporation

All corporate directors have fiduciary duties. They must act in good faith, apply the care a person of ordinary prudence would apply, and do what they sincerely believe is in the company's best interests. Ideally, they rely on the doctrines of loyalty, prudence, good faith and sound business judgment. The board's oversight responsibilities include a duty to monitor the activity and the health of its company and to disclose material facts in filings with the Securities and Exchange Commission (SEC). Stock exchanges also prescribe operating and reporting practices for member companies to follow.

Reporting Management Compensation

In August 2006, the SEC released new rules for reporting executive and director compensation. The SEC dropped its requirement for a compensation committee report and substituted a financial disclosure called "Compensation Discussion and Analysis." This section outlines the objectives of your company's compensation system. Listed in this section are design details of the system, the aspects it is supposed to reward and the methodology behind each facet of the system. Companies must mention the Principal Executive Officer and Principal Financial Officer, but not the CEO and the chief financial officer. The principal officers are subject to disclosure requirements for multiple varieties of compensation including salary, bonuses, stock awards, option awards and deferred compensation.

Insider Trading Issues

Insider trading demands the compensation committee's close attention. Regulatory limits on insider trading apply to certain officers, all directors, and any shareholder with more than 10 percent of the company's issued equity. Certain types of insider trading are prohibited during so-called blackout periods. Special timing and reporting rules apply to insiders who trade restricted stock. Changing the exercise price of stock options can cause regulatory concerns, too, especially if your company's compensation plan lacks an explicit written allowance of such changes.

Tax and Accounting Matters

Many corporations spend a lot of time and resources on taxes. Federal, state, local and perhaps even international laws apply. The most complicated tax issues in the executive pay arena involve stock awards, deferred compensation and severance pay. Nettlesome tax issues also emanate from using offshore trusts to compensate executives and trying to get around corporate tax penalties on annual salaries in excess of $1 million. Difficult tax issues also stem from the timing and amount of severance payments to terminated executives. Companies also need to consider the tax impact of executive compensation in the form of such fringe benefits as insurance, low-cost loans and estate planning services.

> "Adding to the sense of public distrust was the round of high-profile corporate failures and fraud that took place in the early 2000s."

Every compensation committee member needs working knowledge of key accounting concepts and standards, particularly recent changes to accounting standards for equity-based compensation, including stock options. The SEC and the Financial Accounting Standards Board are among the organizations that periodically issue new and amended accounting standards. Taking a proactive approach to director training can promote compliance with such standards.

ERISA and Other Labor Laws

The Employee Retirement Income Security Act (ERISA) has sections that deal specifically with executive payment and service. If your company's executives benefit from special compensation unavailable to most employees, this may be classified as an "excess benefit plan" under ERISA, putting your company at risk of regulatory sanction. The federal government regulates unfunded deferred compensation plans, called "top-hat plans," through other laws.

> "The recent emphasis on good faith as an integral element of the duty of loyalty should be uppermost in the minds of all directors as they apply themselves to the business at hand."

Most U.S. workers have employment at-will status: They can be terminated at any time without explanation or compensation. But employers face limits. Many workers have legal protections based on their race, disability and age. Even inadvertent violations of these protections can have costly consequences. For example, companies commonly face charges of age discrimination from plaintiffs who cite the Age Discrimination and Employment Act, a hot spot on the litigation landscape.

> "The fundamental task of the compensation committee is to establish the compensation philosophy of the company."

Comply with the letter and intent of the law in tailoring employment contracts. Many executives, especially CEOS of large firms, have employment contracts. The common threads in executive employment agreements include procedures to resolve disputes, employment termination and employee separation procedures, limits on going to work for a competitor and contingency arrangements arising from a change in company ownership.

Motivation Compensation

Executive pay usually includes a base salary and contingent incentive payments that reward accomplishment. These incentives may align management's interests with those of stockholders. Encouraging executive action that favors shareholders' interests but damages those of management is unsustainable. Follow a carefully administered, shareholder-approved plan to provide incentive pay such as cash bonuses and stock options, one that specifies procedures for determining payment amounts and timing the payments.

> "The reduction in the number of boards on which a director can serve, the increase in hours devoted to board service, the new emphasis on training and expertise, and the pressure of increased accountability has fueled changes in director compensation over the past few years."

Stock option awards have drawn scrutiny. Companies are required to report them and account for those shares in their financial statements according to specific methods. The tax treatment of stock option compensation varies, depending on the type of option awarded.

The tax and accounting consequences of issuing stock options require careful scrutiny. This is especially true when a company's stock price drops below the option exercise price, reducing the unrealized value of the option to zero. While some companies have responded to this scenario by lowering the exercise price to make the option profitable, at least on paper, others have bought options from the employees, replaced options with grants of restricted stock, and allowed the exchange of old options for new ones.

> "More and more frequently, public companies are using one major accounting firm for auditing services and a competitor firm for nonaudit services, including compensation advice."

Another method of equity compensation, stock appreciation rights (SARs) pay off if the company stock appreciates during a set period of time. SARs require special accounting and tax treatment. Another alternative form of compensation is restricted stock. The holder's ability to transfer the stock is restricted for a period of time and may vest according to a set timetable. Some companies prefer instead to make performance awards, equity instruments that vest based on milestone events. Senior management and directors may face a company requirement to own a certain amount of stock to align their interests with those of stockholders.

Future Concerns

Major compensation controversies seem to occur about every decade, so brace for the next wave. Expect more shareholder involvement, legislative intrusion and tax influence in setting executive compensation. Expect louder critiques from Wall Street, too. Financial analysts probably will become more aggressive in demanding a positive link between compensation policies and shareholder value.

> "Accounting issues for compensation committees generally will involve the value of compensation expense and the timing of such expense."

Many CEOs will continue to command a rich suite of benefits in addition to their base salary and incentive pay. Among these extras are pension benefits, various types of supplemental executive retirement plans and deferred compensation plans. These extras also encompass payments to cover insurance and disability protection, relocation and housing expenses, club memberships and travel privileges.

> "While ERISA generally applies to broad-based rank-and-file benefit plans, there are aspects of the law that compensation committee members will need to know."

How much is too much? The public seems willing to tolerate almost anything when the economy is strong. During a recession in the economy and the stock market, members of compensation committees are more likely to draw scrutiny and criticism. But whatever the economic climate may present, compensation committee members who focus on honesty and fiduciary duty will avoid the troubles that plague careless counterparts at other companies.

About the Authors

James F. Reda has more than 15 years of experience in consulting on compensation issues and is president of his own firm. **Stewart Reifler** is an expert in negotiating and structuring all issues around executive employment. **Laura G. Thatcher** is head of the executive compensation practice at Alston & Bird.