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Chapter 55A

Executive Compensation

by Jamey Seely and Anthony Eppert

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§ 55A:1 Scope note

The topic of this Chapter resides at the intersection of several complex legal disciplines, including corporate law, tax planning, securities regulation and corporate governance. The task of inside counsel in the area of executive compensation is to ensure compliance with a variety of specific legal requirements while communicating with, and coordinating the activities of, the several constituencies that play a role in the design, implementation and operation of an executive compensation program.[1] For most companies and, particularly, publicly-traded companies, these constituencies include a host of interests, including most, if not all, of the following: the company sponsoring the program, the company's board of directors, the compensation committee of the board, key management personnel, outside consultants, shareholders (including major individual and institutional investors), proxy advisory firms and regulatory authorities. Through successful partnering strategies with outside counsel, inside counsel can add significant value to the sometimes difficult process of managing these often diverse interests while meeting the challenge of a multidisciplinary subject matter. This Chapter will illustrate these strategies with detailed discussion of the division of labor between inside and outside counsel on specific engagements, such as the (i) the drafting

[Section 55A:1]

[1]This chapter is intended to cover only U.S. law and its applicability to U.S. employees. To the extent a company has executives that are not U.S. citizens or who live or work in a non-U.S. country, counsel must consider the implications of local law, practice and reporting considerations. Additionally, this chapter is focused on compensation paid to executives, although many of the same issues arise with respect to non-employee director compensation.

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of disclosure documents,[2] (ii) the analysis of executive compensation issues in business combinations,[3] and (iii) the detection and correction of deferred compensation operational errors.[4]

This Chapter will provide an overview of the most common cash- and equity-based executive compensation techniques with an emphasis on how, in each case, corporate law, tax, and securities regulation considerations affect the executive's reward and the corporation's potential benefits. The topics addressed will include (i) short- and long-term cash incentive programs,[5] (ii) equity-based programs, such as restricted stock, stock options, and performance-based equity awards,[6] and (iii) deferred compensation arrangements, including supplemental executive retirement benefits. In each case, the focus will be on programs that are typically described as providing "nonqualified" benefits in the sense that they are not subject to, or are only minimally impacted by, ERISA.[7] In addition, this Chapter will consider the use of executive employment and severance agreements for key personnel.[8]

Throughout the text, references to the "Code" or to a particular "Section" are references to the Internal Revenue Code of 1986, as amended, codified at 26 U.S.C.A., and the Treasury regulations promulgated thereunder.

§ 55A:2 Objectives, concerns, preliminary considerations

An intense spotlight of public, legislative, regulatory and shareholder scrutiny has, in recent years, focused continued

[2] *See* §§ 55A:25 to 55A:31.

[3] *See* §§ 55A:32 to 55A:50.

[4] *See* § 55A:51.

[5] *See* § 55A:29.

[6] *See* § 55A:29.

[7] *See* Chapter 55 "Employee Benefits" (§§ 55:1 et seq.) for a detailed discussion of the provisions and administration of employee benefit programs and the substantive requirements of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), 29 U.S.C.A. §§ 1001 to 1461, the statute governing most corporate-sponsored employee benefit plans.

[8] *See* §§ 55A:33 to 55A:50.

attention on corporate executive compensation practices and led to significant changes in every area of law and practice that touches executive compensation. The pace of change and the focus of shareholders, particularly at publicly traded companies subject to advisory "say-on-pay" shareholder votes regarding executive compensation, have created a staggering burden for counsel seeking to maintain a current knowledge of the law. Concurrently, a critical issue for inside counsel has been the allocation of that burden between limited inside legal resources and the often-specialized knowledge of outside counsel. The central focus of this Chapter is the development of successful strategies for the allocation of that burden in a way that satisfies the business objectives of a corporation's executive compensation program while meeting the high demands of legal compliance in the context of public scrutiny. With executive compensation expected to remain a high profile issue of public interest and ire across the United States and in the global economy, a successful partnering strategy will help minimize the reputational risk of creating a program that fails to satisfy legal norms and help to ensure the program serves its intended purpose.

A well-designed executive compensation program is often a corporation's principal means of attracting and retaining the key personnel that drive a successful business strategy. The creation of a successful program begins with the development of an overall compensation philosophy that establishes the balance between base compensation, short-term rewards and long-term incentive opportunities.[1] With the philosophy in place, the task is then to design a program that implements the philosophy by selecting from among specific compensation techniques to create a coherent program. It is at this point in the process that counsel's role is often most prominent as the corporate law, tax planning, securities regulation, corporate governance and accounting aspects of each technique will often determine their viability in a particular corporate context. However, counsel's role is necessarily ongoing since almost every program has ongoing compliance or disclosure needs and both the corporation and program participants will rely on counsel to explain or interpret the program's nuances.

[Section 55A:2]

[1] *See* § 55A:29.

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A company's approach to executive compensation will often influence the success of its business strategy. But the complexities of the area require the development of a sound legal support system as a necessary step in the implementation of an effective executive compensation program. Because many companies lack dedicated inside counsel with responsibility for the executive compensation area, they often call upon outside counsel to provide the special expertise necessary to assist with the design or documentation of an effective program and to ensure compliance with applicable legal requirements. In such instances, inside counsel nevertheless must serve a liaison function with the business side of the company and the HR department to ensure that such arrangements are appropriate given the nature of the company's business and competitive position. Where corporate budgets permit, dedicated inside counsel with responsibility for executive compensation matters may turn to outside counsel to assist with matters of interpretation, to prepare initial drafts of key documents and to provide a perspective that benefits from the opportunity to work with many different companies across a range of business sectors.

Although reference is made here to "counsel", the multidisciplinary nature of the executive compensation field means that, in fact, legal professionals and compensation consultants and advisors with different expertise may be called upon to provide assistance. In the public company context, executive compensation matters will inevitably require input from the company's advisors on securities regulation matters to evaluate registration requirements and disclosure obligations. Increasingly, the public closely links executive compensation to corporate governance,[2] so the company's corporate legal advisors may be called upon to consider the implications for shareholders, proxy advisory firms, the board of directors, and management when a new program (or an amendment to an existing program) is under consideration.

§ 55A:3 Effective partnering strategies on key engagements in executive compensation

We have selected four tasks central to the operation of an

[2] *See generally* Chapter 46 "Corporate Governance" (§§ 46:1 et seq.).

executive compensation program—tasks in which counsel will be intimately involved—to illustrate the challenges involved in designing an effective partnering strategy. The tasks we address are (i) Compensation Committee governance, roles and responsibilities,[1] (ii) drafting the Compensation Disclosure and Analysis portion of the proxy statement,[2] (iii) the negotiation and documentation of executive employment arrangements including changes in control,[3] and (iv) the detection and correction of operational errors relating to deferred compensation arrangements.[4] These situations involve a cast of characters and the concrete application of the legal issues, which characters and issues will be explained more comprehensively later in this Chapter. We address these specific situations to illustrate common themes, to set the stage for better understanding, and to provide our opinions and experiences regarding real life situations likely to confront in-house counsel.

§ 55A:4 Governance

Compensation Committees play a critical role in the governance and the overall success of a corporation. In setting the targets for the top executives of the company, the Compensation Committee can significantly influence the trajectory of the company and how goals will be achieved. As a result, it is critical for Compensation Committees to closely consider the goals they are setting and ensure they align with where they want the company to go in the upcoming years.

§ 55A:5 Governance—Principal parties

Gone are the days when executive compensation was a decision made between the company and its board. While the committee and the directors still have an important role, compensation committee discussions are dominated by ques-

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[Section 55A:3]

[1] *See* §§ 55A:4 to 55A:24.

[2] *See* §§ 55A:25 to 55A:31.

[3] *See* §§ 55A:32 to 55A:50.

[4] *See* § 55A:51.

tions about how ISS & Glass Lewis[1] will respond and whether there will be a proxy fight. In practice, however, the number of stakeholders with an interest in the process or the result includes a much larger array of stakeholders. Directors must walk the line between fiduciary duties to shareholders and the need to attract and retain top management talent.

The purpose of Sections 55A:4 to 55A:12 on principal parties is to identify these stakeholders, explain each of their interests and concerns, and provide counsel with a framework for dealing with each party.

§ 55A:6 Governance—Role of the compensation committee

As an entity (and not as individual members), the compensation committee of a corporation's board of directors negotiates with the corporation's executives regarding the personal remuneration of those executives. In such negotiations, the committee represents the corporation, with the corresponding fiduciary duties to shareholders that such representation entails. Particularly in the area of executive compensation, the fulfillment of these duties demands particular attention to the composition of the committee,[1] and the processes by which the committee fulfills its assigned duties.

§ 55A:7 Governance—Appointment and composition

For most companies and, particularly, publicly traded companies, the compensation committee of the board of directors has emerged as a focal point for compensation governance efforts. Theoretically, a committee of directors with fewer ties to management will be in a better position to negotiate fairly with management (or, on behalf of shareholder interests, without conflict) on matters related to

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[Section 55A:5]

[1] Institutional Shareholder Services, Inc. (ISS) and Glass, Lewis & Co. (Glass Lewis) are proxy advisory services firms. Hedge funds, mutual funds, and similar groups that manage large and diverse shareholdings often purchase or subscribe to recommendations from ISS and Glass Lewis regarding compensation.

[Section 55A:6]

[1] *See* § 55A:7.

management's compensation. Both the New York Stock Exchange and NASDAQ have adopted enhanced independence requirements for compensation committee members and have also adopted rules requiring compensation committees to consider potential conflicts of interest before selecting compensation consultants, counsel and other advisers.

Eligibility for committee membership may be constrained by several considerations. When vetting potential members (and reviewing the continuing qualifications of current members), the board, the company and their counsel will have to consider the "independence" requirements of the exchange listing standards,[1] "non-employee director" status under Securities Exchange Act Rule 16b-3, and any company-specific rules contained in the corporate by-laws and the charter of the compensation committee.[2] In addition, under Section 952 of the Dodd-Frank Act, the Securities and Exchange Commission and the national securities exchanges have promulgated rules requiring compensation committees to be composed solely of independent directors and introducing a new definition of "independence."[3]

§ 55A:8 Governance—Executives

Particularly with regard to their personal remuneration, the corporation's executives sit across the table from the compensation committee as the counterparty in negotiations, although counsel should remind executives that even in the context of their own compensation, executives are subject to fiduciary duties to the company. Due to the subject matter,

[Section 55A:7]

[1] *See* § 55A:18.

[2] *See* § 55A:19.

[3] Section 952, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010). The Securities and Exchange Commission has adopted rules implementing Section 952. Listing Standards for Compensation Committees, Release Nos. 33-9330; 34-67220. The rules direct the national securities exchanges to establish listing standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent," as defined in the listing standards of the national securities exchanges adopted in accordance with the final rules. *See* § 55A:18. In addition, pursuant to Section 10C(c)(2), the SEC adopted amendments to the proxy disclosure rules concerning issuers' use of compensation consultants and related conflicts of interest.

the executive has a significant personal stake in such negotiations and can be expected to act in his or her own self-interest. This understandable and necessary self-interest on the part of the executive is the primary reason for the intense focus on the independence of the compensation committee as the counterparty. In addition, the individual, self-interested role of executives in this context creates conflicts issues for internal counsel that are addressed in Section 55A:11 below.

§ 55A:9 Governance—Executives—Named Executive Officers

Executives are sometimes classified or categorized in some fashion by various regulatory schemes. Counsel should be aware of these groupings when dealing with the topic of executive compensation. Various securities regulations apply either to all executive officers, as defined under the securities rules, or to the Named Executive Officers (NEOs), for example. Generally, the NEOs are the chief executive officer, the chief financial officer, and the three most highly compensated executive officers (other than the CEO and CFO).

§ 55A:10 Governance—Executives—Top hat group

To gain exemption from ERISA's typical nondiscrimination requirements,[1] certain executive compensation arrangements must be limited to a "top hat" group.[2] The theory behind this exemption is that members of the "top hat" group have sufficient political clout within the organization to effectively fend for their own compensation interests, and thus do not require the protection of certain of ERISA's rules such as the funding requirement. Definition of the "top hat" group is not provided by regulation with any degree of precision. Counsel will want to carefully review any arrangements intended to qualify for a "top hat" exemption from ERISA to ensure that coverage of the arrangements is appropriately restricted.

§ 55A:11 Governance—General counsel

The standard formulation of inside counsel's role holds

[Section 55A:10]

[1] *See* Chapter 55 "Employee Benefits" (§§ 55:1 et seq.).

[2] ERISA § 201(2), 29 U.S.C.A. § 1051(2).

true in the area of executive compensation. The general counsel acts as an attorney for the corporation as represented by its directors. In this role, the general counsel of a corporation advises its compensation committee, and should be allowed to do so directly, without interference from the corporation's executives.

In reality, however, due to the location of counsel's position within the corporate organizational matrix, the potential for conflicts in the realm of executive compensation is high. On one hand, counsel's client is the board. On the other hand, counsel may be an executive managed by other executives. Because counsel's client and managers sit on opposite sides of the table in matters of compensation, a divergence between these roles is almost inevitable. Inside counsel must be aware of the potential for conflict, and be prepared to act appropriately in the circumstances.

The potential for conflict will likely be realized in instances of executive influence. In the first situation, executives may (intentionally or inadvertently) attempt to influence the advice of inside counsel to the board by virtue of the relative positions of the executive versus counsel in the organizational structure. Counsel, however, has an ethical and fiduciary duty to its client, the corporation as represented by the board, to give advice in the interests of the corporation, regardless of functional oversight by any executive. Reporting structures must not taint legal advice. This type of conflict may arise, for example, in the context of shareholder litigation or proxy proposals related to executive compensation, in which cases the personal interests of executives may diverge from the interests of the corporate entity. Inside counsel must remain alert to this possibility. Outside counsel may be needed to ensure appropriate independence of advice for the board.

§ 55A:12 Governance—General counsel—Duties and responsibilities

Inside counsel should take proactive steps to ensure that compensation committee members understand relevant governing law and their duties and responsibilities in the area of executive compensation. Presentations or distribution of written materials related to these topics may help meet this responsibility.

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Inside counsel must assist compensation committee members to determine their independence under various standards, and to vote or abstain accordingly. For example, a director may be "independent" for NYSE listing standards, but not for purposes of Rule 16b-3. External counsel can provide significant value in this process by providing memoranda to support a Committee's determination of independence.

§ 55A:13 Governance—General counsel—Best practices

Beyond the responsibility for legal advice inherent in the position, inside counsel may be uniquely situated to promote best practices in other areas related to executive compensation. For example, the disparate substantive and functional issues involved in executive compensation mandate interaction between the human resources, tax, accounting, and regulatory reporting functions of the corporation. Inside counsel may provide an appropriate nexus to ensure these disparate units are coordinating compliance and reporting duties, and to facilitate such interaction.

Inside counsel will also want to have selected and vetted outside counsel with expertise in executive compensation matters. Having outside counsel pre-selected will allow inside counsel to promptly recommend outside counsel to the compensation committee whenever substantive or process expertise is needed, or when the general counsel is conflicted.

§ 55A:14 Governance—Other internal business units

Other operating units of the corporation will likely be involved in the operation of the executive compensation program. Counsel should be aware of the specific units at his corporation, to ensure that each is involved with the appropriate tasks and decisions.

Generally, a corporation's human resources function will be assigned the administrative duties related to the elements of the executive compensation programs. These duties may involve recordkeeping and payments for deferred compensation arrangements and equity compensation programs, coordination with an external compensation consultant on reports for the board's compensation committee,

gathering of data for the CD&A, oversight of rabbi trust arrangements, and similar duties. The body of law within which the human resources department must perform these duties is complex, and counsel should ensure that adequate legal representation is available to provide advice and guidance in connection with these duties.

A tax reporting unit will generally be delegated the function of recording the corporation's compensation payments accurately for income tax purposes. While corporations generally receive a deduction for cash compensation paid to employees, many provisions of the Federal tax code restrict or delay the recognition of deductions for various types of remuneration to executive officers. A tax reporting unit must be closely involved with other internal units in the executive compensation process to make certain that the appropriate reporting rules are followed.

A corporation will likely have a financial reporting or accounting policy unit as well. This unit must also be involved in the administration of the executive compensation program to maintain accuracy in the corporation's financial statements. This unit follows different rules than the tax reporting unit, however, most commonly in the area of equity compensation. Counsel will want to see that each unit receives accurate guidance in its particular area of endeavor.

§ 55A:15 Governance—Outside counsel

Outside counsel can play a crucial role in the design, implementation, and operation of an executive compensation program. Outside counsel with broad experience in the field can provide subject matter and process expertise drawn from knowledge of a range of different corporate settings. Such outside counsel expertise can augment in-house capabilities to increase overall effectiveness.

In addition, and perhaps more importantly, outside counsel can serve as a source of independent guidance to the compensation committee, as requested by the committee or if the general counsel determines that he is conflicted. Given the increasing scrutiny of the independence of the committee's advisors, such autonomy can prove invaluable.

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Under New York Stock Exchange and NASDAQ listing standards,[1] before relying on the advice of outside counsel (or compensation consultants or other advisers), the compensation committee must take into consideration the following factors: (i) the provision of other services to the company by the person that employs the compensation consultant, counsel or other adviser; (ii) the amount of fees received from the company by the firm as a percentage of total firm revenue; (iii) the firm's policies and procedures designed to prevent conflicts of interest; (iv) any business or personal relationship of the compensation consultant, counsel or other adviser with a member of the compensation committee; (v) any company stock owned by the consultant, counsel or adviser; and (vi) any business or personal relationship of the consultant, counsel or adviser or the firm with an executive officer of the listed company. In addition, the New York Stock Exchange listing standards also include a catch-all provision requiring consideration of "all factors relevant to [the adviser's] independence from management."[2] Under these new requirements, the compensation committee is required to conduct an independence assessment with respect to any compensation consultant, outside counsel or other adviser who directly or indirectly provides advice to the compensation committee, regardless of whether retained by the compensation committee or management. These rules do not require that the committee obtain advice only from counsel or other advisors who have been determined to be independent, and in fact do not require the committee to reach, or to disclose, its independence determination, but instead impose a vetting process that must be conducted before the outside adviser's advice is presented to the committee.[3]

§ 55A:16 Governance—Compensation consultant

An expert independent consultant or compensation attorney can serve as an invaluable aid to assist the compensation committee to fulfill its fiduciary duties described in Section 55A:6 above. While prevailing corporate law will not

[Section 55A:15]

[1] *See* §§ 55A:17 to 55A:18.

[2] NYSE Rule 303A.02(a)(ii).

[3] NYSE Rule 303A.05(c)(iv) and NASDAQ Rule 5605(d)(3).