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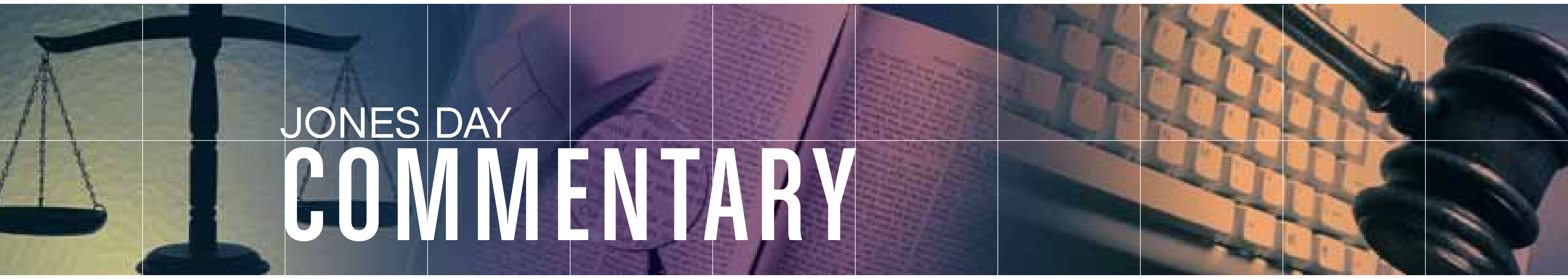

EXECUTIVE COMPENSATION: FUNDAMENTAL CHANGE IS HERE, ARE YOU PREPARED?

It has become fashionable to blame public company executive compensation practices as a major cause of the current economic and financial crisis. These allegations come on the heels of more than 20 years of continuous executive pay criticism. There are more calls for change by the Obama administration, Congress, the SEC, institutional shareholders and their advocacy groups, activist shareholders, Main Street, and the news media, which will be amplified due to the federal government's role as a major stakeholder in our nation's financial system and automobile industry.

Rightly or wrongly, this trend has already resulted in significant legislation and rulemaking aimed at curbing "excessive" executive pay. Some Congressional initiatives have become so aggressive as to raise constitutional questions.[1] More regulation of executive compensation is inevitable. In addition to other bills introduced in the House and Senate that attempt to force change via the federal tax code and other regulatory means, Senators Schumer and Cantwell recently introduced the Shareholder Bill of Rights Act of 2009, S. 1074, to further regulate executive compensation and corporate behavior. The bill responds, in Senator Schumer's view, to a "central cause" of the current crisis—the "widespread failure of corporate governance"—by mandating rules for director term limits and eligibility.

The changes that are being debated, and in some cases implemented, will fundamentally alter how companies evaluate and design compensation programs for their executives and other employees. Companies need to rethink how to effectively utilize compensation alternatives, as they are pressed to strike the right balance between appropriately motivating and rewarding individuals (who are in large part the key

1. A brief discussion of these issues can be found in "Possible Challenges to Retroactive Restrictions on Executive Compensation," a March 2009 *Jones Day Commentary*.

drivers to enhancing long-term shareholder value) on the one hand, and encouraging sound management decisions that do not foster "unnecessary and excessive risk-taking," on the other hand. This *Commentary* highlights some executive compensation practices that may need to be reconsidered.

DEFERRED COMPENSATION

The new tax rules regulating executive deferred compensation contained in Internal Revenue Code Section 409A and its voluminous regulations[2] have forced companies and executives to reexamine whether the benefits from compensation deferral outweigh the rigid requirements imposed by the tax code. Congress will be looking for additional sources of tax revenues, and general tax increases are likely. Deferred compensation arrangements will remain a prime target for future revenue-raising initiatives. Senator Baucus introduced the Compensation Fairness Act of 2009, S. 651, that renews a proposal to prohibit annual deferral of compensation in excess of $1 million, which would result in another layer of deferred compensation regulations.[3]

In light of these developments and possible additional taxes on compensation,[4] companies should consider whether it is prudent to continue deferred compensation programs in their current forms. Executives concerned about increased taxes on current and/or deferred compensation should explore planning opportunities that may allow for adjustments in the payment of deferred compensation within existing legal constraints. For example, companies should consider whether it is appropriate in 2009 to pay out deferred compensation that is grandfathered under such rules or to use the general plan termination provisions under those rules to accelerate payouts. Ultimately, decisions should be made after careful consideration has been given to any immediate and long-term views on the relationship between compensation and company risk-taking.

INCENTIVE COMPENSATION

All companies that are receiving TARP assistance are required to ensure that incentive compensation for senior executives does not "encourage unnecessary and excessive risks that threaten the value of the financial institution."[5] Although the requirements are not currently applicable to non-TARP entities, companies should evaluate whether their incentive compensation arrangements encourage excessive risk-taking. The Shareholder Bill of Rights Act of 2009 would require public company boards to include a risk committee composed entirely of independent directors to oversee and evaluate risk management practices. Companies should consider whether, in light of the current intense scrutiny relating to incentive compensation, it is time to reevaluate existing compensation components (*e.g.*, changing the mix among various types of equity awards and current cash compensation, varying the holding periods for equity compensation and the timing of payment of awards, etc.).

SAY ON PAY

"Say on pay" is intended to provide shareholders with a non-binding advisory vote on executive compensation programs, generally on an up-or-down approach. All companies receiving TARP assistance are now required to include a say-on-pay proposal. Some non-TARP companies have already adopted say-on-pay arrangements, and many others have been urged to do so. While Congress debates whether say

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2. A *Jones Day Commentary* describing the new deferred compensation rules can be found in "IRS Issues Long-Awaited Final Section 409A Regulations," April 2007.

3. Although S. 651 is limited to companies receiving TARP assistance, prior proposals would have applied to all companies. If the cap is violated, all compensation deferred by the individual, including amounts deferred in prior years, would be subject to a 20 percent penalty tax and interest.

4. The House has already passed a bill (H.R. 1586) that would tax at 90 percent "bonuses" paid to employees (whose adjusted gross income is more than $250,000) of certain TARP recipients, and S. 651 would impose on any "retention bonus" and any nonretention bonus in excess of $50,000, a 35 percent excise tax on not only the TARP recipient (with more than $100 million in assistance) but also the bonus recipient.

5. An overview of the executive compensation requirements for TARP recipients is set forth in the *Jones Day Commentary* "Revised Executive Compensation Requirements for Participants Under the Troubled Assets Relief Program," February 2009.

on pay should be mandatory, there have been more than 100 shareholder say-on-pay proposals during the current proxy season. The proposed approach—mandatory up-or-down say on pay—is misguided.[6]

Companies may be better served by continuing to analyze their existing compensation disclosure in light of the evolving shareholder views on particular elements of compensation (*e.g.*, tax gross-ups, perquisites, etc.). Companies should consider how they can best utilize the compensation discussion in their annual reports to shareholders to better communicate their compensation practices and rationale for key aspects of executive compensation that they have determined are necessary given their unique circumstances.

SEVERANCE ("GOLDEN PARACHUTES")

The traditional business practice of providing severance compensation to senior executives is being challenged. Under the American Recovery and Reinvestment Act of 2009 enacted earlier this year, TARP recipients generally are prohibited from making any "golden parachute payment," which can be any payment for departure from a company for any reason, except those made for services performed or benefits accrued, to its 10 most highly compensated employees. Outside of the TARP program, there is growing Congressional interest in further regulating not only severance arrangements directly linked to a change in control, but also regulating severance arrangements that have no relation to a change in control and even other compensation that is based on business transactions. For example, the Shareholder Bill of Rights Act of 2009 includes an extension of the "say on pay" mandate to give shareholders a separate vote on any public company compensation that bears some, as yet undefined, relationship to a business transaction. There also have been reports that the Obama administration and Congress may focus on the compensation practices of hedge funds and private equity firms.

Companies should consider a comprehensive review. Among the questions to ask: Does severance pay, in its current form, serve to advance the strategic goals and objectives of the company over the long term? Is it inconsistent with good corporate governance?

VIEW FROM THE BOARDROOM

Scrutiny of board practices regarding executive pay—deferred compensation, incentive compensation, pay-for-performance, say on pay, severance, clawbacks, etc.—is becoming more intense, and boards are being called upon to become more vigilant.[7] Where does this leave boards of directors in carrying out their stewardship and in the diligent exercise of their fiduciary duties?

Boards of directors will need to become even more proactive and adept in their exercise of good corporate governance of executive compensation practices. For some companies, it could mean starting over from scratch; for others, only minor changes may be necessary. One thing is clear: Despite current attitudes toward executive compensation, one size does not fit all. Each company's approach to executive compensation should be tailored to that company's management style, culture, and strategic goals, and what is perceived to be in the best interests of shareholders.

Boards of directors and senior management must be properly prepared in order to discharge their responsibilities of overseeing and managing executive compensation for the long-term benefit of shareholders. Boards will need to address the perception that "excessive" executive compensation has encouraged "unnecessary and excessive risk-taking that jeopardizes businesses."

In the months to come, we will explore these themes in more detail.

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6. It should also be noted that according to some of the surveys published following the 2008 proxy season, support for say-on-pay proposals may have decreased from prior years at companies where such proposals were on the ballot in 2007 and 2008.

7. The SEIU Master Trust, a consortium of pension funds that manages approximately $1.3 billion in assets, recently issued a press release describing demand letters that were sent out to the boards of directors of 29 major companies in its investment portfolio in which it "demanded that directors investigate a total of more than $5 billion of incentivized executive pay that may have been tied to poorly understood derivatives and other financial instruments that are now worthless."

LAWYER CONTACTS

For further information, please contact your principal Jones Day representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Charmaine L. Slack
1.212.326.8381
cslack@jonesday.com

Manan D. Shah
1.212.326.3986
mdshah@jonesday.com