

# Securities

## E-ALERT

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### The Economic Downturn's Effect on Executive Compensation Practices and Disclosure

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As 2008 draws to a close, public companies are gearing up for year-end decisions about executive compensation in the midst of a severe economic downturn and upheaval in the equity and credit markets. Reduced liquidity, well-publicized failures in the financial services industry, and the specter of global recession have contributed to a climate of continuing uncertainty and heightened volatility in the markets.<sup>1</sup> For many public companies, these increasingly tumultuous conditions are certain to alter the dynamics of executive compensation strategy, design and disclosure. We expect that many companies will re-examine their existing executive compensation programs and closely evaluate prospective programs going forward.

In this alert, we highlight some of the potential consequences of this economic downturn on public companies' executive compensation practices and disclosure. First, we briefly review some common components of executive compensation and outline a typical timeline for executive compensation actions and decisions. Next, we explore some of the potential consequences of the economic downturn on cash-based and equity-based compensation arrangements. We then summarize the executive compensation provisions in the recently-enacted \$700 billion financial recovery legislation, including the potential impact of those provisions on public companies not participating in the relief programs. Finally, we discuss some disclosure considerations for public companies relating to executive compensation actions in this environment.

#### Some Background on Executive Compensation Practices

**Compensation Components.** Some common components of executive compensation arrangements at U.S. public companies are described below.<sup>2</sup>

**Cash Compensation.** A typical executive compensation arrangement includes both base salary and an annual incentive bonus. The targeted amount of annual cash bonus is often expressed as a percentage of the executive's base salary, and is usually based on the achievement of stated performance criteria.<sup>3</sup>

<sup>1</sup> By way of example, in October 2008, the Dow Jones Industrial Index experienced both its most precipitous decline since Black Monday and its best weekly gains since 2003. See *Stocks End Volatile Week in the Black*, Wash. Post (Oct. 19, 2008), at F6.

<sup>2</sup> In addition to the components discussed herein, many executive compensation arrangements include (i) additional benefits and perks (such as medical, death and disability benefits), (ii) retirement plans (such as a pension plan or 401(k)), (iii) deferred compensation arrangements, and (iv) severance and/or change-in-control benefits. Some companies also use multi-year cash or equity-based incentive arrangements. These components are beyond the scope of this advisory.

<sup>3</sup> Commonly-used company-wide performance criteria include net income, earnings per share, revenues, and earnings before interest, taxation, depreciation and amortization, or EBITDA. Many companies also use performance criteria linked to individual divisions or business units.

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Equity Compensation — Stock Options, Stock Appreciation Rights, Restricted Stock, and Restricted Stock Units. Most executive compensation arrangements include awards of stock options, stock appreciation rights, restricted stock or restricted stock units. Stock options give an executive the right to purchase company shares at a fixed price during a stated period of time. As the company's market value increases, the executive has the opportunity to purchase company equity at a discounted price. Stock appreciation rights (known as SARs) give the executive the economic advantages of a stock option, without the obligation to purchase the shares. Restricted stock awards are shares of company stock that are subject to time- or performance-based vesting requirements -- the shares may not be sold or transferred until the vesting requirements are satisfied. Restricted stock units (known as RSUs, performance units or phantom stock) generally represent a hypothetical share of common stock; they are economically similar to shares of restricted stock, but are subject to different tax rules.

***Timeline for Executive Compensation Actions.*** Public companies generally make executive compensation decisions in accordance with the timeline described below.

Fourth Fiscal Quarter. In the fourth fiscal quarter, management plans the year-end financial reporting process. At the same time, compensation committees typically review anticipated full-year results and the likely effect of such results on annual bonus objectives and payouts. At this time, management and the compensation committee may also review compensation plan design and strategy decisions for the upcoming fiscal year.

Early First Quarter of Next Year. Early in the first quarter of the next fiscal year, management and/or the compensation committee generally make a number of executive compensation decisions, including the amount of bonus payouts for the recently-completed year, annual stock option or restricted stock grants, changes to base salary levels, and selection of performance criteria and target levels for the annual bonus plan for the current fiscal year.

## **Impact of the Economic Downturn on Compensation Arrangements**

There are a number of key, interrelated factors underlying the current rocky economic terrain which will likely affect decisions about executive compensation arrangements. First, global stock markets have declined sharply overall, and have also been prone to massive swings from one day to the next. Amid this turbulence, some public companies have suffered steep declines in their stock prices and market capitalizations. Second, many public companies in a wide array of sectors are reporting disappointing results, and this trend is likely to continue. Finally, these adverse economic and market conditions have led to dwindling cash reserves at many public companies.

### ***Impact on Cash-Based Compensation***

There are a number of potential consequences for cash-based compensation as a result of the economic downturn.

***Base Salary.*** Market conditions could cause many public companies to be more cautious in approving increases in executive base salaries. Some companies may consider freezing base pay increases or offering lower base salaries to incoming executives in order to preserve liquidity. In the current environment, there may also be external considerations, beyond purely economic factors, that influence the thinking of senior management and compensation committees when making decisions about base salary changes. These considerations, which will vary from company to company, may include political considerations, institutional investor concerns, and pressure exerted by labor

unions and other constituents advocating that senior executives should “share the pain” with other employees. It should be noted that, in some cases, the consent of the affected executive may be required if his or her employment agreement provides for scheduled increases in base salary or if the executive will have “good reason” to terminate employment and receive severance if his or her base salary is reduced.

Further, decisions about changes in base salary levels will be complicated this year by the lack of current, accurate data about base salary levels and year-over-year changes in base salary levels at peer companies. Peer company and survey data is reviewed by many compensation committees, and such data is used by some to align their company’s compensation levels with comparable compensation levels at peer companies. This year, however, such data is likely to be significantly less useful as a benchmark because the data will not reflect changes (or freezes) occurring after the onset of the severe economic downturn. Compensation committees should consider the usefulness of such survey and peer company data in light of the recent significant changes in economic conditions.

***Annual Bonus Plan - Payouts for Completed Year.*** Many companies will report disappointing earnings for the full fiscal year as a result of the economic downturn. As a result, the annual bonus payouts for such companies may be adversely affected to the extent such payouts are linked to the achievement of specified financial performance criteria. While the effect will vary, in cases where the threshold level of performance is not achieved, no bonus amount may be payable, while in other cases, a payout below the target may be called for. It is worth noting that 2008 performance goals and target levels for many companies were set during a time of comparative economic stability. The projections underlying the performance objectives set in early 2008 likely assumed continuation of these stable economic conditions for the full year. Further, for many companies the 2008 performance goals likely contemplate at least some growth over the previous year’s results. With the severe downturn in the economy, however, these performance goals will, in many cases, be unrealistic or unachievable.

While compensation committees may simply decide to approve payouts at whatever level is dictated (including no payout) by the level of achievement of the previously-approved goals, we think most committees will take into account the “changed circumstances” created by the economic downturn when making bonus decisions. The compensation committee could, for example, modify the performance goals or target levels to reflect the changed economic realities. Alternatively, the compensation committee could consider exercising discretion to award some or all of the annual bonus payout, notwithstanding the company’s failure to achieve the plan’s objectives. This decision would presumably take into account all relevant facts and circumstances, including executive retention considerations, if applicable, and whether the failure to achieve the stated goals reflected some failing by management as opposed to external economic and market forces that could not have been anticipated when the performance targets were set.

In deciding whether to waive performance conditions or otherwise exercise discretion to award bonus payouts where relevant performance criteria might not have been satisfied, compensation committees should consider certain consequences. First, such payouts likely will not qualify as “performance-based” compensation under Section 162(m) of the Internal Revenue Code, which would limit the company’s ability to deduct such payments for tax purposes for the current and, possibly, any future year.<sup>4</sup> Second, there

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<sup>4</sup> Section 162(m) generally prohibits a public company from deducting compensation in excess of \$1 million paid to certain of its executive officers. This limit does not apply to qualified performance-based compensation. Under applicable Treasury regulations, compensation ordinarily is not “performance-based” under Section 162(m) if it can be paid in any circumstance in which the performance goals have not been met.

are disclosure implications flowing from such a decision. For example, the compensation committee's decision to award bonus payouts in these circumstances would need to be explained fully in the Compensation Discussion and Analysis — or CD&A — portion of the company's proxy statement and/or Annual Report on Form 10-K, including the committee's decision-making process, rationale and factors considered.<sup>5</sup> Finally, compensation committee decisions on bonus payouts should be made in a manner that is consistent with the terms of the company's annual bonus plan or other applicable governance documents.

***Designing Bonus Criteria and Targets for Next Year.*** The economic downturn is also likely to cause compensation committees at many public companies to alter their thinking and decision-making regarding the design of the annual bonus plan and performance objectives for next year. Selection of performance criteria, as well as appropriate threshold and target levels, should be considered and designed carefully. Compensation committees will be called upon to assess realistically the company's financial prospects for the upcoming year, and to consider the company's key overall objectives and strategies, in order to tailor the annual incentive plan to the company's realigned priorities.<sup>6</sup> This exercise may be particularly difficult as there will undoubtedly be significant uncertainty about the company's projections for the full year.

While each company will need to consider alternatives based on its own circumstances, some bonus arrangements that might be considered include the following:

- foregoing a performance-based plan and giving the compensation committee sole discretion to pay out bonuses at year-end,
- moving away from quantitative performance metrics and using more qualitative metrics,
- altering the relative weightings amongst various performance objectives,
- using some mix of performance-based objectives and compensation committee discretion, and
- moving to a stock-based annual bonus plan instead of a cash-based plan (or using a mix of stock-based and cash payments).<sup>7</sup>

Companies should be mindful of the requirements of Section 162(m) when considering these issues. Compensation does not fall within the "performance-based" pay exception unless it is, in fact, based on performance. However, Section 162(m) does not require that performance targets be based on growth or increases over a previous year's performance. Under certain circumstances, losses that are less than anticipated can be considered to be successful performance.

### ***Impact on Equity-Based Awards***

The economic downturn also gives rise to a number of potential consequences for equity-based awards.

***Outstanding Awards.*** One major consequence of the steep decline in the stock price

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<sup>5</sup> Further, depending on the plan and the extent of discretion used, bonus payouts that might otherwise be shown in the "Non-Equity Incentive Compensation" column of the Summary Compensation Table might need to be shown in the "Bonus" column of such table. See Item 402(c) of Regulation S-K; Division of Corporation Finance: Regulation S-K Compliance & Disclosure Interpretations (rev. Jul. 3, 2008), Question 119.02, *avail. at* <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.

<sup>6</sup> For example, in the midst of an economic downturn, a company may place greater emphasis on improving its leverage, bolstering its cash reserves and liquidity, or cutting recurring costs.

<sup>7</sup> This last alternative may not be palatable where the company's stock price has suffered a steep decline.

of many companies is that the value of accumulated options and restricted stock awards has declined significantly. Executives at many companies hold a large number of options that are “underwater” (*i.e.*, the exercise price of the options is higher than the market price of the company’s shares). Options that are underwater have diminished incentive and retention effects, which may lead compensation committees to consider alternative compensation strategies to incentivize and retain their executives.

The decline in value of shares underlying options has other consequences for executives. In the case of underwater options that are set to expire soon, executives may simply lose out on a portion of their anticipated “accumulated compensation.” In the case of options that are not yet underwater but are set to expire soon, executives may be compelled to exercise the options (and perhaps sell the underlying shares) at a depressed price.

It is possible that companies with a large number of underwater options may consider taking action to mitigate the effect of a depreciating stock value. Alternatives that could be considered include re-pricing options (*i.e.*, reducing the exercise price of the options) or cancelling and/or replacing the options with new or additional options or other types of equity-based compensation (*e.g.*, restricted stock). These actions, however, have consequences that companies should carefully consider, and such actions might not be permitted under the terms of the applicable plan or under stock exchange listing requirements. Re-pricing stock options is frowned upon by many in the institutional investor community and may not be met with favor by the company’s shareholders, who have suffered losses in the market and who would not be afforded the same opportunity to mitigate the market risks related to the shares. Re-pricing, replacing or exchanging stock options may also implicate a number of stock exchange listing, accounting, tax and securities law issues that are beyond the scope of this advisory.

***New Grants.*** Recent market volatility and lower stock prices will also affect decision-making with regard to new option and restricted stock grants. For instance, public companies with a depressed stock price must contend with the reduced value of the company’s equity when determining the appropriate number of options or restricted shares to grant to executives. In making new grants at the current (and arguably depressed) share price, the company may find it necessary to grant a greater number of options or restricted shares to provide executives with the same economic benefit afforded in prior years. Additionally, making new grants at lower stock values may raise concerns as to whether executives will be unfairly or prematurely rewarded when the company’s stock price rebounds as a result of an overall market adjustment that is not related to individual performance. Recent increased volatility in the stock markets may also complicate the process for determining the expense, for accounting and compensation disclosure purposes, of option grants.<sup>8</sup>

As with other decisions to be made by compensation committees this cycle, decisions about the appropriate number of equity-based awards will be complicated by the lack of current, accurate data about the level of such awards being made by peer companies. Peer company and survey data regarding equity-based awards is likely to be significantly less useful as a benchmark this year because the data will not reflect the impact of the severe economic downturn. Compensation committees should therefore consider the usefulness of such survey and peer company data in light of the recent significant changes in economic conditions.

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<sup>8</sup> High volatility increases the risk that an assigned value does not represent the true, long-term value of the opportunity represented by the option. Further, the Black-Scholes options pricing model (and other option-valuation methodologies) calls for an assessment of historical stock price volatility over a multi-year period. Because the effects of the market’s recent volatility will be reflected in future Black-Scholes valuations, this recent volatility will have the effect of increasing many public companies’ compensation expense for options.

In addition to the considerations noted above, granting a larger number of options or other equity-based awards to compensate for lower share prices raises other concerns.

- **Dilution.** Larger option grants increase the dilution to existing shareholders based on a larger number of shares issuable upon exercise of the options when the stock price rebounds.
- **Shares Authorized by Stock Option Plan.** Company stock option plans include limits on the number of shares authorized for issuance pursuant to the plan. A public company must determine whether there are sufficient shares authorized under its stock option plan to fully support the new option grants. New York Stock Exchange and Nasdaq listing standards generally require shareholders to approve any increase in the number of authorized shares under an option plan.<sup>9</sup>
- **Shares Authorized by the Company Charter.** A company also must determine whether there are sufficient shares authorized under the company's charter to support new option grants. The corporate law of many states (including Delaware) requires shareholder approval to increase the number of authorized shares of stock in the charter.<sup>10</sup>

### Impact of TARP's Executive Compensation Provisions

In response to the recent economic downturn, on October 3, 2008 the President signed the Emergency Economic Stabilization Act of 2008 ("EESA"). Among other things, this Act authorized the Treasury Secretary to establish a Troubled Assets Relief Program ("TARP") to purchase "troubled assets" from financial institutions. Section 111(b) of EESA imposes certain executive compensation restrictions on financial institutions in which the Treasury holds a meaningful equity or debt position. These restrictions have been spelled out with more detail in interim final rules issued by Treasury for financial institutions participating in the Treasury's Capital Purchase Program ("CPP") under the TARP.<sup>11</sup>

**Restrictions Applicable to CPP Participants.** Companies electing to participate in the CPP will need to take steps to ensure compliance with the executive compensation provisions briefly summarized below.<sup>12</sup>

**Incentive Arrangements with Risk Characteristics.** Within 90 days after the Treasury's first purchase under the CPP, the compensation committee of the participating company must review the incentive compensation arrangements applicable to the company's senior executive officers with the company's senior risk officers to ensure that such arrangements do not encourage senior executive officers to take unnecessary and excessive risks. The compensation committee must also make a certification regarding its review in the CD&A portion of the company's proxy statement.

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<sup>9</sup> See New York Stock Exchange Listed Company Manual § 303A(8); Nasdaq Marketplace Rule 4350(i)(1)(A).

<sup>10</sup> See, e.g., Delaware General Corporation Law § 242.

<sup>11</sup> On November 10, 2008, Treasury announced that it will purchase \$40 billion of senior preferred stock from American International Group, Inc. ("AIG") under the TARP. Under its agreement with Treasury, AIG will be subject to the executive compensation restrictions applicable to participants in the CPP as well as certain other restrictions, including a prohibition on all severance payments to the top five senior executive officers, limitations on golden parachute arrangements for other senior employees (approximately 70 employees), and a freeze on the annual bonus pool for the same group of senior employees. See *Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act*, U.S. Department of the Treasury Press Release No. hp-1261 (Nov. 10, 2008), avail. at <http://www.ustreas.gov/press/releases/hp1261.htm>.

<sup>12</sup> For more details regarding these executive compensation restrictions, see *Executive Compensation Rules for Financial Institutions Participating in the Capital Purchase Program*, Covington & Burling LLP Client Alert (Oct. 21, 2008).

Clawback Policies. Bonus and incentive compensation paid to senior executive officers of companies participating in the CPP during the period of the Treasury's investment must be subject to recovery, or "clawback," by the company if the payments were based on materially inaccurate financial statements or other materially inaccurate performance metric criteria. This provision is broader than the recoupment requirement set forth in Section 304 of the Sarbanes-Oxley Act of 2002.<sup>13</sup> While many public companies have clawback policies, in some cases these have been crafted so as to reach no further than the requirements of Section 304 of Sarbanes-Oxley. Accordingly, companies participating in the CPP will need to adopt or expand clawback policies to comply with these rules.

Golden Parachute Arrangements. Companies participating in the CPP may not make certain prohibited "golden parachute" payments to senior executive officers during the period of the Treasury's investment. Participating companies should review their employment and severance arrangements with senior executive officers and, if necessary, amend them to comply with the new rules.

Tax Consequences of Compensation Arrangements. Companies participating in the CPP are subject to new Section 162(m)(5) of the Internal Revenue Code, under which (i) deduction limitations have been reduced from \$1 million to \$500,000 and (ii) companies must include performance-based compensation and deferred compensation when calculating such threshold amount.

***Impact of TARP Provisions on Other Public Companies.*** Although the executive compensation provisions described above technically apply only to financial institutions participating in the CPP (or potentially other TARP programs to which such restrictions may apply), all public companies are well advised to consider the import of the TARP provisions when reviewing their own executive compensation arrangements. At a minimum, the TARP's provisions regarding executive compensation reflect some degree of legislative consensus on the type of substantive limitations on executive compensation that may be appropriate for public companies. As the economic crisis endures and affects a broad array of companies and industries, a wider pool of companies in other sectors could find themselves seeking financial assistance from the government, which would undoubtedly involve agreeing to similar restrictions. More generally, it is not inconceivable that the new Congress might consider extending these or similar provisions more broadly.

Public companies may, therefore, wish to consider modifying their executive compensation arrangements, even if not strictly required to do so, to incorporate such aspects of the TARP provisions as may be appropriate to their circumstances. For example, compensation committees of public companies may wish to evaluate their existing review and decision-making processes with respect to incentive-based arrangements to ensure that they properly take account of risk considerations, and that the committee's review and consideration of risk is appropriately documented. Companies may also wish to consider modifying their existing clawback policies to align them more closely with those required by the EESA, as well as reviewing existing severance arrangements to determine whether they should be scaled back to more closely match those permitted by EESA.

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<sup>13</sup> The clawback requirement in EESA is broader than the recoupment provision of Section 304 of the Sarbanes-Oxley Act of 2002 in that: (i) the EESA clawback requirements apply not only to the principal executive officer and the principal financial officer, but also the three other most highly compensated executive officers, and (ii) the EESA clawback provision is not exclusively triggered by an accounting restatement, does not limit the recovery period, and covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation.

## Disclosure Considerations

Public companies will need to reflect in their public disclosures the material effects of the recent economic crisis on their executive compensation decisions.<sup>14</sup> These disclosure obligations will be manifested in a number of ways, briefly outlined below.

**TARP Participants.** Public companies that participate in the CPP (or other TARP programs to which the executive compensation restrictions of EESA may apply) will need to reflect in their disclosures the decisions made, and actions taken, to ensure compliance with the executive compensation provisions of EESA. For example, the CD&A portion of these companies' proxy statements would likely need to address any material changes made to the severance arrangements for senior executive officers, as well as any material effects on the company as a result of the limitations on the deductibility imposed by new Section 162(m)(5).<sup>15</sup>

**Form 8-K.** Material modifications by a company to its existing executive compensation plans or outstanding awards may trigger an obligation to file a Current Report on Form 8-K under Item 5.02(e). Examples of such modifications might include (i) modifications to outstanding options or stock awards, (ii) modifications to the current year's annual bonus plan, (iii) amendments to severance arrangements or executive employment agreements, or (iv) adoption or material amendment of a clawback policy. Also, adoption of a new plan, or the grant of new awards that are not materially consistent with the previously disclosed terms of awards under previously-disclosed plans, could trigger the obligation to file a Current Report on Form 8-K. This might include the approval of new or materially different performance criteria under next year's annual bonus plan.

**CD&A Disclosures.** The upcoming CD&A disclosure will need to discuss material actions taken, and factors considered, by compensation committee in light of recent market developments. Among other things, this disclosure might need to cover (i) reasons for changes in a plan's structure or design, (ii) rationale for adoption of a new plan or arrangement, and (iii) explanation of a compensation committee's decision to waive performance objectives related to an annual bonus plan. More broadly, the CD&A should discuss any material changes in the processes and procedures for executive compensation decision-making.

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<sup>14</sup> In a recent speech, John W. White, Director of the SEC's Division of Corporation Finance, emphasized the need for public companies' disclosures to reflect executive compensation decisions made in response to current market events. See *Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009*, New Orleans, LA (Oct. 21, 2008), avail. at <http://www.sec.gov/news/speech/2008/spch102108jww.htm>.

<sup>15</sup> Of course, the required certification regarding risk assessment will need to be included in the CD&A as well.

The recent economic downturn and market turmoil are likely to significantly affect decision-making with respect to executive compensation. In addition to the difficult economy, the substantive executive compensation restrictions enacted as part of the TARP may well influence management and compensation committees in making compensation decisions. These compensation decisions, in turn, are likely to receive enhanced scrutiny from stockholders, regulators, and others. In light of these factors, it would be prudent for management and compensation committees of public companies, in collaboration with their advisers, to carefully consider decisions with respect to awards under existing bonus and other executive compensation plans, and to thoroughly evaluate changes in such programs prospectively.

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