OUTSIDE PERSPECTIVES

What Every Compensation Committee Member Should Know About Corporate Governance Reforms

CARTER W. EMERSON
ROBERT M. HAYWARD

The fallout following Tyco, Enron, Global Crossing and similar meltdowns has put executive pay, and the Board compensation committees responsible for executive pay, on the "hot" seat. Members of compensation committees need to be aware that in today's environment their actions are more likely to draw public scrutiny and that a number of recent reforms have been proposed to tighten the rules applicable to executive pay and compensation committees.

The following is a brief summary of the key issues of particular concern to members of compensation committees of listed companies that arise out of the Sarbanes-Oxley Act of 2002 ("SO"), NYSE and Nasdaq proposed rules and pronouncements by non-regulatory bodies, such as the Conference Board's Commission on Public Trust and Private Enterprise.

Committee Composition

Partially on their own initiative and partially in response to SO, the NYSE and Nasdaq have proposed rules to enhance the independence of boards and board committees. Except in the case of a "controlled company," i.e., a company in which more than 50% of the voting power is held by an individual, a group or another company:

• the NYSE proposed rules require every company to have a compensation committee comprised entirely of independent directors; and

• the Nasdaq proposed rules generally require that executive compensation be approved either by a majority of the independent directors meeting in executive session or by an independent compensation committee which can include one non-independent member (not an officer of the company) serving under "exceptional and limited circumstances" for not more than two years.

Companies may have to reshuffle existing committee members or add more independent directors to the board to satisfy the above rules and the stricter definitions of "independence" also proposed by the NYSE and Nasdaq. In addition, compensation committees may want to consider prohibiting any interlocks between their members and executive officers of the company (e.g., reciprocal service by executive officers/directors on each other's compensation committee). These interlock situations are already required to be disclosed in the company's proxy statement.

Consultants

Just as people are questioning whether a company's auditor can be independent after working with management for a number of years, compensation committees should consider the question of whether the company can use the same compensation consultant year-after-year. Because companies routinely retain consultants, compensation committees should make sure that (1) such consultants (especially with respect to CEO compensation) report directly to the committee and not to management and (2) the committee's charter gives them the sole authority to retain and terminate such consultants. Carefully selected consultants that are relied upon by the compensation committee in good faith can help sustain the committee's position if its decisions are challenged, as the Delaware Supreme Court confirmed in a case involving Michael Ovitz and Disney.

Fiduciary Duties

Decisions of independent directors generally qualify for the business judgment rule, i.e., courts will not second guess directors' decisions.

Historically Delaware courts have not actively reviewed the decisions of compensation committees for this reason. However, recent comments by the Chief Justice of the Delaware Supreme Court signal that Delaware courts may begin to more frequently review decisions made by compensation committees. In light of these comments, compensation committees should demonstrate their independence and, as the Chief Justice stated, follow "governance procedures sincerely and effectively."

Enhance Disclosure

SEC rules require that each member of the compensation committee take responsibility for the report included in the company's proxy statement disclosing the committee's criteria for compensating executive officers (especially the CEO). There is often a tendency for this report to become boilerplate – just an update of the prior year and bearing no semblance to reality. Members should take an active role in the preparation of this report in light of the greater scrutiny being given to executive pay. This report should contain a meaningful presentation of the committee's thoughts on executive officers' pay and be consistent with the compensation actually awarded to executive officers as reported elsewhere in the proxy statement.

Ban on Loans

§402 of SO prohibits a company from extending or maintaining credit, arranging for an extension of credit, or renewing an extension of credit (directly or indirectly, including through a subsidiary), in the form of a personal loan to or for any director or executive officer. This prohibition is currently effective, but grandfathers an extension of credit existing on July 30, 2002 so long as there is no material modification or renewal made thereafter. The potential breadth of §402 has raised numerous questions as to the provision's applicability to many common compensation techniques, such as split dollar life insurance and cashless exercises of stock options. In order to determine whether the company should be changing any of its policies, the compensation committee should understand the implications of §402 and be knowledgeable about the company's existing loans to officers and directors or transactions which could be deemed "personal loans."

Stockholder Approval of Equity Compensation Plans

The SEC has published proposals by the NYSE and Nasdaq that would require stockholder approval of most equity compensation plans, including broad-based plans. In addition, the proposed rules would prohibit broker-dealers from voting on equity plans unless the beneficial owner of the shares provides voting instructions. These proposed rules will likely make it harder for companies to put into place new equity plans (or amend existing plans) and will likely increase companies' proxy solicitation costs.

Expensing of Stock Options

Historically, most companies, as permitted by GAAP, have not expensed fixed price stock options. Although Congress did not address this issue in SO, the Conference Board, Warren Buffett and others have recommended the expensing of stock options and FASB has announced that it plans to decide during the first quarter of 2003 whether to overhaul the accounting rules that allow companies to avoid expensing stock options. In addition, many institutional investors, such as TIAA-CREF, are actively pressing companies through stockholder proposals to expense stock options and the SEC has supported these efforts by reversing its position on allowing companies to exclude such proposals from the ballot. Accordingly, the compensation committee, along with the full board, management and the company's accountants, should be actively considering this issue. An increasing number of companies – such as Dow, Bank One, Wal-Mart and Coca-Cola – have already announced that they intend to begin expensing stock options.

Mr. Emerson is a partner and Mr. Hayward is a senior associate in Kirkland & Ellis' securities and governance practice.